

June 30 , 2004

Letter of Comment No: 5550
File Reference: 1102-100

Director of Major Projects - File Reference No. 1102-100
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Re: Share-Based Payment Exposure Draft

Gentlemen:

PNM Resources, Inc., a New York Stock Exchange listed, integrated utility based in New Mexico, appreciates the opportunity to provide comments regarding the Share-Based Payment Exposure Draft ("Exposure Draft"). Our responses to certain questions contained in the Exposure Draft are included below. In addition, we have provided comments on additional issues of concern to our company.

Recognition of Compensation Cost

Issue 1: The Board has reaffirmed the conclusion in Statement 123 that employee services received in exchange for equity instruments give rise to recognizable compensation cost as the services are used in the issuing entity's operations (refer to paragraphs C13-C15). Based on that conclusion, this proposed Statement requires that such compensation cost be recognized in the financial statements. Do you agree with the Board's conclusions? If not, please provide your alternative view and the basis for it.

Response:

We disagree with the Board's conclusions that employees' services received in exchange for equity instruments give rise to recognizable compensation cost. Expensing stock options as proposed in the Exposure Draft, is theoretically flawed, based on the Board's own concept statements and basic economics. Moreover, the proposed accounting treatment would not increase financial statement reliability, transparency or comparability.

Statement of Financial Concepts No. 6, Elements of Financial Statements (Con 6), defines expenses as "outflows or other using up of assets or incurrence of liabilities (or a combination of both) from delivering or producing goods, rendering services or carrying out other activities that constitute the entity's ongoing major or central operations." Con 6 further states, "expenses represent actual or expected cash outflows (or the equivalent) that have occurred or will eventuate as a result of the entity's on-going major or central operations." Despite the label of compensation given stock options, the reality is there is no expense to the company related to the granting of stock options. Cash is the true economic measure of any transaction. No cash (nor any asset that is recorded on the company's balance sheet and is convertible to cash) is transferred to the employee when a stock option is granted. This economic reality is even reflected in the balance sheet accounting under the Exposure Draft, as the net effect on the

balance sheet of expensing stock options is zero. In other words, stockholders equity - the accounting measure of ownership value - does not change.

The only economic impact to shareholders related to the grant of stock options is the dilution to the ownership base that options cause. This dilutive effect is currently considered in the EPS calculation, regardless if the stock option grants are expensed. The addition of compensation expense related to stock option grants in the income statement results in a perverse double counting of the grant as both the numerator and denominator are negatively adjusted for the effect of the options. This "double hit" on EPS is unfair and misleading.

Equally unsettling is the concept that an employee stock option has a value equivalent to a freely tradable option. The reality is that an employee stock option is not the same as a freely tradable option, and therefore any attempt to equate it as such inappropriately results in assigning a value that does not exist. A comparable freely tradable put option would be exchanged for an asset that can be readily measured, assuring an appropriate fair value. The marketplace ensures a continuing means to fair value the option. An employee stock option is non-transferable, terminates with employment and does not result from the same arms length transaction that a freely tradable option would. The models available to measure options are incapable of measuring employee stock options as they do not take into account the unique circumstance surrounding an employee stock option. This circumstance is the employer/employee relationship. Essentially, the option is an opportunity to benefit from continued employment. Most employment relationships contain any number of forms of expressed or implied up-side benefits based on the expanding fortunes of the company. The value of an employee stock option is more comparable to such incentives than a negotiable security. Accordingly, it is impossible to measure and theoretically inappropriate to recognize as an expense.

Although social implications are not valid reasons to invoke for or against an appropriate theoretical approach, it bears mentioning that the drag on earnings caused by this proposed accounting treatment will be a disincentive to broadly distribute stock options to employees. By adopting the fair value method of accounting for stock options, management will have to choose between higher earnings or using a highly effective tool to motivate, retain and reward all employees - managerial and non-managerial. Inevitably, the pressure for higher earnings will end the broad use of stock options that exists today. Public support for the expensing of stock options is widely built upon the desire to end a perceived notion that the huge windfalls, received by senior managers who exercised their stock options, motivated many of the so-called corporate scandals of the late '90's.

Similarly, the Exposure Draft's requirement for employers to expense any employee stock purchase plan grants with an immaterial discount will make such plans less attractive to companies, further resulting in a reduction of equity based compensation for employees.

Moreover, as stated above in the Company's objections to this primary tenet of the exposure draft, the pronouncement does not improve financial reporting. An improvement to financial reporting must result in a meaningful measure that is useful to users of the financial statements. For the reasons discussed above, we believe that the Exposure Draft does not realize this goal. The measures proposed do not provide investors with information that will improve their

evaluation of economic prospects of the reporting entity and change their valuation of said company.

Issue 2: Statement 123 permitted enterprises the option of continuing to use Opinion 25's intrinsic value method of accounting for share-based payments to employees provided those enterprises supplementally disclosed pro forma net income and related pro forma earnings per share information (if earnings per share is presented) as if the fair-value-based method of accounting had been used. For the reasons described in paragraphs C26–C30, the Board concluded that such pro forma disclosures are not an appropriate substitute for recognition of compensation cost in the financial statements. Do you agree with that conclusion? If not, why not?

Response:

Given our stance in Issue 1, we argue that granting stock options for employee services should not be considered compensation expense, and pro forma disclosures as required by Statement 123 are inappropriate. We do believe that current disclosure requirements under Statement 123 regarding share based payment arrangements are inadequate. The much stated concern of proponents of the Exposure Draft is the impact of stock options to existing shareholders. This concern could be better addressed by expanding the disclosure requirements around outstanding options. This means increased disclosure of vested and unvested options for both in the money and out-of the money options. Additionally, the vesting schedules for the unvested options, along with enhanced disclosure regarding the company's exercise and forfeiture history would be beneficial. Moreover, requirements should include more disclosure on employee purchase plans and other claims on equity. The current Exposure Draft does none of this. This information would be of greater value to investors than the expensing of stock options. Given that this information does not rely on complex models with significant subjective assumptions, it will be less confusing and misleading and will provide more meaningful information to investors to assist them in their valuation of the reporting entity.

Employee Stock Purchase Plans

Issue 6: For the reasons described in paragraph C75, this proposed Statement establishes the principle that an employee stock purchase plan transaction is not compensatory if the employee is entitled to purchase shares on terms that are no more favorable than those available to all holders of the same class of the shares. Do you agree with that principle? If not, why not?

Response:

PNM disagrees with the principle that an employee stock purchase plan ("ESPP") transaction is compensatory if the employee is entitled to purchase shares on terms that are more favorable than those available to all holders of the same class of the shares. Given the volatility of the stock market, in general, and the fact that such plans typically do not give the employee any discretion when to effect a purchase, the impact of any discount is difficult to measure and meaningless. Moreover, as discussed above, the balance sheet accounting for such discounts is

nonsensical. The recognition of an expense for a discount that does not result in the use of an asset or the incurrence of a liability is contrary to the concepts espoused by Con 6.

Attribution of Compensation Cost

Issue 9: For the reasons described in paragraphs C89–C91, the Board concluded that this proposed Statement would require a single method of accruing compensation cost for awards with a graded vesting schedule. This proposed Statement considers an award with a graded vesting schedule to be in substance separate awards, each with a different fair value measurement and requisite service period, and would require that they be accounted for separately. That treatment results in a recognition pattern that attributes more compensation cost to early portions of the combined vesting period of an award and less compensation cost to later portions. Do you agree with that accounting treatment? If not, why not?

Response:

As stated above, PNM disagrees with the concept of expensing stock options. If, however, this approach prevails, PNM especially disagrees with the attribution of expense for awards using a graded vesting method. PNM believes that a grant that vests over time is not in substance separate awards, but one award intended to be viewed by the employee as a single award earned over the vesting period. This is clearly espoused in most compensation philosophies. Accordingly, compensation cost should match the percentages of vesting for each period. There is no basis in the accounting literature to weight an expense in such a fashion if there are no attributes related to the expense to suggest that the benefit is obtained in a like weighted fashion. Requiring a graded vesting attribution method, as proposed in the Exposure Draft, would inappropriately weight expense in periods other than those in which service is rendered. The accounting literature describes three pervasive expense recognition principles - associating cause and effect, systematic and rational, and immediate recognition. Companies should be free to choose the attribution method that best matches the attributes of the award, and in the absence of any facts suggesting otherwise, a straight-line attribution method is appropriate. This approach is faithful to the accounting literature's freedom of choice with regard to expense recognition and customary practice of the use of the straight-line method.

Recognition of Tax Effects of Share Based Compensation

Issue 11: Do you agree with the method of accounting for income taxes established by this proposed Statement? If not, what method (including the method established in IFRS 2) do you prefer, and why?

PNM does not agree with the method of accounting for income taxes proposed in the Exposure Draft. The divergent methods for excesses and deficiencies is inconsistent with a desire to have a consistent accounting framework. We believe that it is inappropriate to account for tax benefit excesses and deficiencies, which are essentially identical in nature, differently, as proposed by the Exposure Draft.

The tax benefit excesses and deficiencies resulting from the expensing of stock options are caused by differences between GAAP and tax law. Such differences will always exist, as the method of calculating the book expense and the tax deduction are theoretically different. PNM believes that the most appropriate method is to match the tax accounting with the actual tax deduction - dollar for dollar. Any adjustment to accomplish this should be considered a change in estimate. This is consistent with the treatment of other permanent differences. These changes should be measured periodically. This will require companies to make an estimate of their future deduction at the date of the stock option grant. Any excess or deficiency should be recorded as an adjustment to equity. If the GAAP framework requires the expensing of stock options, it is then appropriate to recognize any resulting deductions in the tax accounting calculation. This approach is the most theoretically consistent with SFAS 109.

Additional Issue

Initial expense recognition for past awards

Notwithstanding PNM's stated position above, the modified prospective method is unfair and inconsistent with the typical transition provisions afforded such drastic changes in accounting principles. Companies with awards granted prior to the implementation date of January 1, 2005 should not be required to expense the unvested portion of the outstanding options upon adoption. These options were granted and valued under the then existing accounting principles. Management's decision regarding these grants can be assumed to have been influenced to a large degree by the existing accounting rules. Accordingly, the transition rules should exempt these unvested options, or at the very least allow the associated expense for these options to be reflected as a change in accounting principle.

Moreover, the transition rules should allow companies to revalue these unvested options using the methods espoused by the Exposure Draft instead of keeping with the previously allowed methods under SFAS 123. The current approach which carries over the expense previously determined under a different set of accounting rules is inconsistent with the financial reporting concepts of consistency and comparability.

PNM Resources appreciates the opportunity to respond to the Exposure Draft. We hope that our comments are helpful and spur some additional debate on the issue at hand. We look forward to working with the Board on future proposed pronouncements.

Very truly yours,

Thomas G. Sategna
Vice President and Corporate Controller
PNM Resources, Inc.