



LETTER OF COMMENT NO. 29



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June 16, 2008

Mr. Russell G. Golden
Technical Director
Financial Accounting Standards Board
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Re: File Reference: Proposed FSP ARB 43-a

Merrill Lynch appreciates the opportunity to comment on the Financial Accounting Standards Board's ("FASB") proposed FSP ARB 43-a (the "FSP"). As a major financial services company with active commodities trading, we remain very interested in the final outcome of this project.

In summary, we generally support the underlying concept of the FSP, which requires marking to fair value commodities inventory that is held for trading purposes, but we have serious concerns about the limited scope of the FSP as proposed. We contend that the current scope is too limited to provide any significant value to preparers and users of financial statements. We believe that more contracts that are entered into for trading purposes should be included in the scope of this FSP, such as storage and transportation contracts. We do not agree that inclusion of such contracts would result in a significant delay to the completion of this project. In addition, we believe such an approach is further in line with the suggestions of the SEC's Advisory Committee on Improvements to Financial Reporting, which supports activity-based accounting guidance as per their May 2008 subcommittee reports. Please find below our comments to your specific questions.

Issue 1: Commodity Inventory

Would you prefer the alternative approach to limit the scope of the proposed FSP to commodity inventories that are not used in production, wholesale, retail, or distribution activities? Why or why not?

We agree with the FSP as written that the scope should be defined in reference to trading activity. Current accounting guidance provides alternative accounting treatment for certain legal entities, including broker-dealers and investment companies in accordance with the respective AICPA Accounting and Auditing Guides, but legal entity distinctions do not always align with our business. We support the move towards an activity-based approach, rather than legal entity distinction or industry level approach, as a method to provide accounting treatments that are more appropriate in certain contexts. Particularly in the commodities industry, we believe that the trading distinction is very clear from an activities perspective. Trading operations of an entity, be it a company that also has production operations or is involved in trading only, are typically managed on a fair value basis and therefore can be distinguished from other activities.

We believe current accounting literature lacks a clear definition of trading that has been challenged and tested in practice. However, we do not believe that more guidance is required. From an internal management perspective, we have clear distinctions as to what is or is not considered trading activity. These internal distinctions drive our management of instruments on a fair value basis versus a historic cost basis. We believe that these distinctions also should be used to determine the accounting treatment. As such, we support the FASB's decision to not provide more guidance in this area, because we believe that this will only serve to increase rule setting in the literature, for which we are not proponents.

Issue 2: Readily Determinable Fair Value

Would you prefer the alternative approach to limit the scope of this proposed FSP to inventories included in an entity's trading activities that have readily determinable fair values? Why or why not?

We strongly believe that the guidance should not consider whether a traded instrument has a readily determinable fair value or not. This issue had been considered in the deliberations of FAS 157, Fair Value Measurements, where it was decided that additional disclosure would be required when an instrument does not have a readily determinable fair value. In addition, FAS 133, Accounting for Derivative Instruments and Hedging Activities ("FAS 133"), requires that commodities contracts that meet the definition of a derivative be accounted for at fair value, regardless of whether or not the fair value is readily determinable. To impose such a restriction in this FSP would create unnecessary and inappropriate earnings mismatch between instruments with similar characteristics as well as unnecessary inconsistency with other guidance. In addition, the nature of trading activity implies the need to manage risk on a fair value basis, even when such fair values are not readily determinable. Therefore, the interplay of trading activity with fair value measurement is appropriate in all circumstances.

Issue 3: Trading Items Other Than Physical Inventory

Do you believe that the Board should consider a broader scope project that would include all contracts and assets or liabilities within an entity's trading activities even if it would result in significantly delaying the issuance of final guidance? Why or why not?

We firmly believe that the scope of this FSP should be expanded. The FSP as proposed is helpful for our organization, as the proposed approach is preferable to our current method of effectively achieving fair value accounting of inventory through the use of fair value hedge accounting under FAS 133. However, the guidance as proposed only reduces the operational burdens and limitations associated with hedge accounting. Our more significant issue is the inability to achieve fair value accounting for other commodities-related contracts associated with our trading platform because of the difficulty in meeting hedge effectiveness criteria in FAS 133. We believe that all contracts that are fundamentally interrelated to commodity trading activities should also be accounted for at fair value. These contracts include the rights to capacity most often secured in the form of transportation (e.g., pipeline, transmission line, rail, and vessel) or storage that are routinely entered into as part of our daily trading operations.

Our commodities trading activities are a combination of customer services, physical trading and financial trading. Physical activities can be hedged using financial instruments. For example, a physical forward can be hedged using a financial fixed for float swap. In this example, both instruments are accounted for at fair value under FAS 133. However, energy capacity contracts such as storage and transport are not in scope of FAS 133 or FAS 159, The Fair Value Option for Financial Assets and Financial Liabilities.

Transportation contracts provide the holders of the capacity the right, but not the obligation, to transport physical commodities from one location to another. The execution of the transportation rights creates a "short" trading position at the receipt point and a "long" trading position at the delivery location. This can also be viewed as being "long" the basis spread, the price differential between the receipt and delivery locations of the underlying transportation contract. For example, the basis spread of transportation from Louisiana to New York would be the differential of prices in Louisiana and New York at a given point in time. These contracts can be valued as a series of daily basis spread options. Storage contracts provide the holder of the storage capacity the right, but not the obligation to store physical quantities of a commodity (inventory). This capacity can be employed to meet future delivery obligations or to take advantage of anticipated time spread differentials. Time spread is the price differential between injection time periods and withdrawal time periods. One common time spread is referred to as the "summer/winter spread". This time spread is the differential of April – October (injection) prices and November – March (withdrawal) prices. This can also be viewed as being "long" the time spread for the pricing point associated with the facility. The delta position associated with these contracts can be effectively hedged through the use of financial and/or physical products that are derivatives under FAS 133. The trading business manages the risk profile associated with these contracts on a daily basis using the same metrics and valuation techniques as instruments that are accounted for at fair

value under current GAAP literature. Excluding these contracts from valuation and measurement would misstate the overall trading position inherent in the portfolio.

We strongly support a view that trading activities managed and valued on a fair value basis should be accounted for on a symmetrical basis rather than the asymmetrical basis prescribed in the current literature. These different measurement methods lead to non-economic earnings volatility and an incomplete presentation of a company's overall commodity risk profile. When businesses that trade energy capacity contracts are sold, the value of these contracts is included in the sales price. Not including the fair value of energy capacity contracts in the financial statements until the time of sale is a misrepresentation of the true financial position to the reader of financial statements. Although cash flow and fair value hedge accounting are intended to provide a means for eliminating certain earnings volatility, the application of hedge accounting is limited, particularly as a result of the uncertainty in forecasting the timing of anticipated transactions (i.e. the optionality inherent in these contracts) and satisfying the highly effective hedge criterion established by FAS 133.

A secondary effect of asymmetrical accounting is that it may influence management to make uneconomic decisions. Having to weigh the asymmetrical impact of contracts on reported earnings, stock price and analysts' views has the potential to influence management's decisions on whether to avoid certain transactions that are economically profitable to shareholders over the term of the contract because the transactions are potentially negative to GAAP income in the short term. The financial statements of businesses exposed to these contracts are not transparent as they do not reflect the true risk profile of the trading position. As with other situations where hedge accounting is not available, this results in accounting dictating economic decision-making, which we believe is not appropriate.

An example of this is the asymmetrical accounting for energy capacity contracts and their associated economic hedges which has had a direct impact on the energy infrastructure within the United States such as that of the natural gas market. With an increasing demand for power and the cultural dissatisfaction with nuclear and coal fired generation, there is a growing need for the ability to have a reliable delivery system for large quantities of natural gas throughout the United States. This has been evidenced by the increases in expansion and new build proposals by storage and transportation providers. However, the number of market participants involved in these activities and the duration for which they are willing to take on future physical risk have been significantly decreased in a large part due to the inability of public firms to absorb the earnings volatility of the asymmetrical accounting in their financial statements between the storage contracts and derivatives used to hedge those contracts. This provides a clear advantage to private firms over public firms in the bidding of the proposed capacity due to the fact that the private firms do not have to report earnings on a GAAP basis. With fewer public firms participating, competition is negatively impacted and the decreased capital investment is diminishing the number of projects that can be undertaken at any given time. Smaller public firms are even more disadvantaged as they have less capacity for the potential earnings volatility. However, the aggregate capital of these small firms is

needed in the bidding process to ensure that the capital requirements essential to build out the United States natural gas infrastructure are fulfilled.

Finally, we challenge the notion that expansion of the scope of this FSP would result in significant delays. By scoping this project in reference to trading activities, this limitation itself will provide any necessary barrier to overuse of fair value or unforeseen inclusion of items that should not be or cannot be measured at fair value. As previously noted, trading activity by its nature is managed on a fair value basis. Contracts that are executed in trading operations should be fair valued.

We would also like to suggest that the accounting for emissions credits be addressed by the FASB in the very near term. We recognize that there are issues with defining emissions credits in the scope of this project. However, the trading of emissions credits is increasing substantially and the accounting is not keeping pace with these developments. We believe that continuing down the path of activity-based accounting for this trading activity is the appropriate next step.

Issue 4: Accounting Policy Election

Do you believe that the measurement attribute for inventories should be subject to an entity-wide accounting policy election? Why or why not?

We agree with the principle in the proposed FSP that focuses on the activities of a reporting entity, rather than an option-based approach or a legal entity classification approach, as is applied with the AICPA Accounting and Auditing Guides for broker-dealers and investment companies. We think an activity-based approach is more meaningful to investors and prevents abuses of “cherry-picking” accounting treatments.

Issue 5: Implementation Issues

- a. What costs would be incurred to implement this proposed FSP?*
- b. Are the transition provisions of this proposed FSP appropriate?*
- c. Given this proposed FSP’s comment period, the Board expects to issue a final FSP in the third quarter of 2008. Does this expected issuance date provide sufficient time for entities to understand and apply the requirements of this proposed FSP, which could be effective for fiscal years (and interim periods within those fiscal years) beginning after November 15, 2008?*

Given the existing scope of this FSP applies to inventory upon which we apply hedge accounting, there would be few implementation issues. Were the scope to be expanded to commodities contracts other than inventory, there would also be few implementation issues as we manage the economics on a fair value basis but account for these instruments on a cost or accruals basis. The expansion of the scope of this FSP would actually reduce costs that we currently incur.

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Thank you again for the opportunity to comment on the FSP. We hope the FASB will give consideration to our comments as you continue to deliberate this project. We are available to answer any questions should you require clarification on any of the points above. Please feel free to call me at (212) 449-2048.

Sincerely,

/s/ David Moser
Managing Director, Accounting Policy