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LETTER OF COMMENT NO. 22



**EDISON ELECTRIC
INSTITUTE**

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March 2, 2007

Ms. Suzanne Bielstein
Director – Major Projects and Technical Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Subject: File Reference No. 1510-100

Dear Ms. Bielstein:

The Edison Electric Institute (EEI) appreciates the opportunity to comment on the Financial Accounting Standards Board's (FASB or the Board) Exposure Draft of proposed Statement of Financial Accounting Standards (SFAS), *Disclosures about Derivative Instruments and Hedging Activities an amendment of FASB Statement No. 133* (the ED).

EEI is the association of the United States shareholder-owned electric companies, international affiliates and industry associates worldwide. Our U.S. members serve 92 percent of the ultimate customers in the shareholder-owned segment of the industry, and 67 percent of all electric utility ultimate customers in the nation. They generate almost 60 percent of the electricity generated by U.S. electric generators.

Summary of Key Comments

We have listed below our main concerns regarding the proposed additional disclosure requirements:

- The scope and specific requirements of the ED are overly broad, and would result in overly complex disclosures for the energy industry's generally accepted business practices.

- Based on the examples provided in the ED, the proposed disclosures appear to work well for Treasury-like transactions – where the number of risk mitigation strategies is limited (such as fixing the interest rate on anticipated issuance of debt or a foreign currency rate for a specific purchase, etc.). However, for commodity transactions that span numerous products and delivery locations, there may be a significantly greater number of discrete risk mitigation strategies (such as the energy price risk on anticipated sales at a particular delivery location, the oil price risk on anticipated purchases at some other delivery location, etc.) leading to potentially voluminous disclosures that are less clear and may confuse financial statement readers through the considerable number of data points that are required to be provided.
- As proposed, competitively sensitive information would be disclosed. The proposed level of detail required in disclosures may be used with other footnote disclosures and analyses contained within MD&A which inadvertently requires the disclosure of competitively sensitive information.
- Disclosing gross notional and fair value amounts will not meet the desired objective of providing useful information about entities' exposure to risk from derivatives, as they are likely to overstate the entity's actual market and credit risk exposures by showing large notional or fair value positions when the net risk position could be relatively small.
- Alternative disclosures, similar to or in harmony with those required in the Securities and Exchange Commission (SEC) FR-61 section II (B) and Regulation S-K Item 305 for market risk, may be more appropriate. The current SEC requirements give preparers alternative presentations from which to choose to minimize the risk of disclosing competitively sensitive information and to provide the financial statement readers with information that best aligns with how risks are managed.
- The proposed disclosures will require significant system and process changes to implement because this is not information currently used by management in the operation of the business or evaluation of its financial performance. For a calendar year company, the information is required to be disclosed for 2007, and we have not yet begun to accumulate information in the format required.
- Given the extent of the proposed disclosures, the changes required to implement them, and other standards that must be implemented by the end of 2007 (e.g., SFAS 157), a December 31, 2007 effective date is not realistic, and

the effective date should be extended to the first reporting period after December 31, 2008.

- These disclosures should only be required for every annual period and not for each interim period.

Overall, we believe that the disclosures included in the ED will not meet the desired objective, that the cost of implementing this ED, as it is presently proposed, may outweigh the benefits, and that the disclosures already addressed by new Statements 157 and 159 and the other Management's Discussion and Analysis disclosure requirements discussed below are sufficient.

In addition to the specific issues listed in the ED, which we address later in this letter, the following comments expand further on several of the above concerns.

Business Practices Involving Derivatives

The use of derivative instruments in general business operations is becoming more and more common as companies choose to mitigate their perceived risks by managing exposures. Risk is a perception of the user, as the FASB recognized by allowing both fair value hedges and cash flow hedges. With significant accounting movements towards fair value accounting, permitting companies to elect to record non-derivative instruments at fair value, we believe the extent and complexity of the proposed disclosures in the ED are disproportionate to the key fair value disclosures covered by SFAS 157 and SFAS 159. We do not believe that it is necessary or appropriate to single out derivative instruments for such extensive additional disclosure.

Disclosure of Competitively Sensitive Information

In considering this project, the ED articulates a focus on "providing enhanced disclosures...to help users of financial statements better understand why an entity uses derivatives in the context of an entity's risk exposures". We have significant concerns that the extent and granularity of the proposed disclosures would reveal significant competitively sensitive information. Disclosures that present information about an entity's market risk exposures are already

required in Management's Discussion and Analysis (MD&A) under the "Quantitative and Qualitative Disclosures About Market Risk" section. We recommend that disclosures of market risk should remain in MD&A, rather than in the footnotes, as this allows management to provide the financial statement readers with information that best aligns with how their risks are managed.

Alternatively, if information about market risk is deemed appropriate for footnote disclosure, we recommend a disclosure structure similar to that currently required by the SEC in FR-61 and Regulation S-K Item 305 that provides entities with alternatives that balance users' perceived need for market risk information with entities' need to minimize the disclosure of competitively sensitive data.

Specific Comments on Individual Disclosure Requirements

Disclosure of an Entity's Objectives and Strategies

The ED would require disclosure of an entity's objectives and strategies for using derivatives, as well as disclosure of derivative positions by "primary underlying risk (for example, interest rate, credit, foreign exchange rate, or overall price)". We believe that "overall price" was probably meant to mean each individual price risk. However, as currently written, this term can be interpreted to be as broad as "overall price risk". Since energy companies use derivatives to mitigate price risk for various types of commodities (e.g., power, gas, coal, oil, etc.), clarification is requested to avoid diversity in practice. Therefore, we request clarification from the FASB relating to commodities as to whether there should be a separate table for each significant commodity or whether all commodities should be combined in the "overall price" risk table (Paragraph 3.a.).

Disclosure of "Gross" Fair Value Amounts of Derivatives

The ED would require disclosure of "gross" fair value amounts of derivatives (even if they qualify for netting under FIN 39, *Offsetting of Amounts Related to Certain Contracts*, EITF 02-3, "Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities," or EITF 03-11, "Reporting Realized Gains and Losses on Derivative Instruments That Are Subject to FASB Statement No. 133 and Not 'Held for Trading Purposes' as Defined in Issue No. 02-3") on the basis that it would help in better understanding what and how risks are being managed and that netting this information would lead to misleading information.

Gross fair value disclosure would overstate the entity's perceived credit risk exposure by showing large notional or fair value positions when the net open or credit position could be relatively small. Further, gross fair value may not provide meaningful information about an entity's market risk as it does not properly reflect a company's locked-in positions, and, therefore, net derivative exposure. The amount of gross or even net fair value bears no relation to the exposure to market risk. Rather, the fair value amounts simply show the extent to which current market prices differ from the contract price and are no indication of market risk.

Additionally, we understand that in order to disclose derivative instruments by primary underlying risk, accounting designation and purpose, a gross disclosure would have to be made. However, we believe that within each of these subsections entities should be able to net positions within a master netting arrangement, or that otherwise qualify for netting under FIN 39. FASB should provide clarification that the use of "gross" presentation is directed toward segregation by primary underlying risk and does not prohibit FIN 39 netting within each category.

Disclosure of Counterparty Credit Risk

We disagree with Paragraph 3. d. a. which would require disclosure of "[t]he maximum amount of loss due to credit risk that, based on the gross fair value of derivative instruments in asset positions, the entity would incur if parties to the derivative instruments failed completely to perform." This disclosure, as we understand, would require us to subset all in-the-money derivatives and note the fair value of this gross asset, and classify it as "credit risk". We believe this is an invalid valuation of credit risk, because:

- the vast majority of our derivative master agreements contain netting provisions, and qualify for netting under FIN 39. Currently, there is a wealth of bankruptcy court precedent supporting the validity and enforceability of these arrangements (which is recognized in the accounting literature when contracts qualify for netting under FIN 39),
- there may be offsetting transactions that may not meet the definition of a derivative or that meet one of the scope exceptions under SFAS 133. In the energy industry specifically, similar contracts may receive different accounting treatment under SFAS 133 based on slight differences in contract default provisions.

Generally, entities manage credit exposure based on the net exposure from all contracts with a particular counterparty, rather than only considering those with a particular accounting designation or those that are in a gross fair value asset position. As proposed, this disclosure would mislead investors, because the disclosed gross amounts would be significantly larger than the other, net credit risk exposures disclosed in the MD&A and footnotes to the financial statements.

Timing of Disclosures

These disclosures should only be required for every annual period and not for each interim period. The additional cost to prepare this disclosure, along with the already shortened interim reporting due dates, outweighs the benefit of disclosing an entity's policies and strategies at every interim period. The existing requirements to update the annual disclosure in interim reports if there are material changes is more appropriate and strikes a balance between the costs and benefits of such extensive new disclosures.

Comments on specific issues in the Exposure Draft

Issue 1: Do you agree with the Board's decision to exclude from the scope of this proposed Statement prescriptive guidance about how derivative instruments should be presented and classified in the financial statements? Why or why not?

We agree with the Board's decision to exclude prescriptive guidance about how derivative instruments should be presented and classified in the financial statements, because there is sufficient current guidance in Paragraphs 17 and 18 of SFAS 133 that companies are already applying. Additionally, certain SEC Staff comments at annual AICPA conferences addressed the presentation of results of hedging relationships on a net basis in the income statement line item associated with the hedged item, as well as the presentation of unrealized gains and losses arising on economic hedges that should be included in the same line item that the economic hedged item would be reported in.

Issue 2: Do you agree that this proposed Statement should apply to both public and private entities? Why or why not?

The proposed Statement should apply to both public and private entities as SFAS 133 applies to both public and private entities.

Issue 3: Do you foresee any significant operational concerns or constraints in compiling the information in the format required by this proposed Statement? Are there any alternative formats of presentation that would provide the data more concisely?

There are significant operational concerns as many systems are not currently set up to capture the required information by all of the categories required by the ED (commodity, accounting designation, positive or negative position of the contract, etc.). Capturing the required information in a well-controlled, SOX-compliant environment will require significant system re-engineering and user testing of the data.

Additionally, as noted earlier, we are also concerned that the volume of quantitative disclosures that would result from applying the ED's provisions will be overwhelming. While Paragraph A15 of the ED provides a simple example for interest rate risk, in our industry the same disclosures would be required for power, gas, oil, coal, capacity, emission allowances, renewable energy credits, foreign currency transactions, and other derivative transactions, further broken down by accounting treatment and purpose. We believe that this granularity required by the ED would be onerous to preparers and would have limited value in achieving the Board's objectives. The requirement, for instance, to split out freestanding derivatives by purpose, by asset or liability position (as detailed in the example table), and by income statement classification (also as detailed in the example table) would lead to a vast amount of quantitative information for each commodity under our income statement classification framework. This framework is already required to be discussed qualitatively, and we believe it is adequate.

Another example of what we believe to be excessive required disclosures is at the end of Paragraph 3.b.: *The purpose categories within each accounting designation category shall consist of a specific asset or liability or forecasted item being hedged by derivatives or the reason why the derivative is held in situations in which the derivative is not designated as a hedging instrument under Statement 133.* At that level of detail (e.g., anticipated purchase of 1 million barrels of oil), one can truly start to glean competitive information, and given that there can be numerous hedging strategies, the volume of information will become significant.

The related gains/losses of fair value hedges and cash flow hedges are already reflected in the financial statements and current disclosures require

ineffectiveness and excluded portions of the hedged risk to be disclosed. Therefore, we would not object to that disclosure.

However, the proposed guidance surrounding the gains and losses on hedged items needs significant clarification, because it is unclear whether it is referring to the gain or loss of the hedged item itself, or the gain or loss of the hedging relationship that contains the hedged item. For example, footnote 5 of the table in Appendix A relates only to the hedged items that are the subject of fair value hedges, whereas Issue 7 and Paragraphs B33-B35 of the ED do not make such a distinction. Perhaps the background information and basis for conclusion should clarify that this is only applicable for fair value hedges, if that is true.

Otherwise, system changes would be required to extract the gain or loss of a hedged item in a cash flow hedge when the change in the hedged item is greater than the gain or loss of the hedging instrument (i.e., the difference that is not required to be recorded).

We believe that the credit disclosures in Paragraph 5 also require further clarification, as they can be interpreted as being required to be split into separate disclosures for derivatives and non-derivatives. This seems counterintuitive, as counterparty positions would normally net between those categories, as discussed previously.

We ask that the Board clarify the application of the ED's provisions (specifically, in Paragraph 3.b.d) with respect to reporting gains and losses on commodity derivatives that result in physical settlement during the reporting period and thus are no longer held at the end of the period. Assume, for example, that an entity enters a derivative forward contract in January to sell 100 megawatt hours (mwh) of electricity in December of that same year at \$50 per mwh. During the year, unrealized gains and losses are recorded in the income statement (assuming the entity does not elect hedge accounting) as the contract is marked-to-market at each interim reporting period.

At the settlement (delivery) date assume the current market price of electricity is \$54 per mwh. Upon settlement of the contract, the entity would record \$5,000 of revenue based on the contract price, and the cumulative unrealized gains and losses during the year will net to zero. We are unclear as to whether the amount to be disclosed under Paragraph 3.b.d. as the "gains and losses reported in the statement of financial performance on derivative instruments that existed during the reporting period but are no longer held at the end of the reporting period" would be zero or whether the entity would disclose the

opportunity loss of \$400 $((\$54 - \$50) \times 100 \text{ mwh})$ based on the price at which the entity theoretically could have sold the electricity absent the contract. We note that the second alternative simulates an economically similar transaction in which the entity sells electricity in the spot market, but has entered a financial instrument to "fix" the price.

As derivatives in total are marked to market throughout the year, this unrealized gain or loss is captured and recorded in the aggregate. However, this theoretical gain/loss information is not currently captured on an individual transaction basis for physically settled transactions in the disaggregated way that would be required to report these amounts within the numerous categories required by the ED.

Finally, the ED in Paragraphs 3.b. c. and 3.b. d. requires separate presentation of income statement amounts for derivative gains/losses depending on whether the derivative is held at the end of the reporting period. The intent of this disclosure requirement is not clear. If the intent is to require separate disclosures of unrealized and realized gains/losses, we believe the ED should reflect this terminology, which is better understood by financial statement preparers and users. If the ED's requirement is to be interpreted literally, then further clarification is requested, because, for energy commodities, separate disclosures would not be meaningful. Whether earnings arise from derivatives held at the end of the period as compared to those held during the period is not a measure that management reviews in monitoring performance. If the purpose of such a requirement is an attempt to provide insight into the future potential earnings impact of derivatives, we believe that information would be provided in a more useful fashion by the proposed risk-based disclosure alternatives we recommend. However, if separate disclosures as set forth in Paragraphs 3.b. c. and 3.b. d. are required, then we would incur additional systems work to capture the required information.

Issue 4: This proposed Statement would require disclosure of (a) the existence and nature of contingent features in derivative instruments (for example, payment acceleration clauses), (b) the aggregate fair value amount of derivative instruments that contain those features, and (c) the aggregate fair value amount of assets that would be required to be posted as collateral or transferred in accordance with the provisions associated with the triggering of the contingent features. Do you foresee any significant operational concerns or constraints in compiling that information for this disclosure?

We believe that there are significant operational concerns related to the implementation of this requirement. Specifically, to identify the fair value of the transactions with contingent features would require significant system modifications to link the tracking system for contingent features with the accounting system for determining the fair value of the underlying transactions on an individual transaction basis.

In this regard, we do not believe that it is necessary or particularly relevant to disclose the aggregate fair value of the underlying transactions with these features. While the fair value of specific transactions may be a trigger for a contingent payment, the aggregate fair values of all such transactions may offset (because some transactions may be assets while others are liabilities) and bear no relation to the actual potential for a particular trigger to occur. Therefore, we believe that it would be sufficient to disclose items (a) and (c) as outlined in Issue 4, and that the elimination of the proposed requirement in item (b) in this issue would reduce the operational concerns we have expressed without any substantive reduction in the usefulness of the overall disclosure.

Additionally, clarifying guidance would be helpful to understand whether the intent of this requirement is to capture only contingent features which would require the entity to take an adverse action (e.g., accelerate cash payment or require the posting of collateral), or whether the intent is broader, requiring disclosure of all contingent features in a contract.

Issue 5: This proposed Statement would require disclosure of notional amounts in tables that also will include fair values of derivative instruments by primary underlying risk, accounting designation, and purpose. Do you agree that this proposed Statement should require the disclosure of notional amounts? Why or why not?

We do not agree with the ED's proposed disclosure of gross notional amounts because such amounts do not necessarily correlate with the entity's exposure to risk. The ED would require disclosure of the absolute notional amounts in order to "better indicate the potential future effect that changes in the underlying would have on the value of the derivative." However, if an entity had a balanced book, the net notional would be zero and the entity would have no exposure to price risk. As such, disclosing the absolute notional amounts would be misleading, and may exaggerate the derivative risk to the entity by showing a very large number when, in actuality, the net exposure may be small or zero.

Additionally, gross notional amounts can easily be duplicative, as in when a company buys a gas futures contract and a basis swap as one complete hedge. In that case, the notional amount would be double the amount from either contract individually, yet the exposure to risk would not be similarly doubled.

We also do not agree with showing net notional amounts in the disclosure. While absolute notional amounts will overstate an entity's exposure to derivative activity, disclosing net notional amounts may reveal competitively sensitive information about an entity's risk management positions to competitors as the disclosure would indicate the entity's long or short position in specific commodities for each specific purpose.

We understand that the goal of notional disclosures is to give some indication of an entity's exposure to market risk. We believe that these disclosures should balance users' perceived needs for this information with the harm that would arise from such granular disclosure of competitive positions. Accordingly, consistent with our other recommendations, we believe that entities should be given choices from several alternatives on how to disclose that information, similar to FR-61 and Regulation S-K Item 305, as mentioned previously.

Examples illustrating our comments of why notional amounts should not be disclosed are provided in Appendix I to this letter. Appendix I also raises detailed concerns over the usefulness and applicability of the notional amounts which should be read in conjunction with the above comments.

Issue 6: This proposed Statement would require disclosure of gains and losses on all derivative instruments that existed during the reporting period regardless of whether those derivatives exist at the end of the reporting period. This proposed Statement would not require disclosure of the aggregate notional amounts related to those derivatives that existed during the reporting period but no longer exist at the end of the reporting period. Do you agree that this proposed Statement should not require the disclosure of the aggregate notional amounts related to derivatives that no longer exist at the end of the reporting period? Why or why not?

We agree that the notional amounts of derivatives that no longer exist should not be disclosed, because, we don't believe that any notional amounts should be disclosed for the reasons discussed above. Further, even if notional

disclosures were required for derivatives existing as of the balance sheet date, we do not believe it is relevant to track and disclose the gross notional quantities of derivative transactions that are no longer open.

Issue 7: This proposed Statement would require disclosure of the gains and losses of hedged items that are in a designated and qualifying hedging relationship under Statement 133. The Board decided that an entity would not be permitted to include information in the tables on "hedged items" that are not in designated and qualifying Statement 133 hedging relationships because "economic hedging" means different things to different people. Do you agree that information about "hedged items" that are not in designated and qualifying Statement 133 hedging relationships should be excluded from the disclosure tables? Alternatively, should the tables include gains and losses on "hedged items" that are recorded at fair value and are used in hedging relationships not designated and qualifying under Statement 133? Why or why not? Would your answer be affected by the forthcoming FASB Statement on the fair value option for financial assets and financial liabilities, which will provide the option to report certain financial assets and liabilities at fair value?

We agree that gains and losses for "hedged items" that are not designated and qualifying SFAS 133 hedging relationships should be excluded from the disclosure tables. We do believe however that it is beneficial for the reader to understand that certain undesignated derivatives have been entered into for an economic reason and a qualitative explanation of the hedged exposure should be permitted to the extent those positions relate to the entity's risk mitigation strategies.

Issue 8: Under this proposed Statement, quantitative information about nonderivative instruments used as part of an entity's overall risk management strategy would not be included in the disclosure tables. However, paragraphs 44 and 45 of Statement 133 would permit an entity to provide qualitative and quantitative information about the derivatives included in the disclosure tables as those derivatives (a) relate to the overall context of its risk management activities and (b) are related by activity to other financial instruments. Do you agree that information that could be provided in the qualitative and quantitative disclosures encouraged by paragraphs 44 and 45 of Statement 133 would be sufficient

to appropriately inform users of financial statements about the risk management strategies of an entity? If not, should additional information about an entity's overall risk management strategies be provided as part of the tabular disclosure required by this proposed Statement?

We agree with this approach to the required disclosures.

Issue 9: The proposed Statement includes examples of qualitative disclosures about objectives and strategies for using derivative instruments, contingent features in derivative instruments, and counterparty credit risk. Are those examples helpful in communicating the objectives of providing information on how and why an entity uses derivatives and on the overall effect of derivatives on an entity's financial position, results of operations, and cash flows? Or, do you believe those examples would be viewed as a prescribed method to comply with the requirements of this proposed Statement?

We agree that examples should be part of the Statement and not construed to be the only way to comply with the requirements. An additional example for commodity price risk specifically addressing the issues related to physically settled transactions (as discussed above) would be beneficial. EEI would be willing to work with the FASB staff on the preparation of this example.

Issue 10: The Board considered but decided against requiring additional disclosures as described in paragraphs B55-B63. Those disclosures focused on providing information on an entity's overall risk management profile, methods for assessing hedge effectiveness, and situations in which an entity could have elected the normal purchases and sales exception. Do you agree with the Board's decisions not to require disclosures in those areas? Why or why not?

We agree with this conclusion by the FASB regarding contracts for which the entity could have elected normal purchases and normal sales but did not. The FASB rejected this disclosure as it would have been unfair to single out the normal purchases and normal sales exception when there are other exceptions.

Issue 11: The Board's goal is to issue a final Statement by June 30, 2007. The proposed effective date would be for fiscal years and interim periods

ending after December 15, 2007. At initial adoption, comparative disclosures for earlier periods presented would be encouraged, but not required, Beginning in the year after initial adoption, comparative disclosures for earlier periods presented would be required. Does the effective date provide sufficient time for implementation?

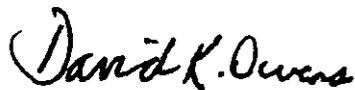
We believe that the effective date should be extended to the first reporting period beginning after December 31, 2008 in light of the other standards that will require significant implementation around December 2007 (for instance, the adoption of SFAS 157 on January 1, 2008), primarily because this Standard will require substantial system changes in order to gather information that management presently does not use to manage the business.

For many companies, systems changes will be required in order to capture the information required for disclosures of derivative gains and losses by the numerous categories currently prescribed (commodity, accounting designation, existence at year end, purpose, etc.). If this information is required to be disclosed for the year ended December 31, 2007, it would need to be captured currently as we are already into the third month of 2007. It is unlikely that companies will be able to make the systems changes until a final standard is issued and the rules known, making a "retroactive" (to January 1, 2007 for income statement information) implementation impracticable.

EEl would be willing to arrange for a meeting with the Board and/or staff to further explain our concerns with the proposed disclosures.

EEl appreciates the opportunity to respond to the proposed Statement. We hope that our comments will be helpful and look forward to working with the Board in the future.

Sincerely,



David K. Owens

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Appendix I – Examples of Notional Amount Disclosures

As discussed in Issue 5, this appendix includes examples illustrating why notional amounts can be misleading.

All examples assume hedge designation and documentation is complete and that all other aspects of Statement 133 are met.

Example 1:

Company A has \$300 million of variable rate debt in place from 20X1 to 20X5. At the start of 20X1 the Company decides to hedge the interest rate risk for a notional amount of \$200 million for the years 20X2 and 20X3 with a forward starting floating to fixed swap. Later that same year the Company also decides that it would hedge the interest rate risk for the same notional amount of \$200m for the year 20X4, and enters into another separate forward starting swap. In effect, the Company used two derivatives covering three years as opposed to one derivative covering three years. With the two tranches of hedges how would it disclose the notional amount?

- a) \$400 million – Under the proposed disclosures the Company would have to disclose a total notional amount of \$400 million (i.e. the sum of the two swaps).
- b) \$200 million – The notional of the hedge portfolio would appear more informative to the reader.

This issue of notional amounts is further complicated if the first hedge is a derivative asset and the second hedge is a derivative liability. Again the notional amounts would be viewed under the respective asset and liability lines, but would the reader try and deduct them thinking that a notional amount of an asset and a notional amount of a liability can be netted?

Example 2:

Company A forecasts it will issue \$300 million of 10 year debt in two years time, and thus hedges the whole \$300 million by using a forward starting 10 year swap. Later that same year, the Company decides to reduce its hedge because it only wants to hedge \$200 million, even though the \$300 million is still probable of being issued. Company A de-designates the \$300 million derivative, enters into an offsetting \$100 million forward starting 10 year swap, and then designates the combination of the two swaps as a hedge of \$200 million of debt issuance. How would the notional amounts be disclosed?

- a) \$400 million – Using the absolute notional amounts, \$400 million (\$300 million original swap offset by \$100 million swap) would be disclosed.
- b) \$200 million – Using the net notional amount.

We understand that the tables can contain additional wording to present the facts of the hedge, but that only works if all hedges are structured and employed the same way. A Company with a central treasury function that has many hedges being employed over differing periods for differing tenures of debt with different hedged risks would need a descriptive line for each and every type of hedge. This would cause the tables to increase significantly.

Example 3:

Companies A, B and C each forecast spot gas purchases at Transco Zone 3 (the nearest supply point) during the month of April 20X1 through to December 20X1 totaling 500 mmbtu a month. All three Companies decide to hedge 300 mmbtu of the purchases for the month of November 20X1.

- Company A enters into a derivative NYMEX forward contract (which is based on Henry Hub supply point) with a notional amount of 300 mmbtu. Because the derivative has basis difference that would create some ineffectiveness, the company also enters into a separate derivative basis swap (Henry Hub for Transco Zone 3) with a notional amount of 300 mmbtu. The two derivatives are combined for the purposes of designating them in the hedging relationship.
- Company B has a policy of mitigating its total exposure by entering into a single derivative contract that swaps the gas price from floating to fixed at Transco Zone 3 by means of a forward contract priced at that location.
- Company C accepts the small amount of ineffectiveness that a NYMEX forward contract will have because it is highly effective in mitigating the price exposure, even though it does not hedge the basis risk. However, the company decides to hedge the full 500 mmbtu of purchases for November 20X1 with a NYMEX forward contract. The next week, the Company decides to reduce the hedged volume and enters into an offsetting derivative for 200 mmbtu, thus reducing its net hedged amount to 300 mmbtu.

In effect all three companies have mitigated all or substantially all of the gas price risks for the 300 mmbtu hedged amounts. Company A has used two derivative contracts, Company B used one derivative contract, and Company C ultimately used two derivative contracts. How would the Companies' disclosures differ, based on our understanding of the ED's proposed requirements?

- a) Company A would disclose a stated notional amount of 600 mmbtu which would suggest to the reader that they may have hedged twice as much volume as they really have.
- b) Company B would disclose a notional amount of 300 mmbtu.
- c) Company C would disclose a notional amount of 500 mmbtu which would suggest to the reader that they may have hedged more than they really have, and also more than Company B but less than Company A.

The disclosure tables allow for a comment that would be worded to read "Derivatives in Cash Flow Hedges Related to Forecasted Transactions – Gas Purchases". However, without additional substantial explanations of whether the period hedged was just the gas price or includes basis, or describes what the net hedged item is, the reader can not put the absolute value gross notional volumes into perspective. If the company has a significant gas hedging program that layers on various derivatives (which may include options, collars, basis swaps, etc.) over various different periods, then one can start to see how complex the tables will start to become, how the amounts therein may bear little relationship to the entity's actual derivative risk exposure, and how comparability between companies will be virtually impossible depending upon the nature of each company's risk mitigation program.

Further Discussion

In order for the notional amount to be meaningful we believe that the disclosures would need to present the hedged quantities for each and every period for which the hedge is in place. A three dimensional table would facilitate this, but would be impractical because such disclosures would significantly increase the amount of information, making disclosure even more onerous.

These issues are exacerbated even further when dealing with several types of commodities with differing units, and differing time periods. Electricity for example can be hedged based on hours within a day, or days over a month, or off-peak versus on-peak. Disclosing the notional amounts without the time frame adds no value to the reader. Disclosing the notional amounts with the time frame provides too detailed information that reveals sensitive commercial aspects of the company as well as providing the reader with too much information for them to discern what are meaningful measures of risk. This isn't just a commodities issue; for as the first examples indicate, even in the treasury

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area the use of options and other strategies could result in notional amounts being misleading.