



December 15, 2010

Technical Director
File Reference: 1850-100
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

File Reference: 1850-100 Leases

The American Gas Association (AGA) respectfully submits our comments on the Financial Accounting Standards Board (FASB) Proposed Accounting Standards Update—*Leases (Topic 840) (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 U.S., of which almost 93 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 meets almost one-fourth of the United States' energy needs.

The AGA appreciates that the FASB and International Accounting Standards Board (IASB) are seeking to develop a converged standard on leasing. Leasing arrangements are widely used in our industry, and there are many provisions included in the ED that will significantly affect our member companies. We have limited our responses to questions for which we have concerns, request clarification, make recommendations, or wish to convey our support.

Summary

Highlights of our comments are summarized as follows:

- We believe the ED's guidance on determining whether a lessor retains exposure to significant risks or benefits associated with underlying leased assets should be expanded to contemplate the returns generated by operating the asset.
- We believe that lessees should have the option not to record lease assets and liabilities associated with short-term leases similar to the election afforded lessors.
- We disagree with the requirement to determine the lease term in a manner other than by reference to the contractually stipulated term as we believe no further obligation has been incurred.
- We believe flexibility should exist to utilize alternative methods of estimating contingent rentals and expected payments under term option penalties and residual value guarantees when such methods are supportable and indicative of management's best estimates.
- We seek clarification on what would constitute a reasonable analysis or framework necessary to assess changes in facts or circumstances when determining whether they would indicate a significant change in lease assets and liabilities.
- We disagree with the proposed requirement to disclose quantitative reconciliation of beginning and ending lease asset and liability balances.
- We seek clarification on the proposed retrospective application with regard to leases that no longer exist as of the adoption reporting date, as well as interaction of the ED's transition provisions with the grandfathering provisions under Emerging Issues Task Force (EITF) Issue No. 01-08, *Determining Whether an Arrangement Contains a Lease*.
- We seek guidance and/or propose our views on the following additional topics:
 - Retention of specialized lease accounting guidance for regulated enterprises
 - *Consideration* of a change in the current accounting requirements that leases of newly constructed assets be subject to the restrictions of phase-in plans by regulated enterprises
 - Recognition of an onerous contract between lease inception and commencement
 - Lessor's accounting model (topic) application when assessing residual assets for impairment

We provide our comments on selected questions in the ED that are relevant to our member companies below.

Responses to Questions in the ED

Question 2(a): *Do you agree that a lessor should apply (i) the performance obligation approach if the lessor retains exposure to significant risks or benefits associated with the underlying asset during or after the expected lease term, and (2) the derecognition approach otherwise? Why or why not? If not, what alternative approach would you propose and why?*

Overall, we agree with the approach for determining when a lessor should apply the performance obligation approach or the derecognition approach. However, we believe that the criteria for determining whether a lessor should apply the performance obligation approach should be expanded to include scenarios where the lessor plans to generate significant returns by operating the asset. Paragraph 28 of the ED notes that the performance obligation approach is appropriate when the "lessor retains exposure to significant risks or benefits associated with the underlying asset either:

- a) during the expected term of the lease; or
- b) after the expected term of the lease by having the expectation or ability to generate significant returns by re-leasing or reselling the underlying asset."

We believe the second criterion should be expanded to include "re-leasing, reselling or operating the underlying asset." That approach is consistent with paragraph BC27, which states the "performance obligation approach is likely to be appropriate in situations in which the entity's business is primarily to generate a return from active management of the underlying assets to multiple lessees during their life or from use or sale of those assets at the end of their lease."(emphasis added)

Question 3: *Do you agree that a lessee or a lessor should account for short-term leases in this way? Why or why not? If not, what alternative approach would you propose and why?*

We appreciate the Boards' effort to simplify the accounting for short-term leases. We note that paragraph 65 of the ED allows lessors the option of not recording lease-related assets and liabilities, nor derecognizing any portion of the leased asset. We believe that a similar option is appropriate for lessees and that the accounting should be symmetrical. That is, we do not believe requiring lessees to capitalize a right-of use asset and related obligation for short-term leases would increase the usefulness of the financial statements for the investor.

Even when a short-term lease's term crosses reporting dates, the incremental information provided does not justify the cost required to compile and track the information. For many companies, accounting for leases is decentralized and leases are manually accounted for using electronic spreadsheets. We believe that the cost of tracking and reporting information regarding short-term leases outweighs the benefits to the financial statement user.

As an alternative approach, we suggest that at the date of lease inception a lessee have the option to elect, on a lease-by-lease basis, not to recognize assets or liabilities arising from a short-term lease in the balance sheet similar to proposed lessor accounting for short-term leases. Finally, consistent with our response to question 8 below, we believe that only the base (contractually obligated) lease term should be included in the determination of whether a lease is “short term” or “long term”.

Question 8: *Do you agree that a lessee or a lessor should determine the lease term as the longest possible term that is more likely than not to occur taking into account the effect of any options to extend or terminate the lease? Why or why not? If not, how do you propose that a lessee or a lessor should determine the lease term and why?*

We believe that only the lease term to which the parties are contractually obligated should be reflected in the rights and obligations recorded in connection with a lease agreement. From the lessee’s standpoint, lease payments should be based on the contractually obligated (base) lease term, excluding payments associated with possible renewal terms. The lessee is not yet obligated to make payments beyond the base lease term and no liability for those payments has been incurred. Similarly, there is no right of use asset beyond the base term. The right to use the asset during the renewal period only comes into existence when and if the extension is exercised. Therefore, we strongly believe that it would be incorrect to record a liability for payments when no obligation exists, or an asset where a right to use has not been established. Similarly, from the lessor’s standpoint, there is no right to receive future rental payments until the term-extending option is exercised by the lessee.

Further, the value of the option to extend the lease is arguably already embedded in the payments for the base lease term. Said differently, any “premium” paid to acquire the term extending option must be included in the base lease term payments, or the lessor would never be paid for the value of such an option. Given that the right to extend a lease has value to both the lessor and the lessee and that unrelated parties do not unilaterally forego value in an arms-length transaction, the value of the option to extend the lease term is included in the right-of-use asset as computed based on lease payments during the base lease term, even though it is not separately identified.

Question 9: *Do you agree that contingent rentals and expected payments under term option penalties and residual value guarantees that are specified in the lease should be included in the measurement of assets and liabilities arising from a lease using an expected outcome technique? Why or why not? If not, how do you propose that a lessee or a lessor should account for contingent rentals and expected payments under term option penalties and residual value guarantees and why?*

We believe that the final standard should allow for more flexibility in measuring contingent rentals. We recommend that companies be allowed to utilize existing valuation methods for measuring contingent rentals and other expected payments noted above.

In many cases, companies have developed proprietary models and techniques to value contractual uncertainties on a “best estimate” basis in order to support management decisions. As an example, for storage or transportation agreements deemed to contain a lease under par. B4 of the ED, forecasted seasonal injection and withdrawal levels often represent the primary contingency associated with contractual consideration allocable to the lease element in the arrangement.

In practice, many of our companies have developed sophisticated, in-house models to predict forecasted demand levels based on seasonal forward pricing, historical usage factors, and anticipated shifts in supply/demand fundamentals due to changes in capacity infrastructure. In many cases, these models are already subject to rigorous internal control processes (for operational and/or financial reporting requirements) to establish the propriety and ongoing monitoring of key assumptions and methodologies.

We believe such an example illustrates that an entity should have the flexibility to use alternative approaches when it can support its methodologies and key assumptions resulting in “best estimates” of contingencies that ultimately affect recorded lease payments. We perceive that in certain situations, the probability-weighted approach described within the ED could result in less, not more, reliable and accurate information.

Question 10: *Do you agree that lessees and lessors should remeasure assets and liabilities arising under a lease when changes in facts or circumstances indicate that there is a significant change in the liability to make lease payments or in the right to receive lease payments arising from changes in the lease term or contingent payments (including expected payments under term option penalties and residual value guarantees) since the previous reporting period? Why or why not? If not, what other basis would you propose for reassessment and why?*

We agree in principle with the provisions of paragraphs 17, 39, and 56 that above factors driving contingent payments should be reassessed if changes in facts or circumstances indicate a potentially significant change on the measurement of related lease assets or liabilities, although we do not agree that such an evaluation is necessary regarding the lease term (see response to question 8 above regarding assessment of lease term). We also appreciate the Boards’ attempt to alleviate the administrative burden of explicitly requiring periodic reassessment of such factors except in cases where facts or circumstances warrant, as indicated in paragraphs BC133 and BC134.

However, we believe it is likely there will be some level of change in facts or circumstances that occur within each reporting period with respect to some or all of these factors. Although we understand this is a potential concern across multiple industries resulting from recent lease roundtable events, the example in response to Question 9 above can be further used to illustrate our concern in that contingent payments may fluctuate period to period in part based on changes

in anticipated use of the underlying asset's capacity due to weather shifts and/or other economic factors.

As such, we have some concern that in the absence of clarification, the steps practically required to assess the significance of changes in facts or circumstances could likely result in the same level of effort expended as if an entity were explicitly required to reassess all contingency factors and remeasure related lease assets or liabilities in order to determine the significance of such changes. Said differently, given the focus on supporting judgments and estimates within the U.S. regulatory environment for both issuers and auditors, we foresee difficulty supporting conclusions regarding the significance of such changes without going through the actual exercise of reassessing assumptions each reporting period and computing the impact on measurement of the related lease assets and liabilities.

Therefore, we would propose that a "trigger event" approach of some form be followed to determine whether changes in the facts and circumstances surrounding contingent payments are significant enough to warrant reassessment of the underlying assumptions influencing measurement (i.e., unexpected asset outages/availability, unusual changes in economic/environmental factors such as demand destruction, changes in an entity's business model or intended use, etc.). We believe this is consistent with the less onerous approach indicated in the basis for conclusions to the ED and is more likely to result in application of the provisions of the ED in the way they appear to be intended.

Question 15: *Do you agree that lessees and lessors should disclose quantitative and qualitative information that:*

- a) identifies and explains the amounts recognized in the financial statements arising from leases; and*
- b) describes how leases may affect the amount, timing and uncertainty of the entity's future cash flows?*

Why or why not? If not, how would you amend the objectives and why?

We agree with substantially all of the disclosure requirements identified in paragraphs 70-86 of the ED and believe these requirements will provide financial statement users sufficient information to understand the impact of leasing activities on an entity and the amount, timing and uncertainty of the entity's future cash flows. However, we do not believe the proposed requirement to reconcile opening and closing balances, disaggregated by class of underlying asset as proposed in paragraphs 77 and 80, is necessary to accomplish those objectives.

We believe that a reconciliation of the open and closing balances provides little additional information that is useful in assessing the amount, timing and uncertainty of the entity's future cash flows, but it substantially increases the complexity of the footnotes to the financial statements. The ED currently requires separate disclosure of right-of-use assets and liabilities on the face of the statement of financial position. Further, cash flows associated with these assets and liabilities would be separately disclosed in the statement of cash flow. We believe these presentation requirements, coupled with the proposed qualitative disclosure requirements, would provide financial statement users the information necessary to understand the nature and impact of leasing activities on an entity.

Further, we do not believe there is sufficient benefit gained from preparing a reconciliation disaggregated by class of underlying asset relative to the cost and effort that would be required to prepare such a disclosure. Whether an entity is leasing real estate or heavy equipment, the fact remains that the entity is committed to future payments, and the aforementioned presentation requirements accomplish highlighting those commitments sufficiently. Further, from the perspective of a lessee, we believe very little information concerning an entity's risk profile could be obtained from presenting disaggregated information.

Finally, from the perspective of a lessee, leasing activities may represent a significant financing activity, but we do not believe the nature of these activities is substantially different from other financing arrangements. Similarly, even material right-to-use assets are not different in nature from, and actually would have to be classified within, property, plant and equipment. Therefore, we believe this aspect of the disclosure requirements for leasing activities should be similar to the current disclosure requirements for financing arrangements and property, plant and equipment, which currently do not require such reconciliations. We believe that presenting reconciliations for leasing activities would give more prominence to these activities relative to an entity's other similar asset use and financing activities, which we believe is unnecessary and unwarranted.

If the FASB were to decide that such reconciliations are required, we would encourage the FASB to consider limiting their use to lessors who generate revenue from leasing activities. Although we still believe that the other proposed qualitative and quantitative disclosures, if properly applied, would eliminate the need for such reconciliations, retaining the reconciliation provisions would be more appropriate for lessors who generate revenue from leasing activities rather than lessees, for which these activities substantially represent another form of financing.

Question 16:

- (a) This exposure draft proposes that lessees and lessors should recognize and measure all outstanding leases as of the date of initial application using a simplified retrospective approach (paragraphs 88–96 and BC186–BC199). Are these proposals appropriate? Why or why not? If not, what transitional requirements do you propose and why?*
- (b) Do you think full retrospective application of lease accounting requirements should be permitted? Why or why not?*
- (c) Are there any additional transitional issues the boards need to consider? If yes, which ones and why?*

The transition guidance in the ED requires entities to “recognize and measure all outstanding contracts within the scope of this guidance as of the date of initial application.” The date of initial application is the beginning of the first comparative period presented in the financial statements at the date of adoption. As SEC filings require three years of financial data, this

retrospective application will potentially require entities to evaluate arrangements that qualify as leases that no longer exist on the date of adoption.

We question the relevance of this prior year information, especially for contracts that no longer exist as of the adoption reporting date. Existing disclosures around leases include information on future minimum lease payments and tenors. Users of financial statements tend to have a more prospective view and investors often request comparisons of current financial information to an entity's plan as opposed to historical comparisons. Thus, the burden that full retrospective application would place on preparers is not, in our view, balanced by the minimal potential benefit to financial statement users. Therefore, we recommend that the Boards allow prospective application of the final standard once issued, or at a minimum exclude lease contracts that no longer exist at the adoption date.

Separately, we note that when companies adopted the consensus in Emerging Issues Task Force (EITF) Issue No. 01-08, *Determining Whether an Arrangement Contains a Lease*, now codified in Accounting Standards Codification (ASC or "the Codification") Section 840-10-15, the transition guidance did not require entities to assess the lease classification of contracts that were executed or acquired prior to May 28, 2003. As a result, our members have a significant number of contracts that have not been assessed under the existing leasing guidance. Unless those contracts were modified and reassessed subsequent to the adoption of EITF 01-8, they continue to be accounted for as executory contracts.

We understand that the Boards did not intend for the ED to change the scope of which contracts are considered leases, but rather had as their objective improvement of the accounting (i.e., recognition, measurement, and disclosure) for those contracts already determined to be leases under the existing guidance. Due to the long-term nature of these agreements, our members will have a number of contracts that will need to be newly assessed if a similar grandfathering clause is not included as part of the transition provisions of the proposed guidance.

We do not believe that requiring the evaluation of contracts entered before May 2003 at this point is cost-justified. Adoption of the new lease accounting guidance as proposed in the ED will be a time-consuming and costly effort by most companies. Providing some relief to retain the existing criteria for scope, such as the continued grandfathering of older contracts, will help companies successfully achieve the "bigger picture" improvements to lease accounting over the long run.

We request that the Boards retain the current scope exception for contracts entered into or acquired before May 2003 so that they would not need to be assessed under the ED. If the transition provisions in the final standard do not include such relief, we request that the Boards consider the time and resources required to identify and assess such contracts when determining the final effective date.

Question 18: *Do you have any other comments on the proposals?*

Lease Accounting by Regulated Entities

General:

ASC Subtopic 980-840 relates to lease accounting for rate-regulated entities. The paragraphs in that section originated from FAS 71, *Accounting for the Effects of Certain Types of Regulation*, but are currently included in this Codification cross section of Topic 980 (Regulated Operations) and Topic 840 (Leases). Since the proposed exposure draft is intended to replace all current GAAP related to leasing, we are concerned that this section may be eliminated.

ASC 980-840-45-3 specifies that regulated entities should record expense for a lease equal to the amount allowed for rate-making purposes, rather than the amounts that would otherwise be recorded as amortization and interest expense on a capitalized lease:

45-3 The nature of the expense elements related to a capitalized lease (amortization of the leased asset and interest on the lease obligation) is not changed by the regulator's action; however, the timing of expense recognition related to the lease would be modified to conform to the rate treatment. Thus, amortization of the leased asset shall be modified so that the total of interest on the lease obligation and amortization of the leased asset shall equal the rental expense that was allowed for rate-making purposes.

We believe that guidance should be retained in Topic 980 when that topic is modified to incorporate the guidance of the final standard on leasing. We believe, as is presently permitted under section 980-840-45-3, that the timing of expense recognition for leases should be permitted to be modified to conform to rate treatment. Recording expense for leases in an amount equal to the amount allowed for rate-making purposes and included in revenues reflects the effects of the regulator's actions and the cause-and-effect relationship between a regulated utility's costs and revenues, resulting in an appropriate matching of the utility's revenues and expenses. In addition, including that guidance in the standard will result in consistency between the accounting treatment for leases and other regulated transactions addressed under Codification Section 980 – Regulated Operations.

Phase-In Plans:

Under the ED and consistent with current capital lease accounting, the recognition in earnings of the combination of amortization expense for a leased asset and interest expense for the related lease obligation will be larger than the cash payments to the lessor in the early years of an arrangement and lower in the later years, assuming level payments. For rate-regulated utilities, that can create a difference between approved rates of return and reported earnings, because in many cases the rates that utilities charge their customers are based on recovery of cash payments to lessors, rather than the front-end loaded costs that may be recorded to earnings for capital leases.

ASC 340-980 *Regulated Operations – Other Assets and Deferred Costs (FAS 92 Regulated Enterprises – Accounting for Phase-in Plans)*, as applied by the utility industry to certain capital leases, prohibits deferral and amortization of that difference as a regulatory asset, despite probable rate recovery of all lease costs by the end of the lease term. Specifically, FAS 92 is applicable to *major, newly completed plant* on which substantial physical construction had not been performed prior to January 1, 1988.

Given the effects of FAS 92 as applied by the utility industry to capital leases, and the expanded quantity of leases expected to be accounted for consistent with current capital lease accounting methods, the implementation of the proposed leasing standard may create a significant disconnect between approved rates of return and reported earnings for rate-regulated utilities, and specific guidance is needed on whether the principles of FAS 92 should continue to be applied under the new leasing standard. When applying the new leasing standard, will rate regulated utilities still be prohibited from recognizing a regulatory asset for higher early-year lease expenses that are probable of being recovered in rates by the end of the lease term?

If the principles of FAS 92 continue to be effective, transition guidance is also needed for existing leases that will for the first time be accounted for consistent with capital leases. As discussed above, for rate-regulated utilities, application of the new lease standard in conjunction with the principles of FAS 92 may cause a significant immediate disconnect between approved rates of return and earnings. For consistency in application, how should the scope limitation of FAS 92 to *new major plant* be applied to new leases going forward, and for existing leases that were entered 5, 10, or 20 years ago under the simplified retrospective approach?

If the new leasing standard was to overturn the guidance of FAS 92 as currently applied to the existing in-scope subset of a regulated utility's leased assets (*new major plant*), how at an interim date during the lease term should utilities transition to deferral and amortization of a regulatory asset when, despite any prospectively applied cost deferrals, there is not an established regulatory asset sufficient to amortize and offset the amount by which lease payments (and rate-based cost recovery) exceed lease expense in the later years of a contract?

Onerous Contracts

Paragraph BC173 of the ED's Basis for Conclusion in the ED indicates that there is no lease recognition between the date of inception and the date of commencement, unless the contract is onerous and refers to paragraph 5(d). There is no paragraph 5(d) in the FASB ED. Paragraph BC35 states that a lessee should apply IAS 37, *Provisions, Contingent Liabilities and Contingent Assets* between the date of inception and the date of commencement of a lease if the lease meets the definition of an onerous contract in IAS 37. There is, however, no mention of onerous contracts in the body of the ED that will become the authoritative guidance for accounting for leases. Please clarify if the Board intends for there to be recognition of onerous contracts between the date of inception and the date of commencement under U.S. GAAP and, if so, how an onerous contract would be defined.

Impairment of Residual Asset

Paragraph 59 of the ED indicates that a lessor shall apply either Topic 350 or Topic 360 at each reporting date to determine whether the residual asset is impaired. It is unclear whether the selection of guidance to follow for evaluating the residual asset for impairment is a choice to be made by the lessor. If the Board did not intend for this to be a choice, we believe Topic 360 provides the most relevant guidance because the residual asset represents the rights retained by the lessor in the leased property, plant and equipment.

Further, we do not see the benefit of performing an impairment assessment on the residual asset at each period. As with other property, plant and equipment, we believe the residual asset should be evaluated for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable.

Conclusion

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

Very truly yours,

Jose Simon [s]

Jose Simon, Vice President and Controller, Piedmont Natural Gas
Chairman of the American Gas Association Accounting Advisory Council