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Technical Director
Financial Accounting Standards Board
401 Merritt 7, P.O. Box 5116
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Dear Board Members and FASB Staff:

Constellation Energy Group, Inc. (“Constellation Energy”) respectfully submits comments on the Proposed Accounting Standards Update, *Leases (Topic 840)* (Proposed Update). Constellation Energy is a leading supplier of energy products and services to wholesale and retail electric and natural gas customers in the United States (U.S.). In addition, we own a diversified fleet of generating units located throughout the U.S. A FORTUNE 500 company headquartered in Baltimore, Maryland, Constellation Energy had revenues of \$15.6 billion in 2009.

We frequently enter into power purchase and sale contracts that we must evaluate for potential accounting as leases under current US GAAP in conducting our business, in addition to more typical leases of buildings, offices, and equipment. Accordingly, the Proposed Update will have a significant impact on our company.

We understand that the Proposed Update was intended to retain the scope of existing lease accounting requirements while eliminating significant differences in accounting between arrangements that have virtually identical economic provisions. However, we believe the Proposed Update as currently written will produce substantially different accounting results for very similar contracts, resulting in less comparability within our industry. As we explain in our letter, this is likely to occur due to a combination of the criteria used to identify a lease and the current diversity in practice as to how those criteria are interpreted. Therefore, we recommend that the Boards revise certain aspects of the Proposed Update (including reconsidering and clarifying the criteria for identifying a lease) in order to create a final standard that preparers will be able to apply consistently and effectively to economically similar transactions.

We are providing detailed comments for the following topics related to the Proposed Update:

- Arrangements that Qualify as Leases
- Classification and Timing of Expenses on the Income Statement
- Requirement to Include Renewal Options and Extensions in the Lease Term
- Estimation of Contingent Rentals
- Transition

While these topics are also addressed in a separate comment letter submitted by the Edison Electric Institute (EEI), with which we concur, we will elaborate below on certain matters related to them. Additionally, we participated in drafting the other comments submitted by EEI as well as the comment letter submitted by the American Gas Association (AGA), and we support the comments communicated in those letters. In particular, in addition to the matters we address in greater detail below, we strongly emphasize the comment recommending that contracts that were grandfathered under EITF 01-8 continue to be excluded from the scope of the Proposed Update. We also support the comment regarding the retention of specialized lease accounting for rate regulated entities. Beyond the specific matters discussed below, we have not repeated EEI's and AGA's comments in our letter.

We present our specific comments below.

Arrangements that Qualify as Leases

Entities in the energy industry own and operate power plants in order to produce power to sell to third parties. These same entities also enter into agreements with other owners and operators of power plants to purchase energy in order to meet obligations to deliver power to customers. These arrangements are typically in the form of Power Purchase Agreements (PPAs). There is divergence in practice around the accounting treatment of these types of contracts under existing US GAAP in ASC 840 *Leases*. The Proposed Update as currently written will lead to further divergence and will result in economically similar contracts receiving dramatically different accounting treatment.

A contract is considered a lease if it conveys the right to control the underlying property plant or equipment. Paragraph B4 of the Proposed Update provides the three criteria a preparer must evaluate to determine whether or not a contract conveys the right to control the underlying asset. These criteria are similar to the existing criteria in ASC 840-10-15-6. Typical PPAs do not meet criteria (c) and (d) because the arrangements do not provide physical access to the plant and the plant continues to be operated by its owner. In most cases, PPAs that are accounted for as leases meet the conditions in criterion (e) (ASC 840-10-15-6(c) under existing guidance) which states, "The entity will obtain all but an insignificant amount of the output or other utility of the asset during the term of the lease, and the price that the entity will pay for the output is neither contractually fixed per unit of output nor equal to the current market price per unit of output as of the time of delivery of the output. If the price that the entity will pay is contractually fixed per unit of output or at the current market price as of the time of delivery of the output, then the entity is paying for a product or service rather than paying for the right to use the underlying asset." There are two aspects of this criterion that are currently interpreted differently by industry participants and the auditing firms, and are applied inconsistently in practice.

The first aspect that has received different interpretations and has been the subject of much debate in our industry is the concept of “contractually fixed per unit of output.” Some have taken a literal view that the price per unit must be fixed at the exact same price for each individual unit sold over the term of the entire contract. This view results in contracts with any differences in pricing being accounted for as leases if they meet the other conditions in the criteria. Such pricing differences are not uncommon, however, and may be in the form of a fixed (specified) escalation percentage, escalation based on an inflation index, separate fixed pricing for different times of the day, or a fixed formula based on the level of production from the plant. Others have taken a less literal view and believe contracts that contain certain variable pricing terms nevertheless meet the criteria for not being a lease. These different interpretations have resulted in diversity in practice around the accounting assessment for these types of contracts.

The second aspect that has received different interpretation is the definition of “output or other utility.” Owners of power plants generally sell the following significant products, in addition to energy, through PPAs:

- Capacity – the capability to produce energy
- Renewable Energy Credits (RECs) – rights to the environmental benefits of renewable energy production that are produced only if the plant runs

The existing guidance requires lease accounting if the buyer “will obtain all but an insignificant amount of the output or other utility of the asset,” assuming other conditions of the criteria are met. There has been substantial debate in practice around whether or not RECs and capacity are considered output or other utility of the plants. The conclusions that come out of these debates have an impact on the determination of whether or not a contract is a lease. Each of these items has separate marketability and could be sold to different buyers. They result from the operation of the plant and they are not produced if the plant does not operate or, in the case of capacity, is unavailable to operate when requested. RECs were created through environmental regulation in order to incentivize entities to generate energy from renewable sources; however, unlike tax credits or grants, the value of RECs is realizable through transactions with third parties and does not require interaction with the government (either in the form of a unilateral transfer or as a reduction of taxes).

Capacity and RECs have significant value to power plant owners and potential power buyers. If capacity and RECs are considered output or other utility, situations where a plant owner is selling the energy to one party and the RECs and capacity to another party would likely not result in lease accounting. On the other hand, if capacity and RECs are not considered output, the PPA for the sale of the energy would be a lease even though a substantial part of the economic benefit of operating the plant and revenue from sales to customers may come from products other than the energy. Different industry participants and firms have taken different views on this issue in the past, which has resulted in divergence in practice around the accounting assessment for these types of contracts.

To date, the divergence in practice for both of these items has not been a significant issue for the industry as the current leasing guidance makes a distinction between operating and capital leases. Due to the long lives of the underlying assets in these contracts, most PPAs that meet the criteria for classification as a lease are accounted for as operating leases. The accounting models for

executory contracts and operating leases result in the same treatment on the balance sheet, income statement, and cash flow statement. Even though an entity may conclude that one PPA is an operating lease and another virtually identical PPA is an executory contract, the transactions will be reflected in the same way in the financial statements, other than disclosures, under existing GAAP.

The Proposed Update eliminates the distinction between operating and capital leases and will require all leases to be recorded on the balance sheet, accounted for differently in both classification and timing of recognition in the income statement, and presented as financing cash flows in the cash flow statement. We note that the intention of the Boards is to eliminate situations where similar transactions receive different accounting treatment by requiring the right-of-use model for all transactions that qualify as leases: Paragraph BC7(d) states, “the existence of two very different accounting models for leases (the capital lease model and the operating lease model) leads to similar transactions being accounted for very differently.”

While we recognize that this is true for certain transactions, the current distinction between operating and capital leases actually creates comparability for PPAs in our industry. For example, assume we have a PPA with a power plant where we purchase 100% of the power at a price that is fixed per unit over the entire life of the plant. This contract would not qualify as a lease because the price is considered “contractually fixed per unit.” Now, assume we have a PPA with a different power plant where we purchase 100% of the power at a price that escalates each year based on inflation. Current interpretations of “contractually fixed per unit,” would require us to conclude that this contract is a lease. Under existing guidance, both contracts would receive similar accounting treatment despite the fact that one is considered a lease and one is not. Due to the divergence in practice around determining whether a PPA qualifies as a lease, requiring the right-of-use model for all leases will potentially result in more economically similar contracts within our industry receiving dramatically different accounting treatment. The comment letter submitted by the EEI includes a number of additional examples that further illustrate the potential diversity in accounting for virtually identical contracts.

In order to avoid this outcome, we recommend that the Boards revise the guidance for determining what qualifies as a lease and provide more principles-based guidance that will mitigate the different interpretations highlighted above.

We would like to highlight the following language included in the Basis for Conclusions of the Proposed Update that, in our view, may provide useful insights into development of a more principles-based set of requirements for evaluating whether a PPA is a lease based upon the nature of the underlying pricing (emphasis added):

BC31: “Existing requirements require classification of contracts as leases if the purchaser obtains all but an insignificant amount of the output of an asset unless payments are specified in terms of a fixed price per unit of output or the current market price per unit of output because, in those circumstances, the entity pays for a product or service rather than the right to use the underlying asset. However, contracts in which the purchaser will obtain all but an insignificant amount of the output of an asset and the lease payments are specified in terms of the time that the underlying asset is made

available for use, rather than in terms of the output from the asset, may meet the definition of a lease.”

BC32: “The boards considered whether a contract that supplies the purchaser with all but an insignificant amount of the output of an asset and specifies lease payments in terms of units of output should be classified as a lease. The boards agreed with the conclusion in IFRIC 4 and ASC 840 that if the price that the purchaser will pay is specified per unit of output, the purchaser is paying for a product or service rather than the right to use the asset. “

We note that this language appears to distinguish leases from executory contracts based upon the principle of whether the pricing is determined on a per-unit-of-output basis versus the passage of time. We agree with the concept that if the price is specified per unit of output, the purchaser is paying for a product or service and not for the right to use the underlying asset. We further agree that payments specified in terms of the time the underlying asset is made available to the purchaser for use may indicate that the contract is a lease.

While we recognize that certain PPAs may qualify as leases, we believe there are a significant amount of contracts in our industry where an entity is simply purchasing a product (i.e. power) that will be accounted for as leases under the Proposed Update as it is currently written. Based on the statements in the Basis for Conclusions, it appears as though the Boards do not intend for these types of contracts to be recognized on the balance sheet as they do not represent the right to use the underlying power plant.

We recommend that the Boards revise paragraph B4(e) in the Proposed Update so that preparers are able to apply the guidance consistently among contracts with similar economics. We believe the following changes (also highlighted in the EEI letter) are critical in order to achieve the Boards’ objective to avoid virtually identical transactions receiving different account treatment:

- Replace the term “contractually fixed per unit of output” in the text of the final ASU with the language from BC31 and BC32 so it is clear that the Boards intend for pricing that is specified per unit of output to result in the purchase of a product or service and pricing that is specified in terms of time that the underlying asset is made available for use may indicate that the contract is a lease.
- Provide examples of pricing that would be considered to be “specified per unit of output.” This will eliminate the literal interpretations some have taken and provide preparers with the ability to assess each individual contract and determine whether or not it should be accounted for as a lease based on the economic substance of the contract. We have provided the following suggested examples of contract terms that indicate the purchaser is paying for a product:
 - Pricing is fixed or determinable by unit of output at the inception date of the contract.
 - Pricing is based on a predetermined formula for all units where inputs to the formula may be based on market indexes or inflation rates.
 - Pricing interacts directly with the actual output of the underlying asset (i.e. the purchaser only pays for output delivered).

- Pricing is based on an index or some other function not related to the inputs used to make the output.
- The owner of the underlying asset retains the pricing risk around the inputs used to the make the output.
- Provide examples of pricing that is specified in terms of the time that the underlying asset is made available for use. We have provided the following suggested example contract terms that indicate the purchaser is paying for the right to use the underlying asset:
 - Pricing that does not fluctuate based on actual output (i.e. the purchaser pays a set amount regardless of the amount of output produced by the underlying asset or the purchaser pays for units even if they are not delivered).
 - The purchaser provides raw materials, inputs and other supplies that are used by the owner of the asset to produce the output.
 - The pricing terms reference actual variable costs associated directly with the inputs so the purchaser, rather than the owner, has the pricing risk around production.
 - The term of the contract extends over all but an insignificant portion of the useful life of the underlying asset.

We believe that clarification of this paragraph is very important. Without this clarification, there will be a significant amount of transactions that are economically similar that will receive dramatically different accounting treatment. Using our example from above, the following charts demonstrate that the two economically similar transactions will receive completely different accounting treatment under the Proposed Update as currently written:

(1) PPA with a power plant where an entity purchases 100% of the power at a price that is fixed per unit over the entire life of the plant.

Balance Sheet	Income Statement	Statement of Cash Flows
No Recognition	Gross Margin – expense recognized ratably over contract term	Operating

(2) PPA with a different power plant where an entity purchases 100% of the power at a price that escalates each year based on inflation.

Balance Sheet	Income Statement	Statement of Cash Flows
Right of Use Asset	Amortization Expense	Financing
Lease Obligation	Interest Expense - interest method with more expense recognized at beginning of contract term	

We believe that incorporating the revisions we have proposed into the final ASU would eliminate substantial disparity in practice, and we ask that the Boards consider our recommendations and revise the criteria for determining whether a contract qualifies as a lease.

Classification and Timing of Expenses on the Income Statement

As noted, we routinely execute contracts for the purchase of fuel and energy from specific plants that qualify as leases under the existing and proposed guidance. These contracts are entered into for the purpose of purchasing power to satisfy load serving requirements in the energy markets and obtaining fuel for owned generation plants. They are an integral part of the key operations of our business. Even though these contracts presently meet the definition of a lease, the expenses associated with these contracts are currently classified as fuel and purchased energy expenses within operating income and are evaluated as part of gross margin by Management and are presented as such within the Management Discussion and Analysis section of our SEC filings. Additionally, the cash payments are presented as operating activities on the statement of cash flows. In this way, these expenses are presented within the same financial statement captions as the costs of purchases under otherwise identical contracts that do not meet the definition of a lease.

The Proposed Update will require preparers to present all lease rental expenses, including those that are essentially the purchase of power or fuel, as amortization and interest expense on the income statement and as financing activities within the statement of cash flows. This could result in substantial amounts of fuel and purchased energy costs being recorded outside of gross margin even though they directly relate to the cost of sales and revenue generation of our constituents and do not reflect the use of an asset. If the final standard does not revise the criteria for determining whether an arrangement qualifies as a lease (as recommended above), we propose that the Boards reconsider the income statement presentation provisions in the proposed guidance and allow preparers to continue to record rental expenses within operating income when the nature of such costs is that they are similar to costs of goods sold. Gross margin is a key financial measurement for the users of financial statements within our industry. We believe that this presentation would provide financial statements that are more representationally faithful by affording similar treatment for such costs even though they may be executed under contracts that fall into different classifications.

The Proposed Update will also result in a significant change to the timing of the recognition of expenses from leasing arrangements. Expenses from PPAs that do not qualify as leases will be recorded ratably over the term of the contract while expenses from PPAs that meet the criteria for lease accounting will be heavily weighted to the front of the contract term under the interest expense method. This divergence further indicates the necessity of the Boards to reevaluate the criteria around whether a contract is, in substance, a leasing arrangement.

Requirement to Include Renewal Options and Extensions in the Lease Term

The Proposed Update will require preparers to record the present value of estimated lease payments based on the longest possible term that is more likely than not to occur. This will require preparers to assess renewal options of all existing leases and attempt to predict whether or not these future options will be exercised. In the Proposed Update, the Boards state the following in BC117, “If optional periods are not included in the lease term, the right-of-use asset or the lease liability might be misstated.”

We do not agree with the decision to require that preparers include renewal option lease payments in the right of use asset and lease payment liability recognized on the balance sheet. We believe these captions should reflect the non-cancelable lease term within the contract. The negotiated contractual payments under the non-cancelable lease term inherently include value attributable to any renewal options under the contract. Entities should not be required to reflect an incremental lease asset or liability on the balance sheet for optional renewals until the option to renew is exercised and the obligation to make future payments actually exists.

By definition, the value of optional periods is not a right-of-use asset since the right is only optional. Rather, the only asset represented by such terms is the option to renew the right of use. The value of a renewal option is the difference between the option rental price and the forward rental price, plus the potential for volatility during the option term (the period leading up to exercise). Including the present value of the potential nominal payments associated with renewal options will overstate the balance sheet by recording assets and liabilities that do not exist. Under the Boards' approach, the amount recorded would be significantly larger than an amount recorded using a fair value approach. Options have a much lower fair value than the amount of the nominal payments required once the option is exercised. Similarly, if the renewal option is ultimately not exercised, entities will be required to derecognize assets and liabilities in the absence of any transaction occurring. This will result in further volatility in earnings and potential misstatement of the balance sheet.

We believe it would be incorrect to record an incremental asset or liability for optional lease terms before that option has been exercised. For a lessee, there is no liability to make payments for an option that has not been exercised, and the right to use the underlying asset does not exist before the option is exercised. For a lessor, there is no right to receive future rental payments before the lessee exercises the option. Further, the value ascribed to the renewal option by the parties to the contract is embedded in the payments under the base lease term. All of the terms of lease agreements, including options, are negotiated between unrelated parties at arm's length, and the market value of those terms are therefore reflected in the consideration negotiated in the transaction. If the lease contract does not specify any additional payment in connection with exercising the option, the value of the option must be reflected in the present value of the non-cancelable lease terms.

Short Term Leases

We do not agree with the strict definition of short term leases that requires the maximum possible lease term to be twelve months or less including renewal and extension options. We appreciate the Boards' attempt to provide relief around very immaterial short term leases; however we recommend that the Boards allow the simplified model for leases with a non-cancelable term of twelve months or less. As previously stated, it is incorrect to include any amounts on the balance sheet for obligations or assets that do not actually exist at the balance sheet date.

Estimation of Contingent Rentals

The Proposed Update will require lessees and lessors to measure lease payments on the basis of expected outcomes, which is described as the probability-weighted average of the cash flows for a reasonable number of outcomes. We recommend that the Boards allow more flexibility in the measurement of contingent rental payments. Many entities have established sophisticated models to value contractual uncertainties for internal financial reporting purposes. For example, many energy and utility companies have developed internal models to value PPAs that predict power plant production levels, outages, weather patterns, and include market fundamentals such as supply and demand estimates and forward power and fuel prices. Entities should have the ability to use internal models when they provide a more reliable means of estimating contingent rental payments than the probability weighted approach prescribed in the Proposed Update. We recommend that the boards clarify the language so the probability weighted approach is the preferred method when a more reliable method does not exist.

Transition

The transition guidance in the Proposed Update 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 with respect to contracts that no longer exist. Existing disclosures around leases include information on future minimum lease payments and tenors. As such relevant and similar prior period data, although not identical, is already available.

Users of financial statements, particularly analysts that follow public companies, 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. We recommend that the Boards allow prospective application of the final standard once issued or at a minimum exclude transactions that no longer exist at the adoption date.

A significant amount of time and effort will be required by entities to implement this proposed guidance. Many entities have hundreds and even thousands of transactions that will need to be evaluated individually under the right-of-use model. This will require significant changes to systems and processes. This will also require entities to begin the process well in advance of the actual adoption date. We recommend that the Boards provide a minimum of a full two years for implementation once a final standard is issued so entities can begin evaluating leases as of the date of initial application.

Conclusion

Constellation Energy appreciates the opportunity to provide comments on these important issues around the accounting for leasing transactions. Power Purchase Agreements are significant to

our business and we want to ensure the accounting continues to faithfully represent the underlying economics of these transactions.

Very truly yours,

/s/ Bryan P. Wright

Vice President, Chief Accounting Officer and Controller for Constellation Energy