Matt Simmons
Vice President & Controller
Tel. 610.774.3552 Fax 610.774.6092
jmsimmonsjr@pplweb.com

PPL Corporation
Two North Ninth Street
Allentown, PA 18101-1179
Tel. 610.774.5151
http:// www.pplweb.com

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Technical Director – File Reference No. 1590-100
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116
(e-mail: director@fasb.org)

LETTER OF COMMENT NO. 43

Dear Technical Director, Board members and Staff:

RE: Proposed Statement of Financial Accounting Standards, *Accounting for Hedging Activities, an amendment of FASB Statement No. 133*

PPL Corporation (PPL) appreciates the opportunity to comment on the proposed Statement of Financial Accounting Standards, *Accounting for Hedging Activities – an amendment of FASB Statement No. 133*, which would amend the accounting for hedging activities in FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and other related literature.

PPL is an energy and utility holding company. Through its subsidiaries, PPL controls more than 11,000 megawatts of generating capacity in the United States, sells energy in key U.S. markets, and delivers electricity to about four million customers in Pennsylvania and the United Kingdom.

PPL uses derivatives extensively to hedge its commodity, interest rate and foreign currency risks. Many of these contracts qualify as cash flow hedges or fair value hedges, but others do not even though they significantly hedge a known exposure. Derivative contracts can be very complicated, and the intricacies involved in qualifying for hedge treatment and testing effectiveness are many and complex, even to those who specialize in derivative accounting or risk management. The sheer volume of rules and interpretations increases the chances of differing or mistaken accounting treatment. As a result, we appreciate how difficult it is for users of financial statements to understand the true economics and risks from an entity's portfolio of derivative instruments.

Therefore, PPL appreciates the Board's consideration of this issue and agrees with the Board's objectives to simplify accounting for hedging activities, improve financial

reporting of hedging activities, address and resolve major practice issues related to hedge accounting, and address differences resulting from recognition and measurement anomalies between the accounting for derivative instruments and the accounting for hedged items. However, while the proposed changes may address some of the deficiencies and complexities of the current rules, we believe that the proposed changes also create several significant issues that offset the expected benefits. The proposed changes may simplify the criteria to qualify for hedge treatment but will make the measurement of effectiveness more complicated. If implemented as proposed, this guidance will discourage the use of economic hedge activities because of the potential for volatility in earnings. Additionally, we are concerned that the expected benefits do not outweigh the incremental cost to implement the proposed changes. Therefore, we do not support certain concepts in the proposed standard as currently drafted, particularly in view of a potential convergence of accounting standards with International Financial Reporting Standards (IFRS) that will create comparability issues for financial statement users.

Hedgeable risks

We are concerned about the proposed elimination of an entity's ability to hedge individual risks as the hedged risk, particularly the benchmark interest rate in a cash flow hedge or a fair value hedge. Currently an entity is able to hedge all or a portion of its exposure to changes in the benchmark interest rate through the use of derivative instruments, but generally does not have the ability to hedge changes in its entity-specific credit spreads. Since the benchmark interest rate is inherent in both the hedging instrument and the hedged item, any volatility in an entity's credit spreads would result in ineffectiveness if the requirement to assess effectiveness based on the total risk underlying the hedged item is adopted. If this volatility is substantial, as has been observed in the recent credit markets, it is very likely that an interest rate derivative would not qualify for hedge accounting, even under the proposed *reasonably effective* assessment guidance.

Entities that choose to continue to hedge risk related to the benchmark interest rate could effectively be penalized by earnings volatility, even if they qualify for hedge accounting treatment. However, entities not electing to hedge will not incur such a volatility penalty to earnings by leaving identifiable risk exposures unmanaged. We believe it is misleading to investors if ineffectiveness resulting from changing credit spreads, which is generally unhedgeable, is reflected in earnings for entities that continue to elect to manage interest rate risks through hedging despite the volatility penalty.

Finally, valuing the change in creditworthiness will often be based on unobservable data and will not result in improved financial reporting. Many entities do not have publicly traded debt or, for those that do, such debt may not trade on a regular basis in a secondary market. Additionally, as a result of new issue premiums generally demanded by investors, the credit spread priced on new debt issuances generally does not equal the credit spread priced on existing debt trading in a secondary market. Because the valuation may be hypothetical and the accounting results may be inconsistent with

management's intents or risk programs, we believe entities will be less likely to pursue economic risk management strategies.

Therefore, we recommend that the ability to hedge the benchmark interest rate be retained.

Threshold for hedge effectiveness

We agree with the Board's proposal to modify the effectiveness threshold from *highly effective* to *reasonably effective* at offsetting changes in the fair value or cash flows of the hedged exposure. The current requirements cause many derivative contracts that provide a significant offset to changes in the hedged exposure to be marked to market through earnings under the current accepted interpretation of the *highly effective* threshold. In fact, hedges that are essentially identical in effectiveness can receive very different accounting treatment depending on whether the quantitative assessment of effectiveness is slightly above or slightly below the effectiveness threshold. As such, PPL and many other companies must provide additional disclosures to help users of the financial statements properly evaluate the effectiveness of management's risk management activities. The financial statements would have more transparency and clarity if similar hedging activity received the same accounting treatment. An example of this hedging activity involves written options. Energy companies who own generating assets have, as their natural risk position, a purchased call on the energy from the generating assets. The most appropriate risk management activity would be to sell an offsetting call; yet, written options rarely qualify for hedge treatment. We believe that hedge accounting treatment for written options would be acceptable under the *reasonably effective* threshold. If the Board concurs, we recommend that the final standard include an example of this activity.

We are concerned, however, that a new "bright line" representing *reasonably effective* may evolve. Already we've heard 50%-150% mentioned casually. Because entities must ultimately reflect all entity operations as discrete values, and audit firms must opine that those values were prepared in accordance with GAAP, we believe that the trend towards a bright line is inevitable without clarifying principles and/or examples from the Board. We recommend that the final standard clarify that management's judgment of all relevant facts and circumstances is a key determinant in assessing whether a hedge is *reasonably effective*.

Frequency of hedge effectiveness assessments

At a minimum, we agree with the Board's objective to require reassessment of hedge effectiveness only in the event circumstances suggest that the hedging relationship may no longer be reasonably effective. Additionally, PPL would support a decision to not require reassessment of the hedge under any circumstances after inception if it is determined at inception that the hedging relationship is expected to be reasonably effective over the duration of the hedge. We believe that the performance of hedges is monitored for risk management purposes, regardless of the accounting classification. If a hedge is no longer reasonably effective, management has the option to settle or offset the derivative to address the economics caused by the breakdown between the hedge and the

underlying exposure. Conversely, if the derivative is continued – perhaps because management believes that the changed circumstances are temporary – the financial statements would accurately reflect the temporary, large portion of ineffectiveness.

This approach would eliminate the need to define triggering events, which could easily result in a de facto quantitative bright line test for determining when reassessment is required in order to provide assurance that the hedging relationship is expected to remain reasonably effective. We believe that this would be inconsistent with the principles articulated in the proposed guidance. Accordingly, we ask that the Board reconsider its decision to require hedge effectiveness assessments after inception.

Means of assessing effectiveness

Paragraph 6 of the proposed standard would permit entities to assess effectiveness using qualitative means, although, in certain situations, a quantitative assessment may be necessary. While the proposed guidance may lessen the complexity of hedge accounting treatment for certain derivative instruments, we do not believe the proposed guidance will simplify the hedge effectiveness assessments for commodity positions. PPL participates in markets for electricity, gas, oil, emission allowances and other products on a daily basis, and the relationships among these energy commodities are in constant flux. To prove that a derivative provides a reasonably effective hedge at inception, PPL will need to continue its current routine quantitative assessments, and we believe this to be true of other entities that use commodity derivative contracts. As such, this offered simplification may not significantly reduce the time and complexity associated with hedge effectiveness assessments.

Assumption that a hedge is perfectly effective

The proposed elimination of the critical terms matching and short-cut methods would seem to eliminate the misinterpretation and subsequent misapplication of these methods for assessing and measuring ineffectiveness. However, there are many situations in the energy industry when the derivative instrument perfectly matches the hedged exposure, particularly when physical derivatives are used. Examples include the forward purchase of electricity with the title transfer at the load zone where the hedged exposure is, or the forward sale of electricity at the point where the generating unit connects to the electricity grid. These contracts may qualify as "all-in-one hedges" as currently permitted by DIG Issue G2, *Cash Flow Hedges: Hedged Transactions That Arise from Gross Settlement of a Derivative ("All-in-One" Hedges)*, provided that gross settlement is assured. If the proposed elimination of these methods is adopted, entities will no longer be able to assume that the change in the hedged item is equal to the change in the derivative; therefore, entities will need to develop the methodology and analytics for conducting initial effectiveness testing and subsequent measurement of ineffectiveness, which may require significant investment in systems for a change that seems to be a matter of form over substance.

Dedesignating a hedging relationship
We understand the Board's rationale to prohibit the dedesignation of hedges simply because the entity chooses to remove the designation: since the economics of the relationship between the hedging instrument and the underlying exposures have not changed, it seems that the accounting should not change. That may be true of a single derivative, but dynamically managing a portfolio of derivatives becomes much more complex, and a prohibition on voluntary dedesignations does not take that into account. We believe that there are instances when dedesignations without terminating or offsetting derivatives are appropriate. For example, an entity may designate a NYMEX-traded gas contract as a hedge of delivered gas at a particular plant. When market conditions change, the entity may choose to dedesignate the contract at that plant and redesignate for another plant. This would be prohibited under the proposed guidance.

Also, the proposed guidance states that a hedging derivative may be considered to be effectively terminated when an offsetting derivative instrument is entered into: however, concurrent documentation of such effective termination is required to terminate the hedging strategy. An offsetting derivative is expected to offset future changes in the cash flows or fair value of the original derivative. However, this guidance does not fully address market realities; for example, PPL, in managing its energy positions, may intend to enter into derivative contracts that offset existing hedges, but due to market conditions may have to enter into a series of derivative contracts over time that, when aggregated, offset the original position. The proposed guidance implies that this practice would not be considered a dedesignation until all the offsetting contracts were aggregated.

Finally, we note that the proposed prohibition on dedesignations would supersede DIG Issue H7, *Foreign Currency Hedges: Frequency of Designation of Hedged Net Investment.* That guidance allows entities to use one derivative to hedge a net investment in a foreign entity with full recognition that, as the net investment varies over time when earnings, dividends and other capital transactions occur, a portion of the hedge can be dedesignated and redesignated. A common practice is to dedesignate a portion of the net investment hedge equal to declared dividends to mitigate the effect on earnings due to the translation of the dividend receivable. We believe that this practice appropriately reflects the true net economics of the transactions and should continue to be permitted.

In summary, we believe that this prohibition is inconsistent with the Board's objective to simplify and facilitate the continuation of hedge accounting. If such a change is adopted, it will severely limit entities' ability to obtain hedge accounting for dynamic hedging programs or will result in the entities incurring real incremental costs to transact externally to accomplish the same result. We believe these changes are unnecessary and outside the stated objectives of the exposure draft; accordingly, we strongly recommend that the current practice for dedesignation and redesignation be retained.

Transition
Under the proposed transition guidance, an entity is not required to dedesignate a hedging relationship if the designated risk or risks being hedged are permitted before and after the

effective date of this proposed guidance (such as benchmark interest rate risk hedges of an entity's own debt). For hedges of the benchmark interest rate risk of an entity's own debt initiated prior to transition, the hedging relationship need not begin at inception of the debt. The dedesignation exception also would apply to a benchmark interest rate hedge related to an entity's own debt that was accounted for under the shortcut method. Although dedesignation would not be required for those situations, prospective accounting using the shortcut method would not be permitted.

We do not believe that it is necessary or appropriate to dedesignate and redesignate other hedging relationships that require new documentation to comply with the amended guidance. Given the *reasonably effective* threshold for designation as a hedge, we believe that a majority of hedge relationships would qualify for hedge accounting after the effective date. However, dedesignation and redesignation would require entities to capture and reflect time value associated with the non-zero fair value of their hedges at the time of transition, introducing ineffectiveness unrelated to any substantive change in the hedging relationship.

We believe it would be more practical and less costly simply to require hedging relationships to be evaluated at the effective date to ensure that they comply in all respects with the substantive provisions of the revised guidance. If so, the hedge documentation would be updated without dedesignation and redesignation. We do not believe that any benefit would be obtained by introducing additional ineffectiveness into financial statements for existing hedge relationships when such ineffectiveness really only reflects the mechanics of adopting prospective changes in the computation of ineffectiveness.

Convergence with IFRS

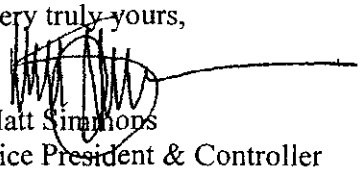
We noted, and concur with, the views of the two dissenting Board members regarding the likelihood that U.S. public companies will adopt IFRS in the foreseeable future. With that pending transition, it does not seem prudent to require a transition to new hedge accounting rules only to transition again when IFRS becomes mandatory. A possible outcome is that the accounting for a long-term contract would be done under today's requirements, then changed to reflect this proposed guidance, and changed again to reflect International Accounting Standard 39, *Financial Instruments: Recognition and Measurement*. A final change in accounting may be required depending on the outcome of the International Accounting Standard Board's (IASB) discussion document on accounting for financial instruments at fair value. We are convinced that the frequent changes in accounting requirements will not add clarity and transparency to financial statement users. Additionally, implementation of the new guidance will require significant efforts to create and document new hedge designations, revised valuation methodologies, long haul models, and revisions to accounting procedures, internal controls and systems. We remain highly uncertain that the expected improvements to the financial statements will be great enough to warrant this effort.

In summary, we believe that any material changes to current GAAP hedge accounting rules should be part of a joint project with the IASB. We are concerned that the IASB will not adopt guidance similar to that the proposed changes, which would require additional significant resources to comply with IFRS.

Summary

We would like to thank the Board for the opportunity to share our views on this major accounting issue and would welcome further discussions with the Board to ensure that our perspectives are fully understood.

Very truly yours,



Matt Simmons
Vice President & Controller

cc: Mr. P. A. Farr
Mr. J. E. Abel
Ms. M. A. Calder
Mr. M. A. Cunningham
Ms. K. A. Durn
Mr. V. Sorgi
Ms. K. S. Walker
Mr. M. D. Woods