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January 31, 2007

LETTER OF COMMENT NO. 13

Mr. Lawrence Smith  
Director, Technical Application and Implementation Activities  
Financial Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
Norwalk, Connecticut 06856-5116

**VIA ELECTRONIC MAIL**

**RE: Proposed FASB Staff Position FIN 39-a  
Amendment of FASB Interpretation No. 39**

Dear Mr. Smith:

Constellation Energy Group, Inc. (Constellation Energy) appreciates the opportunity to respond to the Financial Accounting Standards Board's (FASB) request for comments on the Proposed FASB Staff Position (FSP) FIN 39-a, *Amendment of FASB Interpretation No. 39*. We understand that FIN 39, as a result of this FSP, will be amended to allow a reporting entity to offset fair value amounts recognized for the right to reclaim cash collateral or the obligation to return cash collateral against the fair value amounts recognized for derivative instruments executed with the same counterparty under a master netting arrangement.

We support the FASB's consideration of netting fair value cash collateral with the fair value of derivative positions. Our principal recommendation is that the decision to net fair value cash collateral with fair value derivatives should be an accounting policy election by the individual companies, subject to appropriate disclosure, and not made a requirement for netting the derivative fair value amounts. Therefore, we disagree with the provision of the proposed FSP that would *require* the netting of fair value cash collateral if fair value derivative positions that are part of master netting arrangements are netted.

We have the following specific comments on the proposed FSP.

**Netting Derivatives and Collateral Should be Independent Elections**

According to the proposed FSP, "a reporting entity shall not offset fair value amounts recognized for derivative instruments without offsetting fair value amounts recognized upon payment or receipt of cash collateral against that net amount" (footnote 5). We understand this to mean that an entity would be required to net fair value cash collateral if the entity wants to net the derivative position and that the derivative transaction amounts themselves could not be presented net if fair value cash collateral were not also offset.

We believe that the decision to offset fair value cash collateral against derivative positions should be made as an election that is independent of whether to offset the derivative positions themselves. Entities that elect to net the fair value of derivatives should not be required to net collateral against those amounts. We do not believe that it is appropriate to require entities to net collateral as a condition for netting derivatives amounts for several reasons:

- The derivative and the collateral are fundamentally different instruments with different purposes. Because of the fundamental differences between the fair value amounts associated with the transaction as compared with the balances associated with credit mitigation, we believe that decisions about offsetting of the derivatives should be independent of whether collateral (fair value or otherwise) is offset and that there should not be a requirement to offset the transaction risk exposure with the credit risk mitigant on the balance sheet. In this regard, we disagree with the statement in paragraph 4c of the FSP (amending paragraph 10 of FIN 39) that “offsetting the fair values recognized for derivative instruments outstanding with a single counterparty and fair value amounts recognized upon payment or receipt of cash collateral results in the net fair value of the position between the two counterparties being reported...” This implies that transactions with fair value cash collateral have different fair values than those which do not involve collateral or have other types of collateral.
  - The derivative position represents the transactional risk exposure of an arrangement measured at fair value with changes reported in earnings or accumulated other comprehensive income – it is the transaction.
  - By contrast, the collateral (if any) represents a mitigant to counterparty credit risk that tracks the fair value of the transaction but is not a component of the underlying economics of the transaction, nor does it provide the potential for gains or losses, other than to mitigate potential credit loss.
  - While the net asset or liability that would result from applying the provisions of the proposed FSP represents the amount that would be paid or received if fair value cash collateral (and no other collateral) were used to satisfy the derivative, the existence of fair value collateral does not change the economic exposure of the transaction to changes in the fair value of the underlying.
- Reducing derivative amounts only by the amount of fair value cash collateral is not an accurate measure of credit exposure, as many arrangements require collateral posting only after a certain threshold is exceeded. While there may be a basis for permitting netting under FIN 39 if all of the other requirements of that interpretation are met, netting only fair value cash collateral does not necessarily present the actual credit exposure of the transaction, and presentation of net credit risk should not be the basis for a decision to require netting of fair value cash collateral, particularly when key components of credit exposure (non-fair value cash collateral and other credit mitigants) are not reflected.
- While we recognize that, without regard to paragraph 5c, FIN 39 allows fair value amounts recognized for derivative instruments to be offset under a master netting arrangement without the “intent to set off”, in practice, collateral is rarely settled net, unlike derivative instruments. Derivatives are routinely net settled for payment purposes. However, under normal operations the collateral routinely is not expected to be used to satisfy the derivative – it is simply protection against a possible default, which is rare. Collateral often may be settled even while the related derivative positions remain open simply due to market price movements that reduce or eliminate the credit exposure. Further, even when the derivative transactions themselves are netted at the time of ultimate settlement, it is likely that the entity may settle the collateral separately from the transaction. Given that the circumstances in which collateral is actually settled against the related derivatives are rare, the FSP should not require entities to net fair value cash collateral when there is no intent to do so and its past practices show a history of settling collateral separately from the derivative position. Certainly this should not be a basis for essentially prohibiting the

continuation of an existing practice of netting derivative amounts without also netting collateral.

- We also believe there are practical constraints that support making the decision to offset collateral elective.
  - Derivatives that qualify and are accounted for as normal purchases and normal sales (NPNS) often are included in the same master netting arrangement and share the same total collateral with derivative instruments that are recorded at fair value on the balance sheet. The allocation of that total collateral between the recognized fair value derivative instrument and an unrecognized NPNS instrument would require additional administrative and financial reporting efforts and may produce a less meaningful result when there are multiple accounting treatments covered by the master netting arrangements.
  - Our industry generates, produces, and physically delivers commodities and uses derivative instruments to help manage the associated risks. Risk management systems outside the financial services industry may not be equipped to handle the type of net reporting that would be mandated by the proposed FSP. Many risk management systems do not track collateral with individual transactions and trades in an interrelated fashion. Additionally, collateral positions are periodically reviewed with the counterparty based on monthly net derivative positions. The collateral amount is then adjusted accordingly and is reported as one amount. This can cause additional administrative difficulties in knowing against which specific derivative positions (e.g., current vs. non-current) on the balance sheet to net the collateral each month.

While we are not recommending additional disclosures, we believe that if a primary objective in requiring netting of fair value cash collateral is to present net credit risk, disclosure would be a preferred method to make this presentation. In many other instances, collateral is not presented net against the associated exposure (for example, debt secured by mortgages on property, plant, and equipment), and the FSP itself would not permit net presentation of cash collateral that is not a fair value amount. In fact, credit exposure disclosures already exist for entities subject to public company reporting requirements. There is required disclosure in Management's Discussion & Analysis where an entity is to report its market risks and credit risks. We believe that, if the objective is to provide disclosure of the net credit exposure associated with derivative transactions, it would be appropriate to have a similar disclosure within the footnotes to the financial statements, and that disclosure could cover all credit mitigants, not just fair value cash collateral. However, we do not believe that is appropriately addressed as part of this FSP and should not be the basis for required offset of fair value cash collateral.

Based on the reasons set forth above, we believe that the decision to offset fair value cash collateral against the derivative position should be an election that is independent of whether to offset the derivative positions themselves, subject to disclosure of the policy elected. With this election, an entity would then have the option to net derivative positions on the balance sheet without being required to net the cash collateral. An entity should be required to disclose its accounting policy election for collateral, just as it is presently required to do under FIN 39.

Finally, notwithstanding our comments, if the Board retains this provision of the FSP, we believe that this requirement, which is substantive, should be articulated more directly and made explicit in the main body of the FSP rather than in a footnote as it is presently codified.

### **Definition of Fair Value Cash Collateral**

According to the proposed FSP, the offsetting of fair value amounts recognized for the right to reclaim cash collateral or the obligation to return cash collateral with the fair value derivative

positions specifically requires that the cash collateral be a “fair value” amount. Paragraph A3 of the proposed FSP provides some insight into the apparent definition of this term: “...the receivable or payable associated with cash collateral is conditional because the amount of the receivable or payable **varies based on changes in the net fair value of the related derivative instruments subject to the same master netting arrangement** [Emphasis Added].” This provision appears to indicate that cash collateral is a “fair value amount” if it fluctuates commensurate with the level of the fair value derivative position. However, given that the determination of whether collateral is a “fair value amount” is a significant decision in determining whether collateral amounts are within the scope of this FSP, we believe that the definition of “fair value amount” should be made explicit in the body of the FSP.

### **Balance Sheet Classification**

The netting of fair value cash collateral with the fair value of derivative contracts on a classified balance sheet could lead to diversity in practice in the absence of principles or specific guidance as to how to apportion the collateral between the current and non-current categories. While in theory it may be appropriate to apportion the collateral between these categories, we believe that allocation exercise could be time-consuming and administratively burdensome, especially to the extent that there is a significant number of master netting arrangements, multiple accounting treatments covered by those arrangements, or both.

We propose that the collateral should *first* be netted against the non-current fair value derivative position to the extent of the amount of the non-current fair value of the derivative position and *then* to the current portion of the fair value derivative instruments, if needed. We believe that this reflects the true nature of fair value of collateral – if there are non-current fair value amounts to which the collateral relates, the collateral will not be eligible for return as long as those amounts remain outstanding. This proposal aligns with one of the working principles decided in Phase B in the Board’s current project on Financial Statement Presentation: the placement of items on the balance sheet should “help the user assess the liquidity of an entity’s assets and liabilities ...” Liquidity is often measured by the level of working capital (current assets less current liabilities). By attempting to keep current assets and liabilities limited to the current amount of derivative positions, excluding cash collateral, an entity’s liquidity can be better assessed by the user.

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In summary, while we support the premise that netting fair value cash collateral amounts against related fair value derivatives could be appropriate, we believe that this treatment should be elective and should be independent of the election under FIN 39 as to whether or not to net the underlying derivative fair value amounts.

We appreciate the opportunity to comment on this proposed FSP.

Sincerely,

/s/ Reese Feuerman  
Vice President & Controller

/s/ Randall Hartman  
Assistant Controller – Accounting Policy & Research