April 1, 2011

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

Re: Leases Targeted Outreach – March 2011

Dear Sir or Madam:

The Edison Electric Institute (EEI) respectfully submits our comments on the Leases Targeted Outreach document dated March 2011 (the Outreach Document). EEI is the association of United States shareholder-owned electric companies. Our members provide service to 95 percent of the ultimate customers in the shareholder-owned segment of the industry, and represent approximately 70 percent of the United States electric power industry.

Several of our member companies took part in the lease outreach meetings held by the Financial Accounting Standards Board (the Board) over the last several weeks. We offer these comments to document the views of our industry and supplement the thoughts presented at those meetings. EEI very much appreciates that the Board is considering the amendments outlined in the Outreach Document to the proposal for lease accounting set forth in the Proposed Accounting Standards Update – Leases (Topic 840) (the ED) issued in August 2010.

We are particularly pleased that you have focused on addressing the definition of a lease to improve the ability to differentiate between contracts that convey the right to control the use of an asset versus contracts that provide for the purchase and sale of a product or service. As noted in our comment letter in response to the ED dated December 15, 2010, we believe the current guidance for determining whether a contract contains a lease is not effective in making that distinction, and the considerable diversity in interpretation of that guidance causes further application difficulties and lack of comparability. For example, most power purchase agreements (PPAs) are
entered into for the purpose of buying or selling a product; however, the previous guidance resulted in many of these contracts being considered leases. Further, that guidance resulted in economically similar contracts often being accounted for in substantially different ways. We believe the proposed revisions to the definition of a lease outlined in the Outreach Document are more principles-based and are more likely to properly identify those contracts where the right to control the use of an asset has been conveyed.

**Right to Control the Use of the Underlying Asset**

In our view, the most important of the proposed changes in the definition of a lease are the changes to identify when the right to control the use of the underlying asset has been conveyed. We offer the following observations on these proposed changes:

We strongly support the changes proposed in Appendix A regarding the right to control the use of the underlying asset. Specifically, we support the change in the guidance to require that a customer have both the ability to direct the use of the underlying asset and receive benefit from the use of the asset in order for a contract to convey the right to control the use of the underlying asset. This change makes the criteria for control more consistent with the revenue recognition ED and consolidation guidance. Application of this guidance will likely result in fewer PPAs being leases, but we believe that is appropriate. Previously, the criteria inappropriately scoped in many contracts that were simply the purchase and sale of a product in substance.

We further support the changes outlined in paragraph A11(c) of Appendix A of the Outreach Document. The focus on the nature of the payments, rather than on what has evolved to be very rules-based criteria, is a major improvement. Paragraph 9 of Agenda Paper 5E states, “We think the principle behind paragraph B4(c) of the ED is that a customer controls the use of an asset if it obtains all or almost all of the benefits from use of that asset and pays for the right to use the asset, rather than the actual use of, or output from, the asset. In that case, the customer is considered to be taking on asset risk rather than just receiving a service from the use of an asset.” This language describes the principle well, indicating that when a customer pays for the right to use the asset, rather than the actual use of, or output from, the asset, the customer is considered to be taking on asset risk, rather than just receiving a service (or product) from use of the asset. We believe this language should be included in the final standard as it clearly portrays the principle around implementing the proposed leasing guidance. The assumption of asset risk is a clear distinction between a lease and a service contract. This change addresses one of the major concerns raised in our comment letter on the ED, which was that the current pricing criteria were not effective in appropriately making the distinction between leases and executory contracts, and that
the diversity in interpretation added to the confusion. Application of this guidance will require significant judgment, but is still expected to reduce the current level of diversity in practice.

While we strongly agree with the direction of the changes outlined in paragraph A11(c), some additional clarity may be helpful. It may be unclear what “pays for the right to use” means independent of “rather than ...” The key point is whether or not an arrangement is primarily for the right to use the asset for a period of time or for the economic benefits to be received from the actual use of the asset. Clarification will help preparers distinguish between an arrangement that is primarily for the use of the asset for a period of time as compared to an arrangement that is primarily for the economic benefits received from the use of the asset. Contracts that are for the purchase of a product generated by a specified asset should not be subject to lease accounting if the customer is paying for the product and not the right to use the asset over time. We suggest the following alternative language which may be clearer:

The customer has rights to obtain substantially all of the potential cash flows from use of the specified asset throughout the lease term of the agreement and makes payments that are primarily based on the time the underlying asset is made available or reserved for the benefit of the customer pays for the right to use the asset, rather than making payments that primarily depend on the amount of benefit that flows to the customer from use of the asset.

We note that the indicators expressed in paragraph A11 are proposed to be used if, having considered the factors in paragraphs A9 and A10, it is still unclear whether a contract contains a lease. We understand that you are aware that some may infer from this language that the indicators in paragraph A11 should not be considered in determining whether a contract contains a lease in cases where the customer has limited rights in determining the amount of output of an asset or where few operating decisions (other than maintenance decisions) are required. As several of our members indicated at the outreach meetings, we believe the indicators expressed in paragraph A11 are very important factors in determining whether or not a contract contains a lease and, therefore, suggest that the importance of these criteria be raised to an equal standing with paragraph A9. We appreciate your intention to remedy this, and we suggest that one way to do that would be to include the A11 criteria in paragraph A9 as follows:

When assessing whether a customer has the ability to direct the use of a specified asset, a customer and supplier shall consider all available evidence. Indicators of the customer's ability to direct the use of a specified asset can be evidenced as follows include:

(a) The customer controls physical access to the specified asset.
(b) The design or function of the asset is customer-specific and the customer has been involved in designing the specified asset.
(c) The customer has rights to obtain substantially all of the potential cash flows from use of the specified asset through the term of the agreement and makes payments that are primarily based on the time the underlying asset is made available or reserved for the benefit of the customer, rather than making payments that primarily depend on the amount of benefit that flows to the customer from use of the asset.

We generally agree with the indicators in paragraph A9(a) to determine whether a customer has the ability to direct the use of a specified asset; however, we believe it would be beneficial for the Boards to clarify that these criteria apply when the customer has the exclusive ability to make certain decisions around directing the use of the specified asset. Certain contracts have shared decision making abilities that may be difficult to assess under the suggested criteria. We suggest modifying A9 (a) to say “By having the exclusive or unilateral ability to make decisions about using the specified asset that significantly affect the benefit received by the customer from that use throughout the lease term.” This will eliminate potential diversity in practice around these types of contracts.

An example that pertains to our industry is a contract that provides the customer with the ability to request when a power plant will run, or dispatch rights. Even though the customer influences and even requests when the plant will run, the owner/operator has the ability to deny dispatch at their discretion under certain circumstances. These circumstances may include, but are not limited to, planned and unplanned outages and power grid reliability issues.

We note paragraphs A11(c) in Appendix A and B7(c) in Appendix B are similar, but one refers to potential cash flows and the other to economic benefits. When evaluating power purchase agreements to determine if the contracts contain a lease, the term “economic benefits” could be interpreted to include production tax credits available to the owner of the facility based on generation from certain renewable energy power plants. We believe “potential cash flows” better reflects the FASB’s intentions in this regard. We believe “potential cash flows” includes products, services, output, or other economic inflow that can be derived through commercial interactions with a third party for the sale of the asset’s economic benefits. By contrast, tax credits reflect cash inflows from non-reciprocal transactions with the government taxing authority in its role as such. This clarification would eliminate current diversity in practice around how to interpret “output” of a specified asset.
As noted above, we believe that the ability to direct the use of the asset is an important factor in determining whether a contract is, in substance, a lease. However, if the Boards decide against revising the definition of “the right to control the use,” the proposed changes to paragraph B4 of the ED as set forth in Appendix B would be effective in addressing the current practical application difficulties and inconsistencies. We would recommend similar clarifying wording changes to those we suggested above to paragraph A11(c).

Two Types of Leases

The second most critical of the changes proposed, in our view, is the notion that there are fundamentally two different types of leases: financing leases and other-than-financing leases. We strongly agree with this proposal. Many leases, including PPAs that are determined to be leases, provide for the use of the asset for a period of time primarily in order to obtain the product it produces, but do not represent an in-substance purchase of the asset. In the case of PPAs, customers will likely make the choice to purchase power, rather than constructing and operating their own plant, in order to mitigate the risks of ownership and outsource significant activities relating to operation and maintenance of a power plant. A straight-line recognition of expense in this case better reflects the underlying economics of the transaction.

While not specifically addressed in the Outreach Document, we further believe that rent expense associated with other-than-financing leases should be presented as a component of operating income and operating cash flows, as these costs are critical elements of operations. As noted in our comment letter submitted in December 2010, our members execute contracts for the purpose of purchasing power to satisfy load serving requirements, satisfying governmental requirements for purchases of renewable energy, and other contractual sales obligations and fuel requirements for owned generation plants. The costs incurred under those contracts are an integral part of the key operations of our members. Even though some contracts 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 within the Management Discussion and Analysis sections of the SEC filings. Further, the cash payments are presented as operating activities on the statement of cash flows.

Other Concerns with Outreach Document – Definition of a Lease

We do not support broadening the definition of an asset to include assets of a particular specification. A lease, by its nature, involves the right to use a specified, uniquely
Financial Accounting Standards Board  
April 1, 2011  
Page 6

identifiable asset. This approach is generally consistent with the application of lease guidance in current US GAAP and IFRS. If the supplier has a substantive right to substitute a different asset at their discretion, the customer does not have control of the asset. A supplier’s right to substitute an asset at any time (other than when the identified asset is not functioning properly) generally results in a contract that is more akin to a service.

Along that same line of thought, we support the notion that the underlying asset can be a portion of a larger asset, so long as that portion is a physically distinct portion of the asset. For example, a floor of a building or a specified strand within a fiber-optic cable containing multiple strands could be the subject of a lease. We do not support lease treatment for a percentage of an asset, such as 5% of the capacity on a natural gas pipeline or 50% of a single unit of a power plant. In these cases, the customer does not control a specified asset.

As a practical consideration, with the control definition expanding under this alternative to require both power and benefit elements, customers will be less likely to control the use of a non-physical portion of a larger asset or assume asset risk. If the proposed changes are made to “right to control the use of the asset,” the changes relating to a specified asset and a portion of an asset become less critical, since it is unlikely that a customer will have the rights to direct the use of the asset when they can’t direct what asset the benefits come from or are only entitled to a percentage of the benefits. However, if these provisions are changed to include assets of a particular specification or a percentage of capacity, the population of contracts that will require evaluation will expand significantly, creating an administrative and operational burden that does not seem justified. We believe this is an unnecessary change given the acknowledgement that there will be very limited, if any, circumstances where a non-physical portion of a larger asset would require lease accounting. We believe it would be simpler and less complex to retain the current, well-understood scope of a lease as pertaining to a physically distinct portion of an asset.

We generally support the addition of guidance that a contract does not contain a lease if an asset is specified, but that asset is incidental to the provision of a service. We do, however, foresee difficulties with the interpretation of “incidental.” It is unclear whether the determination of “incidental to the provision of a service” implies that the asset is of a relatively small dollar value, whether the asset may be substituted with another similar asset without concern to the customer, or something else.

For example, the concerns regarding this concept can be illustrated by reference to a contract to transport natural gas from producing regions near the Gulf of Mexico to customers in the northeastern United States. On the one hand, the gas certainly cannot
Financial Accounting Standards Board
April 1, 2011
Page 7

be transported without use of the pipeline, of which there are few alternatives given the capital-intensive and environmentally disruptive aspects of those assets. On the other hand, the customer does not specify, and is not interested in, which specific portions or paths on a gas pipeline the pipeline company uses to move the gas. Rather, the customer only is concerned that gas is delivered where and when requested, as with the use of a common carrier for shipping. Thus, it is difficult, using the current indicators, to determine whether the pipeline would be deemed incidental to the provision of natural gas transportation. Further clarification of the concept is needed.

**Topics outside of the Outreach Document**

*Variable Lease Payments*

While not part of the Outreach Document, our members who attended the outreach meetings noted that the Board was interested in receiving feedback on the components of variable lease payments to be included when measuring lease assets and liabilities. It is our view that, at inception of a lease, a liability has only been incurred for minimum lease payments, including those payments that are dependent on an index (to be initially measured at the spot price at inception). Future payments that are dependent on the occurrence of a future event do not meet the definition of a liability in paragraph 35 of Concepts Statement No. 6, *Elements of Financial Statements*, which reads:

> Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events. (emphasis added)

We agree that the signing of the lease agreement and relinquishing control of the underlying asset to the lessee is a past event that creates an obligation; however, we believe that the obligation created relates only to those payments which must be made regardless of the occurrence of future events. Payments that depend on the occurrence of a future event should only be recognized when that event occurs.

*Leveraged Leases*

We also understand that the elimination of leveraged lease accounting within the ED is being revisited by the Boards, with related outreach being conducted to determine whether the leveraged lease model is worth grandfathering for existing leveraged leases, or continuing in some form under US GAAP. The leveraged lease model is unique in that it is directly derived from cash flows received and paid. While many of our member companies do not have leveraged leases, several do and would certainly be impacted by the elimination of this accounting model. In the absence of proposed
guidance on leveraged leasing, we respectfully propose two alternatives for leveraged leases:

Several of our member companies favor the grandfathering of past leveraged lease transactions (i.e., allow leveraged lease accounting to continue for transactions entered into before the effective date of the new guidance). A grandfathering approach would avoid transition issues, such as whether the asset or the nonrecourse debt should be recorded at fair value, the treatment of deferred taxes, and associated consolidation conclusions for existing trusts and other legal entities.

An alternative approach to grandfathering leveraged leases would be to take a one-time adjustment to retained earnings similar to the treatment used in the implementation of FSP 13-2 Accounting for a Change or Projected Change in the Timing of Cash Flows Relating to Income Taxes Generated by a Leveraged Lease Transaction (ASC 840-30-35 – Subsequent Measurement). Under this approach, an entity would perform a recalculation of a leveraged lease from the inception of the lease using the proposed finance lease methodology. The income that would have been recorded under the proposed model would be compared to the income recorded under the existing leveraged lease model from inception of the lease to the date of transition. The cumulative difference would then be recorded as an adjustment to the opening balance of retained earnings in the period of transition as required by ASC 250 - Accounting Changes and Error Corrections. From the effective date forward, all such transactions related to the lease would be recorded under the proposed finance lease model through the end of the lease term.

**Conclusion**

EEI greatly appreciates the Board’s efforts in performing outreach on these matters related to lease accounting. These issues are important to our industry, and we hope that our comments are helpful in your continued deliberations.

Very truly yours,

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