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**By Electronic Mail** 

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We appreciate the opportunity to comment on the Exposure Draft (ED) of a Proposed Accountings Standards Update, Fair Value Measurements and Disclosures – Improving Disclosures about Fair Value Measurements. Constellation Energy, a Fortune 500 company based in Baltimore, Maryland, is a leading supplier of energy products and services to wholesale and retail electric and natural gas customers. Constellation Energy is a major generator of electricity with a diversified fleet of generating units strategically located throughout the United States, totaling more than 9,100 megawatts of generating capacity. The company delivers electricity and natural gas through Baltimore Gas and Electric Company (BGE), our regulated utility in Central Maryland, and directly to wholesale and retail customers nationally. In 2008, Constellation Energy's revenues totaled \$19.8 billion.

Constellation Energy applies fair value accounting on a regular basis, including the measurement of derivatives and investment securities. We support the FASB's effort to address issues regarding fair value accounting on a comprehensive basis. Our comments are generally organized on a basis consistent with the issues presented at the beginning of the ED.

## **Sensitivity Analysis**

Issue 1: With respect to the disclosure of the effect of changes in reasonably possible, significant, alternative inputs for Level 3 fair value measurements for each class of assets and liabilities (sometimes also referred to as sensitivity disclosures), the Board is seeking input from financial statement preparers about their operationality and costs.

In general, we believe that additional disclosures are not necessary to support the reliability of most Level 3 fair value measurements and that the proposed sensitivity disclosure may not address the more fundamental economic phenomena that appear more likely to contribute to changes in fair value than estimation uncertainly. However, if the final Accounting Standards Update retains a sensitivity disclosure requirement, we believe it should be modified consistent with our recommendations below.

The Basis for Conclusions of the ED provides detail regarding the factors underlying the proposed sensitivity analysis disclosure. Therefore, we have organized our comments and concerns related to the operationality and cost of providing this disclosure as responses to specific considerations in the Basis for Conclusions.

BC 17. Furthermore, with respect to fair value measurements using significant unobservable inputs (Level 3), many users have concerns about the reliability of the estimate, and, therefore, would benefit from information about the potential range in fair value measurements if the reporting entity were to use reasonably possible alternative inputs.

The Basis for Conclusions indicates that users have concerns about the reliability of estimates using significant unobservable inputs and proposes to increase the disclosure requirements around these estimates. We believe the reliability of fair value estimates is already addressed comprehensively in the accounting literature, auditing standards, and disclosure and internal control requirements for public companies through the following elements:

- A consistent definition of fair value including a requirement to maximize the use of market participant data and assumptions
- A hierarchy for classifying fair value measurements to indicate the source and reliability of the significant inputs
- For Level 3 measurements (the least reliable level), a roll forward that shows the impact on current earnings (both realized and unrealized)
- Certifications pursuant to the Sarbanes-Oxley Act for public companies
- Independent audit opinions on fair presentation in accordance with GAAP and (for public companies) effectiveness of internal controls

Assuming these safeguards are in place and operating effectively, which is a fundamental presumption undergirding external financial reporting, we believe that they provide appropriate assurance regarding the reliability of Level 3 estimates.

Further, we are concerned that the sensitivity disclosures, as proposed, are likely to be misunderstood and potentially misinterpreted. While Level 3 measurements are the focus of the ED, those measurements often are determined based upon the level of and relationships to Level 1 and Level 2 measurements, and many nonderivative contracts and physical assets are hedged by derivatives or other financial instruments and embody the same valuation uncertainties as Level 3 fair value measurements. As a result, by focusing only on Level 3 measurements, the proposed sensitivity analysis would provide an incomplete picture of the potential for changes in fair value because it excludes other changes in value related to these Level 1 and Level 2 measurements, non-derivative accrual contracts, and physical assets. Given that the same factors that drive changes in Level 1 and 2 measurements, nonderivative contracts, and physical assets will also affect Level 3 measurements, disclosing sensitivities only for Level 3 fair value measurements recognized in the financial statements embodies significant potential for presenting incomplete and misleading information.

Considering the economic and market events of the last 12-18 months, we believe that concerns about the reliability of fair value estimates may result, at least in part, from the unprecedented volatility in the markets. However, that volatility is, in our view, reflective of underlying changes in fair value and is not an issue of measurement reliability. Because management of reporting entities must estimate the fair value of financial instruments as of the

balance sheet date considering inputs available as of that day, such economic volatility naturally is expressed in financial statement volatility. For the reasons expressed above, we do not believe the proposed sensitivity disclosures are necessary, and may not be effective, for addressing these concerns. While we believe that existing disclosures appropriately address the reliability of most fair value measurements, we recommend that any additional disclosures that may be adopted give consideration to providing a measure of market risk that would capture the inherent potential volatility associated with the use of fair value rather than a sensitivity analysis on inputs. We believe this type of analysis would be a more appropriate and direct means for addressing concerns that may be driven by market risk.

# BC10. The Board believes that users would benefit from information about a range of fair value for Level 3 measurements because of their greater degree of uncertainty and subjectivity.

While we acknowledge that in general there is a greater degree of subjectivity for estimating Level 3 measurements, we also believe that the degree of subjectivity is relatively narrow for many types of instruments; that is, not all Level 3 measurements are the same with respect to complexity and degree of subjectivity. Accordingly, other than for a smaller subset of highly subjective Level 3 estimates we describe below, we believe that additional and potentially voluminous quantitative disclosures are not necessary for most Level 3 measurements.

We believe that the fair value estimates for most Level 3 commodity derivatives have a high degree of reliability, for several reasons:

- U.S. GAAP requires management to classify assets and liabilities in the lowest level in the fair value hierarchy for which inputs are significant to the fair value measurement. We understand that significance was intended to be interpreted as a relatively low threshold (i.e. 10 20% of the overall fair value or term) and thus we classify entire contracts within Level 3 even though up to 80% 90% of the fair value or term is based on inputs that are observable. As an example, assume an entity executes a three year contract to make monthly purchases of natural gas at a set contract price. Natural gas futures trade on an exchange but are generally only liquid for up to two years; thus, the market price for the third year of the contract is considered unobservable. Since the third year would represent 33% of the term of the contract, the entity would classify this entire contract in Level 3 even though over 66% of the term and up to 80% of the value (after considering the impact of discounting) is based on Level 1 or Level 2 inputs.
- The unobservable inputs used in Level 3 commodity derivative measurements are generally modeled from our Level 1 and Level 2 inputs and reflect market relationships and historical correlations. The primary input to the valuation model for these instruments is the forward commodity price curve. As previously mentioned, generally the forward prices in excess of two or three years are not observable and thus must be modeled. However, the forward prices are projected based on the observable prices and historical correlations and trends. Also, as entities enter into new derivative contracts we obtain some price discovery on the accuracy of our forward commodity curves, and firms routinely employ rigorous monthly procedures to validate these estimates as an internal control best practice.

For these reasons, we believe the majority of Level 3 measurements are reliable estimates, particularly for commodity derivatives, and that the range of fair values that would result from using alternative inputs would not provide meaningful information beyond that which is already reflected in the fair value measurement attribute and existing disclosure requirements. Further, we believe the cost of providing the proposed sensitivity disclosures would not be justified in light of the lack of substantive incremental benefit.

However, we note there could be a subset of Level 3 measurements that require significant judgment and for which fair value can rightfully be described as more subjective. These instruments may be characterized by some or all of the following characteristics:

- the possibility of an "all or nothing" gain/loss,
- lack of regular remeasurement other than for external financial reporting
- choices among inputs without benefit of relevant observable similar inputs for reference
- substantial variation in the outcome resulting from relatively minor changes in inputs.

Following is an example of a contract that would be representative of the subset of Level 3 measurements that exhibit these characteristics. The terms of an investment transaction we executed in a prior year provided that, if a particular event occurred, we would pay the counterparty a predetermined amount, and if the event did not occur we would not make any payment. Thus, there were only two possible outcomes: pay a single sum or pay nothing, but the fair value of this instrument would fluctuate between these two amounts (potentially by a substantial amount) as management's estimate of the probability changed. There was no reference market to estimate the probability of the event occurring and thus management was required to make its best estimate consistent with the valuation requirements of GAAP.

If it is determined to require sensitivity disclosures similar to those proposed in the ED, we recommend narrowing the scope of the proposed sensitivity analysis to a subset of Level 3 measurements such as illustrated in the above example that are highly subjective and uncertain and for which the impact on earnings could be material. We believe that limiting the scope of the sensitivity analysis will directly address the area where the most potential additional benefit could be realized at a reduced incremental compliance cost than under the proposal.

BC 11. Under current SEC rules, registrants may present sensitivity information to comply with the disclosure requirements in Financial Reporting Release No. 48, Disclosure of Accounting Policies for Derivative Financial Instruments and Derivative Commodity Instruments and Disclosure of Quantitative and Qualitative Information About Market Risk Inherent in Derivative Financial Instruments, Other Financial Instruments, and Derivative Commodity Instruments, for quantitative information about exposure to future changes in market risk from financial instruments. Consequently, some SEC registrants may already be providing sensitivity information in their MD&A disclosures although it is different from the type of sensitivity information required by this Update.

The fact that some registrants are presenting sensitivity disclosure in reports to the SEC is, in our view, unlikely to provide benefit in satisfying the sensitivity disclosures proposed by the ED. Further, those SEC disclosures are directed toward market risk, not toward perceived issues of reliability for a limited subset of fair value measurement as reflected in the ED.

In accordance with the referenced SEC rules, we currently disclose in MD&A value at risk (VaR) and economic value at risk (EVaR) as measures of market risk. VaR and EVaR are statistical models designed to predict the risk of loss based on historical market price volatility. Thus VaR and EVAR attempt to predict the likelihood that the fair value will be impacted by all market risks. While VaR addresses recognized fair value measurements, EVaR is computed across our entire market-risk sensitive portfolio. We use these VaR and EVaR measures of market risk to manage and control our business and employ systems and processes to capture the data to perform these calculations on a daily basis. We believe this type of data about market risk would be more likely to provide decision useful information to financial statement users and would be consistent with the information management uses to operate the business.

In contrast, we do not currently capture the data necessary to perform the proposed sensitivity analysis in the ED. Even if we were to do so, by excluding many sources of market risk beyond Level 3 measures that are recognized in the financial statements, the proposed sensitivity analysis would not provide information that would be useful in our business.

Consequently, we believe that the use of VaR and/or EVaR would provide a more holistic view of the potential for changes in value as a result of market risks, some of which must be valued using unobservable inputs and management estimates that may be correlated with risks that are not included in Level 3 measurements. Therefore, if the final Accounting Standards Update requires additional disclosures, we recommend permitting other metrics beyond sensitivity analysis, such as VaR and EVaR, in place of the proposal.

# BC 12. For sensitivity disclosures to be useful for further analyses by users of financial statements, the proposed amendments would require quantitative disclosure about significant inputs used in Level 3 measurements and about reasonably possible alternative inputs.

We believe the scope of the proposed sensitivity analysis is overly broad and thus the quantitative disclosure about significant inputs would be voluminous. As Level 3 measurements are based in part on unobservable information, it is likely that most significant unobservable inputs would have at least one reasonably possible alternative input (since reasonably possible is generally interpreted to be consistent with a 50% threshold). In conducting our business we enter into derivative contracts to buy and sell power, natural gas and coal (as well as other commodities) in markets throughout the United States. In the case of power, the commodity cannot be transported across long distances nor stored and thus there exist thousands of delivery points across the U.S. The fair value of a power derivative contract is driven largely by the forward commodity curve for its specific delivery point. Based on the proposal, we would potentially need to quantitatively disclose the forward commodity prices for thousands of delivery points. In order to be meaningful, the data would need to be disaggregated since the price of power at a given delivery point is uncorrelated to most other delivery points because of the highly regional nature of the power grid.

If the proposed sensitivity disclosure is retained, in order for it to be meaningful and avoid requiring an overwhelming amount of relatively homogeneous information, we believe that the term 'significant input' needs to be defined at an appropriate level. If significant input was defined as the forward commodity curve for power, we would need to consider the alternative forward commodity curves for each delivery point and aggregate the potential range of alternative values. In contrast, if significant input was considered the individual forward commodity curve for each delivery point that is highly correlated, then the likelihood of an

alternative value rising to the level of materiality is remote unless there is a significant concentration. We believe that this would be of interest to users as opposed to a general range of fair value above and below the estimated fair value. As such, we believe that the final document should clarify what level of detail and analysis is intended for companies to disclose for significant inputs, and we recommend that such clarification focus on identification of individual inputs that are probable of having a significant impact, not simply aggregating small variations in numerous individual inputs.

#### **Effective Date**

# Issue 3: Is the proposed effective date operational?

We believe that the effective date of the Update is not operationally achievable. For provisions other than the sensitivity analysis, which will be separately discussed below, we believe the effective date should be delayed at least until periods ending after 3/15/10. The changes to the Level 3 rollforward to require disaggregated reporting of transfers in and/or out and purchases, sales, issuances, and settlements will require system modifications to allow appropriate data tagging at a transaction level. While these modifications are not as significant on a prospective basis, because these modifications were not performed as of 1/1/09, we would not be able to properly capture the transaction data for the year ended 12/31/09 for inclusion in the year to date Level 3 rollforward in our 12/31/09 financial statements. If the requirement was only to show a gross fourth quarter rollforward, because these modifications were not in place as of 10/1/09, it would require a manual process to review activity for the quarter to appropriately categorize it. We do not believe one quarter of disaggregated reporting will provide incremental benefit sufficient to justify the cost and risk of implementing a manual process for one quarter. Delaying the implementation until 2010 will allow preparers to make appropriate system modifications to begin tagging data as of 1/1/10.

In regard to the effective date of the sensitivity analysis, if the final document includes this required disclosure, we believe the effective date should be delayed until at least 12/31/10. Our information systems are currently not designed to capture and track reasonably possible alternative inputs only for Level 3 fair value measurements recognized in the financial statements. While we provide certain market risk information as required by the SEC, it also is not the same as that proposed by the ED, either in scope or nature. Because the proposed sensitivities relate to a subset of fair value measurements that are not presently evaluated in the manner proposed, and because the proposal covers only a subset of such measurements that does not correspond with meaningful market risk analysis, system and process modifications to prepare the proposed disclosures, along with accompanying controls, will require more than one quarter to implement.

We note that the Board's agenda includes a project to examine and develop a framework for disclosures. We believe it would be more appropriate to consider the ED's proposals in connection with that project. However, if additional disclosures are deemed to be sufficiently urgent to warrant earlier implementation, we also note that the Board is currently conducting a project on the accounting for financial instruments. Accordingly, we recommend using a consistent effective date for that project and for the consideration of potential sensitivity disclosures about fair value. The accounting for financial instruments project will likely require system and process changes and it would be more effective to design, implement, and test these changes together.

#### **Other Matters**

In ¶820-10-50-2bb and ¶820-10-50-c.3, the proposal would require that significant transfers between Level 1, Level 2, and Level 3 shall be presumed to have occurred as of the beginning of the interim period in which the transfer occurs. We do not believe it is necessary to prescribe the methodology for implementing this requirement, and we believe that reasonable justification may exist that the transfer could be presumed to have occurred at the end of the period (when price verification procedures are performed) or even using specific identification (in the case of a significant identifiable market event). As such, we believe the final standard should not mandate a single convention for this purpose and instead should simply require disclosure of the policy or convention used for determining when the entity has presumed transfers occurred.

## **Conclusion**

We believe that the existing requirements for measuring, recording, and disclosing fair value are appropriate and would not benefit from the additional disclosures, that the proposed sensitivity disclosures may serve to undermine the perceived reliability of fair value measurements,, and that the resulting information may be subject to misunderstanding and misinterpretation. Additionally, we believe that the extent and timing of any incremental disclosures should be considered in connection with other relevant projects.

If the proposed model for sensitivity analysis is retained, we believe that the scope should be narrowed to exclude Level 3 measurements where a majority of the fair value is based on observable inputs. Instead, we believe that any incremental disclosure should focus on those contracts that involve significant judgment. Further, we believe that statistical measures such as VaR and EVaR that are currently used by management and for satisfying SEC disclosure requirements would provide more meaningful information regarding market risks. Thus, we believe the final standard should allow for flexibility in meeting any requirement for sensitivity analysis to allow management to select from a variety of measures.

Finally, the effective date for additional disclosure requirements should be deferred until the end of 2010 for the proposed sensitivity disclosures and until the first quarter of 2010 for other disclosures.

Thank you for consideration of our comments.

Sincerely,

/s/ Bryan P. Wright
Vice President, Controller

/s/ Randall E. Hartman
Assistant Controller – Technical Accounting & Policies