November 21, 2005

Director, Technical Application and Implementation Activities
Financial Accounting Standards Board
401 Merritt 7
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RE: Proposed FSP No. FAS 133-a, Accounting for Unrealized Gains (Losses) Relating to Derivative Instruments Measured at Fair Value under Statement 133

The Edison Electric Institute (EEI) appreciates the opportunity to comment on Proposed FSP No. 133-a, which provides guidance for the accounting for unrealized gains (losses) relating to derivative instruments measured at fair value under FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities.

EEI is the association of the United States shareholder-owned electric companies, international affiliates and industry associates worldwide. Its U.S. members serve 97 percent of the ultimate customers in the shareholder-owned segment of the industry, and 71 percent of all electric utility ultimate customers in the nation. They generate almost 60 percent of the electricity produced by U.S. electric utilities.

Issue #1 – Reference Market Criteria

The proposed FSP permits the calculation and deferral or recognition of an unrealized gain or loss at inception only if the transaction price presumption is rebutted at initial recognition. Paragraph 3a indicates that the transaction price presumption is not rebutted if the market in which the transaction occurs is the reference market for the derivative instrument. Alternatively, paragraph 3b states that if the transaction occurs in a market that is not the reference market (for example, a retail market), then the transaction price presumption is rebutted.
Because the term "reference market" is defined in the proposed Fair Value Measurement standard (FVM ED), both preparers and auditors of financial statements have a limited understanding of the full implications of this new concept and how it would be applied under the FSP. However, it appears to us that the provisions of paragraph 3 of the FSP would prohibit the calculation of an inception gain by a dealer for any transaction in a wholesale market because that would be deemed to be the dealer's reference market. By contrast, it appears that, under the FSP as drafted, inception gains / (losses) would only qualify for recognition if they occurred between a dealer and an end-use customer.

We are concerned that this apparent limitation on the recognition of inception gains and losses ignores the reality of arbitrage opportunities within the wholesale reference market. The experience of the electric utility industry is that there are many types of suppliers and customers within and across the wholesale market, each with different product needs, risk appetites, and transaction requirements. For example, broad categories include power generators, power marketers, traders, electric distribution utilities, cooperatives, municipalities, competitive energy suppliers, and retail aggregators. Each of these types of entities transacts in the wholesale market, yet each may enter into transactions (including those meeting the definition of a derivative) that involve a willingness to pay or receive payment at a price other than the "reference market" price, potentially resulting in inception gains for the other party to the transaction.

One example is an electric distribution utility that purchases power from a power marketer through wholesale derivative transactions for resale to the utility's retail customers. Because of the power marketer's volume of business, market liquidity, visibility into the market, number of potential counterparties, etc., it may be able to obtain all the power it needs to supply the utility at a price that is less than that charged to the utility. Our view is that, if the power marketer is accounting for both contracts by marking them to market through earnings in accordance with SFAS 133, the sale of power at a favorable price would qualify as an inception gain subject to the minimum reliability threshold. Further, if the inception gain could be evidenced through a fair value estimate meeting the minimum reliability threshold, it should also qualify for recognition in the absence of specific transactions by the power marketer to acquire some or all of the power supply. However, we are concerned that the language in paragraph 3a of the proposed FSP could prohibit the power marketer from recognizing an inception gain because, as a wholesale market participant, it was transacting in its reference market.
We believe that this aspect of the draft FSP inappropriately applies what is effectively a bright-line test for overcoming the transaction price presumption by limiting the recognition of inception gains/(losses) to transactions outside the reference market. The FVM ED (par. 15) indicates that transactions outside the reference market are but one example of when the transaction price presumption has been rebutted. We believe that this presumption can also be rebutted by dealers engaged in transactions in the wholesale market when fair value measures that fall within levels 1-4 of the fair value hierarchy support valuations other than that indicated by the transaction price. We believe that the FSP should not be more restrictive in this regard than the Exposure Draft of the Statement of Financial Accounting Standards to which it relates.

We believe that in many cases it can be demonstrated clearly that inception gains exist and meet the minimum reliability threshold even when the transaction occurs in the reference market, as we understand that concept. One alternative to addressing this issue would be to revise the provisions of the FSP to clarify that a transaction outside the reference market is only one example in which the transaction price presumption has been rebutted, consistent with the FVM ED. EEI’s recommended approach, would be simply to require that the calculated inception gain/(loss) meet the appropriate minimum reliability threshold since that appears to be the primary concern that exists with respect to the recognition of inception gains on derivatives. We also believe adopting this method will result in less confusion regarding the concept of a reference market, and therefore less diversity in practice. Regardless of the specific way in which this issue is addressed, we believe that the FSP should be consistent with the FVM ED’s principle that permits rebuttal of the transaction price presumption when persuasive evidence exists and that the restrictive provisions of paragraph 3a of the draft FSP should be removed.

Issue #2 – Recognition Timing of Inception Gain or Loss

An area of concern in FSP 133-a relates to situations where the “minimum reliability threshold” is not met and the inception-gain is reserved.

FSP As Proposed:
   b. If the minimum reliability threshold is not met for the estimate at initial recognition of the derivative instrument, an unrealized gain (loss) shall be recognized as a deferred credit or debit, separate from the derivative instrument. An unrealized gain (loss) that is deferred shall be recognized in income when the minimum reliability threshold for the
estimate is met (or when the contract expires due to maturity or exercise). An unrealized gain (loss) that is deferred shall not be amortized into income or recorded in equity.

The application of the foregoing provision is not entirely clear as it relates to the release of deferred inception gains or losses into earnings on contracts that have multiple delivery or settlement periods spanning more than one reporting period. For such contracts that never meet the minimum reliability threshold, we believe that the deferred inception gain or loss should be apportioned to each delivery/settlement period and should be recognized in earnings as the associated delivery or settlement occurs. This reflects the fact that the inception gain is an aggregation of the amount applicable to each individual settlement within the contract. However, the proposal could be interpreted to require that the inception gain or loss would be reserved and held in its entirety on the balance sheet until the reporting period where the entire contract has matured (i.e., the conclusion of the final delivery or settlement period). This application would result in deferring inception gains on the balance sheet even when the related derivative asset or liability has been realized and would create income statement volatility between reporting periods which does not align with underlying economic events.

As an example, assume that an entity executes a 5-year derivative financial transmission rights (FTR) contract on November 1, covering the period from 1/1/06 to 12/31/10. FTR contracts are similar to locational basis swaps in other industries, which are contracts that provide a payment based upon the difference in price between two locations, or bases. Assume that the contract’s modeled value at inception is $10 million, and all valuation inputs are Level 5. Thus, the entire inception-gain of $10 million is reserved. Also, assume that the minimum reliability threshold will never be met.

Assume that there are no market price movements after inception and that actual liquidations equal the initial modeled cash flows. Each month as settlements occur under the contract, the entity would recognize the actual revenues and derecognize the associated modeled mark-to-market derivative value from its balance sheet, but it would not derecognize the deferred unrealized gain. Thus, the realized FTR revenue would be offset by the reversal of the MTM asset. As it relates to the above derivative contract, this effectively results in zero net income to be recognized over the life of the contract, until the final reporting period. In this example, if one were to interpret the FSP to require that the entire inception-gain not be recognized until the contract expires due to maturity at the conclusion
of the final settlement period, the entire $10 million value of the contract would not be recognized in net income until the expiration date of the contract in 2010.

The guidance regarding the recognition of deferred inception gains or losses for which the minimum reliability threshold is not met needs to be clarified as it relates to derivatives that involve multiple deliveries or settlements. We believe that the intent of the FSP’s provision is to release the inception gain or loss as the contract settles, and that this approach should be applied to contracts with multiple settlements; however, a literal interpretation of the FSP could lead to a view that one should not release inception gain or loss deferrals into earnings until the final settlement of a multi-year contract that includes multiple interim settlements. Under this view, deferred inception gains and losses will be deferred on the balance sheet beyond periods in which the related portion of the derivative has been recognized, and earnings recognition will not be representative of the actual economic earnings process, introducing income statement volatility that does not reflect actual transactions or changes in value.

If the minimum reliability threshold is not met for the estimate at initial recognition of the derivative, thus requiring a deferral of the inception gain / (loss), then the deferred gain / (loss) should be recognized periodically in income as the contract expires due to maturity. That is, an appropriate portion of the deferred unrealized gain or loss would be recorded into income during the periods as the contract settles; the inception-gain would then be released into income completely if the minimum reliability threshold is met or would be fully recognized upon expiration of the contract in cases where the threshold is never met. In the above example, the inception gain or loss will be recognized into earnings periodically as the contract settles, starting in 1/1/06 and ending in 12/31/10.

We believe that it is both theoretically appropriate and also practical to apportion deferred inception gains to each future period under derivatives that involve multiple deliveries or settlements and to recognize the appropriate amount of that deferred gain or loss in connection with each periodic delivery or settlement. In order to avoid confusion or the possibility of diversity in applying the FSP, we recommend that the FSP be revised to provide explicitly for this interpretation for derivatives involving multiple delivery or settlement periods.

**Issue #3 – Transition Guidance**

Paragraph 10 indicates that the FSP shall be applied retrospectively as of the beginning of the fiscal year in which it is initially applied. We believe that
retrospective application is impractical, particularly if the final FSP retains the reference market concept discussed above. Specifically, we believe that retrospective application would require the following procedures:

- Examining all open derivative contracts as of the date of application, whether or not inception gains/(losses) have previously been recognized in earnings;
- Applying the reference market concept to the period of time at which each derivative contract was initially executed, which could be several years in the past;
- Segregating those contracts that rebut the transaction price presumption and those that do not;
- Reconstructing market price and other fair value information for all prior periods that include even one contract that rebuts the presumption;
- For those transactions that rebut the presumption, attempting to apply the fair value hierarchy retroactively to all periods from inception through the end of the year prior to the date of application of the FSP (because at any point when the fair value estimate is within levels 1-4 of the hierarchy, the inception gain/(loss) must be recognized in earnings);
- Calculating the amount of prior inception gains or losses actually recognized in a period prior to the date of application that would not qualify for recognition under the FSP’s guidance;
- Calculating the amount of inception gains that should have been recognized under the FSP’s guidance prior to the date of application of the FSP but were not;
- Determining the adjustment to retained earnings to reflect the combined effect of these calculations.

In the energy industry, and we suspect in other industries as well, long-term derivative contracts spanning several years are not uncommon. As a result, it is likely that, at the date of initial application of the FSP, retrospective application would require trying to reconstruct facts and market data for each interim reporting period covering many prior years. We believe several facets of this process are impractical and may be virtually impossible, including:

- Applying the reference market concept to prior transactions – because this concept is newly defined, it may be difficult to apply to prior periods where data necessary to identify the reference market may not now exist.
- Applying the fair value hierarchy to prior transactions – because the fair value hierarchy is newly defined, it may be very difficult to determine the level at which fair value data used to recognize prior inception gains would fall within the new hierarchy.
Determining inception gains eligible for recognition – retrospective application would appear to require consideration of whether derivatives for which inception gains were not previously recognized now qualify for such recognition. The data to make such a determination or to calculate the amount of any such gain may not exist because it was not relevant at the derivatives’ inception, particularly for those entities who amortize deferred inception gains. Further, this analysis would have to be performed for all reporting periods from inception of each transaction through the end of the last period prior to the date of implementation of the FSP.

Relevance – we question whether it is relevant or useful to adjust opening retained earnings at beginning of the period of application for the effect on prior periods of applying an entirely new concept for determining fair value and identification and accounting for inception gains. If we understand the FSP correctly, the retrospective adjustment could involve some or all of the following:

- Recognition of inception gains not previously recorded;
- Elimination of inception gains that were previously recorded; and,
- Elimination of previous amortization of inception gains.

Rather, we believe that it is more critical to focus on placing all derivatives on the same accounting basis as of the date of initial application with appropriate disclosure of the method by which that objective was accomplished. We do not believe that financial statement users receive any benefit from, or would necessarily even be able to discern a meaningful difference in, a full retrospective application as opposed to a more practical, modified retrospective approach.

In at least two other instances, recent new accounting standards have provided exceptions to a full retrospective application due to the impracticability of that approach. They include:

- FIN 46(R) – permitted evaluation of variable interests based upon facts existing as of the date of initial implementation rather than reconstructing facts from prior periods or performing the evaluation required by that interpretation retrospectively.
- SFAS 143 – permitted initial recognition of asset retirement obligations using a discount rate determined as of the date of implementation rather than reconstructing the rates that would have applied in all prior periods in which the ARO arose.
We believe a similar practical approach is warranted for this FSP. We believe that a modified prospective application would be more practical, provide appropriate uniformity, and avoid unneeded and perhaps unduly difficult reexamination of prior periods. Therefore, we recommend that the FSP be applied prospectively as follows:

- The FSP should be applied to all new transactions entered into on or after the effective date.
- The recognition of the remaining amount of any deferred inception gains existing as of the effective date should be subject to the provisions of the FSP as of that date.
  - If the associated derivative meets the minimum reliability threshold for recognizing an inception gain as of the date of initial application, the deferred inception gain should be recognized at that time. This amount could be recognized by adjusting opening retained earnings as of the beginning of the fiscal year of initial application.
  - If the associated derivative does not meet the minimum reliability threshold for recognizing an inception gain, the deferred gain should remain on the balance sheet until settlements occur under the contract (in accordance with our comments on Issue #1 above) or until the minimum reliability threshold has been met.
  - Any amortization of deferred inception gains should cease.

We believe that the approach places all outstanding derivatives on a consistent basis as of the effective date of implementation of the FSP without requiring an examination of multiple prior periods that would provide little, if any, additional useful information in the financial statements.

**Issue #4 – Presentation and Disclosure**

Regarding the recording of an inception gain (loss) deferral as a separate asset or liability, we believe that the deferral should be netted on the balance sheet as a contra asset or liability against the associated derivative contract amount to avoid grossing up assets and liabilities. The modeled unrealized inception gain or loss in essence represents the reporting entity's best estimate of the fair value of the derivative at inception. Thus, the deferred inception gain or loss is not a stand-alone asset or liability but is a component of the derivative itself. This presentation better aligns with the concept that contracts that do not meet the minimum reliability threshold are assumed to have zero fair value at initial recognition. Moreover, netting the inception gain or loss reserve against the related mark-to-market asset or liability is consistent with industry practice of
netting other reserves, for example counterparty credit risk reserves against the related mark-to-market assets.

Furthermore, if the gain (loss) reserve is viewed as an adjustment to arrive at fair value (which we believe it is), there would be no purpose to disclosure of any deferred gains (losses). Accordingly, we recommend that the disclosure requirements proposed in paragraph 6.b. be removed. We also believe that all disclosures should be addressed in the FVM ED and the disclosures in paragraph 6.a. be moved to that standard.

We appreciate the opportunity to share our views regarding the guidance.

Sincerely,

/S/

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Business Operations

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