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Energy to Serve Your World®

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Leslie Seidman, Chairman Financial Accounting Standards Board 401 Merritt 7 PO Box 5116 Norwalk, Connecticut 06856-5116

Sir David Tweedie, Chairman International Accounting Standards Board 30 Cannon Street London EC4M 6XH United Kingdom

Submitted via electronic mail to director@fasb.org

Re: Leases Targeted Outreach - March 2011

Dear Madam and Sir:

We appreciate the opportunity to provide our views on the Leases Targeted Outreach document (the "Outreach Paper"). In this letter, we have attempted to answer the questions posed in the Outreach Paper drawing on our experiences in applying the proposed guidance to actual contracts.

Southern Company is a leading U.S. producer of electricity, and owns retail regulated electric utilities in four states, a growing competitive wholesale generation company, as well as fiber optics and wireless communications. Southern Company has 4.4 million customers and more than 42,000 megawatts of generating capacity.

#### Overall

We are extremely encouraged by the redeliberation process that the FASB and the IASB (the "Boards") and their staff have undertaken. It is clear that the Boards have seriously considered the comments received on the exposure draft and that they are attempting to address the concerns raised to the extent possible. We are, however, concerned about the Boards' continued push to finalize the leasing standard in a relatively short period of time noting that the issues raised in the Outreach Paper are foundational to the project and critical to the application of a final standard. We believe that these issues are significant enough to the project as a whole that, had the Boards not established a self-imposed June 30 deadline, these issues alone would have warranted re-exposure of the standard.

## **Responses to Questions in the Outreach Paper**

#### Questions – Definition of a lease

- 1. With respect to Appendix A to this paper, do you think that the preliminary draft guidance:
  - (a) is an improvement to the guidance included in paragraphs B1-B4 of the ED in determining whether a contract contains a lease?
  - (b) can be consistently applied?
  - (c) would create any new issues or unintended consequences?

We believe that the preliminary draft guidance is an improvement to what was included in the exposure draft. As we and others within the utility industry highlighted in our comment letters, there has historically been diversity in practice in the application of ASC 840-10-15 with respect to what represents a "contractually fixed price per unit of output" and what constitutes "output", especially as it relates to power purchase agreements. We believe that the guidance in the Outreach Paper with respect to defining a lease is easier to apply and we are generally supportive of the criteria proposed. Based on our efforts to apply the guidance to various contracts, we believe that the guidance can be consistently applied.

### 2. Do you have any suggestions as to how to improve the guidance?

In evaluating the guidance in Appendix A, we agree with the overall concept captured in the two criteria outlined in ¶A8. Additionally, we believe that the supplemental definition of the "ability to receive the benefit from the use of the specified asset" in ¶A10 as the right to obtain "substantially all of the potential cash flows from use of that specified asset" is an important one. We agree that equating "control" with the cash flows from the use of an asset is a reasonable conclusion that can be applied consistently between companies and between industries. We also believe that the concept in ¶A9(b) is an important distinction in determining whether some contracts contain a lease.

As mentioned earlier, we applied the proposed guidance to several contracts that we have evaluated in the past. For the most part, the application was straightforward and we believe that the results were reasonable. However, we did feel it necessary to highlight for the Boards' benefit a power purchase agreement with two variations in facts and ask you to consider whether or not you agree with our conclusions.

**Contract A:** A power purchase agreement where the customer agrees to purchase all of the electricity produced by a wind farm for a term of 20 years. The contract has no minimum payments, i.e., no capacity charge, and pricing is based on a fixed price schedule, on a "per kilowatt" basis, established prior to the commencement of the contract. While the customer purchases all of the electricity produced, the supplier retains title to the renewable energy credits (RECs) produced by the operation of the wind farm. The RECs have substantial value in comparison to the value of the electricity produced.

**Analysis:** Based on the criterion in ¶A10, we would conclude that the power purchase agreement is **not** a lease. Our conclusion is based on the fact that the customer is not obtaining substantially all of the potential cash flows from the wind farm as it has only

contracted to purchase the electricity produced and not the associated RECs. **Would the Boards agree?** 

**Contract B:** Same facts as in Contract A except that in this instance the customer is purchasing the RECs associated with the wind farm in addition to the all of the power produced. As in Contract A, pricing is on a "per kilowatt" basis, reflecting higher prices than Contract A due to the purchase of the RECs.

Analysis: Based on the criteria in ¶A8-¶A10, we would conclude that the agreement does represent a lease. With the purchase of both the electricity and the RECs, we believe that the customer has the ability to direct the use of, and receive the benefit from the use of, the wind farm assets. We would conclude that the customer obtained the ability to receive the benefit from the use of the assets through its rights to obtain substantially all of the potential cash flows generated by the wind farm. Additionally, relying on the guidance in ¶A9(b), we would conclude that the customer obtained the ability to direct the use of the assets at the commencement of the agreement, given that the customer will have no substantive decision-making ability after commencement. Would the Boards agree?

In analyzing Contract B using the guidance in Appendix A, it was unclear to us if the considerations in ¶A11 should be applied to **all** contracts or if the indicators are only to be considered when there is no clear answer from applying ¶A9 and ¶A10. We recommend that the Boards clarify if those indicators can or should be considered for all contracts or if their consideration is limited to situations where application of ¶A9 and ¶A10 does not yield a clear answer. In our Contract B example, we believe that a case could be made that the contract is not a lease if we consider the fixed "per kilowatt" pricing in the contract to equate to "making payments that depend on [the] amount of benefit that flows to the customer from the use of the asset" per ¶A11(c). Since the customer is only required to pay for the electricity produced and the pricing is fixed at the commencement of the contract, we feel an argument can be made for the fact that the customer is purchasing power (and RECs) and not the right to control the wind farm assets. **Would the Boards agree?** 

3. If you do not think that the preliminary draft guidance in Appendix A is an improvement in determining whether a contract contains a lease, do you think that the proposed changes to paragraphs B1-B4 of the ED set out in Appendix B address practical application difficulties regarding the existing definition of a lease?

Based on our analysis and our application of the proposed guidance in both Appendix A and Appendix B, conceptually we prefer the wording in Appendix A in addressing many of the issues raised in comment letters on the exposure draft. We believe that the goal of achieving consistency between the leasing standard and the revenue recognition standard is an important one. However, we believe that the guidance in Appendix B, as currently drafted, is easier to understand and apply. In our analysis of the guidance in Appendix A, we did not note any difficulties in applying the guidance, as we understood it, nor did we note any unintended consequences of applying the guidance that the Boards should be made aware of. However, as indicated above, we would ask the Boards to work to clarify how the guidance in Appendix A is intended to be applied in practice.

## **Questions – Types of leases**

# 1. Do you think that:

- all lease transactions should recognize profit or loss on a consistent basis and that this basis should create a higher lease expense (lessee) / income (lessor) in the early years of a lease (the approach in the ED); or that
- ii) certain lease transactions should recognize higher lease expense / income in the early years of some lease arrangements (e.g. those with a significant financing element) and other lease transactions should recognize a straight-line pattern of lease expense / income recognition (e.g. those with an insignificant financing element)? Why?

We believe that there is a reasonable basis for distinguishing between two types of leases and recognizing lease expense differently for each type of lease. We believe that there is a meaningful difference between leasing retail space in a shopping center for a relatively short period of time and leasing manufacturing equipment for the majority of its economic life. While both of these contracts are called leases, we believe that the economics are substantially different and that the accounting should reflect that if at all possible.

2. If you prefer approach ii) above, do the indicators identified in Appendix C appropriately distinguish between a lease with a significant financing component (i.e. those leases recognizing higher lease expense / income in the early years) and those with an insignificant financing component (i.e. those leases recognizing a straight-line pattern of lease expense / income)? Do you have any suggestions as to how to improve the indicators?

We generally agree with the indicators outlined in Appendix C. Based on our analysis of some of our contracts, we believe we can apply the guidance as currently drafted in most instances without issue. We have some concern that "bright lines" will develop with respect to the "length of term" indicator and that this factor could become the predominate indicator for assessing a lease's classification in practice if the guidance in ¶C1(b) is ignored. We would therefore encourage the Boards to reiterate in the final standard that no single indicator should be considered individually conclusive.

We found applying the guidance in Appendix C for distinguishing between finance leases and other-than-finance leases to be a relatively straightforward process for many of our contracts. However, in applying the guidance to our previously mentioned wind farm power purchase agreement (Contract B), the answer was not straightforward.

We have presented our preliminary conclusions from our analysis of Contract B in the following table:

Indicator	Facts	Conclusion
Residual asset/ potential ownership transfer	There is no provision for ownership of the wind farm assets to be transferred to the customer at any time	Other-than-finance lease
Length of lease term	The term of the agreement is 20 years which is significant to an estimated useful life of 25 or 30 years	Finance lease
Rent characteristics	The rent payments are reflective of the current market for renewable energy (supporting other-than-finance); the pricing schedule is fixed at the commencement of the agreement (supporting finance); the expected payments over the term of the agreement is expected to return the supplier's full investment in the project (supporting finance)	Finance lease
Underlying asset	The assets are not specialized and are available for purchase by the customer	Finance lease
Embedded or integral services	While the supplier has the responsibility to maintain the wind farm assets as part of the agreement, these services are not considered to be an integral part of the agreement	Finance lease
Variable rent	In theory, all of the rental payments are variable given that they are contingent on the wind blowing and the wind farm producing energy	Other-than-finance lease

Given the facts outlined above, we would tentatively conclude that the power purchase agreement represents a finance lease. **Would the Boards agree?** 

3. If you prefer approach ii) above, would you prefer that lease expense / income is presented as two line items in profit or loss (interest expense and amortization expense (lessee) / interest income and lease or rent income (lessor)) or would you prefer that lease expense / income is presented in one operating expense line item (e.g. rent or lease expense (lessee) / rent or lease income (lessor))?

We do not believe that either the two-line approach or the one-line approach is preferable. Instead, we believe that the arguments put forth for distinguishing between two types of leases and for allowing for different recognition methods also support a difference in financial statement presentation. We believe that the profit and loss effects of financing leases should be presented, using the two-line approach, as amortization of the right-of-use asset and interest expense, while the profit and loss effects of other-than-financing leases should be presented as rent expense, using the one-line approach.

### Conclusion

We believe the accounting outlined in the Exposure Draft is a significant improvement over the current accounting for leases and the accounting outlined in the exposure draft. We encourage the Boards and their staffs to continue their diligent efforts to address implementation issues identified in their outreach activities and to focus on finalizing a workable accounting model that meets the needs of financial statement users without being overly burdensome to preparers.

Sincerely,

W. Ron Hinson

Chief Accounting Officer and Corporate Comptroller