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Ms. Suzanne Bielstein  
Director – Major Projects and Technical Activities  
Financial Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
Norwalk, CT 06856-5116

Subject: File Reference No. 1201-100

Dear Ms. Bielstein:

Calpine appreciated the opportunity to send a representative to participate in the September 21, 2004 round table discussion regarding the Financial Accounting Standards Board's (FASB or the Board) Exposure Draft of proposed Statement of Financial Accounting Standards, "Fair Value Measurements" (FVM ED). On behalf of Calpine Corporation (Calpine), I am writing to provide follow-up commentary on issues discussed at the round table in advance of the FASB's redeliberations of the FVM ED.

Calpine is primarily an electric generation company engaged in the development, construction, ownership and operation of power generation facilities and the sale of electricity, predominantly in the United States. As such, we use nonfinancial commodity derivatives to manage risk exposures inherent in our generation of electricity. We believe that application of the model contained in the FVM ED creates issues that are unique to companies using nonfinancial commodity derivatives to manage commodity price risk inherent in a manufacturing process. The uniqueness stems from the fact that the risk exposures being managed often arise from the underlying property, plant and equipment (PP&E) owned by the company. For example, our power generation assets create a position that is long electricity prices and we often manage our long electricity exposure by entering into short commodity derivative contracts. In fact, our risk managers monitor and manage our risk by focusing on the net risk exposures created by our combined PP&E and contractual positions. This dynamic would apply to any business dependent upon liquid commodities as inputs into or outputs from its manufacturing process whether they are processors of agricultural products or producers of refined petroleum products, to name a couple.

Our view on some of these unique issues in relation to the model contained in the FVM ED are contained below:

### **Changes in credit standing**

At the round table discussion and in many of the comment letters, respondents commented that incorporating changes in a company's credit standing within fair value calculations would impact a company's earnings in ways inconsistent with the revenue recognition framework. We support this view because we believe an underlying issue of realizability exists. We do not believe that a change in our credit rating would in any way change our obligation to procure natural gas or deliver power under any of our commodity derivative contracts and, as a result, do not believe that it should trigger an earnings recognition event.

At the round table discussion, Ms. Seidman requested that participants provide the FASB staff with their views as to how to operationalize this concept. We would suggest that consideration of credit standing in calculating fair values only be applied if the realizability tests embedded within the existing revenue recognition framework are met. We believe that for changes in a company's credit standing to be incorporated into the company's fair value calculations, those changes must change the company's underlying obligations.

### **Valuation techniques**

The FVM ED references the use of multiple valuation techniques in calculating Level 3 valuations. Like other respondents, we believe that this would impose an unnecessary burden on financial statement preparers especially in situations where generally accepted valuation techniques already exist. In valuing commodity derivatives, a variety of generally accepted models and modeling techniques exist that are readily available. Using other valuation techniques that are inconsistent with the generally accepted modeling techniques would not provide meaningful data and would result in unnecessary effort on the part of financial statement preparers.

### **Fair Value Hierarchy**

Like other respondents, we believe that the fair value hierarchy should be based on an analysis of the reliability of the inputs rather than on the characteristics of the assets and liabilities being measured. Using this approach, we believe that market inputs should be rated as most reliable and entity inputs rated as least reliable. We also propose that the hierarchy recognize that situations exist where valuations are so dependent (maybe solely dependent) upon entity inputs that the information is unreliable due to its lack of representational faithfulness. Stated another way, if information is based solely on management inputs that cannot be corroborated by external data, the valuation becomes solely a management estimate. This estimate may not represent the value at which an asset or liability could be exchanged in a current transaction between knowledgeable, unrelated willing parties. The valuation may not represent fair value as defined by the

FVM ED because it is too imprecise to faithfully represent the value at which a willing unrelated party would exchange the underlying asset or liability.

This phenomenon is often the case with some of our longer dated power sales and gas supply contracts. If we are unable to account for those contracts which qualify as derivatives under the normal purchases and sales exemption, we must account for them at fair value. Often these longer dated contracts will extend out beyond periods for which market based inputs, such as prices, exist. As a result, the valuation becomes heavily dependent upon management inputs. While it is true that the pricing established for these contracts is negotiated at inception between a willing buyer and seller, we often establish the pricing with a view to earn a certain rate of return on an underlying asset, such as a power plant. However, under the derivative accounting rules, the long-term contract is accounted for separately from the underlying asset. In these circumstances the contract is valued based on its pricing versus the prevailing commodity prices in the market. When market prices are unavailable, management must estimate future prices. Management's estimate of these future prices may or may not be consistent with the estimates of other market participants.

### **Transaction costs**

Many respondents articulated a view that certain transaction costs should be included in calculating fair values. We concur with this view, especially where those costs represent transportation costs or basis differentials. Ignoring the basis differentials inherent in commodities misrepresents their values. Although natural gas is a fungible commodity that has the same chemical make up regardless of its location, natural gas for delivery at Henry Hub has a different value than natural gas for delivery at Houston Ship Channel due to transportation costs, among other market factors. We believe that ignoring this cost in calculating a company's commodity derivative valuations would misrepresent the valuation.

### **Bid/Ask Prices**

The FVM ED incorporates bid/ask price differentials into valuations but allows the netting of long and short positions when calculating the valuations. We agree with this approach and, in fact, currently incorporate a similar technique in calculating liquidity reserves on our commodity derivative positions. However, we believe that application of the approach should be clarified to allow for offsetting of positions between levels of the hierarchy as articulated by other respondents and it should allow for offsetting of underlying asset positions. As we articulated earlier, many companies that use commodity derivatives to manage risk exposures created by their underlying manufacturing process have a short or long position created by their PP&E. In our case our generation assets are naturally short natural gas and long power (the inputs into and outputs from our manufacturing process). To hedge these exposures we enter into offsetting commodity derivative positions. These positions often qualify for cash flow hedge treatment and we often designate them as such. To incorporate bid/ask price differentials into the valuation of these commodity derivatives without considering the

offsetting position of our generation assets would likely result in hedging ineffectiveness or hedge disqualification that is not consistent with economic reality because we often hold these positions to physical delivery and never cross the bid/ask spread upon settlement. Or, if we do not designate the commodity derivatives as cash flow hedges but intend to settle the commodity derivatives by delivery to or from our generation assets, consideration of a bid/ask spread in the valuations would create artificial reserves that would be reversed into earnings at settlement.

We appreciate the opportunity to express our views on these issues and would welcome the opportunity to discuss these matters in greater detail. If you have any further questions or require any additional information, please feel free to contact me at (713) 570-4811.

Sincerely,  
Randy Kruger, Jr.  
Vice President Accounting, Calpine Energy Services

CC:  
Robert Kelly, Executive Vice President and Chief Financial Officer  
Charles B. Clark, Jr., Senior Vice President and Chief Accounting Officer