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Constellation Energy®

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Technical Director
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
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File Reference No. 1820-100

Dear Board Members and FASB Staff:

Constellation Energy Group, Inc. ("Constellation Energy") and its regulated affiliate, Baltimore Gas and Electric Company ("BGE"), respectfully submit comments on the Financial Accounting Standards Board ("FASB") Proposed Accounting Standards Update, *Revenue Recognition* (Proposed Update). Constellation Energy is a leading supplier of energy products and services to wholesale and retail electric and natural gas customers and owns a diversified fleet of generating units in the United States (U.S.). A FORTUNE 500 company headquartered in Baltimore, Maryland, Constellation Energy had revenues of $15.6 billion in 2009.

Overall Comments

We have concerns regarding the potential for increased complexity and operational difficulties resulting from certain of the provisions in the Proposed Update, including:

- The impact of customer credit risk
- Contract costs
- Disclosure requirements
- Retrospective application
- Implementation guidance
- Onerous performance obligations

Below we provide responses to certain of the specific questions directly posed by the Boards. We also provide a discussion of our concerns and suggested remedies related to certain issues which were not specifically posed as questions in the Proposed Update but for which we believe this project provides an appropriate opportunity to address.

Please note that the Edison Electric Institute (EEI) is also submitting a comment letter that reflects the consensus views of its members on the Proposed Update. Constellation Energy fully supports and endorses the comments provided by EEI.

Question 5 – Impact of Customer's Credit Risk on Revenue Recognition
Paragraph 43 proposes that the transaction price should reflect the customer's credit risk if its effects on the transaction price can be reasonably estimated. Do you agree that the customer's credit risk should affect *how much* revenue an entity recognizes when it satisfies a performance obligation rather than *whether* the entity recognizes revenue?

Response
We do not agree with the recognition of credit risk as a reduction of revenue as part of the initial determination of contract consideration. In our view, this approach would obscure differences in customer credit quality and collection practices, which are currently transparent in the financial statements in the form of gross revenue coupled with separate recognition of bad debt expense. We believe that users of the financial statements value the insight into and understanding of our collection practices and the credit quality of our customers which would be obscured by netting this impact within the revenue line item. Credit losses have traditionally been viewed as a cost by users, and we have not observed any fundamental economic or analytical change to warrant an alternative approach. Further, the proposed guidance would result in inconsistent classification between the initial recognition (i.e., as a reduction of revenue) and the subsequent measurement (i.e., as a separate expense component).

We believe that it is counterintuitive to recognize revenue at some amount other than the transaction price, particularly for our regulated operations. Due to the regulated nature of our utility company, the rates that BGE charges to its customers are approved and mandated by the Maryland Public Service Commission (PSC). We do not believe it would be appropriate to reflect sales prices for BGE's sales of power and gas to its customers that differ from the rates mandated by the PSC. Such a requirement would cause disparity between revenues reported to regulators and the Company's GAAP revenues. In addition, we believe the same principle applies for nonregulated revenues. It is transparent and intuitive to recognize revenue at the price charged to the customer, and introducing a reduction for a factor unrelated to price would impair, rather than improve, the quality of financial reporting.

Based on the above discussion, we do not believe it is appropriate to adjust the amount of sales revenues to reflect credit risk. We believe the consistent recognition of all credit risk as an expense, both in the initial determination of contract consideration and in the subsequent measurement of collectability, is the most representationally faithful presentation. Accordingly, we request that the Boards remove this provision from the final standard.

Question 9 – Contract Costs
Paragraph 58 proposes the costs that relate directly to a contract for the purposes of (a) recognizing an asset for resources that the entity would use to satisfy performance obligations in a contract and (b) any additional liability recognized for an onerous performance obligation. Do you agree with the costs specified? If not, what costs would you include or exclude and why?

Response
We generally agree with the fundamental types of costs specified in paragraph 58 of the Proposed Update that would be considered to relate directly to a contract. However, because such costs would also be utilized in the ongoing evaluation of contracts for onerous performance obligations as proposed in paragraph 55, we request further clarification regarding hedge costs including the cost offsets (i.e., hedge benefits) provided by hedges as described more fully below.

In carrying out our energy and energy-related business activities, we frequently enter into derivative and non-derivative transactions as hedges against fluctuations in commodity prices. We believe the combination of the physical commodity supply contracts coupled with the associated hedges represents the total "direct costs" of satisfying the customer performance obligations. We believe that these hedge

costs/benefits meet the criteria in paragraph 58(e) as they represent "other costs that were incurred only because the entity entered into the contract". Accordingly, these hedging instruments (both designated and qualifying cash flow hedges and economic hedges) should be included in the ongoing evaluation of contracts for onerous performance obligations. For instance, assume that a company enters into a forward sale of power that does not meet the definition of a derivative (i.e., a performance obligation) and simultaneously enters into a purchase contract to fix the costs to serve the sale contract. Our understanding is that the cost to fulfill the sales contract should incorporate the beneficial effects of the hedging instrument (i.e., the locked-in cost to serve the contract), but we believe that this should be made explicit in the final standard. We request that the Boards address hedge costs in the final standard language or include an example indicating that such hedge costs would be properly classified as "direct costs" under paragraphs 58 and 55.

Question 11 – Disclosure Requirements
The Boards propose that an entity should disclose the amount of its remaining performance obligations and the expected timing of their satisfaction for contracts with an original duration expected to exceed one year. Do you agree with that proposed disclosure requirement?

Response
We disagree with the proposed disclosure requirement because we believe that the proposed guidance in paragraph 78 of the Proposed Update which requires disclosure of the expected future settlement of performance obligations currently under contract would unduly increase litigation risk associated with disclosing forward-looking information within the financial statement footnotes. These types of forward-looking disclosures are typically included within the Management's Discussion and Analysis section of SEC filings and not included in the footnotes. These disclosures of future revenues for companies in the energy industry, by their nature, will be highly volatile from period to period and would likely be stale by the time the financial statements are filed with the SEC. Further, these proposed disclosures would provide users of the financial statements an incomplete view of a Company's future revenue stream. In other words, companies would only be required to disclose revenues currently under contract but would not be permitted to include projected revenues beyond those currently under contract. Many industries sell only a portion of their expected volumes under forward contracts. The remainder may be sold as produced or based upon spot demand. Further, while those sales may not be contracted, the price of probable forecasted sales may be fixed through the use of hedges. The proposed disclosures would exclude all of these common sources of large, ongoing portions of entities' revenue. This incomplete data will likely conflict with other disclosures and projections made to investors which would result in additional confusion rather than increased transparency. Accordingly, for the above reasons, we request that the Boards remove the required disclosures related to the amount of remaining performance obligations.

The Proposed Update would also require a substantial increase in the volume of disclosures related to revenue recognized in the current period from contracts with customers. Due to the high volume of contracts we execute, it would be administratively burdensome from an operational standpoint to disaggregate and disclose the satisfaction of performance obligations by relevant categories. Further, because the relevant categories selected for disclosure will vary from company to company, the resulting disclosures will likely not be comparable even for companies within the same industry. We believe this overall increase of required disclosures, coupled with incomplete and incomparable information as discussed above, could result in confusion and misunderstanding by users of financial statements.

Due to these concerns, we request the Boards to address disclosures related to recognizing revenues from contracts with customers as part of the overall disclosure framework project. We believe that a comprehensive disclosure framework addressing all aspects of financial statement disclosures would be a

more effective approach, and would prove more informative to financial statement users, instead of imposing incremental standard-specific disclosure requirements for each convergence project.

Question 13 – Retrospective Application
Do you agree that an entity should apply the proposed guidance retrospectively (that is, as if the entity had always applied the proposed guidance to all contracts in existence during any reporting periods presented)?

Response
No. We believe that full retrospective application of the new revenue recognition guidance would be highly burdensome and would be extremely difficult to operationalize as we would need to monitor and potentially restate an extremely high volume of contracts over a multiple-year period (i.e., up to five years for SEC registrants). Moreover, retrospective application would require companies to maintain two sets of books for the entire retrospective period using two different sets of accounting principles and interpretations, would necessitate significant changes to information systems to capture the appropriate data, and would involve duplicative costs to audit those dual amounts and the related internal controls. For preparers with a high volume of contracts that expire prior to the effective date of the new standard, the costs of a full retrospective application would be quite substantial. In addition, the implementation of new accounting principles can be complex even when undertaken as a single project. Expanding the application of new revenue recognition standards to three years while maintaining the old rules during the same period will create increased complexity and associated risk of introducing errors.

Retrospective application may have a theoretical appeal in spite of its costs, but in our view the perceived benefits of this approach are modest. We believe that most financial statement users are more interested in understanding and predicting future revenues and cash flows and how the current period results compare to expectations. Under the proposed approach, three years of historical income statements would have to be restated, yet comparisons to more than one year would likely be stale. Further, the requisite restatement of quarterly data, even for expired contracts, provides an added layer of complexity with little incremental benefit. Accordingly, we believe that retrospective application is likely to produce only modest benefits that, in our view, do not outweigh the substantial costs of implementation.

An alternative and preferable approach in our view would be to require a cumulative effect adjustment for contracts with unfulfilled performance obligations as of the latest balance sheet date upon implementation (similar to the approach discussed in EITF 02-3, *Issues Involved in Accounting for Derivative Contracts held for Trading Purposes and Involved in Energy Trading and Risk Management Activities*). This approach worked well in our industry, adjusted the balance sheet to reflect cumulative earnings on a basis comparable to the new approach, and provided data in the current period on the new basis that investors could compare to their expectations.

Question 14 – Implementation Guidance
The proposed implementation guidance is intended to assist an entity in applying the principles in the proposed guidance. Do you think that the implementation guidance is sufficient to make the proposals operational?

Response
We believe that the implementation guidance could be made more effective by providing a comprehensive example, from start to finish, showing the amounts and timing of assets/liabilities recorded, allocation of transaction price, satisfaction of performance obligations, assessment and recognition of onerous performance obligations, sample disclosures, etc. In reviewing the piecemeal guidance contained in the Proposed Update, it is difficult to understand the practical application of the entire framework.

Other Comments

Onerous Performance Obligations

The nature of the energy industry reflects a many-to-many relationship between the energy commodity suppliers and the energy commodity customers. That is, energy companies like ours who actively participate in both the wholesale and retail energy markets, have an extremely large number of customers who buy their energy commodities (e.g., power, gas, etc.) from us and we, in turn, procure supplies of those energy commodities from numerous suppliers in addition to procuring fuel to burn in our own power generating plants. We manage these supply and demand positions on a portfolio basis in a rapidly-changing, dynamic market environment in order to optimize the ultimate profit that we earn on each customer contract. These portfolio positions, both supply and demand, change on a continual basis to reflect changes in market conditions, the addition of new customers and contracts, the procurement of new commodity supplies, the physical generating capabilities of our power plants, the availability of fuel to operate our power plants, etc. Because energy companies manage these supply and demand positions at a portfolio level (i.e., groups of supply and demand positions aggregated by geographic region), we currently do not have a direct link between each individual customer contract and the costs expected to be incurred to satisfy the contract (either at the contract level or the performance obligation level). The costs associated with establishing this direct link and maintaining this link in the dynamic market environment in which we operate would be extremely high and would, in our view, greatly exceed any benefits that would accrue to financial statement users.

We appreciate the attempted modification of the Discussion Paper's proposal to limit the evaluation of onerous performance obligations to an exception-based test. However, while we understand the intent of requiring recognition of onerous performance obligations, we believe that this requirement would introduce unnecessary complexity and administrative burden for preparers. We strongly agree with the Boards' conclusion, as articulated in the Discussion Paper, regarding the complexity and administrative burden that would have been introduced by a similar provision. Paragraph BC131 of the exposure draft states, "In the Discussion Paper, the Boards noted that the amount of an entity's performance obligations could change for reasons other than an entity's performance (for example, for changes in the price or quantity of goods or services that an entity expects to transfer to the customer to satisfy its remaining performance obligations). The Boards also noted that reflecting those changes in the measurement of the performance obligations would require an entity to remeasure its performance obligations at each reporting date. In the Discussion Paper, **the Boards rejected such an approach because they concluded that it would be unnecessarily complex for most contracts with customers**" [emphasis added].

We believe that this same complexity and administrative burden will equally apply to the provision that the Boards ultimately included in the exposure draft by requiring companies to make an assessment on an ongoing basis (i.e., each reporting period) of whether a contract contains any onerous performance obligations. This provision effectively would require companies to remeasure every performance obligation at each reporting date and compare the expected costs of those performance obligations to the expected revenues to be received from satisfying those obligations in order to determine whether the obligation is "onerous" as defined. It is our view that the proposal, as written, would produce the very complexity that the Boards acknowledged and ultimately rejected. Accordingly, we request that the Boards remove the onerous contract provision entirely.

If the Boards decide to retain a requirement to recognize onerous performance obligations in some form, we request modification of the provisions to reflect our suggestions in the following paragraphs. In absence of elimination of the onerous performance obligation provisions, we believe that additional

clarification and guidance is necessary to ensure proper application of this principle. First, the most significant operational issue associated with the current proposal could be alleviated if qualitative factors were used to define and identify situations in which the potential for an onerous performance obligation exists. As noted above, by defining an onerous performance obligation in terms of a mathematical test, the proposal effectively requires measurement of all performance obligations in order to determine whether they are considered onerous. If the test is intended, as described in the exposure draft, to mirror the impairment test for assets, we believe that the indicators of an onerous performance obligation should be qualitative.

Further, the proposed guidance acknowledges the possibility of recording an onerous performance obligation related to one portion of a contract despite the fact that the contract overall is profitable. Like many companies in the energy industry, we negotiate contracts that contain multiple deliverables as a group with the objective of achieving a targeted margin on the overall contract, not necessarily to achieve a profit on each deliverable individually. Accordingly, we believe the proposed guidance would result in asymmetrical financial results by recognizing a liability for one portion of a contract without the ability to recognize an offsetting asset for a profitable portion of the very same contract. In our view, it is misleading to record an onerous performance obligation, and corresponding expense, on a single element of a contract when the overall contract remains profitable throughout the duration of the contract. In other words, it does not make sense to us to recognize a loss for a portion of a contract in one period and then reverse this loss in subsequent periods because the overall contract will result in a positive margin. The proposed asymmetrical financial presentation would result in unwarranted earnings volatility and reduced transparency for financial statement users as they would only have visibility into portions of a contract without having a complete understanding of the expected profitability of the entire contractual arrangement with that customer. Accordingly, we request the Boards to raise the level of the onerous contract evaluation requirement to be performed at least at the whole contract level, if not at the overall portfolio level as determined by the company's risk management and portfolio management practices, instead of at the performance obligation level. In absence of this change, we request the Boards to consider instituting a threshold for recognizing onerous performance obligations. This recognition threshold would prevent companies from having to recognize an onerous performance obligation for only partial and/or temporary changes in the estimated costs to satisfy the performance obligation in an otherwise profitable contract. For instance, instead of the proposed guidance, the Boards could require companies to recognize a liability when the estimated costs to satisfy an individual performance obligation exceeds the amount of transaction price allocated to that performance obligation **and** it is "probable" that a loss will be incurred on the overall contract.

The following example highlights the unanticipated, and in our view asymmetrical, outcome of recording an onerous performance obligation on only one part of a contract due to a temporary increase in market prices for one element within a contract while the overall contract remains profitable. Assume a company enters into a contract to sell both power and renewable energy credits (RECs) to a single customer over a 5-year term for a single fixed price. The contract receives accrual accounting treatment because the contract does not qualify as a derivative. In order to obtain the supply of power and RECs to satisfy this contractual obligation, the company then enters into two separate purchase contracts to buy power and RECs from two different suppliers. The purchase of RECs is executed for the same 5-year term as the original sale contract at a cost that is lower than the sale price in the original contract, thus the profit margin on the REC sale has been locked in. The purchase of power is executed for only the first 3 years, also at a price that is lower than the original sale price. However, because the last two years of power supply are unhedged, the company is exposed to fluctuations in spot market power prices for the last two years. Now assume that in a subsequent reporting period the forward market price of power for the last two years of the original sale contract increases to a level that indicates that the power portion of the contract will incur a loss. Accordingly, the company recognizes an onerous performance obligation, and corresponding expense, for the estimated forward loss on the power portion of the contract. However, the

locked in profit margin on the REC portion of the sale contract is much greater than the projected loss on the power portion and the overall contract remains profitable. Finally, assume that the forward market price of power returns back to the original levels and the company executes another power purchase contract for the remaining two years at a price lower than the original sale that locks in the profit on the entire power portion of the sale contract. The company now reverses the onerous contract liability and corresponding credit to expense to reflect the fact that the power portion of the contract will, in fact, be profitable. At the end of the 5-year term of the contract, the company has now realized positive profit margin on both the power and REC portions of the contract with no realized losses on any portions of the contract in any period.

As illustrated in the above example, the proposed guidance related to onerous performance obligations could result in unnecessary income statement volatility related to only portions of a contract that could be temporarily onerous while the overall contract remains profitable throughout the entire contractual term. We believe that this asymmetrical and volatile earnings impact is an unintended outcome of the Proposed Update and ask that the Boards reevaluate this provision and raise the level of the onerous performance obligation assessment to be performed at least at the whole contract level, as discussed above, if not at an even higher portfolio level as dictated by a company's risk management and portfolio management practices.

Finally, the proposed guidance does not clearly indicate whether the requirement to record an onerous performance obligation applies only to recognized performance obligations (i.e., once a contract liability has been recognized on the balance sheet) or to all performance obligations regardless of whether or not they have been recognized on the balance sheet. We suggest the Boards clearly indicate in the final standard whether the onerous performance obligation provisions apply to all performance obligations or only to recognized performance obligations.

Conclusion

Constellation Energy and BGE appreciate the opportunity to provide comments on these important issues. The proper amount and timing of revenue recognized on contracts with our customers is significant to our business and we want to ensure the accounting continues to faithfully represent the underlying economics of the transactions.

Very truly yours,

/s/ Bryan P. Wright
Vice President, Chief Accounting Officer,
and Controller for Constellation Energy

/s/ Anne A. Hahn
Vice President, Controller – Baltimore Gas & Electric Co