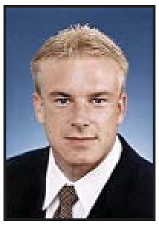
Credit Risk Management: Where Does It Go From Here?

The topic of credit risk management has always been at the forefront of any discussions involving energy strategies, but never more so than today as financial and regulatory issues have combined to raise questions that delve into the actual strength of the industry.

In this discussion, conducted by Gary M. Vasey, an editorial adviser to Power & Gas, several experts from different sectors of the industry attempt to answer questions pertaining to the future of credit risk management. Whatever the real answers ultimately turn out to be, no one can say for certain, but they will have a large bearing on the future of the energy industry.

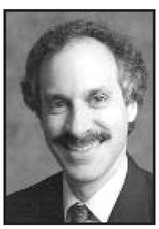
Those participating in the roundtable are:

Greg Norman, *Senior Director, Corporate Credit for Duke Energy Corp. He is responsible for Credit Policy, Contract Administration, Reporting, the Collateral Desk and Credit Systems. Norman is a CPA with 15 years' combined financial and energy experience. He joined Duke in 1997.*



Jim Negus *is the leader of KPMG LLP's Trading and Financial Risk Management practice. He is based in Los Angeles and can be reached at 213-955-8460 or jtnegus@kpmg.com.*

Don Jefferis *is vice president of business development for Cogency Software. He has more than 18 years of experience in risk management and finance. Prior to joining Cogency, he spent two years at TenFold Corp. in various executive positions.*



Peter C. Fusaro *is chairman of Global Change Associates, Inc. New York, NY, www.global-change.com. He is the author of What Went Wrong at Enron and three other energy risk management books.*

Jill Feblowitz *is service director for AMR Research. She is responsible for setting strategic direction and shaping the research agenda for energy industry services. She also researches, analyzes and writes on business and software trends emerging with applications and service providers in the energy and utility industry.*

Gary M. Vasey *is president of VasMark, a strategic marketing consulting and communications firm that works with buyers and sellers of energy software.*

Q.: The energy industry is riddled with challenges in 2003. How do you prioritize the credit risk management challenges (and opportunities) on the "burning issues" list?

NORMAN: Effective credit risk management requires various forms and degrees of sophistication. Several factors we consider in prioritizing our "burning issues" include trading volume, client concentration, client credit profiles, liquidity i.e. margin and collateral management, system infrastructure and contracts. Our goal is to remain flexible and strategically focused on business and financial factors.

FEBLOWITZ: Credit risk management is certainly high on the list of priorities for a majority of energy companies. At this point, though, access to credit ranks higher. Traditional sources of capital have dried up, and companies have slashed the amount of money available for capital investment. Then too, companies may be doing limited trading. Depending on the outcome of FERC's investigation into trading practices, there is a potential for 37 more companies to join Enron and Reliant in having their right to trade power taken away.

The Committee of Chief Risk Officers has taken the first step toward restoring confidence in the energy industry. CCRO's recommendations include standards on governance, disclosure, credit risk, and risk valuation. At minimum, shareholders can be protected from undue risk if an energy company understands counterparty credit exposure, has visibility into position, meets disclosure requirements, and controls rouge trading.

NEGUS: Energy industry executives over the past year have seen a sea change in the scope of risk-related issues they now have to contend with. I would rank the challenges as follows:

Greater concentration of risk exposure due to the decline in market liquidity.

Expansion of credit focus to the retail sector.

Standard use of credit pricing when bidding/trading/marketing/procuring.

JEFFERIS: At the highest level, you might bifurcate energy players into those that hopped onto the wave of expanding and diversifying into the merchant and trading explosion of the mid to late 1990s and those that did not. The former group is fighting for survival and the latter is assessing their strategy to capitalize on their relatively strong position in today's challenging market.

Corporates — across the board — have been hit hard with credit losses; and no industry has been hit more acutely than energy. Compounding the challenge for the energy sector is the capital access dependency for both those firms that rode the wave and those that did not. It would be difficult not to say that business vision and strategy is "the" burning issue for energy firms today — but "the" key constraint to an actionable vision is the company's creditworthiness posture.

FUSARO: Credit issues are important, but actually not as important as they were a year ago. The reason is that the structure of energy trading particularly for gas and power has changed to more short-term trading with the attendant migration of trading to NYMEX which has government-regulated contracts and OTC clearing. This has eliminated much of the need to monitor credit and counter-party risk as the exchange matches all parties on a daily MTM basis. It's the flavor of the month to say how active credit risk management is, but the fact is that this should have been done before. The horse has left the burning barn. After all, the energy trade lost much of its market making ability with the demise of Enron and 16 other top 20 gas and power marketers. We are only now starting to rebuild the market. Similarly, the re-launch of electricity futures for NYISO and PJM that work will alleviate some of the short-term price risk for power trading.

Q.: What has fundamentally changed in the energy industry over the past year or two that has brought credit risk to the forefront?

FEBLOWITZ: Most companies were burned in the Enron debacle because they did not have the ability to understand their counter party exposure and act on that quickly. Given the size of the deals in the industry and the awareness that even the largest of counter parties could collapse and put a company at risk, utilities used to a conservative industry have had to take notice.

NEGUS: Credit risk has always been an issue that energy industry executives have had to factor into their decision-making. However, over the past two years, the industry has experienced widespread credit losses, which have raised a variety of questions among the boards of directors of many companies. Consequently, some companies have now established risk-management committees whose officers are responsible for managing credit risk.

NORMAN: As a result of emerging from a regulated environment, many power and gas companies failed to focus on counterparty credit risk management. Companies did not appreciate the need for sophisticated credit risk management policies, procedures and systems. The need to integrate market and credit risk became a new focus. Surplus generating capacity created in anticipation if deregulation started to drag down balance sheets.

Typically, commercial management was challenged by the loss of current business when credit limits were reached. In general, businesses did not contemplate higher levels of expected and unexpected credit losses. The role of collateral and liquidity brought an increased focus from treasury and senior management. While juggling these complex issues, credit found itself in the forefront of decision making.

JEFFERIS: Structurally, on the wholesale side, little has changed over the past couple of years; rather, deep-rooted and systemic problems around the credit process came to light during the severe stress that the energy industry was placed under with the near simultaneous occurrence of massive bankruptcies, overcapacity rationalization, and market oversight and inquiry. The energy market - primarily meaning electric power - is of such a large physical size and it took off with such velocity that many of the nuts-and-bolts back-office processes followed behind the marketing-led organizations. The daisy-chaining that takes place provides a fantastic ability to manage market risk but it has the unfortunate by-product of creating exponential credit risk. So, while it has been there for a long time, it was dormant.

FUSARO: Market-making requires an active credit function and active market monitoring. This will continue to be an active area of utility and banking activity as the lessons learned is "get to know your counterparty" has been underscored.

Q.: If you were hired by a company's board of directors to prepare a credit-risk management "report card," what would be the three top criteria that you would look for and how do you think the typical company stacks up today?

NORMAN: First, I would look for effective credit risk policies and procedures. Second, I would focus on data integrity as credit is the end-user of information generated from multiple sources. Next, I would be concerned about the organizations credit culture.

I think the best in the market are already setting the lead. However, many companies have ground to make up.

FUSARO: The credit risk report would include active MTM monitoring on any available network platform on a real-time basis, more active use of VaR (voodoo at risk, but it's the best we have at present), and more authority given to the risk control group to countermand poor trading strategies and execution. Fourth, more active use of credit derivatives where appropriate.

Currently, most energy boards of directors believe they already have elements of what is required to successfully manage credit risk. However, approaching the issue of risk, whether it is credit or any other element of organizational risk, without first assessing your state of preparedness will, in the end, cost more money and might lead to a competitive disadvantage.

— Don Jefferis

FLEBOWITZ: Although new CCRO regulations will require energy companies to invest in trading and risk management systems that support uniform business practices, 61% do not have the systems to support these requirements. Companies that have traded heavily in the past and already invested in information technology and integration infrastructure are close to being ready to meet new standards. Most energy companies, however, are not ready to meet the standards because they do not have the requisite systems in place.

Uniform business practices and legible business processes are essential, but it's packaged applications that provide credibility. Improved business processes based on existing spreadsheets will not be sufficient. If companies don't build IT capabilities, they will make significant investments in change management, especially every time protocols change.

JEFFERIS: It is difficult to evaluate a company's credit function without first establishing context. So, foundationally, the first order of business would be to understand the company's business vision, strategy and forecasts to understand what businesses they are pursuing and how they plan on making money. Understanding capital, investment, and risk tolerance is critically important. In terms of a "report card," I would likely suggest a CCRO credit benchmarking as a starting point. The energy industry has poured incredible resources into the project and has developed a terrific starting point for assessing quality of credit processes.

Now, to answer your question. First, I would look at the people factor. Does the company have a person with the credit experience for the job, given the company's business strategy. Second would be a review of counterparties, contracts and the legal aspects of credit. This area is so critical to ensuring that credit management can successfully take place. That said, it is also the most often overlooked area and inhibits the ability to introduce sound credit management practices. Lastly, would be leadership support for establishing a high capability credit function – is management supportive of the investment and business changes required to execute a top-notch credit program.

We are currently working with many corporate boards of directors to develop credit risk "report cards." These essentially are risk models that allow directors to anticipate and react to risk issues before they occur. However, many companies reach out to us after a problem already exists. The first step in assessing a company's state of "credit-risk preparedness" is to determine whether clear roles and responsibilities have been established. Second, a standard of credit measurement must be decided upon, followed by assurance that there is a clear and open line of communications with management.

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Q.: What are the big obstacles to launching a top-notch credit risk management function?

NEGUS: We are finding that all too often companies are set in their ways and are not open to change overnight. Many organizations continue to silo credit information, and when it comes to credit negotiations, the pace is often slow motion. Since credit risk management is just beginning to appear on many companies' radar screens, most organizations as yet lack the talent required to bring about and accelerate the changes needed to address the issue.

NORMAN: There are several key success factors to consider:

- Organizational Culture
- Proper Functional Alignment i.e., Market Risk and Credit Risk
- Data Integrity
- Adequate Access to Senior Management
- Integration and Transparency with Commercial Personnel

JEFFERIS: In addition to the issues previously discussed, data and information management is a significant issue. Specifically, very few information management systems in place at energy firms today were designed with credit management needs in mind. Rather, credit attributes exist on a counterparty or transaction basis for purposes of processing a given transaction. Further complicating the situation is the fact that credit management needs to occur across an enterprise, consolidating multiple lines of business and divisions while considering the complexities of contractual arrangements throughout.

FUSARO: There really aren't any. The talent, modeling capability and software are available. More importantly, senior management at energy trading companies are not stupid and know that this is an important function for trading to go forward.

Q.: What role do credit derivatives play in helping the energy industry?

FUSARO: Credit derivatives are one more useful tool to manage the unpredictable and highly volatile price risk of the energy complex. Oil, gas, power and even coal currently exhibit, and will continue to show, unprecedented price volatility. Credit risk derivatives are a means to have counterparties perform and ensure that unnecessary risk i.e., trading disasters or miscalculations, don't take down the company. The good news is that this is one of the few growth areas in the energy trading complex today.

NORMAN: Credit derivatives are one of several options available for mitigating credit risk. As it currently stands I have not seen a lot of activity in U.S. energy markets.

NEGUS: Most energy industry executives no longer consider credit derivatives a viable option. The market has literally dried up. Management's difficulty in understanding how they work, in addition to their considerable cost, has led the industry to avoid them.