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Lifting the Lid: Calpine Seen Downplaying Woes in Accounts

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Calpine Corp. has been struggling badly ever since the Enron Corp. collapse in 2001 exposed the weaknesses of its power generation and trading business, **but a recent study of its accounts suggests worse may still be to come.**

While Calpine has not violated any accounting rules, its 2003 financial statements alone cannot be trusted to provide the true financial health of the company, according to analysis by RateFinancials Inc, an independent research firm.

It says Calpine has underplayed expenses, allowing it to show higher profits; may have to slash the value of its assets and could be understating certain liabilities. New York-based RateFinancials specializes in identifying red flags in company statements and then selling the research to money managers and insurance companies.

"Based on what we have it looks like there is very little value for equity investors in Calpine," said David Hughes, the RateFinancials analyst who probed Calpine's accounts.

Bad news is nothing new to investors in Calpine, which is saddled with about $17 billion in debt. Those who bought its shares when they were trading above $50 in 2001, and stuck with them, have lost almost all their investment as they now languish at $3.48.

There had been some hope it could make a recovery if power markets improve in the next two to three years and Calpine can meet its debt repayments which start in two years.

But the analysis of the notes to Calpine's financial statements suggest it is at best going to be a long haul back.

For example, Hughes says Calpine does not recognize the cost of internally produced natural gas as a fuel expense, thereby understating its costs by $374.3 million in 2003. A similar move helped it curb expenses by $180.4 million in 2002 and $99.9 million in 2001.

While Calpine Chief Accountant Chuck Clark says that under U.S. accounting rules it does not have to show this item in the income statement, Hughes argues that this can still be misleading.

"They are understating the expenses associated with electricity production at their gas-powered plants," he argued.

LESS VALUE

Another red flag is the true value that Calpine carries on its books for some of its power plants which seem to be chronically underutilized, operating at around 40 percent of capacity.

"Given the sustained decline in operating margins for power produced by the company's plants and the lack of energy purchase agreements for the company's unused capacity, it is likely that material impairment of the company's fixed assets, including construction in progress, has occurred and remains unrecognized," Hughes wrote in his report.

Under the accounting rules, if doubts arise regarding the earning ability of an asset then its value should be written off under an 'asset impairment' test. But the decision to conduct such a test is left to the discretion of the company, which can argue that weak industry conditions that could reduce the asset's value are only temporary in nature.

Brian Russo, an analyst with Criterion Research, a New York-based independent research firm, says he has faced the same problem while trying to value Calpine's assets. He gets around it by doing his own analysis based on estimated future cash flows expected from those plants rather than taking the company's book value assessment, which might be out of date.

Calpine's Clark said it does not have to take a write-off because the long-term income it expects from the plants justifies the current book value.

Certainly this is convenient as any further asset write-offs could prompt its lenders to declare it had broken debt covenant and then slap the company with higher interest rates that could potentially force Calpine into bankruptcy, Hughes said.