December 15, 2010

Technical Director
Financial Accounting Standards Board
401 Merit 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Re: Exposure Draft – Leases (Topic 840)
File Reference No. 1850-100

Edison International (Edison) appreciates the opportunity to provide comments on the FASB’s Proposed Accounting Standards Update on Lease (Topic 840) (Lease ED). Edison, through its subsidiaries, is a generator, purchaser and distributor of electric power. Edison is the parent company of Southern California Edison (SCE), one of the nation’s largest electric utilities, and Edison Mission Group, a competitive power business with more than 10,000 megawatts of generating capacity.

General Comment

We support the FASB’s efforts to continuously improve the quality, transparency and readability of financial statements. We are concerned, however, that the Lease ED fails to achieve these goals. Our concerns arise because we may be required under the Lease ED to record billions of dollars of assets and liabilities arising under long-term power purchase agreements (PPAs) similar to capital leases under current GAAP. However, recording these agreements as capital leases would have no impact on our true financial condition, earnings power or ability to generate cash flow.

For example, Edison’s utility subsidiary is required to purchase power from renewable generators in order to comply with state renewable portfolio standards. Under state regulatory decisions, purchased power costs are recovered from utility customers on a dollar for dollar basis and do not affect earnings. As set forth in the Lease ED, long-term PPAs such as the utility’s renewable contracts, may be converted for accounting purposes into capital leases. This could result in the utility recording billions of dollars of new assets and liabilities on its balance sheet. In sum, the Lease ED, if adopted, could significantly increase our total assets and liabilities, further complicate our financial statements and add unnecessary complexity and additional disclosure without changing the true financial position of the enterprise.

From a technical accounting perspective, there are two principal areas that we believe require further deliberation:

- Guidance in determining whether an arrangement contains a lease.
• Measurement of the right-of-use asset, including application to a power purchase agreement that contains a lease.

Before discussing these areas, it may be helpful to provide background information regarding long-term power purchase agreements from specified power plants.

Background

Two major developments have occurred in the United States that have impacted the electric utility industry: (1) change in regulations to encourage competition in various elements of the electrical infrastructure, and (2) public policy support for renewable energy as a means to achieve environmental and other objectives\(^1\). These developments have resulted in a significant amount of capital investment in power plants by non-utility power producers. In order to support capital investment, commercial arrangements have been developed and formalized in power purchase agreements. Power purchase agreements\(^2\) vary depending on the fuel, market structure, regulatory considerations as well as a number of other commercial matters. Attachment B provides illustrations of common power purchase agreements together with a finance lease illustration. We expect these trends to continue and, therefore, the application of lease accounting to power purchase agreements is a significant issue for our industry.

Guidance in Determining Whether an Arrangement Contains a Lease (Question #4)

Determining whether an arrangement contains a lease is addressed in ASC Topic 840, Leases (ASC 840), particularly ASC 840-10-15. In light of the elimination of operating lease treatment in the Lease ED, we recommend that the principles for determining whether an arrangement contains a lease be re-considered. We believe that the current guidance creates a presumption that a power purchase agreement for the output of a specific power plant is a lease unless certain rules are met. We disagree with this presumption and do not believe in many cases that lease accounting provides more meaningful information to investors.

Using the illustrations outlined in Attachment B, the following table provides a high level comparison of which party bears performance risks for key aspects of these arrangements:

\(^1\) Public policy support includes state renewable portfolio standards that require (or encourage) utilities to purchase a percent of their electrical power from renewable energy sources.

\(^2\) In California, long-term power purchase agreements are subject to a procurement process that requires pre-approval by the California Public Utilities Commission. Provided the utility obtains approval of power purchase agreements and complies with the terms and conditions, the actual amount paid under such agreements are recovered through customer rates, without a profit.
We believe there are substantial differences between a classic finance lease, where a lessor completes its performance by the transfer of control over the use of an asset to the lessee, and ongoing performance risks retained by sellers in power purchase agreements. We understand that there are different viewpoints on whether such arrangements contain a lease or not. We believe that re-considering this topic would lead to a more principle-based approach that can be applied consistently to different facts and circumstances. We believe that under the Lease ED similar contracts could result in dramatically different accounting treatment which would result is less meaningful financial statements. See Attachment A for a suggested principle-based approach.

If the Board decides not to re-consider the principles for determining whether an arrangement contains a lease, we recommend including further guidance on ASC 840-10-15-6(c). The Lease ED proposes to retain these provisions. Diversity in practice has resulted from interpretation of these provisions based on different types of products and contract terms. Specific areas of diversity include:

- **Fixed price per unit of output.** A literal interpretation of this provision is that each unit of output must have the exact same price. Under this definition, a contract that provides for $1.00 per unit of output during year 1 and $1.10 per unit of output in year 2 would not meet the criteria and, therefore, the power purchase agreement would be accounted for as a lease (assuming all other requirements are met). Another interpretation of this provision is that the contract pricing must be set for each unit of output at inception of the contract. This interpretation would result in classifying the above example as a supply contract instead of a lease.

- **Output and other utility.** One interpretation of this provision is that output or other utility represents a physical attribute from the use of an asset. Under this definition, energy and capacity would be the output from the use of a power plant. Another

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3 In a wind or solar project, the buyer is required to purchase all of the output (must-take contract) on a unit of output basis, subject to specified curtailment provisions. The Seller takes the risk on the resource (i.e. amount of wind or Sun).
interpretation of this provision is that output or other utility represents both physical and economic or financial benefits from the use of an asset. Under this definition, energy, capacity and renewable energy credits would be an output and other utility derived from use of the plant as such products are not dependent on any other inputs.

Lastly, the Lease ED contemplates only a service and lease component in an arrangement. We believe that the guidance should be expanded to clarify that an arrangement may contain more than a lease and service component and that the lease component represent only the right to use the underlying asset. In this regard, we note that paragraph 13 of IFRIC 4 provides a useful reference to lease payments for other elements in the arrangement (e.g. for services and the cost of inputs). In addition, we note that pricing in a power purchase agreement also is intended to recover other holding or operating costs (e.g. insurance and property taxes). Accordingly, we recommend the final standard refer to lease and non-lease elements in lieu of service elements to address this point.

Measurement of the Right-of-Use Asset Where a Power Purchase Agreement Contains a Lease (Question #6)

The Lease ED proposes that lessees and lessors should apply the guidance in proposed standards Update, Revenue Recognition (Topic 605): Revenue from Contracts with Customers, to distinct service component of a contract that contains service components and lease components. We do not believe that this approach is appropriate to power purchase agreements for the following reasons:

- Power purchase agreements contain more than a lease and service element as described above. Accordingly, we believe that the lease standard should be revised to focus on lease and non-lease elements. We do not support that lease accounting should apply to a combined contract unless the service component is distinct. We believe that this would result in capitalization in certain cases\(^4\) of right-of-use assets greater than the fair value of the underlying asset which we believe would be misleading to investors.

- The proposed standard for revenue recognition presumes commercial arrangements have evolved to provide transparency of price information that can be applied to the elements of an arrangement that contains a lease. This is not always the case for power purchase agreements. The electric industry uses a number of products and agreement that do not provide transparency to the return of and on capital for the right to use an asset. Products such as energy, capacity, renewable energy credits, and ancillary services all are intended to achieve different market objectives than solely for compensation for the capital investment for a power plant. Furthermore, there are multiple market structures that provide different market pricing in the United States and, accordingly, use of market information in one market may not be comparable to another market.

While the revenue recognition model may be appropriate in some cases, alternate models may be more appropriate in other complex arrangements. We believe the model outlined in IFRIC 4,\(^4\)

\(^4\) This situation could be the case of long-term leases of a substantial portion of the estimated useful life of an asset.
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should be included as an alternative to the revenue recognition model, as well as a cost plus profit approach in determining the measurement of inputs (inputs include the capital for the right-of-use asset).

Other Comments on Exposure Draft

Lease Accounting by Regulated Entities

ASC 980-840-45-3 provides guidance for regulated utilities to record lease expense based on the amount allowed for rate-making purposes in the statement of income. We believe that this guidance should be retained as this presentation is reflective of the regulatory treatment of such costs and is more meaningful to the users of our financial statements.

Lease Term (Question #8)

We believe that including renewal options using the longest possible term that is more likely than not to occur would result in recording lease liabilities by lessees in excess of the definition of a liability and assets by lessors in excess of the definition of an asset. We appreciate that the history of leasing has resulted in form-based structuring to obtain specific accounting results. However, we do not believe that it is theoretically sound to create a principle that conflicts with the definition of a liability or asset.

We recommend that the current definition of a lease term be retained. We believe that the current definition, and related definition of penalty, provides an appropriate guidance to determine the substance of the lease term.

Contingent Rentals

The Lease ED requires inclusion of contingent rents in determining the right-of-use asset and lease liability for a lessee. We support inclusion of contingent rent as an estimate of the future economic benefits of the right of use asset and the present value of the lease payments to the extent not controlled by the lessee. In most cases, the lessee has explicit control over the use of the underlying asset and, therefore, determines the use of the underlying asset. However, in some cases, the classification of a lease (under the current guidance) is based on the lessee obtaining all but a minor amount of the output of a specific asset, which represents implicit control through exclusion of third parties from substantive use. In these situations, the right-of-use asset is subject to a performance obligation of the seller. This does not exist in a traditional lease where the lessor performance is completed and the lessee has explicit control over the property.

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5 Liabilities are obligations of an entity that arise from past transactions or events, the settlement of which may result in the transfer or use of assets, provision of services or other yielding of economic benefits in the future.

6 Assets are resources controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.
As a result, the seller’s performance obligation is a predicate to the buyer receiving benefits from the use of the asset and, further, the receipt of such benefits is a predicate to the buyer’s payment obligation. We believe that this interrelationship should permit netting of the buyer’s lease liability against the right-of-use asset in the same manner permitted by lessors under the performance obligation model. Such amount, if material, can be presented on the face of the balance sheet with appropriate disclosure of the details of such arrangements.

Secondary Property Use

It is common in the utility industry to have a substantial number of agreements for the restricted use of property, including easements or right-of-way agreements for land. For example, a utility may have an easement or right-of-way to cross private property with its transmission lines. The primary use of the land may be for farming or as a state or national park. In these cases the utility agrees to place its tower on a small footprint of the land and will not access the land except to service its tower. As a second example, a utility may allow a cellular service provider to attach a cellular antenna to one of its poles or towers. Usually in these cases, the utility will attach the antenna on behalf of the cellular provider and the cellular provider will not be allowed by the utility to access the pole or tower to which its property is attached.

We are concerned that the proposed standard may treat these agreements as leases unless clarified in the final standard. The definition of lease under paragraph B1 includes: fulfillment of the contract depends on providing a specified asset or assets (the “underlying asset”). The definition does not address situations where the underlying asset may have multiple uses which may separately meet the definition of a lease. Since many agreements for secondary property use, including easements or right-of-way agreements, represent a limited right to use property we do not believe that these agreements convey control over the underlying property consistent with paragraph BC30. Accordingly, we do not believe that these agreements meet the definition of a lease. However, since criteria set forth in paragraph BC 31 and BC 32 focuses on output, it is unclear how this would be applied to leases of property. Accordingly, we suggest the final standard clarify the definition of a lease to include the transfer of control over the primary use of the underlying asset. Alternatively, we would suggest that the final standard clarify that agreements for the use of property, such as easements and right-of-ways, that convey only limited use of land or property are intangible assets and are scoped out of the standard under paragraph 5(a). Currently the only authority addressing this is ASC 350-30-55 which gives examples of acquired intangible assets. Specifically, ASC 350-30-55-30 gives easements as an example of an acquired intangible asset. We feel that unless these issued are addressed specifically in the final standard there could be substantial diversity in practice related to these types of agreements.

Transition

We recommend two points with respect to the transition provisions:

- The transition guidance for “Determining Whether an Arrangement Contains a Lease” (ASC 840-10-15), did not require entities to assess the lease classification of contracts that were executed or acquired prior to May 28, 2003. Unless these contracts were modified and reassessed subsequent to the adoption of EITF 01-8, they continue to be
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accounted for as executory contracts. We recommend that this transition guidance be retained in a final standard on leases.

- When lease payments are uneven over the term of the lease, the transition provisions adjust the right-of-use asset by the amount of recognized prepaid rent. In certain cases the recognition of the right-of-use asset, when including the amount of prepaid rent, may exceed the fair value of the right-of-use asset. This situation may not be adjusted by an impairment review since such test is based on undiscounted cash flow. Accordingly, we recommend that this transition provision include a cap equal to the fair value of the right-of-use asset.

Disclosure

We agree with the objectives set forth in paragraph 70, however, we believe that the disclosure requirements set forth in paragraphs 73-80 would result in overly complex and lengthy footnotes in practice. Furthermore, we are concerned that the additional details would provide limited benefits to the users of the financial statements when compared to the cost to provide this detailed level of disclosure. Specifically, we recommend deletion of:

- Paragraph 75 on short-term leases.
- Paragraph 77 on reconciliation of opening and closing balances of right-to-use assets and liabilities to make lease payments, disaggregated by class of underlying asset.
- Paragraph 80 on reconciliation of opening and closing balances for lessors.

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We appreciate the opportunity to comment on the lease exposure draft. We appreciate the Board’s efforts in grappling with the diverse issues that relate to accounting for leases and we encourage ongoing thoughtful deliberation. We prefer to the Board take the time necessary to complete deliberation on this important standard and not make the schedule the driving force to issuing a new standard.

We are available to discuss the foregoing comment at your convenience.

Sincerely,

W. James Scialli
Executive Vice President,
Chief Financial Officer and Treasurer

Mark C. Clarke
Vice President and Controller
Proposed Approach to Contracts that Convey the Right to Control Use of a Specified Asset

Revise ASC 840-10-15-6 to provide principle-based guidance to determining whether the right to control the use of property is in substance a lease.

An arrangement conveys the right to use property, plant or equipment if the arrangement conveys to the purchaser (lessee) the right to control the use of the underlying property, plant or equipment. The right to control the use of the underlying property, plant or equipment should be evaluated based on the facts and circumstances that include, but not limited to, the following factors:

Factors which indicate the purchaser has control of the property, plant or equipment (and therefore accounted for as a lease):

- The seller has the obligation to provide the output\(^7\) from specific property, plant or equipment.
- The purchaser has the right to determine the timing and amount of output from the property, plant or equipment.
- The purchaser has the ability to operate the property, plant or equipment or direct others to operate the property, plant or equipment in a manner it determines while obtaining or controlling more than a minor amount of the output or other utility of the property, plant or equipment.
- The purchaser has the ability or right to control the physical access to the underlying property, plant or equipment while obtaining or controlling more than a minor amount of the output or other utility of the property, plant or equipment.
- The purchaser is obligated to make substantial payments to the seller that is not dependent on the output of the property, plant or equipment.

Factors which indicate the seller has control of the property, plant or equipment (and therefore not accounted for as a lease):

- The seller is committed to provide the output from specific property, plant or equipment, but may substitute output from another source.
- The purchaser is obligated to make payments based only on the actual units delivered (payment cannot be made for units not delivered such as a take or pay agreement).
- The purchaser is obligated to purchase all of the output of the property, plant or equipment without dispatch rights (must-take contract) and such costs are recovered under a regulatory mechanism without the opportunity to earn a rate of return.

\(^7\) Output and other utility from property, plant and equipment means the physical delivery of units derived from the use of such property, plant or equipment; or economic or financial benefits to the purchaser related to the use of underlying asset.
- The purchaser is obligated to make payments that are contractually fixed per unit of output or determined based on current market prices, while obtaining or controlling all but a minor amount of output of the property, plant or equipment. Contractually fixed per unit of output refers to one or more prices that are determined at the inception of the contract for output (such prices may vary based on pre-determined criteria provided such prices are on based on units of output). In assessing whether a contract is contractually fixed per unit of output, the pricing provisions shall not transfer to the buyer the risk of performance of the use of the asset.

If an arrangement contains one or more indicators of control by both the seller and purchaser, the indicators shall be weighted based whether the substance of the pricing provisions contain elements that are designed to recover a portion of the seller’s capital investment in the power plant irrespective of the quantity of output, in which case the arrangement shall be classified as a lease.
Illustrations of Power Purchase Contracts\(^8\)

For purposes of these illustrations, the Buyer represents the party that takes the output and the Seller is the party that provides the capital to build the facility.

**Classic Finance Lease**

The Seller (financial investor) agrees to arrange construction of a gas-fired power plant for the Buyer (build-to-suit arrangement). The Seller provides the capital to build the plant which is designed to meet Buyer’s specification through a contract with an engineering and construction company on a fixed price basis. The Buyer takes physical control over the plant at completion of construction. The Buyer makes payments to the Seller to recover the capital costs of the plant and a return on investment. The Buyer operates the plant, manages the fuel supply and has all the risk and rewards of ownership. Title to the power plant is transferred to the Buyer at the end of the lease.

**Classic Tolling Agreement**

The Seller (an independent power producer) agrees to build a gas-fired power plant for the Buyer. The Seller provides the capital to build the plant through a contract with an engineering and construction company on a fixed price basis. The Seller retains physical control over the plant during the period of the agreement. The Buyer makes capacity payments to the Seller to recover the fixed costs (including the capital component of the investment) of the plant and a return on investment. The Seller is responsible to maintain availability of the plant in order to earn the capacity payment. In addition, the Seller is paid a price per unit for variable operations and maintenance costs. The Buyer decides when to dispatch the power plant and is responsible to provide the fuel and purchase all of the output. Title to the power plant is retained by the Seller at the end of the lease.

**Gas-Fired PPA**

The Seller (an independent power producer) agrees to build a gas-fired plant for the Buyer. The Seller provides the capital to build the plant through contracting with an engineering and construction company on a fixed price basis. The Seller retains physical control over the plant during the period of the agreement. The Buyer makes capacity payments to the Seller to recover the fixed costs (including the capital component of the investment) of the plant and a return on investment. The Seller is responsible to maintain availability of the plant in order to earn the capacity payment. The Seller provides the fuel, but operates the plant based on dispatch instructions received from the seller. The Buyer purchases all of the output from the plant. The Seller is paid a price per unit for variable operations and maintenance costs and payment for fuel costs based on a gas price index at a quantity determined with reference to an agreed upon heat rate. Title to the power plant is retained by the Seller at the end of the lease.

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\(^8\) Illustrations do not necessarily reflect actual transactions, but are rather used for comparison purposes in comparing and contrasting the accounting treatment. All of the illustration assume the Buyer takes all of the output or other utility of the power plant.
Cogeneration PPA

The Seller (an independent power producer) agrees to build a cogeneration plant for the Buyer (based on an agreed upon specification). The Seller provides the capital to build the plant through a contract with an engineering and construction company on a fixed price basis. The Seller retains physical control over the plant during the period of the agreement. The Buyer makes capacity payments to the Seller to recover a portion of the fixed costs (including a portion of the capital component of the investment) and a return on investment. The Seller is responsible to maintain availability of the plant in order to earn the capacity payment. In addition, the Seller is paid a price per unit for steam and variable operations and maintenance costs. The plant is designed to operate during all periods of availability and the Buyer is required to purchase all of the power and steam from the plant. Title to the power plant is retained by the Seller at the end of the lease.

Wind/Solar PPA

The Seller (an independent power producer) agrees to build a wind/solar plant for the Buyer. The Seller provides the capital to build the plant through contracting with a turbine supplier and a construction company, each on a fixed price basis. The Seller retains physical control over the plant during the period of the agreement. The Buyer purchases the output on a fixed price per unit of output. The Seller is responsible to maintain a minimum level of production over a specified period of time (e.g. 24 months), or the contract may be terminated. Title to the power plant is retained by the Seller at the end of the lease.

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9 In this illustration the Buyer purchasers both the power and steam from the plant. In many cogeneration projects, the power is sold to the local utility and the steam is sold to a third party host. When the power and steam is sold separately, the arrangement generally does not contain a lease as more than a minor amount of the output is sold to another party.