April 25, 2011

Technical Director  
File Reference: 2011-175  
Financial Accounting Standards Board  
401 Merritt 7  
Post Office Box 5116  
Norwalk, CT 06856-5116  

File Reference: 2011-175 Selected Issues about Hedge Accounting

Dear Sir or Madam:

The Edison Electric Institute (EEI) respectfully submits our comments on the Financial Accounting Standards Board (FASB) Discussion Paper – Selected Issues about Hedge Accounting (DP). EEI is the association of United States shareholder-owned electric companies. Our members provide service to 95 percent of the ultimate customers in the shareowner-owned segment of the industry and represent approximately 70 percent of the United States electric power industry.

Summary

EEI appreciates the FASB soliciting comments on the International Accounting Standards Board’s (IASB) Exposure Draft and in particular its openness in considering multiple approaches for improving and simplifying the hedge accounting standards. EEI has previously submitted comment letters on each Board’s Exposure Draft¹, and thus in this letter we have not repeated these detailed comments. Instead, we have summarized our views into an overall recommended framework, including a discussion of the critical items that we believe the final hedge accounting model should contain. In an appendix to this letter, we responded to specific questions contained in the Discussion Paper. In the appendix, we also summarized our recommendations to the IASB regarding their proposed changes to the accounting for own use contracts noting that we believe the current Normal Purchase Normal Sale provisions in U.S. GAAP are superior.

Hedge Accounting Framework

We believe that the best approach for revised hedge accounting requirements is to identify and articulate key principles underlying hedge accounting. In that regard, we strongly support the objective in Paragraph 1 of the IASB’s Exposure Draft that hedge accounting should “represent... the effect of an entity’s risk management activities” and “convey the context of

¹ For your reference, we are including a copy of our comment letter to the IASB.
hedging instruments in order to allow insight into their purpose and effect.” We believe it is critical to base hedge accounting requirements on the reality that many entities use derivatives for hedging purposes and that accounting for derivatives provides the greatest benefits to financial statement users when it most transparently reflects an entity’s risk management activities.

In originally developing SFAS 133, one of FASB’s cornerstone decisions stated: “Special accounting for items designated as being hedged should be provided only for qualifying items.” We believe an appropriate starting point for developing a new underlying principle governing hedge accounting would be to build off the IASB approach, focusing on applying hedge accounting consistent with an entity’s risk management strategy rather than the previous philosophy toward limiting hedge accounting.

We believe that financial statement users benefit most when accounting presentation and economic/business decisions are closely aligned to the greatest extent possible. Hedging strategies are specific to a particular company for numerous reasons, including differences in lines of business, size, sophistication, investor base, etc. As such, the hedge accounting framework should build off a company’s existing economic hedging or risk management program. By linking the standard to economic hedging, a company should be able to leverage the business-driven analysis / documentation used in support of its risk management program to support its application of hedge accounting and present its results in a manner that is more consistent with its strategy and actual risk management activities.

We summarize our views on principles that we believe should drive the hedge accounting requirements as follows:

- **Hedge accounting improves the usefulness of financial statements for investors by reflecting the effects of economic hedging transactions and reducing accounting mismatches**
  - In Paragraph BC12 of its Exposure Draft, the IASB noted that hedge accounting ‘was also an indication that in many situations the information that resulted from the normal requirements without applying hedge accounting did not provide useful information or omitted important information.’

- **Instances where a company is prevented from achieving hedge accounting or required to continue or discontinue hedge accounting in conflict with its risk management strategy should be fewer than presently exist or have been proposed**
  - Currently hedge accounting is considered an exception to the normal recognition and measurement requirements, and thus the guidance contains many detailed rules and requirements to limit its use, resulting in valid economic hedging strategies being ineligible for hedge accounting
  - Similarly, financial statement users receive suboptimal information if an entity is prohibited from voluntarily reducing or discontinuing hedge accounting even when it has discontinued or changed its economic hedging strategy, which appears to us to be a likely outcome of each Board’s proposed limitations on dedesignation
Financial Accounting Standards Board  
April 25, 2011  
Page 3

Our previous comment letters provided our detailed views on each of the Boards’ Exposure Drafts. However, based on the principles outlined above, there are certain critical provisions that we believe the final hedge accounting model should contain. Therefore, we reemphasize our prior recommendations that the Boards include the following in the final standard on hedge accounting:

- Establish an effectiveness threshold of “reasonably effective”
- Permit component hedging for separately identifiable and reliable measurable nonfinancial risks consistent with existing provisions for financial risks
- Continue to permit voluntary redesignation of hedging relationships when in accordance with an entity’s risk management policy
- Continue to permit subsequent redesignation of hedging instruments in new hedging relationships

Conclusion

We appreciate the Boards’ careful and deliberate commitment to developing high quality hedge accounting standards, even though this has resulted in modifications to the process for completion of this project. We support these efforts, and we strongly recommend that the Boards should develop a framework to serve as the cornerstones for their decisions on hedge accounting. We believe that the IASB’s objective, which links hedge accounting and risk management, is an appropriate starting point for developing a principle-based standard. When an appropriate framework is developed along with the inclusion of critical detailed provisions, including those highlighted above, we believe that the final standard will reduce the complexity of the current model and provide improved decision-useful information to investors by reflecting economic hedging activity in the financial statements.

Very truly yours,

[Signature]

Richard F. McMahon, Jr.

Attachment: Edison Electric Institute comment letter on IASB Exposure Draft ED/2010/13 – Hedge Accounting
Appendix
Responses to Questions for Respondents

Question 2: Do you believe that the proposed guidance and illustrative examples included in the IASB’s Exposure Draft are sufficient to understand what is meant by risk management, how to apply that notion to determine accounting at a transaction level, and how to determine the appropriate level of documentation required? Why or why not?

We believe that the principle-based provisions of the IASB Exposure Draft are sufficient to implement hedge accounting requirements based upon an entity’s risk management strategy. We note the current requirements under U.S. GAAP similarly require an entity to formally document the hedging relationship and the entity’s risk management objective and strategy for undertaking the hedge. While U.S. GAAP does not formally state what is meant by risk management, we are not aware of issues in practice with understanding the accounting requirements, applying these requirements at a transaction level, and determining the appropriate level of documentation. Because risk management covers a wide range of activities, we encourage the Boards to continue to limit guidance regarding risk management at the level of a principle and continue existing requirements to disclose the broad underpinnings of their risk management strategy.

Question 4: Do you foresee any significant auditing issues arising from the proposed articulation of risk management and its link to hedge accounting? For example, is the information required to be disclosed regarding an entity’s risk management strategies measurable and objective? Could the inclusion of an entity’s risk management objectives create an expectation gap that the auditor is implicitly opining on the adequacy of an entity’s risk management objectives?

As noted in our answer to question 2, U.S. GAAP already contains a link between hedge accounting and an entity’s risk management and we are not aware of auditing challenges associated with the current requirements. We also note the reference to risk management to determine the appropriate accounting is similar in concept to the FASB’s use of business strategy in the Accounting for Financial Instruments Exposure Draft. See further discussion in our response to question 22 on the disclosure requirements.

Question 7: Do you believe that the proposed criteria are appropriate when designating a component of an item as a hedged item? If not, what criteria do you suggest? Do you believe that the proposed guidance and illustrative examples are sufficient to understand how to determine when the criteria of separately identifiable and reliably measurable have been met? If not, please describe what additional guidance should be provided.

and

Question 8: Do you believe that “separately identifiable” should be limited to risk components that are contractually specified? Why or why not?

We strongly support the ability to achieve hedge accounting for a component of a nonfinancial asset or liability. As discussed in our letter to the IASB, we agree with the IASB’s proposed criteria of ‘separately identifiable’ and ‘reliably measurable’. We also agree with the concept in ¶B14 that the assessment of risk components would consider the particular market structure and the evaluation would differ by risk and market. Finally, we strongly agree with the example in ¶B15(b) which shows the principle that if a component is an ingredient in a product then it is separately identifiable even if not explicitly stated in the contract. Limiting the component to contractually specified risks
would severely and unnecessarily limit the benefit of allowing component hedging and would likely cause a divergence in economic hedging and hedge accounting.

**Question 14: Do you foresee any significant operational concerns, including auditing issues, in determining how to assess whether a hedge achieves other-than-accidental offset? If yes, what concerns do you foresee and how would you alleviate them?**

We believe the concept of ‘other-than-accidental offset’ will be difficult to apply in practice. We support the FASB’s proposed threshold of ‘reasonably effective’. This threshold is appropriately broad so as to accommodate most economic hedging strategies, particularly when combined with the ability to hedge component risks, but still requires an appropriate minimum level of effectiveness. However, we believe the final standard should explicitly stress that the effectiveness threshold is not a bright line, i.e. 50%, and that facts and circumstances will dictate whether the hedging relationship is reasonable.

**Question 16: Do you foresee any significant operational concerns or constraints in determining whether (a) a change to a hedging relationship represents a rebalancing versus a discontinuation of the hedging relationship or (b) an entity’s risk management objective has changed? If yes, what concerns or constraints do you foresee and how would you alleviate them?**

We provided extensive comments to the IASB regarding operational concerns in determining whether a change to a hedging relationship represents a rebalancing versus a discontinuation and whether an entity’s risk management objective has changed. We also provided comments to both Boards emphasizing our view that both documents unduly restrict the ability of entities to adjust hedge levels consistent with normal risk management activities.

EEI strongly believes that retaining the ability provided under current practice to voluntarily dedesignate and/or redesignate a hedging relationship will alleviate many of the concerns we identified. Instead of removing or restricting dedesignation, we urge the Board to consider principle-based modifications such as allowing voluntarily dedesignations and/or redesignations when in accordance with the company’s risk management objective and strategy. This is in the spirit of current U.S. GAAP which requires such documentation when electing hedge accounting, and is also consistent with our view that financial statement users benefit from hedge accounting that aligns with risk management to the greatest extent possible.

We will not repeat our detailed comments on the IASB Exposure Draft; however, a summary of our concerns in this area included:

- Whether an entity could rebalance a hedge relationship by substituting hedging instruments: our example involved removing a gas derivative and adding a more effective power derivative. The entity’s overall risk management objective has not changed in that both hedges mitigate the risk of forward price movements, but a more effective hedging instrument at an appropriate price became available.
- Whether an entity could discontinue hedge accounting when it effectively terminated the hedging instrument: our example noted that for bilateral derivatives it may not be possible to ‘sell’ the original derivative but the entity may
enter into an offsetting derivative (or, depending on market conditions, a series of derivatives to offset the original position). We were concerned that “effective offset” would not be considered a criterion for terminating a hedging relationship since the entity continues to legally own the offset position.

- Whether an entity could rebalance a hedging relationship by combining a new derivative with an existing hedging instrument: our example noted this practice is common in modifying a hedge to reflect seasonal differences more closely once the market for the seasonal derivatives becomes liquid. It is unclear whether the seasonal derivative could be added to the existing hedge relationship.

**Question 22: Do you foresee any significant auditing issues arising from the inclusion of risk management disclosures in the notes to the financial statements? If yes, what issues do you foresee and how would you alleviate them? Do you believe that it is appropriate to include risk management disclosures in the notes to the financial statements rather than in other information in documents containing financial statements? Why or why not?**

Yes, we have significant concerns with the disclosures proposed in the IASB’s Exposure Draft, particularly the requirement to include individual quantities or amounts of each risk managed using derivatives and the analysis of how hedging changes the risk exposure. We believe that disclosures on hedge accounting should focus on the risk management strategy and the impact hedge accounting has on the entity’s financial statements and should not be expanded beyond hedge accounting. Disclosures about the total population of risks to which the entity is subject should not be included in this standard but should be considered separately if deemed appropriate by the Boards.

We also believe that the disclosures proposed by the IASB represent forward looking information which is not required to provide a fair presentation of historical financial results. Such quantitative disclosures about all risks being managed would be relevant to all entities, not only those using derivatives and electing hedge accounting. Therefore, it would be inappropriate and incomplete to require such disclosures only for those entities using a particular type of risk management instrument (derivatives for which hedge accounting has been applied) while entities managing risk using physical assets, nonderivative contracts, or derivatives accounted for at fair value through earnings would not have to make such disclosures.

**Question 23: Do you believe that the changes proposed by the IASB provide a superior starting point for any changes to U.S. GAAP as it relates to derivatives and hedging activities? Why or why not? Should the FASB be making targeted changes to U.S. GAAP or moving toward converging its overall standards on derivatives and hedging activities with the IASB’s standards?**

We do not believe that the FASB necessarily needs to make a wholesale change in the accounting for derivatives and hedging activities, nor do we necessarily believe that all aspects of the IASB’s proposals are optimal. As summarized in the framework presented in our letter, we believe certain targeted improvements to remove current bright lines will improve hedge accounting by reducing the complexity and allowing entities to achieve hedge accounting for a larger number of valid economic hedging strategies.
The targeted improvements that would make the greatest impact, and are most critical in our view, include:

- Establishing an objective for hedge accounting with a link to risk management strategy
- Reducing the threshold for achieving hedge accounting to reasonably effective
- Eliminating the requirement for a quantitative test of effectiveness
- Eliminating the prohibition against component hedging for nonfinancial risks

We also note that the IASB Exposure Draft proposed changes in the requirements for “own use” contracts, which are similar in nature to the Normal Purchase Normal Sale provisions in U.S. GAAP. As we indicated in our comment letter on that document, we believe that entities should be able to elect to account for such contracts as derivative contracts when the contract is entered in connection with an entity’s risk management strategy and when failure to account for the own use contract as a derivative would create an accounting mismatch. This election should be available on a contract by contract basis in order to continue to accommodate the multi-faceted nature of business entities; their various products, services, and risks; and multiple potential risk management strategies they may employ.

We believe this approach is preferable to the current and proposed requirements by the IASB and has the added benefit of resulting in an outcome that is more similar to U.S. GAAP. Whether or not a contract provides for physical delivery should not, in our view, control the accounting treatment, consistent with existing U.S. GAAP under which it is the characteristic of net settlement (including physical settlement of a commodity that is readily convertible to cash) that is indicative of a derivative. Additionally, providing entities the ability to make such an election is more consistent with a principles-based approach that is designed to align with an entity’s risk management program as compared to a prescriptive approach based on contract form or a perceived desire to limit use of a particular accounting treatment.
8 March 2011

International Accounting Standards Board
30 Cannon Street
London, EC4M 6XH
United Kingdom

Email: www.ifrs.org

Reference: Exposure Draft ED/2010/13 – Hedge Accounting

Dear Sir or Madam:

The Edison Electric Institute\(^1\) (EEI) respectfully submits our comments on the IASB’s Exposure Draft on Hedge Accounting (ED). EEI appreciates the opportunity to comment on the above-referenced ED.

EEI supports the issuance of high quality accounting standards that provide transparency in financial statements and meet the needs of investors and other readers. We further support the goal of attaining a single set of high quality global standards through convergence efforts with the Financial Accounting Standards Board (FASB). While the majority of our member companies presently apply U. S. generally accepted accounting principles (GAAP), we strongly encourage the IASB and the FASB to reach a converged standard that will improve transparency and comparability upon adoption. We have made this same appeal to the FASB. It is in this light that we offer our comments.

Summary
We concur with the assessment of both IASB and FASB that the existing hedge accounting guidance is highly rules-based, complex and inflexible. Achieving hedge accounting treatment is often difficult, even while accomplishing a rational risk management strategy. As such, the current hedge accounting model often does not adequately portray an entity’s risk management activities. These deficiencies, in turn,

\(^1\) EEI is the association of United States shareholder-owned electric companies. Our members provide service to 95 percent of the ultimate customers in the shareowner-owned segment of the industry and represent approximately 70 percent of the United States electric power industry.
have led many investors to look to companies to make additional, unaudited disclosures that recast accounting results as economic results in order to report the entity’s hedging activities consistent with its risk management strategy and objectives. Transparency, relevance, and faithful representation of these activities within financial statements, as well as comparability across reporting entities, is compromised.

Fundamentally, we agree with the IASB's principles-based approach underpinning a revised hedge accounting model. We believe that the articulation of a clear objective for hedge accounting is a necessary, important foundation for establishing appropriate specific guidance. In that regard, we strongly support the objective in Paragraph 1 of the ED that hedge accounting should “represent…the effect of an entity’s risk management activities” and “convey the context of hedging instruments in order to allow insight into their purpose and effect.” We believe it is critical to acknowledge that many entities use derivatives for hedging purposes, particularly to manage risks associated with forecasted transactions, and that the guidance for derivatives should reflect an entity’s risk management activities rather than establishing significant impediments to applying hedge accounting.

Conceptually, we also support much of the specific approach to hedge accounting proposed in the ED. Overall, these provisions effectively implement the objective of establishing a hedge accounting framework that more faithfully represents risk management activities in the financial statements.

Specific provisions of the ED that we support and key considerations for our member companies include:

- Elimination of bright lines in assessing whether hedge accounting can be applied to contracts entered into for risk management purposes
  - We believe the elimination of bright lines acknowledges the real-life complexity of risk management and will result in improved financial reporting that reflects entities’ risk management activities. Entities face many risks, some of which may be mitigated through hedging activities, some may be mitigated through additional controls, and some cannot be mitigated at a reasonable cost. Each entity must continually assess the risks it faces and the costs of mitigating those risks against its risk appetite. Additionally, the types of instruments available to hedge a risk exposure may be several or few, perfect or imperfect, and/or traded in liquid or illiquid markets. Risk management is complex, requires significant judgment and needs the flexibility to adjust to changing conditions. We support accounting standards that take these realities into account.
• Ability to hedge risk components in non-financial items
  o The utility industry regularly uses various inputs (fuel) to create outputs (electricity), and it also purchases and delivers products that are priced based upon an underlying commodity (electricity, natural gas, and other fuels) plus a transportation cost. The ability to achieve hedge accounting for fuel costs in a coal transportation contract or to hedge gas commodity prices without the related transportation (basis) costs will result in accounting results that reflect economic results.
  o We strongly believe that component hedging should include relationships where the hedged component may exceed the total value of the forecasted transaction. We describe these situations and the reason for our view in more detail later in this letter.

• Ability to hedge net positions, whether they are net positions comprised of offsetting exposures or exposures with derivatives
  o This change will allow accounting documentation to align with actual risk management activities. For example, a utility may sell the forecasted output of its generation units on a forward basis by entering into a calendar-year electricity contract, which is a common instrument. However, for most generating plants, a maintenance outage is planned for a few weeks during the year. Overall, the calendar-year contract is still an effective hedge, but the addition of a forward purchase to offset the period of the maintenance outage perfects the hedge. Currently, unless the contracts were entered into simultaneously, it was difficult to achieve hedge accounting for the net position.

• Hedge accounting treatment for option premiums
  o We concur with the view that, when options are used for risk management purposes, the premiums are, economically, similar to insurance premiums. We further agree that the ability to reflect the cost of option premiums in a like manner will improve accounting results.

• The ability to continue hedge accounting (rebalancing rather than dedesignating) when the hedging relationship is adjusted
  o Our member companies have encountered instances when the hedging instrument changed, which has “created” ineffectiveness or even resulted in the discontinuation of hedge accounting treatment. Current requirements to dedesignate and redesignate a hedging relationship are administratively burdensome and artificially give rise to ineffectiveness for accounting purposes even though neither the hedged item nor the hedging instrument has been terminated. We believe this proposal better reflects the underlying economics where an existing relationship was continued and not terminated.
Designating a previous hedging instrument into a new hedge relationship
  o This proposal is in accordance with the objective that risk management should be reflected in hedge accounting and does not introduce a rule that could cause an unnecessary breakdown in this link. As more fully explained in our comment letter on the FASB’s hedge accounting proposal, which would prohibit this approach, the result of such a prohibition would be to (1) prevent entities from achieving hedge accounting in instances where they were economically hedged or (2) cause an entity to transact externally for the sole purpose of achieving hedge accounting.

(EEI comment letter to the FASB link— http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175821405903&blobheader=application%2Fpdf)

However, while we support many of the overall aspects of the ED, we believe that a few of the proposed changes need to be revised in order to meet the document’s objective of enhancing entities’ ability to reflect more transparently the economic results of risk management activities within their financial reporting. We discuss our specific concerns and recommendations below.

Voluntary Rebalancing and Discontinuing Hedge Accounting

We believe that provisions related to rebalancing and discontinuing hedging relationships need to be clarified or revised in order to accommodate common risk management strategies if the ED’s objective is to be achieved. Many entities frequently adjust the level of their cash flow hedges voluntarily in order to achieve their risk management objective. Failure to permit hedge accounting for normal risk management adjustments would reduce, rather than increase, the alignment between hedge accounting and risk management activities.

Therefore, we believe that the rebalancing provisions should explicitly recognize and permit hedge accounting for voluntary changes in hedge levels consistent with an entity’s risk management objective, even when those changes might reduce the hedge level or be executed with offsetting derivatives. As noted in our comment letter to the FASB, we strongly disagree with overly restrictive limitations on adjustment of hedging relationships when those adjustments are consistent with an entity’s risk management objective and are permitted under existing accounting requirements. Absent clarification of the ED, we believe it is possible that reporting entities could decrease their use of hedge accounting if the final standard is interpreted to exclude some of the most common redesignation and rebalancing activities that presently are eligible for hedge accounting.
Risk management commonly involves “risk selection” rather than simply risk reduction, as noted earlier in our comments. At times, continuing to maintain a hedge may increase the risk of adverse price movements to an entity, and as a result there are instances where effective risk management involves reducing hedge levels. IFRS and U.S. GAAP presently permit adjustment of hedge levels (increases as well as decreases) by means of dedesignation and/or redesignation of hedges to continue to be accounted for as cash flow hedges. We provide specific examples of these circumstances later in this letter.

We note that the ED includes a number of provisions regarding required or permissible rebalancing or discontinuation of hedging relationships. The ED states that an entity must discontinue hedge accounting if the hedging relationship (entirely or only a part of it) ceases to meet the qualifying criteria, which includes expiration, sale, termination, or exercise of the hedging instrument. It also states that an entity may voluntarily discontinue hedge accounting only to apply a different method of assessing hedge ineffectiveness or to adjust the hedge ratio following a change in the relationship between the hedged item and the hedging instrument.

We evaluated whether the ED would allow continued use of hedge accounting for activities that involve the voluntary adjustment, including reduction, of hedge levels consistent with a documented risk management strategy or objective. While it is possible that the provisions described above could be interpreted to accommodate current hedge accounting practices, we believe it is not clear whether an entity voluntarily could adjust (increase or reduce) the hedging relationship in accordance with its risk management objective and still apply hedge accounting.

Following are several common circumstances in which electric utilities and other energy companies currently may discontinue hedge accounting voluntarily in part or in total.

**Example 1** – A company that is obligated to supply electricity to customers in a region where it does not own physical power generation plants forecasts the need to make future purchases of power to serve those customers. In order to hedge price risk associated with those forecasted purchases, the company initially purchases gas derivatives to hedge power price risk because the forward gas market is highly correlated with, and is more liquid than, the forward power market. As the delivery period approaches and the forward power market becomes more liquid, the company dedesignates the near-term gas hedges and replaces them with new near-term power derivatives. The effectiveness of the hedge relationship would be increased through this transaction. The gas derivatives that were dedesignated could then either be used as hedges of
another forecasted transaction or sold if no longer needed within the context of the overall regional portfolio.

Under existing accounting rules, this rebalancing would be achieved by a series of dedesignations and redesignations as needed. We believe that the ED's provisions regarding voluntary prospective rebalancing could be interpreted to permit discontinuation of hedge accounting for the gas hedges and initiation of hedge accounting for the power derivatives because it improves effectiveness. However, we also believe that some might conclude that hedge accounting for the gas derivatives could not be discontinued if they were not terminated. We believe the final guidance should be clarified to accommodate hedge accounting for this type of risk management activity.

Example 2 - The same company as in Example 1 uses derivatives to hedge the price risk of its probable forecasted purchases of electricity. Accordingly, it has executed a number of forward power purchase derivatives to reduce its exposure to price increases. Due to price changes in the power markets (similar to what occurred through the middle of 2008), forward power prices have increased substantially, providing the entity significant economic gains on its hedges. As a result of the changes in market prices, the company now determines that power prices are much more likely to decrease than to increase in the future. In accordance with its risk management objective, it sells some of its power derivative hedges, thereby lowering its hedge ratio but remaining within its risk management objective.

Under existing accounting rules, the entity could reduce its hedge level to reflect these expectations. We believe that the ED's provisions regarding voluntary prospective rebalancing could be interpreted to permit discontinuation of hedge accounting for the power derivatives that were sold because the hedging instrument has been sold. However, in our industry, hedging primarily occurs in bilateral or over the counter markets, and the original hedge levels are likely to be reduced by executing an offsetting derivative with a different party; sale or termination of the original derivative is uncommon. Because of these mechanics, we believe that some might conclude that hedge accounting for the reduction in hedge level by executing offsetting derivatives would not be permitted.

In considering these examples, we also note that entities often aggregate forecasted transactions and hedge them with combinations of derivatives that are adjusted over time. In order to adjust the hedge level, the entity may enter into additional derivatives that offset part or all of the risk of the existing derivatives.
**Example 3** – The same company as in Example 2 has executed a number of forward power purchase derivatives to reduce its exposure to price increases for a full calendar year because monthly derivatives are not liquidly traded. As the delivery year approaches, monthly power derivatives are traded more frequently. In accordance with its risk management objective, it buys additional derivative quantities for forward months when demand is expected to be high and sells forward derivative quantities for other months when demand is expected to be lower. The forward sale contracts effectively replace portions of the calendar-year derivative hedge in order to “shape” the hedge for the year to reflect expected purchase levels more closely.

The entity would dedesignate the existing hedging instrument and redesignate a compound derivative consisting of the prior hedging instrument combined with the additional, newly executed derivatives. While this is simply an extension of the above examples, we have similar concerns to those expressed above that an entity may be in a position where economically it has closed out a risk but, for accounting purposes, one derivative continues to receive hedge accounting (despite management’s intent to discontinue) and the offsetting derivative is being marked to fair value through profit and loss (despite management’s intent to adjust its hedge levels).

The types of hedging activities described above are consistent with common, fundamental risk management strategies used for hedging in our industry, and we believe they should continue to be eligible for hedge accounting consistent with the objective articulated in the ED. Absent clarifications to the ED to address these issues, we believe it is likely that practices currently accommodated under what are deemed to be more restrictive hedge accounting rules might be interpreted to be ineligible for hedge accounting in the future.

Therefore, we request the Board to include explicit guidance and examples in its final hedge accounting standard that would clarify and definitively permit the application of the new hedge requirements to circumstances such as these. One method for doing so would be to clarify that these types of activities fall within the provisions of the standard, and this could be accomplished by indicating that rebalancing includes when the hedging instrument has been sold, terminated, or effectively terminated. The standard could define effective termination as when a new derivative is executed that is expected to offset future changes in the fair value or cash flows of the all or a portion of derivatives designated as hedging instruments. We also believe that examples illustrating these provisions, similar to the examples we have provided, should be included.
Required Rebalancing

The ED states that if a hedging relationship ceases to meet the objective of the hedge effectiveness assessment but the risk management objective remains the same, the entity must rebalance the hedge so that it meets the qualifying criteria.

We believe that this provision needs to be clarified so that it is not interpreted to require rebalancing simply because ineffectiveness occurs. In all but a few hedging relationships, some level of ineffectiveness is likely. Further, executing additional transactions to rebalance hedging relationships also usually requires an entity to incur transaction costs. Most risk management policies and activities anticipate and accommodate a modest level of ineffectiveness without necessarily requiring rebalancing.

We believe it would be inefficient and costly to require rebalancing that is not consistent with an entity’s risk management policy. Such a requirement would impose incremental costs considered unnecessary by management and would result in divergence between hedge accounting and the entity’s risk management activities.

Component Hedging

We support the extension of component hedging to non-financial hedging relationships, and we strongly believe that the final standard should permit component hedging even if the value of the component that is hedged may exceed the total value of the forecasted transaction. This can often occur in both electricity and gas hedging, where the end product to be delivered at a specific location is priced with two components:

- The commodity price at a liquid (hub) location
- The differential in price between the hub location and the actual delivery location.

Energy prices at physical delivery locations are often correlated to prices at other locations. The strongest correlation is usually to the nearest "hub" with liquid pricing. As a result, physical delivery locations may reflect pricing at either a premium or a discount to the hub price. It is important to note that the delivery component generally is relatively small compared to the commodity component of the price, rarely resulting in the potential for a negative overall price.

To accurately portray actual risk management activity, the final standard must permit hedging of the hub component, which otherwise would meet the proposed criteria, even if the remaining component is a deduction from the hub price. In some cases, this component will be contractually specified, but in our industry, the existence of markets and the nature of the underlying commodities are such that the physical commodity
component of the overall product is generally easily and objectively identifiable. While we understand that the exposure draft would prohibit such treatment for financial instrument hedging relationships, we believe that the nature of physical commodity operations and pricing as we have described above is sufficiently different to support our recommendation.

Disclosures

We do not agree with the disclosures proposed in paragraph 46 of the ED for several reasons.

- Conceptually, we do not believe that it is necessary or appropriate to include in the footnotes the individual quantities or amounts of each of the risks to which the entity is exposed as proposed by subparagraph (a). Such disclosure is not required for a fair presentation of the historical financial statements. Similarly, we do not believe it is appropriate to include the analysis proposed by subparagraph (c) that would require disclosure of how hedging changes the risk exposure.
- From a practical perspective, such disclosures (when combined with other information about the volume of financial instruments used) inappropriately provide significant competitively sensitive information that should not be required to be presented.
- Additionally, defining what exposures should be included (for example, from physical assets, recognized financial instruments and derivatives, or firm commitments) and how they would be measured poses many definitional issues and complexities that render this proposal not operational.

We understand how the information proposed for disclosure by this paragraph could be helpful to an investor in assessing an entity’s future earnings prospects or exposure to risk prospectively. However, we believe that neither of those objectives is within the function of the audited financial statements and footnotes because such an assessment is forward looking based upon consideration of projections and possible future events. This type of forward-looking information is not required in order to provide a fair presentation of historical financial results and, in our view, is not appropriate for inclusion in the footnotes to audited financial statements.

Rather, we believe qualitative aspects of the information proposed in paragraph 46 most appropriately would be included in a discussion of earnings, financial condition, and risk expectations for the future. We note that, for public entities registered with the U. S. Securities and Exchange Commission, these types of discussions presently are included under other filing requirements (outside the audited financial statements), including Form 10-K Item 1, Business; Item 1A, Risk Factors; Item 7, Management’s
Discussion and Analysis of Financial Condition and Results of Operations; and Item 7A, Quantitative and Qualitative Disclosures About Market Risk.

Contracts for Physical Delivery of Non-Financial Items

We believe that entities should be able to elect to account for contracts that are eligible to be settled net in cash that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity’s expected purchase, sale or usage requirements (“own use” contracts) as derivative contracts when the contract is entered in connection with an entity’s risk management strategy and when failure to account for the own use contract as a derivative would create an accounting mismatch.

For the sake of clarity, we believe that the treatment of such contracts should be made explicitly clear and should incorporate the following provisions:

- Accounting for an own-use contract as a derivative should be based upon the entity’s election
- The default accounting treatment for own use contracts should be retained, absent an election for derivative accounting
- Such an election should be available for both cash-flow and fair-value risk management strategies
- Such an election should be available at a granular level (as low as the individual contract) consistent with the entity’s election at the inception of the contract in accordance with its risk management policy

To elaborate, in our industry many companies manage a net position of derivatives, executory contracts, and physical long positions, as described in paragraphs BC213 and BC214 of the Basis for Conclusions and Illustrative Examples. The ability to account for own use contracts as derivatives would eliminate the accounting mismatch that can occur, without the administrative burden of applying and monitoring hedge accounting.

We note that the Board considered this approach as an alternative to the ED’s provisions. We believe that this approach is preferable, and it has the added benefit of resulting in an outcome that is more similar to current U. S. GAAP. Because derivative accounting is the default treatment under U. S. GAAP, there are companies in our industry that choose not to make the normal purchases and normal sales election and therefore account for those contracts as derivatives when they are in circumstances similar to the criteria the Board has set forth for accounting for own use contracts as derivatives.
International Accounting Standards Board
8 March 2011
Page 11

We also believe that further clarification in the criteria for treating own use contracts as derivatives is necessary due to the reference to entities managing their entire business on a fair value basis (Appendix C and paragraph BC218). Entities may have multiple risk management strategies for different lines of business or product lines within their total operations and similar contracts might be used in different ways for different lines of business or product lines. For example, some of our member companies have a variety of lines of business including regulated delivery of electricity and gas, nonregulated sales of physical electricity and gas in wholesale and retail markets, and energy trading activities. Some of these lines of business relate to products involving physical delivery for which own-use accounting is most transparent, while others relate primarily to activities for which mark-to-market through earnings treatment best reflects the economics of the activity. Therefore, the ability to elect derivative treatment for own use contracts should be permitted at a level consistent with the entity’s risk management activities.

We do not believe that own use contracts should be eligible to be accounted for as derivatives solely when a fair value-based risk management strategy is used for all aspects of an entity’s operations, but that an entity should be eligible to apply derivative accounting to own use contracts in cash flow hedge relationships as well and failure to do so would result in an accounting mismatch.

Conclusion

Overall, we are very encouraged by the IASB’s and FASB’s efforts to simplify the criteria to apply and maintain hedge accounting, which we believe will be a significant benefit to financial statement users and preparers. We strongly encourage the continuation of convergence efforts in this area, and we appreciate your consideration of these issues and our comments.

Very truly yours,

Richard F. McMahon, Jr.