

April 25, 2011

Technical Director
File Reference: 2011-175
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

File Reference: 2011-175 Selected Issues about Hedge Accounting

Dear Sir or Madam:

The American Gas Association (AGA) respectfully submits our comments on the Financial Accounting Standards Board (FASB or "Board") Discussion Paper – *Selected Issues about Hedge Accounting* (DP). The American Gas Association, founded in 1918, represents 199 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 U.S., of which 91 percent — more than 64 million customers — receive their gas from AGA members. Today, natural gas meets almost one-fourth of the United States' energy needs. AGA appreciates the FASB soliciting comments on the International Accounting Standards Board's (IASB) Exposure Draft (ED) and its attempts to improve and simplify the application of hedge accounting.

## Summary

AGA previously submitted a comment letter in response to the Board's May 2010 Financial Instruments Exposure Draft, in which we commented on certain proposed amendments to hedge accounting. In general, we supported the simplification efforts inherent in those proposals, particularly with regard to demonstrating hedge effectiveness. There were certain aspects which we disagreed with, primarily associated with the prohibitions on dedesignation, redesignation, and other operational risk management practices.

Based on our review of the IASB's ED, we believe there are benefits associated with both sets of proposals. Therefore, we have summarized our views into an overall recommended framework below, including a discussion of the critical items that we believe the final hedge accounting model should contain. We respond to specific questions contained in the DP in the appendix to this letter.

## **Hedge Accounting Framework**

We strongly support the objective in Paragraph 1 of the IASB's ED that hedge accounting should "represent...the effect of an entity's risk management activities" and "convey the context of hedging instruments in order to allow insight into their purpose and effect." We believe hedge accounting requirements which reflect an entity's actual use of derivatives for economic hedging purposes provides the greatest benefits to financial statement users. Although the Board's May 2010 ED would relax certain hurdles for achieving hedge accounting qualification, certain other proposals therein still appear largely based on a view that hedge accounting is "special accounting" and should thus be limited. Currently, hedge accounting is considered an exception to the normal recognition and measurement requirements, and thus the guidance contains many detailed rules and requirements to limit its use, resulting in valid economic hedging strategies being ineligible for hedge accounting

We believe an appropriate starting point for revising existing hedge accounting guidance would be to build off the IASB approach, focusing on applying hedge accounting consistent with an entity's risk management strategy rather than a philosophy which tends to limit hedge accounting. A hedge accounting framework which builds off a company's existing economic hedging and risk management programs is more likely to reflect the intent and effect of such activities. Instances where a company is prevented from achieving hedge accounting or required to continue or discontinue hedge accounting in conflict with its risk management strategy should be minimized.

Based on the principles outlined above, there are certain critical provisions that we believe the final hedge accounting model should contain. The above framework and the following recommendations are also consistent with those of our industry counterparts in the electric utility industry, as noted in the Edison Electric Institute's (EEI) related comment letter to this DP. Specifically, we believe the following should be addressed in the final standard on hedge accounting:

- Establish an effectiveness threshold of "reasonably effective"
- Permit component hedging for separately identifiable and reliably measurable nonfinancial risks consistent with existing provisions for financial risks
- Continue to permit voluntary dedesignation of hedging relationships when in accordance with an entity's risk management policy
- Continue to permit subsequent redesignation of hedging instruments in new hedging relationships

## Conclusion

Overall, we are very encouraged by the IASB's and FASB's efforts to simplify the criteria to apply and maintain hedge accounting, which we believe will be a significant benefit to financial statement users and preparers. We strongly encourage the continuation of convergence efforts in this area, and we appreciate your consideration of these issues and our comments.

Very truly yours,

Jose Simon [s]

Jose Simon, Vice President and Controller, Piedmont Natural Gas Chairman of the American Gas Association Accounting Advisory Council Question 2: Do you believe that the proposed guidance and illustrative examples included in the IASB's Exposure Draft are sufficient to understand what is meant by risk management, how to apply that notion to determine accounting at a transaction level, and how to determine the appropriate level of documentation required? Why or why not?

We believe the ED's guidance in this area is sufficient and should be limited to principles-based application. Risk management is applied differently depending on a company's size, risk tolerance, etc. Current requirements under U.S. GAAP are similar in that an entity must formally document the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge, and we are not aware of related practice issues in regard to this requirement.

Question 4: Do you foresee any significant auditing issues arising from the proposed articulation of risk management and its link to hedge accounting? For example, is the information required to be disclosed regarding an entity's risk management strategies measurable and objective? Could the inclusion of an entity's risk management objectives create an expectation gap that the auditor is implicitly opining on the adequacy of an entity's risk management objectives?

As noted in response to question 2, U.S. GAAP already contains a link between hedge accounting and an entity's risk management and we are not aware of related auditing challenges currently. See further discussion regarding proposed disclosure requirements in our response to question 22.

Question 7: Do you believe that the proposed criteria are appropriate when designating a component of an item as a hedged item? If not, what criteria do you suggest? Do you believe that the proposed guidance and illustrative examples are sufficient to understand how to determine when the criteria of separately identifiable and reliably measurable have been met? If not, please describe what additional guidance should be provided.

and

Question 8: Do you believe that "separately identifiable" should be limited to risk components that are contractually specified? Why or why not?

We strongly support the ability to apply hedge accounting for a component of a nonfinancial asset or liability, and we agree with the IASB's proposed criteria of 'separately identifiable' and 'reliably measurable'. Limiting such components to contractually specified risks would unnecessarily limit the benefit of allowing component hedging and would be inconsistent with many entities' risk management activities and thus out of step with the framework articulated above. The examples in ¶B14 and ¶B15(b) provide support for the notions that such evaluations will necessarily be facts and circumstances driven, and that non-contractually specified risks can be separately identifiable on a qualitative evaluation. For our industry, certain physical gas delivery locations are priced at a negative basis to the benchmark natural gas futures (NYMEX) contract due to supply/demand factors. Therefore, we believe it is worth clarifying within the

final standard that certain physical risk components (i.e., a commodity price benchmark of an "all-in" delivery location) can be priced at a premium to the all-in price (i.e., negative basis) due to such factors, while the relationship itself is still reasonably effective and in accordance with common risk management hedging practices.

Question 14: Do you foresee any significant operational concerns, including auditing issues, in determining how to assess whether a hedge achieves other-than-accidental offset? If yes, what concerns do you foresee and how would you alleviate them?

We believe the concept of 'other-than-accidental offset' will be difficult to apply in practice. Further, some may interpret the IASB's ED to require use of hedging instruments that result in an even higher level of effectiveness than that required under the current bright-line guidance (i.e., the ED requires an entity to designate in a manner that will "produce an unbiased result" and "minimize expected hedge ineffectiveness"). Therefore, we support the FASB's proposed threshold of 'reasonably effective'. This threshold is appropriately broad so as to accommodate most economic hedging strategies, but still implies an appropriate minimum level of effectiveness.

Question 16: Do you foresee any significant operational concerns or constraints in determining whether (a) a change to a hedging relationship represents a rebalancing versus a discontinuation of the hedging relationship or (b) an entity's risk management objective has changed? If yes, what concerns or constraints do you foresee and how would you alleviate them?

As noted in our comment letter to the Boards' May 2010 ED, we disagree with overly restrictive limitations on adjustment of hedging relationships when those adjustments are consistent with an entity's risk management objective and are permitted under existing accounting requirements. We foresee similar operational practice issues with respect to the IASB's proposals it relates to the topic of rebalancing vs. discontinuation.

We strongly believe that retaining the ability provided under current practice to voluntarily dedesignate and/or redesignate a hedging relationship will alleviate many of the concerns previously expressed by our members, the electric utility industry through the EEI, and more broadly by various constituents. Instead of removing or restricting dedesignation, we urge the Board to consider principle-based modifications such as allowing voluntarily dedesignations and/or redesignations when in accordance with the company's risk management objective and strategy. At times, continuing to maintain a hedge may increase the risk of adverse price movements to an entity, and as a result there are instances where effective risk management involves reducing hedge levels. We believe that the rebalancing provisions should explicitly recognize and permit hedge accounting for voluntary changes in hedge levels consistent with an entity's risk management objective, even when those changes might reduce the hedge level or be executed with offsetting derivatives.

Question 20: Do you believe that the proposed presentation of a separate line item in the statement of financial position would increase the transparency and the usefulness of the information about an entity's hedging activities? Why or why not?

While we view the other topics addressed herein as the most critical to achieving a well-functioning hedge accounting standard, we also believe that further disaggregation within the face of the financial statements should be minimized where possible. Specifically, as it relates to the IASB ED's proposal that a fair value hedging gain or loss on a hedged item be recognized and presented as a separate line item from that containing the hedged item itself, we believe this would make the face of the balance sheet overly cluttered and more difficult for users to understand (particularly considering similar changes proposed within other pending joint Board standards). We believe that the current approach under both U.S. GAAP and IFRS of directly adjusting the hedged item for changes in fair value, in one line item on the face of the financial statements, is most appropriate.

Question 22: Do you foresee any significant auditing issues arising from the inclusion of risk management disclosures in the notes to the financial statements? If yes, what issues do you foresee and how would you alleviate them? Do you believe that it is appropriate to include risk management disclosures in the notes to the financial statements rather than in other information in documents containing financial statements? Why or why not?

We have significant concerns with the disclosures proposed in the IASB's ED, particularly the requirement to include individual quantities or amounts of each risk managed using derivatives and the analysis of how hedging changes the risk exposure. We believe that disclosures on hedge accounting should focus on the risk management strategy and the impact hedge accounting has on the entity's financial statements and should not be expanded beyond hedge accounting. Disclosures about the total population of risks to which the entity is subject should not be included in this standard but should be considered separately if deemed appropriate by the Boards. In fact, integrating comprehensive risk disclosures into the notes to the financial statements might be more appropriately considered as part of the FASB's Disclosure Framework project.

We also believe that the disclosures proposed by the IASB represent forward looking information which is not required to provide a fair presentation of historical financial results. Such quantitative disclosures about all risks being managed would be relevant to all entities, not only those using derivatives and electing hedge accounting. Therefore, it would be inappropriate and incomplete to require such disclosures only for those entities using a particular type of risk management instrument (derivatives for which hedge accounting has been applied) while entities managing risk using physical assets, nonderivative contracts, or derivatives accounted for at fair value through earnings would not have to make such disclosures. Further, this could lead to a competitive disadvantage to those entities that have elected to apply hedge accounting consistent with otherwise prudent risk management activities, as they would be required to present such forward looking information regarding hedge levels and the like while those who have not elected hedge accounting would not be required to do so.

Question 23: Do you believe that the changes proposed by the IASB provide a superior starting point for any changes to U.S. GAAP as it relates to derivatives and hedging activities? Why or why not? Should the FASB be making targeted changes to U.S. GAAP or moving toward converging its overall standards on derivatives and hedging activities with the IASB's standards?

As may be inferred from the above discussion, we do not believe that either Board's proposals necessarily represent an optimal set of hedge accounting guidelines, although both include proposals which we support. For example, we support the IASB's proposal to measure hedge ineffectiveness based on the "lower of" test as currently retained under U.S. GAAP, but do not support the FASB's May 2010 ED proposal to also recognize ineffectiveness associated with "under-hedge" performance (as noted in our response to the FASB's May 2010 ED). Conversely, we do not support the IASB's proposal that hedged forecasted transactions must be "highly" probable of occurring, nor its proposal that a cash flow hedge reserve (OCI) be released simply when it is determined that a hedged forecasted transaction is "no longer expected to occur" (as both represent higher thresholds than current U.S. GAAP requires relative to their respective scenarios, resulting in potential inability to apply hedge accounting in accordance with normal risk management activities). However, we believe certain targeted improvements to remove current bright lines will improve hedge accounting by reducing the complexity and allowing entities to achieve hedge accounting for a larger number of valid economic hedging strategies.

The targeted improvements that would make the greatest impact, and are most critical in our view, include:

- Establish an objective for hedge accounting linked to risk management
- Reduce the threshold for achieving hedge accounting to reasonably effective
- Eliminate the requirement for a quantitative test of effectiveness
- Eliminate the prohibition against component hedging for nonfinancial risks
- Allow voluntary dedesignation and redesignation activities in accordance with an entity's risk management activities