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Letter of Comment No: 65
File Reference: 1201-100
Date Received: 9-7-04

September 7, 2004

Technical Director – File Reference No. 1201-100 Financial Accounting Standards Board 401 Merritt 7, P.O. Box 5116 Norwalk, Connecticut 06856-5116

VIA ELECTRONIC MAIL

We are writing to provide comments on File Reference No. 1201-100, Exposure Draft of Proposed Statement of Financial Accounting Standards, Fair Value Measurements (the "ED"). Constellation Energy, a Fortune 500 company based in Baltimore, Maryland, is the nation's leading competitive supplier of electricity to large commercial and industrial customers and one of the nation's largest wholesale power sellers. Constellation Energy also manages fuels and energy services on behalf of energy intensive industries and utilities and owns and operates a diversified fleet of 35 power plants in 12 states. The company delivers electricity and natural gas through the Baltimore Gas and Electric Company (BGE), our regulated utility in Central Maryland. In 2003, Constellation Energy's combined revenues totaled \$9.7 billion.

Constellation Energy must apply fair value accounting on a regular basis, including the measurement of derivatives and recording impairments of long-lived assets. We support the FASB's efforts to address issues regarding fair value accounting on a comprehensive basis. Our comments are organized consistent with the issues presented at the beginning of the ED.

Valuation Techniques

Issue 2: This proposed Statement would clarify and incorporate the guidance in FASB Concepts Statement No. 7, Using Cash Flow Information and Present Value in Accounting Measurements, for using present value techniques to estimate fair value (Appendix A). Is that guidance sufficient? If not, what additional guidance is needed?

The ED discusses present value techniques for estimating fair value in Appendix A. Paragraphs A2(f) and A23 through A27 indicate that estimates of the fair value of a liability must include the effect of an entity's creditworthiness. While this approach has been included in Concepts Statement 7, for practical reasons certain liabilities recorded at fair value may not currently reflect the effect of an entity's creditworthiness. For example, such an adjustment may not be incorporated in the measurement of either (a) Level 3 derivative liabilities whose value can fluctuate from asset to liability from period to period and for which the probability of default is

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relatively low or (b) liabilities of entities which do not issue debt publicly and for which the determination of a credit adjustment may be relatively subjective.

If the provisions of the ED are adopted, it is our understanding that the final standard for the first time would explicitly incorporate into Level 1 GAAP the requirement to include the effect of an entity's creditworthiness in estimates of the fair value of all liabilities. Because entities may not be applying such a factor currently, the final standard should provide that the initial effect of incorporating an entity's creditworthiness in the valuation of liabilities should be reported as the cumulative effect of a change in accounting principle, similar to the proposed transition provisions for the effect of using bid and asked prices for valuations in dealer markets.

Pricing in Active Dealer Markets

Issue 7: This proposed Statement would require that the fair value of financial instruments traded in active dealer markets where bid and asked prices are more readily and regularly available than closing prices be estimated using bid prices for long positions (assets) and asked prices for short positions (liabilities), except as otherwise specified for offsetting positions. Do you agree? If not, what alternative approaches should the Board consider?

Mid-Market Pricing

Paragraph 17 of the ED indicates that, in active dealer markets where bid and asked prices are more readily and regularly available than closing prices, fair value shall be estimated using bid prices for long positions and asked prices for short positions. This approach is conceptually similar to the use of a "close-out cost adjustment" as recommended in the report *Derivatives Practices and Principles* issued by the Group of Thirty Derivatives Study Group. However, this guidance as proposed in the ED would only be applicable to this subcategory of contracts valued using Level 1 estimates of fair value and would not apply to derivatives for which fair value is estimated in other ways, for example, using closing market prices or Level 2 or Level 3 estimates.

Many entities that use derivatives currently have applied the guidance issued by the Group of Thirty and record a close-out cost reserve for all derivatives, regardless of how fair value is estimated. We believe that applying this approach to all open derivatives positions is conceptually supportable because it recognizes that, in order to close a risk position of any size, one must generally transact at a price that is less favorable than the most recent market quotation. Further, applying bid-offer pricing only to a subset of Level 1 contracts would be administratively difficult for those entities that manage risk on an aggregate basis using a variety of derivatives. For these reasons, we recommend that the final standard permit the application of bid-ask pricing in determining the fair value of all derivatives, regardless of which Levels of the fair value hierarchy are applied in valuing those contracts.

Determining Offsetting Positions

We support the provisions of paragraph 17 of the ED, which include an exception to bid-ask pricing in active dealer markets by permitting offsetting positions to be valued at mid-market prices. Note 8 to that paragraph states that "other pronouncements specify whether and, if so, when such offsetting is appropriate." However, the ED does not indicate what specific pronouncements would govern when offsetting is appropriate.

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For purposes of determining offsetting positions eligible for pricing at mid-market, we believe that the final standard should specify that offsetting should be determined on a risk basis and that it would not be appropriate for this purpose to apply the netting provisions of FASB Interpretation 39 (FIN 39), which relates to balance sheet netting of amounts due to and from two parties. Application of mid-market pricing should not be governed by credit netting provisions. Rather, mid-market pricing should be applied to offsetting risk positions based upon the existence of offsetting long and short positions for the same underlying and the same settlement period.

In the energy commodity markets, many transactions are executed in a brokered, over-the-counter or bilateral market. Among market participants, certain counterparties (such as generators of power) more consistently may be sellers of energy, while other counterparties (such as distribution companies) more consistently may be buyers of power. As a result, unlike financial instruments such as exchange-listed futures contracts, contracts for the purchase and sale of energy commodities are often executed with different counterparties and would not be eligible for balance sheet credit netting under FIN 39. However, if such purchases and sales are for the same underlying and settlement period, the effect of valuing such offsetting transactions at the bid and ask price would introduce an artificial "reserve" equal to the bid-ask spread that would only be reversed into earnings upon settlement of the contracts.

We believe that it would be inappropriate to apply bid-ask pricing to offsetting risk positions as described above because it would create artificial reserves on the balance sheet and result in deferral of the recognition of earnings until the settlement of contracts. In order to avoid doubt as to the intent of paragraph 17 of the ED, we recommend that any requirement in the final standard to use bid-ask pricing specifically provide that offsetting positions should be determined on a risk basis and not on the basis provided for credit netting on the balance sheet under FIN 39.

Fair Value Disclosures

Issue 11: This proposed Statement would require expanded disclosures about the use of fair value to remeasure assets and liabilities recognized in the statement of financial position. Appendix B illustrates those disclosures. This proposed Statement also would encourage disclosures about other similar remeasurements that, like fair value, represent current amounts. The Board concluded that those disclosures would improve the quality of information provided to users of financial statements. Do you agree? If not, why not?

The ED specifies certain required disclosures about fair value in paragraph 25 and illustrates those disclosures in paragraphs B22 and B23. We have several concerns about these proposed disclosures as described below.

Disclosure Table for Assets and Liabilities Remeasured on a Recurring Basis

The proposed disclosure table for assets and liabilities remeasured at fair value on a recurring basis as illustrated in paragraph B22 is similar to disclosures presently required by SEC release FR-61 governing trading activities. This raises the potential for duplicative disclosures for public companies with trading activities. Further, the definition of fair value and the three levels of the fair value hierarchy in the ED differ in some respects from the three categories of valuation methodology required under the FR-61 disclosures. As a result, there is the potential for conflict between two similar disclosures that could lead to confusion for financial statement users.

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We recognize that the SEC and the FASB promulgate accounting and disclosure standards under different frameworks, and those standards may differ in their objectives and specific provisions. However, in a situation such as this where the ED's proposed disclosures overlap and conflict with existing SEC disclosure requirements, we request the FASB to coordinate the final provisions of its document with the SEC to the greatest extent possible in order to minimize the potential for conflicting disclosures that could result in confusion for financial statement users.

Basis for Assigning Fair Value Between Hierarchy Levels

The ED does not explicitly indicate how the fair value of assets or liabilities should be assigned among the three levels in the fair value hierarchy for purposes of disclosing how fair value is determined. We believe that the final standard should explicitly recognize that the classification of the fair value of assets and liabilities between the various levels in the fair value hierarchy should be presented in accordance with an entity's risk management practices with appropriate disclosure of the basis of presentation. We are aware of at least two potential bases of presentation that could occur, and we believe that either should be permitted:

• By Settlement Period – Under this methodology, the fair value of individual contracts is segregated between each of the levels in the fair value hierarchy based upon the availability of market information for each settlement period within each contract. For example, a five-year natural gas purchase contract may be valued using exchange-quoted prices for two years, over the counter bid-ask quotes for two years, and management extrapolation of prior period data for the last year. For that contract, the first two years would be classified as Level 1, the second two years as Level 2, and the final year as Level 3 in the disclosures of how fair value was determined.

We believe that the primary objective of reporting the components of fair value among each of the levels in the valuation hierarchy is to identify the relative subjectivity exercised in determining the fair value of an entity's assets and liabilities. We believe that the settlement period approach is consistent with that objective. Reporting the determination of fair value by settlement period across contracts provides the financial statement user with a detailed view of the basis underlying the determination of fair value and is especially important in industries such as the energy industry where many contracts span periods that require the use of more than one level of the hierarchy to determine fair value.

• By Contract - Some entities may not have the systems and procedures required to identify by settlement period the components of fair value between each of the hierarchy levels and may even obtain fair value amounts by requesting quotations from third parties on a periodic basis for financial reporting purposes. In such situations, an alternative presentation would be to classify the fair value of an entire contract based upon the most subjective level in the hierarchy used to determine fair value. Thus, for the same five-year gas contract described above, because the fair value of the entire contract is not observable in either an identical or similar market where the differences are objectively determinable, the fair value of the entire contract would be classified as Level 3.

Presenting this disclosure on a contract-by-contract basis provides a more conservative indication of the relative subjectivity in the determination of fair value amounts. Because

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this requirement would result in disclosure of an entire contract's value based upon the most subjective method used to value its components, the reported breakdown between the fair value hierarchy levels may overstate the inherent subjectivity actually involved in determining the fair value of such contracts. However, for entities for which the settlement period approach is not practical, we believe that this approach is a reasonable alternative presentation.

The determination of fair value inherently is a matter of judgment, particularly in industries where physical (i.e., non-financial) commodity contracts must be classified as derivatives and recorded at fair value. Those derivatives often are not traded on an exchange or actively quoted in a dealer or broker market and may require the use of multiple elements of the valuation hierarchy to determine fair value for a single contract. We recommend that the final standard explicitly permit entities to make the required disclosures about how fair value is determined on a basis consistent with how they manage their business and their risk positions, including either of the two bases described above. We believe that it would be appropriate to require each entity to disclose the basis upon which it presents these disclosures.

Reporting Unrealized Changes in Fair Value During the Period

The ED includes a requirement to disclose unrealized gains and losses during the period only for assets and liabilities held at the end of the period. Limiting this disclosure to unrealized gains and losses relating only to assets and liabilities held at the end of the period would inappropriately exclude changes in the fair value of assets and liabilities disposed prior to the end of the period and would be administratively difficult to implement.

Conceptually, unrealized changes in fair value during a period are more reflective of the effect on earnings or comprehensive income of assets and liabilities measured at fair value than are realized transactions, which merely represent the exchange of one asset or liability for another or for cash. The proposed disclosure would be analogous to disclosing sales associated only with accounts receivable as of the end of the period, or expenses only associated with accounts payable at the end of the period, and provides an incomplete perspective of the effect of fair value measurements on earnings. We believe that all unrealized changes in fair value, including unrealized gains and losses from assets and liabilities recorded at fair value but settled or disposed prior to the end of the period, are a more complete indicator of the effect of such items on earnings and comprehensive income, especially for derivative contracts.

Further, from a practical perspective, many companies account for all unrealized changes in fair value in the aggregate, and it would not be practical or cost-effective to segregate such amounts between assets and liabilities held at period-end versus those held at some time during the period but disposed before period-end. This is particularly true for entities that engage in a substantial amount of hedging or trading activities involving a large volume of contracts.

While not explicitly articulated in the ED, we believe that the apparent purpose of the proposed requirement to disclose unrealized gains and losses is to identify for the financial statement user the effect on earnings and comprehensive income of unrealized changes in assets and liabilities that are recorded at fair value during the period. The ED asserts in paragraph C66 "that because the disclosures required by this Statement rely largely on information used to develop the related fair value measurements, entities should have the information necessary to make the disclosures."

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With respect to the proposed disclosures for unrealized gains and losses, that would not be the case without significant additional effort not currently required in the management of our business. Therefore, we believe that the disclosure of unrealized gains and losses should apply to the entire unrealized change in fair value of all such assets and liabilities held during the period, not just those held at period end.

Assets and Liabilities Remeasured on a Nonrecurring Basis

Paragraph 25(b) of the ED specifies disclosure requirements for "assets and liabilities that are remeasured at fair value on a nonrecurring (or periodic) basis *during the period*" (emphasis added). We agree that this disclosure should be limited to those items for which a remeasurement has occurred during the period; disclosing the fair value amounts of all assets and liabilities that *potentially* could be remeasured at fair value (for example, all long-lived assets subject to impairment testing) would be burdensome and would clutter the financial statement notes with information that is not necessary. We believe that the final standard should clarify that this disclosure requirement of paragraph 25(b) only applies to those assets or liabilities for which a remeasurement at fair value has occurred during the period in order to eliminate doubt as to the applicability of these disclosures.

Other Issues

Issue 13: This proposed Statement represents the completion of the initial phase of this project. In subsequent phases, the Board expects to address other issues, including issues relating to the relevance and reliability of fair value measurements and the unit of account that should be used for those measurements. What, if any, other issues should the Board address? How should the Board prioritize those issues?

The ED indicates that the FASB will consider issues relating to the relevance and reliability of fair value measurements in the next phase of this project. We believe that consideration of these issues is very important. We encourage the FASB's efforts to ground financial accounting standards in conceptually supportable and consistently applied concepts, but we also believe that there is a need to balance theoretically ideal applications of fair value measurements with the important objectives of relevance, reliability, transparency, and the reduction of unnecessary complexity.

The use of fair value as a measurement basis has been implemented on a standard-by-standard basis; for example, fair value measurements are mandated in standards governing accounting for derivatives, impairments of long-lived assets, and asset retirement obligations, among others. The process of adopting these standards properly included significant deliberation regarding the merits of using fair value measures and the extent to which such measures should be applied. We are also aware that other future projects will consider the extension of the required use of fair value measurements, such as for all financial instruments.

As financial statement preparers, auditors, and users have gained experience with the application of fair value measurements under existing standards, it is likely that practical application issues that may not have been anticipated during the adoption process for these standards have been identified related to the relevance, reliability, complexity, and transparency of such measures. Therefore, we recommend that the FASB investigate the extent to which experience with existing

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requirements for the use of fair value measurements may have identified such practical considerations that should be evaluated in the next phase of the project, both for application to existing standards as well as for use in developing new standards that involve fair value measurements.

We support the FASB's on-going efforts to establish accounting principles that are grounded on a sound conceptual basis and to balance those concepts with practical considerations. We believe that it is particularly important to a comprehensive project on the application of fair value measurements to examine this balance thoroughly in order to assure that fair value remeasurement requirements are developed with due consideration of both theoretical support and practical considerations.

We appreciate the opportunity to provide our views on these important matters.

Very truly yours,

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