

**RESTORING CONFIDENCE IN U.S.
ENERGY TRADING MARKETS**

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Introduction

Starting with the Enron Corp. bankruptcy filing on December 2, 2001, the United States gas and power trading business has sustained one blow after another. Credit downgrades, accounting scandals, governmental investigations, falling stock prices, indictments and guilty pleas have been reported in the news for months. The companies involved have included many well-respected energy trading companies. Throughout the energy trading business, few companies with gas and power trading operations have been spared reputational harm and economic loss.

There has been a loss of confidence in the entire business, which emerged less than a decade ago. Rapid growth, inadequate credit and risk management controls, a poorly designed California energy market and the Enron bankruptcy all contributed to this loss of confidence. Where does the gas and power trading business go from here? Did energy derivatives in any way contribute to the problems? Is there more bad news to come? Has the turnaround started? How does this relatively new trading business reshape itself going forward to avoid the mistakes of the past? This paper attempts to answer these questions and more, with a specific focus toward the United States markets, given the unique confluence of events that included the Western energy market crisis. The European energy markets have experienced some similar issues, but there is no real parallel to the Western energy market issues.

The problems may not be over, but a better future is in sight. There are a multitude of ongoing efforts to restore confidence in the energy trading business. Participants in the industry have worked diligently to address credit issues through better contracts and documentation. New entrants have entered the market; many of which are world-class financial organizations. New risk management policies have been developed, modeled on the Group of Thirty recommendations, which will improve overall energy risk management and control. The rules for mark-to-market accounting have been revised and clarified. Finally, the Federal Energy Regulatory Commission (FERC) and the Commodity Futures Trading Commission (CFTC) are working closely to prosecute those that violated the rules. These initiatives have already begun to improve energy trading practices and will ultimately serve to restore confidence in these vital activities.

Importance of Managing Energy Price Risk

The production and distribution of energy, often in the form of natural gas and power, is important to nearly every country in the world. The price of energy is important to companies, both large and small, as well as to individuals, all of which consume energy. Further, the cost of energy is a significant portion of the cost of nearly every good sold in the US. Outside the US, where energy costs are generally much higher, that portion of the total cost is often much higher. Energy costs affect the competitiveness of a country and the standard of living of its citizens. This highlights the need to manage the volatility of energy prices. Accordingly, tools, such as derivatives, that can help manage the price risk for energy can be extraordinarily valuable to a country, its economy and its citizens.

A couple of examples are in order. A gas producer has purchased the right to drill for gas on a promising tract of land in offshore, Texas. The producer is selling its current gas production at market prices, which because of shifting demand conditions can be quite volatile. Because volatile cash flows affect the producer's ability to service its debt, banks will not provide the gas producer with funding to drill for additional gas unless it enters into a derivative whereby it receives a fixed price for its gas of at least \$4.00 per MMBTU¹ of gas. The derivative transfers the market risk from the producer to a party better able to manage it, provides a predictable cash flow to the producer, and allows the producer to secure a loan that will finance additional exploration for gas. The benefits are far reaching.

The need to manage price risk in the power business is equally important. An aluminum smelter uses huge amounts of power to produce its product. When power prices rise above \$30 a megawatt hour, it will no longer be able to sell its aluminum for a profit, because its product will cost more to produce than it can be sold for on the world markets. The smelter currently buys its power at market prices. To insure that it will be able to operate its plant and profitably produce aluminum, it enters into a long-term power derivative, whereby the smelter will be guaranteed that it will not pay more than \$25 a megawatt hour for power. The smelter has transferred the power price risk to a third party who should have a greater ability and wherewithal to manage it. The economy, as well as the company, gains from this transaction by lowering costs and dispersing risk.

Dealers pass risk through the system through a variety of mechanisms. Many risks are managed through offsetting transactions with other dealers, by passing their risk on to organized futures exchanges and through utilization of offsetting transactions in money, currency and capital markets.

It is very important to have the tools (including the derivatives in the above examples) available to manage energy price risks. To make sure such tools are available, it is critical that the enforceability of these tools is legally certain.

¹ Million British thermal units.

Evolution of the Gas and Power Markets

Regulation of gas and power utilities, both at the Federal and State level, has historically followed the traditional regulatory model for a public utility. The utility is granted a monopoly over a specified service territory and guaranteed a modest return on its investment in authorized facilities to serve its customers in that territory. In the 1970s, the US experienced energy shortages, and it was clear that the traditional model was not working. A more efficient model was needed, where access to both gas and power and the facilities to transport them would be opened to competition. The following paragraphs present a brief summary of the evolution of the gas and power markets.²

Gas. In the US, the development of commodity markets for natural gas can be traced back to the Natural Gas Policy Act of 1978 (NGPA). In the 1970s, there had been shortages of natural gas moving in interstate commerce; the NGPA increased wellhead prices and thereby encouraged exploration and brought additional supplies of gas to the marketplace. At this time, most gas was sold under long-term contracts, often for a term of twenty-five years, but this began to change gradually as new supplies came online. Over the course of the 1980's, an active market developed for the buying and selling of physical gas. The spot market was born wherein customers could arrange to buy or sell gas (for physical delivery) for a period of thirty days. The prices of these spot transactions were reported in *Inside FERC* and other energy industry publications. The gas commodity market was in its infancy or perhaps adolescence. When Congress passed the Natural Gas Wellhead Decontrol Act of 1989, there was no confusion about the direction of the gas markets. The goal was to promote a competitive gas marketplace by removing the remaining first sale ceiling prices.

With price deregulation underway, the FERC began to tackle the complex infrastructure necessary to transport natural gas in interstate commerce. Deregulating gas prices would be of limited usefulness if it were impossible to transport gas to a point of sale and/or a point of purchase. Otherwise the gas that happened to be at the right point of sale or purchase would benefit from the price deregulation. All other gas would in effect be held captive to a complex and archaic physical and process infrastructure for the transportation of gas.

In Order No. 436, *Regulation of Gas Pipelines after Partial Wellhead Decontrol*, the FERC began a process of making gas pipeline capacity available to third party shippers. This was a giant step forward in the development of the gas commodity markets, because now, a buyer or a seller of natural gas could transport the gas on a pipeline that it did not own. Order No. 436 was followed by several orders, including Order No. 636, which required the unbundling of pipeline sales from transportation and

² It is beyond the scope of this paper to address the changes in the various states, which are as material as the changes detailed above. However, the goal in general was the same – to bring greater efficiency to the gas and power business.

the release of capacity on interstate pipelines. These orders made available the infrastructure that was critical for the markets to fully realize the benefits of a competitive marketplace.

For the gas markets, a further critical step was the development of the futures market and the over-the-counter (OTC) market for the financial trading of gas. Against the backdrop of price deregulation and infrastructure deregulation, the New York Mercantile Exchange (NYMEX) launched a gas futures contract on April 3, 1990. It was an immediate success and the NYMEX gas contract continues to be a great success today. This also helped to develop the OTC financial trading market in gas – commonly referred to as gas swaps market, the regulatory framework for which will be addressed below.

Power. Deregulation in the power business came more slowly than for gas. In general, the power business is more regional and less of a national business than gas. The power business did not and does not have the equivalent of the interstate pipelines to create a connected national web. This is in part due to the difficulties in transmitting power over long distances through transmission systems that were not designed for that purpose and the fact that power cannot be stored. Against this backdrop, the Public Utility Regulatory Policy Act of 1978 (PURPA) can be credited with the first step toward creating more competitive power markets.

Section 210 of PURPA brought new participants (and more power) into the market by encouraging non-utility generators to build power plants using principally non-fossil energy sources. These new facilities, called “qualifying facilities” (QFs), were entitled to receive the avoided cost of the local utility to which the QFs sold their power and the QFs were entitled to obtain transmission service to the purchasing utility. This was a significant start to the development of competitive power markets.

The Energy Policy Act of 1992 (EPA) was the next big step. Again, a new participant was created for the power markets, this one called “exempt wholesale generator” (EWG). An EWG could own a generation facility and sell power exclusively into the wholesale power market. So long as the EWG did not have market power, the EWG was typically able to sell power at negotiated prices to its wholesale customers. The EPA also broadened the FERC’s authority to require utilities to provide transmission service to QFs, EWGs, power marketers and other participants in the market. The difficulty in obtaining transmission of power to customers across transmission lines that the seller did not own was a major impediment to the development of competitive power markets. The EPA laid the groundwork for such transmission and further development of the markets.

On May 10, 1996, the FERC continued to make the power markets more efficient and more competitive by issuing Order No. 888, “Promoting Wholesale Competition Through Open Access Non-discriminatory Transmission Services by Public Utilities and Transmitting Utilities”. The FERC ordered sweeping changes aimed at unbundling all the services offered by existing public utilities into their various components (for

example, transmission and ancillary services) so that the new participants would also have access to those services and a chance to compete against such utilities on a level playing field. This was followed by Order No. 2000, wherein the FERC promoted regional transmission organizations and directed that “all transmission owning entities in the Nation, including non-public utility entities, place their transmission facilities under the control of appropriate regional transmission institutions (RTOs) in a timely manner.”

Most recently, the FERC issued a notice of proposed rulemaking on: “Remedying Undue Discrimination through Open Access Transmission Service and Standard Electricity Market Design” (commonly referred to as SMD). In SMD, the FERC is proposing to standardize the rules for the transmission of power and thereby remedy undue discrimination and enhance competition in the power markets. A white paper on SMD is expected from the FERC in April and a final order in late summer of 2003.

Trading. This regulatory framework is also supplemented by the regulation of power marketers by the FERC and the regulation of future exchanges by the CFTC. Starting first with power marketing, all power marketers are required to file for a power marketing license under Section 205 of the Federal Power Act to buy and sell power at market-based rates in interstate commerce. This gives the FERC an opportunity to review the application and to put conditions on any license that it grants. In addition, each power marketer is required to file periodic reports with the FERC for its oversight of the industry.

Under the Commodity Exchange Act (CEA), the CFTC has jurisdiction over “contracts of sale of a commodity for future delivery”, which is commonly referred to as a futures contract. Most energy traders trade futures on the NYMEX (such as the NYMEX gas contract), which is regulated by the CFTC. Physical trading of energy would generally fall under the forward contract exclusion from the CEA, which excludes “any sale of any cash commodity for deferred shipment or delivery.” The rationale for this exclusion is that forward contracts are ordinary supply contracts where delivery is deferred for commercial convenience or necessity.

The CEA was recently amended by the Commodity Futures Modernization Act of 2000 (CFMA). The CFMA provided long-awaited legal certainty for OTC derivatives by excluding a broad range of swap agreements and other OTC derivatives from coverage under the CEA. Concerns about the enforceability of OTC derivatives transactions due to exchange-trading requirements of the CEA were finally put to rest with enactment of this legislation. In many respects, the CFMA simply codified previous exemptions administered by the CFTC and added clarity to the regulatory status of swaps under the CEA.

Several key provisions and exclusions were provided to privately negotiated derivatives based on transaction-type and trading facility. Most OTC derivatives transactions involving any commodity (other than an agricultural commodity) or “excluded commodities”, defined as a broad range of interest rate, currency, credit,

equity, weather and other derivatives are excluded from regulation if they are entered into on a principal-to-principal basis by sophisticated counterparties known as “eligible contract participants” and not entered into on a trading facility.

The CFMA also provided legal certainty for OTC energy derivatives considered “exempt commodities” under the CFMA. Exempt commodities (defined as commodities other than excluded commodities or agricultural commodities) include commodities such as energy products, chemicals and metals, are excluded from most of the provisions of the CEA.

Exempt commodity transactions entered into solely between eligible contract participants that are not entered into on a trading facility, and exempt commodity transactions entered into on a principal-to-principal basis between eligible commercial entities remain subject to the CFTC’s antifraud and antimanipulation jurisdiction under Section 2(h). Eligible commercial entities are essentially users of or dealers in the underlying commodities or takers of commodities risk that are also "eligible contract participants" (but not individuals).

The CFMA also provides legal certainty for OTC derivative transactions entered into through electronic trading facilities. Yet another provision permits clearing of OTC derivatives transactions without disqualifying those transactions from any of these exclusions. The CFMA requires, however, that clearing of excluded OTC derivatives transactions occur through a clearing organization regulated by the Securities Exchange Commission, the CFTC or the Federal banking regulators or by an approved comparable foreign financial regulator.

The result of the changes effected by the CFMA is a regulatory framework that provides certainty, allows the marketplace to provide oversight for transactions between sophisticated counterparties and ensures the enforceability of such transactions. At the same time, the CFTC retains residual antifraud and antimanipulation jurisdiction.

What Went Wrong?

Beginning with the first OPEC oil embargo in 1973, and extending through the 1980s, industrial nations have seen periodic bursts of energy price volatility that affected consumers and energy-consuming industries, as well as energy producers. At the same time, banks facing interest rate and currency volatility have developed risk management tools – most notably, swaps and related privately negotiated derivatives – that enabled banks and their clients to trade unwanted risks for risks they were better able to manage. Given the importance of energy prices, it was not long before there were attempts to develop similar tools for managing energy price risks. Once the initial obstacles posed by the CFTC to legal certainty for energy swaps were cleared, energy derivatives began to develop as a business.

In large part, the technology and processes to manage energy price risks came from global financial institutions and crossed over to energy companies. The energy traders had to understand everything Wall Street and the City of London understood about trading interest rates and currencies and then adapt that knowledge for the physical energy business. The processes and controls developed to manage swaps, however, were a natural extension of credit and market risk management skills that are intrinsic to the financial industry. It is not clear that the energy industry, when it adopted these newly developed financial tools, paid adequate attention to the risk management and internal control environment.

The result was that companies rushed to expand their business opportunities to include energy trading in the early 1990s. The complexity was daunting, but new entrants continued to appear. The number of power marketers seeking certificates increased year after year. It had never been done before and it challenged the best minds in the business. Rapid growth increased the risks and controls but knowledge did not always keep pace.

A few years before the end of the decade, there was an early warning sign of problems to come. In 1998, Power Company of America (PCA) defaulted on its obligation to supply power at a time when prices were increasing rapidly. Looking back, that may have been one of the first signs that the industry had grown too quickly and beyond what was prudent. Many companies took more risk with respect to PCA not delivering power than was appropriate. Failure to deliver electrons is a credit event just as devastating as the failure to pay money. The industry had more to learn about credit and the impact that market design can have on an industry.

Another warning sign was the extensive political bickering in the struggle to design a system for the trading of power in California. The goal was a competitive market for the buying and selling of power, but that was not the result. The compromise – deregulation at the wholesale level, but price caps at the retail level -- was complex and flawed. The utility restructuring law took effect in 1998, and the problems started almost immediately. Wholesale power prices in California were deregulated, yet power distribution companies were capped in the amount of power costs that could be recovered from ratepayers. There was a severe drought in the Pacific Northwest, which contributed to power shortages, while capped retail prices provided little if any incentive to conserve energy. Finally, there was little if any incentive to invest in generation assets, which meant there was not enough generation capacity in the state to meet peak day power demands. Given the foregoing, skyrocketing prices and the financial failure of two of the state's largest public utilities this was not a complete surprise.

The inefficient functioning of the California energy market created a medium in which price manipulation could flourish. To date, two traders have plead guilty to price manipulation. There may be more to come. In addition, at least one generator has settled a claim against it that it withheld power from the California market for the purpose of driving up power prices and making additional profits on its power. There

are many ongoing investigations into possible criminal activity, much of it focused on the California markets. (See FERC discussion below under Section V, Regulatory Framework.) This appears to be a wake up call that the energy trading industry has heard loud and clear. The industry is responding as described in the next section of this paper.

The Enron bankruptcy also dealt a significant blow to the energy markets. A large proportion of Enron's losses were the result of trying to reconcile two conflicting strategies: one was to invest in energy, telecommunications, and other technology businesses, which required substantial debt; the second was to grow into a major dealer in swaps, which required substantial creditworthiness. Enron executives knew that their firm's credit quality was essential to a counterparty's willingness to do business with Enron. But rather than adapt the investment strategies to reality as the result of experience, they chose to use very aggressive accounting policies to maintain the appearance of creditworthiness. As Enron sought to establish itself as a major participant in energy and energy derivatives trading, it attempted to evade the discipline of the market and inflate its creditworthiness through its well-documented failures in corporate governance, accounting and disclosure. In addition, Enron allegedly attempted to seek profits by whatever means it could, including manipulating prices in the California market. The strategy proved unsustainable on all fronts.

The effects of Enron's bankruptcy, which shattered more than the illusion of its own creditworthiness, were wide ranging. In particular, the loss of a major trader that had been perceived as investment grade – albeit barely – proved an object lesson in the importance of creditworthiness in financial markets. More immediately, the weak credit standing of many of the remaining energy trading companies now became apparent. The result was a collapse of volume in natural gas and, to a far greater extent, power derivatives markets. Yet the realization that the need to manage energy price risks goes on has led to constructive efforts to learn from mistakes and to restore confidence in energy trading and energy derivatives. It is worth noting that despite this failure many of the protections afforded through OTC derivatives documentation and credit derivatives worked extremely well in context of unwinding transactions and in settling credit derivatives transactions where entities bought protection on Enron as a reference entity.

Restoring Confidence in the Energy Markets

Credit and Liquidity. The gas and power trading industry by its own admission has severe credit problems. The wave of credit downgrades has come and gone several times and more may be on the way. Additional bankruptcies are a real possibility for companies that may have left the energy trading business on a going forward basis, but that still have significant positions in their trading books. The answer is better understanding in the industry of credit risk and the methods to manage credit risk inherent in trading contracts. There is a difference between a counterparty rated “BBB” and one rated “A”, which must be taken into account in doing transactions and measuring the amount of credit risk a company can prudently take. For too long, the

industry failed to differentiate between credits above investment grade and failed to include appropriately stringent credit terms in its master trading agreements. For example, default provisions need to be made broader to include credit events of affiliated companies of the counterparty, not just credit events of the counterparty.

With respect to liquidity, the industry should never again rely as heavily on a single liquidity provider as it did in the past. As the credit issues are addressed, as well as the matters described below, liquidity will return to the market. Also, as the industry reshapes itself, new participants (and liquidity) will enter the market. This has already started with traditional financial institutions having applied for and received power marketing licenses.

The energy trading industry is investigating practices and institutions that might facilitate the intermediation of credit risk in energy trading. One practice is collateralization of counterparty risk exposures. As derivatives activity among financial institutions grew during the 1990s, concern among the major dealers grew over the corresponding growth in counterparty exposures. Collateralization of counterparty exposures, in which one party to a derivative transaction posts collateral on the amount it owes on its contracts with another party, was a natural result. In effect, a counterparty by receiving collateral is reducing credit risk and taking on more manageable operational risk; the counterparty can then reduce its operational risk by improvements in its collateral management procedures. The practice has proved successful as demonstrated by its significant growth, with the latest estimates showing over one-half trillion U.S. dollars of collateral in use compared with US\$ 437 billion in 2002.³ In recognition of the effectiveness of collateral, the Basel Committee on Banking Supervision is increasing its recognition of the benefits of collateral in its New Capital Accord, to be issued in 2004 and implemented in 2006.

Another risk management tool is netting of counterparty exposures. Netting takes two forms, and the ISDA Master Agreements facilitates both. First, payment netting reduces settlement exposure by providing for the netting of offsetting payments due at the same time. Second, netting in bankruptcy, commonly known as close-out netting, reduces pre-settlement credit exposure by providing for the netting of offsetting obligations to and from the defaulting party. The importance of netting in reducing exposures and thereby enhancing systemic stability has been recognized by regulators and incorporated into capital standards. ISDA has played a major role in assisting governments worldwide in adopting enforceable and robust netting provisions. Currently, 24 jurisdictions have in place netting laws that pertain to derivatives and four more are considering them. In addition, ISDA has obtained legal opinions on the enforceability and degree of protection afforded by netting in 39 jurisdictions.

The energy trading industry has been hard at work to increase the opportunity to net financial transactions and physical transactions, which have historically been documented under different master agreements. The Edison Electric Institute (EEI)

³ ISDA Margin Survey 2003: Preliminary Results, paper presented at ISDA 2003 Annual General Meeting, Tokyo, April 9, 2003.

developed a Master Netting Agreement to bridge the various master agreements used in energy trading and is working with ISDA on a physical power annex to the ISDA master. In an effort to enhance credit terms in the physical electricity markets, EEI also recently developed a Collateral Annex similar to the Credit Support Annex used with the ISDA Master Agreement for financial trades. ISDA is also developing a physical gas annex and has developed an Energy Agreement Bridge that would enable parties who have multiple master agreements, one of which is an ISDA Master Agreement, to link those separate agreements together to terminate and net across products in the event of a default. The point is, that the industry is working together to converge master forms and enhance netting of energy transactions.

The industry has also been working for several years on an amendment to the US bankruptcy laws to enhance legal certainty with respect to cross-product netting of financial and physical transactions. Passage of this legislation is essential in supporting the documentation efforts described above that have been developed to bridge physical and financial energy derivatives transactions.

Finally, energy trading participants and regulators are studying the use of a clearinghouse as a potential solution to the industry's credit problems. Fortunately, the regulatory reform achieved in the CFMA removed regulatory obstacles that hampered development of OTC clearinghouses in the past.

Once a clearinghouse is in place, a trade conducted on a bilateral basis between two counterparties could be transferred to a clearinghouse for multilateral clearing. The transfer could reduce the collateral required for energy transactions and be a step toward better management of credit risk for gas and power transactions. Currently, the NYMEX, the Intercontinental Exchange and several other companies offer the opportunity to clear trades through a clearinghouse. A number of industry, academic and regulatory forums are also analyzing clearing.

Nearly all participants in a CEO Roundtable at the Global Energy Management Institute of the University of Houston on February 3, 2003 stated a desire to start using a clearinghouse soon to clear at least a portion of their trades. Further, chief risk officers at energy companies, who typically oversee credit and risk functions have formed the Committee of Chief Risk Officers (CCRO) to unite the industry in working through the industry's credit issues. The CCRO has posted on its web site, a novation agreement that will serve as a bridge between the existing master agreements and the clearinghouses. Novation agreements are intended to be used in cases where two parties have entered into one or more transactions and one of those parties subsequently transfers its rights, liabilities, duties and obligations to a new counterparty.

The February 5, 2003, CFTC and FERC technical conference on Credit Issues & Potential Solutions in the Energy Markets provided a forum for market participants and regulators to consider various credit solutions for the energy markets. A number of relevant topics and themes were considered including the necessity of counterparty risk management in rebuilding trust in the markets, the impact of collateral, the transition to

multilateral netting as a solution to the current credit gridlock in the energy industry, the interaction between physical and financial transactions, the lack of standardized documentation in the energy markets, the role of credit in the physical and financial markets, the integration of energy OTC trades into a classical clearing model and the importance of protecting central counterparty clearinghouses under insolvency law regimes and bankruptcy codes in the United States, the United Kingdom and across Europe.

Better Controls and Ethics. The complexity and diversity of energy trading moved beyond the internal controls of many companies. The energy industry has started to follow the trail blazed by the Group of Thirty, a group of practitioners, regulators and private participants in OTC derivatives activity that produced recommendations to assist dealers and end-users in managing derivatives activities in the early 1990s. The goal of the study was to add to the soundness and utility of OTC derivatives by contributing to the public understanding of the nature and potential of derivatives and by providing guidance on principles of good risk management. The CCRO has made an excellent start in its white paper on Governance, wherein it details the risk management responsibilities of the board of directors, the “Risk Oversight Committee” and all the various support functions. The paper also suggests best practices, policies and procedures in the areas of valuation and risk metrics, credit risk management and risk management disclosures. For the power industry, the Electric Power Supply Association (EPSA) has developed and placed on its web site a “Code of Ethics and Sound Trading Practices for Electric Power Suppliers. Many participants in the energy trading business have adopted the EPSA code or one like it and then gone a step further by imposing more stringent internal codes of conduct and guidelines for their traders. This has also been a serious discussion topic at industry seminars. More needs to be done in this area. The policies recommended by the Group of Thirty are core recommendations for OTC derivatives. The energy industry needs to come together and adopt an energy version of those principles.

Accounting. Guidance for energy derivatives is also being addressed by the accounting standards setters. Modifications for accounting of energy derivatives are being made to an already extensive set of guidelines that currently exist for OTC derivatives. The regulatory framework in the United States for the gas and power markets also includes extensive accounting requirements promulgated by the Financial Accounting Standards Board (FASB). In June of 1998, FASB issued accounting guidance for derivatives in Statement of Financial Accounting Standards No. 133 (SFAS 133), *Accounting for Derivative Instruments and Hedging Activities*. SFAS 133 defines a derivative by its characteristics and applies to all entities (except for special provisions that govern not-for-profit entities and other entities that do not report earnings as a separate caption in a statement of financial performance).

SFAS 133 requires that all instruments that meet the definition of a derivative be carried on the entity's balance sheet at fair value and the change in fair value recorded in earnings unless there is an appropriate hedging relationship. This approach is based on the premise that fair value is the most relevant measure for financial instruments and

the only relevant measure for derivatives. Fair value is an estimate of the price an entity would realize if it were to sell an asset, or the price it would pay to relieve a liability in a current transaction between willing parties. Energy trading contracts that meet the definition of derivative under SFAS 133 must comply with the standard. In terms of disclosure, discussion of the purpose of the derivative activity is required for derivatives involved in trading activities under FAS 133. Extensive disclosures are required for derivatives used as hedging instruments. The SEC also requires additional disclosures on market risk.

The accounting issues related to energy trading and risk management activities have received significant attention by FASB and its Emerging Issues Task Force (EITF). Until recently, energy traders followed the requirements of EITF Issue 98-10 that permitted energy trading positions (contracts that met the definition of a derivative under SFAS 133, physical contracts that did not and certain inventory positions) that were entered into by entities involved in energy trading activities to be accounted for at fair value with changes in fair value taken into earnings each period.

After recent concerns were raised with respect to certain energy contracts, the EITF amended its accounting guidance in late 2002 for contracts involved in energy trading and risk management activities through EITF Issue 02-03 which rescinded EITF Issue 98-10. The result was to limit energy trading instruments that could be carried at fair value to those contracts that meet the definition of a derivative under SFAS 133.

For those contracts that meet the definition of a derivative and are held for trading by dealers, the FASB reiterated its views on the support needed to substantiate profit recognition. Physical contracts that do not meet the definition of a derivative must be accounted for on an accrual basis and certain inventory positions could no longer be carried at fair value unless appropriate under other accounting literature. Finally, the EITF decided that gains and losses (realized and unrealized) on all derivative instruments within the scope of Statement 133 should be shown net in the income statement, whether or not settled physically, if the derivative instruments are held for trading purposes.

Regulatory Framework

For the last twenty years, Congress and the FERC (as well as most States and their respective public utility commissions) have wisely steered the gas and power business away from a traditional regulatory approach for public utilities and toward increased competition and greater efficiency. It has been estimated by the Chairman of the FERC that deregulation in the gas industry has saved consumers several hundred billion dollars in natural gas costs. Just as every person should have access to the interstate highway system, third parties should have access to the pipes and wires in interstate commerce. The pipes and wires are analogous to common carriers. The evolution is not yet complete, but tremendous progress has been made. There should be no rollback of third party access to pipes and wires. Further, no one seems to be seriously advocating a return to the days of controls on gas and power prices. Price controls

cause shortages, as the US experienced in the 1970s, and as is common in many third world countries.

Just as Congress and the FERC have steered gas and power toward greater competition and efficiency, Congress and the CFTC have steered its commodity oversight toward creating greater legal certainty and “regulation” by the market for transactions between sophisticated counterparties. As stated above, such oversight is complemented by the FERC oversight of power marketers under Section 205 of the FPA. Are more laws and/or regulations required? Should the bill proposed by Senator Feinstein of California, “Energy Market Oversight Act” be adopted? Existing federal and state regulation for energy derivatives is extensive and is currently being employed through FERC and CFTC enforcement actions. The case for new legislation and regulations has not been made.

Every company buying and selling power in interstate commerce is required to seek a power marketing license under Section 205 of the FPA. It is required to make periodic reports to the FERC. The FERC already has the statutory framework for significant oversight over the power market and has in fact recently required additional information to be provided in periodic reports. With respect to gas, the FERC has not chosen to require such certificates, but has a similar statutory authority to do so under the Natural Gas Act (NGA). The CFTC has broad oversight over the commodity futures markets used in the energy trading such as NYMEX and has the authority to investigate and prosecute “manipulation” in the commodity markets.

Further, across the US, every state has a public utility commission and a panoply of laws, including anti-fraud laws and others directed specifically at the energy business, which provide further oversight of energy and energy trading.

Currently, the CFTC has ongoing investigations of more than twenty companies regarding their energy trading activities. In mid-March, the CFTC charged Enron with market manipulation and operation of an illegal futures exchange through its trading system, Enron Online, and charged a trader with attempting to manipulate the gas markets. The CFTC has recently entered into a settlement with El Paso Corp. in connection with the reporting of fictitious trades to industry price indices and has criminally charged a former natural gas trader with Dynegy with intentionally reporting false natural gas price and volume information to energy reporting firms in an attempt to affect prices of natural gas contracts.

The March 26, 2003 FERC report took broad action on the Western Energy Markets finding evidence of market manipulation during the California power crisis of 2000-2001. The staff and the FERC focused on price manipulation, reporting of price indices, Enron trading strategies, wash trading and one-to-many electronic trading platforms. The FERC has stated that it is committed to promulgating clarifying rules to address industry issues and to aggressively pursuing those that violated the rules. Additional companies may face further investigation of their wholesale power trading activities.

Legislative efforts to regulate energy derivatives, such as Senator Feinstein's Energy Oversight Act, would not provide any material benefit to the extensive statutory and regulatory oversight available for energy trading. These efforts would introduce uncertainty into the regulatory framework for energy trading and would make it much more difficult to manage energy price risk.

Policymakers would do well to heed the concerns expressed by the Federal Reserve Chairman Alan Greenspan. On March 7, 2002 when discussing energy derivatives during a Senate Banking Committee hearing, Chairman Greenspan noted "a significant down side if we regulate where we do not have to in this area, because one of the major, and indeed the primary, area for regulation and protection of the system is counterparty surveillance; that the individual private parties looking at the economic events of the -- looking at the status of the people with whom they are doing business when they have this derivatives transaction. We've got to allow that system to work, because if we step in as government regulators, we will remove a considerable amount of the caution that is necessary to allow those markets to evolve. And while it may appear to be sensible to go in and regulate, all of our experience is that there is a significant downside when you do not allow counterparty surveillance to function in an appropriate manner."

Conclusion

The market worked. Prices spiked but then returned to normal levels. The turnaround for energy trading has started. The industry is focused on reform and solving the problems of the past. Codes of conduct, better contracts, better ways to mitigate credit risk, through improved collateral management, netting and/or clearinghouses, are all under way.

The industry regulators, collectively the FERC, the CFTC and the state public utility commissions all need to cooperate in the regulation of energy, energy infrastructure and energy trading through existing laws and regulations, with an emphasis on the development of efficient and competitive energy markets and legal certainty of the enforceability of energy derivatives. They have and should continue to use their broad panoply of powers to bring enforcement actions against those firms who violate laws and regulations.

The legislative focus should be directed toward improving the bankruptcy law so that creditors can safely net physical and financial transactions in bankruptcy without challenge. There will be no benefit from additional regulation like the Feinstein bill but there will be unnecessary costs. Yes, there may be more ups and down in the energy trading, but a safe and sound energy trading business is in formation today. The FERC and the CFTC must continue with their policies (started many years ago) of promoting efficient and competitive energy markets and legal certainty for energy derivatives. This approach will serve all users of energy well.

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