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Technical Director
Financial Accounting Standards Board
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File Reference: 1810-100 Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging

The American Gas Association (AGA) is pleased to submit its comments concerning the Financial Accounting Standards Board (FASB or the Board) Proposed Accounting Standards Update—*Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities—Financial Instruments (Topic 825) and Derivatives and Hedging (Topic 815)* (the ED). The American Gas Association, founded in 1918, represents 202 local energy companies that deliver clean natural gas throughout the United States. There are more than 70 million residential, commercial and industrial natural gas customers in the United States, of which almost 92 percent — more than 65 million customers — receive their gas from AGA members. AGA is an advocate for natural gas utility companies and their customers and provides a broad range of programs and services for member natural gas pipelines, marketers, gatherers, international natural gas companies and industry associates. Today, natural gas provides almost one-fourth of the United States' energy needs.

AGA appreciates the FASB seeking to improve the accounting for financial instruments and simplify hedge accounting. Financial instruments and hedging are widely used in our industry, and as a result there are many provisions included in the ED that will significantly affect us. We have limited our responses to questions for which we have concerns, request clarification, make recommendations, or wish to convey our support.

Summary

We believe that the current rules regarding hedge accounting are overly complex and restrictive, and the proposals in the ED effectively simplify hedge accounting while maintaining the core principles as originally intended. However, we do not believe the proposals related to investments currently accounted for under the equity method are needed or will result in more useful information being provided to the users of financial statements. Also, we disagree with some aspects of the prohibitions related to the dedesignation of hedges, and we have included examples of why we use the dedesignation and redesignation of hedges to manage our business. Finally, some of the provisions appear to be geared toward financial institutions, and we request examples illustrating their application to the types of instruments we hold or clarification if certain assets or liabilities we hold are intended to be in scope.

Responses to Questions in the ED

Question 4: *The proposed guidance would require an entity to not only determine if they have significant influence over the investee as described currently in Topic 323 on accounting for equity method investments and joint ventures but also to determine if the operations of the investee are related to the entity's consolidated business to qualify for the equity method of accounting. Do you agree with this proposed change to the criteria for equity method of accounting? If not, why?*

We believe that amending the criteria for equity method accounting would add an unnecessary level of complexity to the accounting for significant equity investments. The exposure draft states that an investment would qualify for equity method accounting only if it meets both of the following criteria:

- the investor has significant influence over the investee; and
- the investee's operations are considered related to the investor's consolidated operations (integral).

We believe that the current “significant influence” criterion is understandable, workable, and consistent with the economic substance of such relationships, and therefore we believe that it should continue to be the key consideration in determining if a substantial economic relationship exists between the investor and investee. In fact, we believe that an investor having significant influence over an investee is in itself an indication that the investee's operations are “related to the investor's consolidated operations.” Our concern is that the criteria included in the ED could be interpreted narrowly and result in some investments for which we currently utilize the equity method being scoped out.

Question 8: *Do you agree with the initial measurement principles for financial instruments? If not, why?*

We do not believe reporting non-derivative financial instruments at fair value, including an entity's own debt, provides financial statement users material, relevant information. Many non-derivative financial instruments are held for the purpose of payment or collection of contractual cash flows, rather than to profit from short-term changes in market conditions. Fair valuing these instruments on the Balance Sheet would incorporate information not directly relevant to an entity's business strategy and how these assets and liabilities are managed within the organization. Furthermore, we believe a significant number of non-derivative financial instruments are not traded in active markets and thus, fair value estimates will be less reliable. Thus, we believe amortized cost is a more accurate representation of the entity's business performance. As it stands currently, the Exposure Draft states that a financial liability, such as debt, may only be measured at amortized cost when it is contractually linked to an asset not measured at fair value. Often a company's debt is not contractually linked to its assets even in instances in which the purpose for issuing debt is to fund the acquisition or construction of long-lived assets. We believe the Board should take this business purpose into account when determining how non-derivative financial instruments should be measured.

Question 17: *The proposed guidance would require an entity to measure its core deposit liabilities at the present value of the average core deposit amount discounted at the difference between the alternative funds rate and the all-in cost to-service rate over the implied maturity of the deposits. Do you believe that this remeasurement approach is appropriate? If not, why? Do you believe that the remeasurement amount should be disclosed in the notes to the financial statements rather than presented on the face of the financial statements? Why or why not?*

In our industry, it is common for a company to require customers to provide deposits to the utility. While the purpose of this activity is to mitigate the credit risk of a customer, these deposits might be "core deposit liabilities" based on the definition provided in the ED. We note that the measurement methodology proposed in the ED is complex and could unduly complicate a routine and basic function of our operations. While this proposed amendment may be necessary for banks and other companies where core deposits are a primary function of their operations and the related valuation of these deposits is necessary to evaluate their financial status, it is not relevant for the types of deposits that are common in our industry, which simply represent a form of collateral.

Question 18: *Do you agree that a financial liability should be permitted to be measured at amortized cost if it meets the criteria for recognizing qualifying changes in fair value in other comprehensive income and if measuring the liability at fair value would create or exacerbate a measurement attribute mismatch? If not, why?*

We strongly agree with the exception that permits an entity to measure a financial liability at amortized cost if certain criteria are met. We believe that amortized cost is the appropriate measurement methodology in most cases for the debt instruments issued by companies in our industry, and this exception would allow capital-intensive companies such as those in our industry to continue to present debt at amortized cost. This will mitigate the risk that there will be a mismatch between the assets, which are primarily not presented at fair value, and the debt used to fund the capital expenditures that give rise to those assets.

Question 32: *For financial instruments measured at fair value with qualifying changes in fair value recognized in other comprehensive income, do you believe that the presentation of amortized cost, the allowance for credit losses (for financial assets), the amount needed to reconcile amortized cost less the allowance for credit losses to fair value, and fair value on the face of the statement of financial position will provide decision-useful information? If yes, how will the information provided be used in your analysis of an entity? If not, why?*

In paragraphs 84 through 87 we note that the Exposure Draft is proposing that an entity shall present on the face of the statement of financial position (SFP) various financial amounts in addition to the actual carrying value of that financial item. The FASB has a separate project concerning Financial Statement Presentation, and we believe that such disaggregation of financial information on the face of the SFP should be addressed in that separate project. Specifically, we note the FASB's tentative decisions from its April 2010 meeting on its Financial Statement Presentation project, which stated in relation to the disaggregation objective:

“Retain disaggregation as one of the core presentation principles. (July 2009) The core disaggregation principle should require an entity to consider disaggregation by function, nature, and measurement bases in the financial statements as a whole. ***The Exposure Draft should include guidance for applying that disaggregation principle in each financial statement.*** (October 2009).”

While we understand that various constituents use the financial statements for various purposes and will require varying levels of detail, we strongly believe that the face of the financial statements is not the right place for such detail; such detail is better suited for the footnotes to the financial statements. We are concerned that the SFP would be so “cluttered” with data that the average user could overlook the primary purpose of that financial statement.

The impact of these changes would become apparent when presenting the fair value of financial instruments (for which qualifying changes in fair value are recognized in other comprehensive income) for the current period end and also for the comparative period end. In fact, when the text is included with the required amounts the SFP would look more like a note; text would be required in order for the user to know what each amount relates to. We recommend that the FASB reconsider its proposal and require the SFP reflect the measurement attribute actually used, with supplemental detail to be reported in the respective footnote (referenced on the face of the SFP).

Question 56: *Do you believe that modifying the effectiveness threshold from highly effective to reasonably effective is appropriate? Why or why not?*

We strongly support the FASB's efforts to simplify hedge accounting. Under current GAAP the ranges used to validate whether a hedging relationship "highly effective" essentially operate as bright-lines. Changing the criteria from 'highly effective' to 'reasonably effective' offers an opportunity to remove a bright-line in accounting, something that we generally favor. A small change in ineffectiveness should not dramatically affect the results of the accounting, which is the situation under current GAAP. We believe a small change in ineffectiveness should simply result in a commensurate change in the reported net income.

Although we sometimes use derivatives to hedge financial instrument transactions, our focus is mainly on the impact of hedge accounting rules on cash flow hedges of derivatives for commodities, such as natural gas. Quite often in the derivatives market a hedging instrument is focused on a prime location/delivery point (e.g. Natural gas at Henry Hub), while the forecasted purchase is at various other delivery points. The use of the Henry Hub product is at times the only liquid financial instrument available to mitigate most of the economic volatility, and thus relaxing the effectiveness threshold would better reflect the use of that derivative by an entity. Additionally, the correlation between a forecasted sale and a commodity derivative can change for a variety of reasons, which could impact compliance with a bright-line effectiveness threshold in the short term even though long-term correlations in hedging relationships remain effective.

With this in mind, we believe that it is more appropriate to establish an effectiveness threshold as reasonably effective. Since ineffectiveness would continue to flow through to the income statement, we believe that a reasonably effective standard is appropriate in that it avoids unnecessarily large changes in net income driven by relatively minor shifts in the effectiveness of a hedge strategy.

We suggest that an example or examples of an appropriate qualitative assessment would be helpful and are willing to provide some examples.

The Exposure Draft also indicates that in certain instances, a quantitative, rather than qualitative, assessment may be required. We encourage the Board to provide specific guidelines as to when this quantitative assessment may be required to qualify a derivative for hedge accounting treatment. We are concerned that without greater clarity, auditors and regulators will develop informal guidelines that lack consistency of application.

Question 57: *Should no effectiveness evaluation be required under any circumstances after inception of a hedging relationship if it was determined at inception that the hedging relationship was expected to be reasonably effective over the expected hedge term? Why or why not?*

We believe that once a reasonably effective hedge relationship is established at inception, the better approach is to not prescribe additional effectiveness evaluations in the absence of indicators of a substantive diminution in effectiveness. If a hedge strategy clearly falls below the “reasonably effective” threshold as the result of clear changes in facts and circumstances, then the impact of the ineffectiveness will be evident. At that point, the reporting entity will also need to decide if the hedge strategy should be changed, discontinued or terminated. In our opinion, little or no value is added by requiring additional effectiveness evaluations once a reasonably effective hedge relationship is established at inception in the absence of a substantial decline in effectiveness.

Question 58: *Do you believe that requiring an effectiveness evaluation after inception only if circumstances suggest that the hedging relationship may no longer be reasonably effective would result in a reduction in the number of times hedging relationships would be discontinued? Why or why not?*

Yes, we believe that requiring an effectiveness evaluation after inception only if circumstances suggest that the hedging relationship may no longer be reasonably effective would result in a reduction in the number of times hedging relationships would be discontinued. As noted in our reasons for supporting the change to a “reasonably effective” standard, we believe that many hedging relationships remain reasonably effective over time even though, in the short term, they may not be deemed “highly” effective. Accordingly, we believe this more reasonable standard would reduce the instances in which valid hedging relationships are discontinued due to failure to meet a bright line test.

Question 61: *Do you foresee any significant operational concerns or constraints in calculating ineffectiveness for cash flow hedging relationships? If yes, what constraints do you foresee and how would you alleviate them?*

We disagree with the FASB’s proposal to recognize ineffectiveness in earnings associated with under-hedges on cash flow hedges— i.e. when the change in fair value of the forecasted future transaction (measured by calculating the change in hypothetical derivative) exceeds the change in fair value of the associated derivative instrument. Recognizing the ineffectiveness gain or loss in this circumstance results in recording an amount in earnings from a future transaction that has not yet occurred nor been recorded in the financial statements, which we believe to be inappropriate.

The Board addressed the rationale for excluding the recognition of ineffectiveness from under-hedges in Statement No. 133’s basis for conclusions paragraphs 379 through 381. Paragraph 379 indicates that “the result would be to defer in other comprehensive income a nonexistent gain or loss on the derivative and to recognize in earnings an offsetting nonexistent loss or gain.” We believe the Board’s conclusion, as stated in paragraph’s 379 through 381, on this matter was correct and do not believe a change to this methodology is required.

Question 63: *Do you foresee any significant operational concerns or constraints arising from the inability to discontinue fair value hedge accounting or cash flow hedge accounting by simply dedesignating the hedging relationship? If yes, what constraints do you foresee and how would you alleviate them?*

The Exposure Draft proposes to remove the criteria in Topic 815 for discontinuing a hedging relationship when ‘the entity removes the designation of the fair value or cash flow hedge.’ Per the Basis for Conclusions, the driving force behind making this change is that ‘arbitrary dedesignations, which do not involve actual economic transactions, should not be used as a tool for changing measurement attributes and/or managing the classification of certain items reported in net income.’ While we agree with the underlying premise that an entity should not be able to discontinue hedge accounting by simply ‘writing a memo’ with no change in actual economic conditions, we believe the specific proposed guidance related to modifying and terminating a hedging relationship is too narrow and will prohibit the discontinuance of hedge accounting in circumstances that involve actual economic transactions. We also disagree with the absolute prohibition from redesignating the existing derivative or offsetting derivative in a future hedging relationship. Applying the guidance as proposed will lead to accounting treatments that do not match the economics of the situation and that vary substantially for different entities with similar economic circumstances, which in turn would lead to complexity and loss of comparability for users of the financial statements.

Dedesignation and Redesignation

Entities that are geographically diverse and that manage risks actively in numerous markets with varying liquidity over time constantly exhibit business reasons to dedesignate, modify, and redesignate their hedging relationships without terminating the related derivative. This activity reflects the dynamic changes in economic relationships and evaluation of risks in multiple parts of the entity. This is particularly true in an environment where risks are actively managed at a portfolio level where the hedged item represents a group of contracts and the hedging instrument consists of a portfolio of derivative contracts designated as single composite derivative.

The Exposure Draft is proposing to prohibit the ability to dedesignate the hedging relationship but to allow the modification of the hedging relationship by adding a derivative to an existing hedge relationship. However, in numerous instances an entity may add and remove derivative instruments from the existing hedging relationship in order to both maintain and to improve the effectiveness of the hedging relationship. The following example illustrates one such situation:

A gas utility or other entity that supplies gas to customers may use derivatives to hedge the price risk of their probable forward purchases of gas. Due to changes in the market price of gas that could result from one or more factors (e.g. discovery of new sources of gas or change in customer demand), it may determine that gas prices are more likely to decrease rather than to increase in the future. Under current GAAP, the entity would reduce its hedge level to reflect the lower forecast of gas purchases by dedesignating certain of the derivatives. The dedesignated derivatives could then be used as the hedge of another forecasted transaction, retained as a trading position (receiving mark-to-market accounting), or sold if not needed. Based on the proposed guidance for a modification in the Exposure Draft, the entity would only be able to achieve the current accounting by selling the hedge derivative and then subsequently repurchasing a new derivative if needed as a hedge for another forecasted transaction.

As this example illustrates, the practice of dedesignating and redesignating hedges in response to changes in business and economic conditions reflects valid and commonly used risk management and portfolio optimization techniques. Further, the internal matching and optimization of positions before executing an external trade is also a common and efficient manner for minimizing transaction costs. While in some cases the same effect could be accomplished through external trades, that imposes additional economic costs (transaction costs and crossing the bid-offer spread) and could subject the entity to criticism as transacting simply to achieve an accounting result.

In order to accommodate these common hedging activities, we believe that ¶121 of the Exposure Draft should be reworded to note that an entity can modify an existing relationship by both adding and removing derivatives.

Effective Termination

The Exposure Draft is proposing that effective termination of a hedging relationship can only be achieved if the new derivative is expected to fully offset future changes in fair value or cash flows of the original derivative instrument. We recommend the word “fully” be replaced with a less absolute term such as significantly. Fully offsetting future changes is not always possible due to differences in counterparty credit risk, different markets used to execute and terminate hedges, and limited availability of futures markets for commodity hedging. For instance, the original derivative instrument may have been executed in a bilateral transaction and thus is subject to counterparty credit risk. Subsequently, an offsetting derivative instrument may be purchased on an exchange, which would not be subject to entity-specific credit risk, or with another bilateral counterparty with different credit risk. It would not be transparent to require the entity to continue hedge accounting for the bilateral derivative while using mark-to-market accounting for the exchange-traded derivative simply because the counterparty credit risk did not fully offset.

Redesignating

If a hedging relationship meets the proposed criteria for dedesignation, the Exposure Draft further prohibits the redesignation of both the original hedging derivative instrument and the offsetting derivative instrument in a new hedging relationship. This absolute prohibition adds unnecessary complexity to the accounting for derivatives while increasing transactions costs. As noted above, there are legitimate business reasons why an entity would either terminate or modify an existing hedging relationship due to a change in economic conditions and remove a derivative from the hedging relationship. Given the change in economic conditions, it is unclear why the entity would be prohibited from dedesignating and redesignating the original derivative in a new hedging relationship.

Conclusion

The proposal in the exposure draft would impose requirements that reflect a narrow application of hedge accounting that could likely only accommodate the simplest of static hedging strategies. Many real world risk management strategies would be prohibited from receiving hedge accounting and result in accounting that does not match the economics of the transaction since entities would not transact simply to achieve an accounting result. In certain instances, derivatives would be carried at mark-to-market even though they are achieving an economic hedge that would otherwise meet all requirements for hedge accounting if a new derivative had been executed. In other instances, hedge accounting may be required for one derivative even though a second, more effective hedge has been executed but must use mark to market accounting. In order to alleviate these concerns, we recommend that the Board (1) change the guidance around modification of hedging relationships to allow adding and removing derivatives, (2) remove the prohibition on redesignating a derivative, and (3) eliminate the requirement that a derivative hedge be fully offset in order to achieve effective termination.

Question 68: *Do you agree with the transition provision in this proposed Update? If not, why?*

The exposure draft does not provide specific transition guidance with respect to existing hedges, in particular those hedges that have been documented using either the shortcut method or the critical terms match method, both of which would be eliminated by the proposed guidance. Assuming the hedged risk and hedging relationship are the same before and after transition, the relationship would qualify under the new guidance as a reasonably effective hedge. We believe that a modification of the hedge documentation to address the hedging requirements under the proposed ASU should be considered sufficient to keep the hedge relationship intact, and that there is no need to “dedesignate” the existing hedge relationship and “redesignate” the now off-market derivative in a new hedge relationship (as those terms are used in Topic 815). Requiring computation of the new, “theoretical” ineffectiveness that such a formal dedesignation/redesignation would entail would introduce accounting differences when no underlying transaction or change in economics has occurred. Thus, we believe that this would be of little benefit, and potentially confusing, to users of financial statement, and we recommend that the final ASU specifically indicate that the “re-documentation” approach we have recommend is sufficient and that no ineffectiveness is

created by documenting the compliance of existing hedges with the newly issued requirements.

Further, we believe that the presumption of no ineffectiveness under the shortcut and critical terms match methods would preclude the need to perform a retrospective long haul calculation of ineffectiveness through the transition date. That is, the new requirements regarding measuring and recording ineffectiveness should be applied prospectively. We suggest adding clarifying language to clarify the transition requirements with regard to these existing hedges as well.

Conclusion

We appreciate your consideration of this topic and our related comments. The proposed changes to the accounting financial instruments and hedging will have a significant impact on our industry, and we would be pleased to discuss any of these matters with you and to provide any additional information that you may find helpful in addressing these important issues.

Very truly yours,

Jose Simon [s]

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