

# EDISON ELECTRIC INSTITUTE

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Technical Director
Financial Accounting Standards Board
401 Merritt 7
Post Office Box 5116
Norwalk, Connecticut 06856-5116

LETTER OF COMMENT NO. 49

Submitted to: director@fasb.org

Re:

Exposure Draft - Proposed Statement of Financial Accounting

Standards – Accounting for Hedging Activities – An Amendment of FASB Statement No. 133

File Reference No. 1590-100

Dear FASB Members and Staff:

The Edison Electric Institute (EEI) is submitting these comments in response to the above-referenced Exposure Draft (ED). EEI members companies have applied the provisions of Statement 133 since its inception and are directly and significantly impacted by these proposed revisions. EEI is the association of U.S. shareholder-owned electric companies throughout the United States. EEI represents approximately 70 percent of the U.S. electric power industry, including companies that generate and transmit electricity and operate in electricity markets throughout the country.

#### **Summary of Comments**

EEI appreciates the opportunity to provide comments on this ED. EEI concurs with the FASB's objectives of simplifying hedge accounting, improving the financial reporting of hedging activities, resolving practice issues, and addressing certain recognition and measurement anomalies.

Our comments on the ED may be summarized as follows:

- We generally support the proposed amendments to Statement 133, specifically the use of "reasonable effectiveness" and qualitative analyses (when appropriate) for applying hedge accounting; an exception-based evaluation for changes in effectiveness; and, the symmetric recognition of ineffectiveness on cash flow hedges. We believe that all of these changes are consistent with the fundamental principles underlying Statement 133 and would simplify and improve the reporting of derivatives and hedging activities in the financial statements.
- We strongly disagree with the ED's provisions restricting the ability to dedesignate a hedging relationship in paragraphs 13-15, and we provide a number of examples illustrating and supporting our concerns. Unlike other changes designed to reduce complexity within the existing principles governing hedge accounting, we believe that this provision represents a fundamental change in the underlying principles of Statement 133 that recognized risk management as a valid practice for hedge accounting. The proposed prohibitions on dedesignation are not consistent with simplification and will, in fact, increase complexity for affected entities because well-established risk management activities that are presently eligible for hedge accounting treatment under the Statement's current provisions will have to be fundamentally redesigned in order to continue to qualify for such treatment, which may not be possible at all.

In summary, if the current dedesignation provisions of Statement 133 were retained and paragraphs 13-15 of the ED are removed, we would be able to support the other provisions of the ED, taken as a whole. However, and notwithstanding our support for the objectives of this project, if the new and onerous dedesignation provisions of the ED are retained, we could not support issuance of a final standard in that form. Affected EEI member companies may find it much less complex for their operations and more a representationally faithful presentation of their economic performance to continue to apply the existing rules governing hedge accounting, particularly with the potential for future changes under IFRS.

Following are our specific comments on the ED. First, we address certain of the Issues on which the Board requested comment, and then we provide additional comments on other matters of importance to our industry not otherwise addressed in those Issues.

# Comments on Issues in the ED

Issue 2: For the reasons stated in paragraphs A18-A20, the Board decided to continue to permit an entity the ability to designate the following individual risks as the hedged risk in a fair value or cash flow hedge: (a) interest rate risk related to its own issued debt (that is, its liability for funds borrowed), if hedged at inception, and (b) foreign currency exchange risk. Do you believe the Board should continue to permit an entity to designate those individual risks as a hedged risk?

We agree with the Board's decision to continue to permit an entity the ability to designate these risks as the hedged risk. This would allow companies to synthetically create variable-rate debt or fixed-rate debt using two financial instruments at a lower cost than by issuing actual variable-rate debt or fixed-rate debt in a single instrument. We believe that it is appropriate for the accounting to reflect the economic substance, which is the same as if a single instrument had been issued, rather than to be controlled by the legal form.

# Issue 4: Do you believe that modifying the effectiveness threshold from highly effective to reasonably effective is appropriate? Why or why not?

We agree with the Board's modification of the effectiveness threshold from highly effective to reasonably effective at offsetting changes in fair value or variability in cash flows. Under the current effectiveness requirements, many economic hedges may not be recognized as such due to the difficulty in meeting the highly effective threshold, yet those hedges often provide substantial offset to changes in cash flows or fair values associated with the hedged risk. In industries that involve a manufacturing activity (such as the generation of electricity), price risks associated with that activity are often hedged with derivatives (sales price of electricity, purchase price of fuel). We strongly believe, as do many analysts who follow our companies, that having the ability to apply hedge accounting to those derivatives provides a more transparent and relevant presentation of the economic results of management's risk management activities that enables financial statement users to evaluate the effectiveness of management's stewardship of enterprise resources and operations.

Further, while we do not believe the Board should provide a specific quantitative threshold for reasonably effective, we believe that clarifying guidance in the form of principles and illustrations or examples would be helpful in applying the provisions of the Standard. While several of the original Statement 133 examples have been amended, we believe it would be helpful if those

illustrations were supplemented with additional, explicit guidance. In the absence of such clarifying guidance, we anticipate that a quantitative 'bright line' test may develop in practice as audit firms and companies work through the implementation of the new requirements, just as unwritten bright-line tests are applied in practice under the current requirements of Statement 133. Under widely held existing interpretations of the "highly effective" standard, hedges that are resentially identical in effectiveness receive starkly different accounting treatments depending upon whether the quantitative assessment of effectiveness is above, or just slightly below, a specific threshold, which we believe is inappropriate and misleading.

Therefore, while we support the proposed principles-based approach, we also recommend the inclusion of additional guidance in the final standard that reinforces this approach and assists in its application. Below we have provided suggested wording that incorporates the essence of our recommendation. There may be additional guidance beyond this suggestion that would be appropriate. However, at a minimum, we recommend that the final standard include language such as the following, inserted in the final standard at the end of paragraph 6:

However, the threshold for determining whether a hedging relationship is expected to be reasonably effective should not be interpreted as a minimum quantitative threshold. For example, it would not be appropriate to designate any minimum percentage level of correlation or expected offset of changes in the hedged item's fair value or the variability in hedged cash flows in order for a hedging relationship to be considered reasonably effective. Rather, the determination of whether a hedging relationship is expected to be reasonably effective, even using a quantitative assessment, is a matter of judgment based upon consideration of all relevant facts and circumstances.

We also recommend the addition of language such as the following immediately after paragraph 10 of the final standard:

In many circumstances, an entity may be able to conclude that a hedging relationship is expected to be reasonably effective without performing a quantitative assessment. While not all-inclusive, a quantitative assessment generally would not be required in any of the following circumstances:

a. The hedging instrument has the same or similar underlying as the hedged item and does not contain leverage factors that significantly modify that relationship.

> b. The underlying of the hedging instrument is clearly and closely related (as that term is defined and used in paragraph 10 b of Statement 133 and DIG Issue C20) to the underlying of the hedged item.

Issue 5: Do you foresee any significant operational concerns in creating processes that will determine when circumstances suggest that a hedging relationship may no longer be reasonably effective without requiring reassessment of the hedge effectiveness each reporting period? Do you believe that requiring an effectiveness evaluation after inception only if circumstances suggest that the hedging relationship may no longer be reasonably effective would result in a reduction in the number of times hedging relationships would be discontinued? If so, why?

We agree with the Board's decision to require reassessment of hedge effectiveness only in the event circumstances suggest that a hedging relationship may no longer be reasonably effective. Assuming that the concept of reasonably effective is not reduced in practice to a mere quantitative test, we do not foresee significant operational concerns in determining when circumstances suggest that a hedging relationship may no longer be reasonably effective. This approach is similar in nature to the 'triggering event' concept set forth in paragraph 8 of Statement 144 that requires testing long-lived assets for recoverability based upon events or changes in circumstances. That approach has worked well in practice, in our view.

As applied to hedging activities, we believe that for most entities there are certain fundamental hedging relationships that are relatively typical. In our industry, such relationships include hedges of forecasted purchases of power or fuel to generate power and forecasted sales of power. The factors considered in determining whether these typical hedging relationships are expected to be reasonably effective would be articulated as part of each entity's documented hedging strategy and likely would be monitored for risk management purposes, regardless of accounting implications. We believe that it would not be significantly difficult to utilize existing risk management practices, or other monitoring techniques, to determine if circumstances indicate a reassessment of effectiveness should be performed for purposes of applying hedge accounting.

In order to reinforce this principle, we believe it would be helpful to add language similar to the following to paragraph 7 of the final standard:

This may include, for example, significant changes in the factors evaluated and documented in making the original determination that the hedging relationship was expected to be reasonably effective in accordance with paragraphs 9-12.

However, similar to our response to Issue 4 above, we are also concerned that in practice a de facto quantitative bright line test for determining when reassessment is required may develop in order to provide a greater sense of assurance that a hedging relationship is expected to continue to be reasonably effective. We believe that this would be inconsistent with the principle articulated in the ED. Accordingly, we request the FASB to provide clarifying guidance such as examples of qualitative triggering events that illustrate the principles used to identify circumstances in which a quantitative assessment would be necessary and/or situations in which a qualitative assessment is not sufficient. Consistent with our earlier recommendation, we believe this should include an explicit statement, such as the following, as part of paragraph 7 of the final standard that:

A minimum percentage level of correlation or expected offset of changes in the hedged item's fair value or the variability in hedged cash flows does not necessarily require reassessment of a hedging relationship to determine whether it remains reasonably effective. While an entity may choose to implement a quantitative rule of thumb as a cost-benefit measure to assist with the identification of potential circumstances for reevaluation, whether a specific hedging relationship should be reevaluated is a matter of judgment based upon consideration of all relevant facts and circumstances.

Issue 7: In the statement of operations, Statement 133 does not prescribe the presentation of gains and losses associated with hedging instruments, including the effective portion, the ineffective portion, and any amounts excluded from the evaluation of effectiveness, such as forward points. Do you believe that Statement 133 should be amended to prescribe the presentation of these amounts?

We believe that Statement 133 should not be amended to prescribe the income statement presentation of gains and losses associated with hedging instruments. The detailed disclosure requirements in Statement 161 provide adequate information pertaining to the amounts and income statement classification of such gains and losses. Further, any additional prescriptive disclosures within

Statement 133 might result in requirements that are not compatible with all industry standard presentations. Consistent with current practice, we believe that reporting entities should be afforded the latitude to determine the most transparent presentation for their business and disclose that presentation as required by other existing standards.

# Comments on Specific Provisions of the ED

#### Cash Flow Hedge Clarification

We agree with the provisions outlined in Paragraphs 12 and 27 that allow the use of a single derivative instrument to hedge the cash flows of a group of forecasted transactions within a specified time period. In order to clarify that this provision applies to all derivatives, including physical commodities, we believe that the insertion of the word "price" in two places as follows would be helpful:

"That time period is reasonable if the difference is minimal between the forward rate (price) on that derivative and the forward rate (price) on a derivative or derivatives that would exactly offset the changes in cash flows of the forecasted transactions."

We also believe that it would be helpful to clarify that a qualitative approach may be used in making this evaluation if appropriate. For example, derivative contracts for the delivery of electricity or gas for a specified quantity in each day of a particular month settle just prior to the delivery month, and there is generally no daily forward rate or price available in the market; rather, during the delivery month there is generally only a daily or hourly spot market. Thus, such monthly derivatives are the best and most effective available contracts for hedging forecasted daily deliveries. Therefore, we believe that it would be helpful, and consistent with the provisions of paragraphs 12 and 27 of the ED, to clarify that in such situations, a qualitative evaluation may indicate that the use of a single commodity derivative that is based upon and settles a few days prior to the delivery month meets the criteria specified in those paragraphs.

#### Dedesignation of a Hedging Relationship

We note the significance of the proposed changes in paragraphs 13 through 15 regarding the qualifications for removing the designation of an effective hedging relationship after it has been established. If enacted, these provisions would prohibit hedge dedesignation absent settlement or termination of the hedge. We believe that this prohibition is inconsistent with the ED's stated objective of simplifying and facilitating the continuation of hedge accounting and also represents a fundamental philosophical change in the hedge accounting requirements used in practice successfully by many entities since the adoption of

Statement 133. Paragraphs 357-359 of Statement 133 considered and rejected a risk reduction criterion for applying hedge accounting, instead explicitly adopting hedge accounting requirements that permit dedesignation and redesignation in order to reflect the entity's "desired level of risk based on its view of the market." The ED's provisions revoke this fundamental aspect of Statement 133, going well beyond simplification. If adopted as proposed, this change would require many entities to make substantive and potentially complicated revisions in their hedge accounting policies and procedures in order to continue to utilize well-established practices consistent with the underlying principles of Statement 133. We believe that such a fundamental change does not simplify, and in fact has the potential to complicate significantly, the use of hedge accounting.

We also disagree with the apparent underlying reasons that are the basis for this provision in the ED. Paragraph A11 states that the accounting should not change because "the economics of the relationship between the hedging instrument and hedged item...have not changed" and that "the Board does not believe that dedesignation should be used as a tool for changing measurement attributes and/or managing the classification of certain items reported in earnings."

While the premise of no change in economics may be true and easy to demonstrate in a simple hedging environment, large entities that are geographically diverse and that manage risk actively in numerous markets with varying liquidity over time often have equally valid reasons to dedesignate without terminating the derivative that reflect changes in economic relationships and evaluation of risk in multiple parts of the entity. The prohibition on dedesignation fails to recognize that this is the case, as illustrated by several following examples that highlight the pervasive and potentially negative consequences of this provision.

**Example 1** – An electric utility or other entity that supplies electricity to customers often will use derivatives to hedge the price risk of their probable forward purchases of electricity. In the electricity markets, contracts for delivery of electricity over a calendar year period in the future trade more actively than contracts for delivery of electricity during specific seasons or months in those future years. The utility or other entity may enter into a physically settling derivative contract to purchase electricity at a fixed price for delivery in equal monthly quantities two years in the future. Several months prior to the start of the calendar year for delivery, the monthly contracts for that year typically become more actively traded, and this allows the entity to adjust its overall hedge levels for specific

months to reflect the relatively greater risk in peak summer or winter months versus lower risk in off-peak spring and fall months. It may do so by executing forward sales contracts for specific off-peak months, thereby reducing the hedge quantity in those months but leaving the peak months unchanged. It would then dedesignate the entire annual hedge contract and redesignate the combination of the annual contract and the monthly contracts as a single compound derivative in a hedge relationship. For peak months for which the hedge quantity did not change, these provisions of the ED would appear to prohibit dedesignation and redesignation, yet this hedge strategy is valid and widely used in our industry.

**Example 2** – Natural gas purchases are often hedged with the NYMEX natural gas futures contract, which is highly correlated with natural gas prices at numerous locations in the eastern two-thirds of North America. An electric utility or nonregulated power generator with natural gas-fueled power plants in various locations may purchase such futures contracts to hedge the forecasted purchase of gas for those plants. As a result of changes in perceptions of risk between locations, it may choose to dedesignate contracts at one location and redesignate them for another location. This would be prohibited under the ED.

**Example 3** — Diverse energy companies often have both trading and nontrading activities managed by different individuals or groups with different economic objectives. While traders will adjust positions to profit on their view of short-term market changes, risk managers may hedge over longer periods of time and adjust those hedges actively to reflect changes in the overall level of risk based on many factors. Using the same gas futures contract described above, because of perceived changes in risk, the risk manager for natural gas-fueled power plants may choose to decrease his hedge ratio, while a short-term gas trader may want to initiate a long position in gas futures. Entities that include both types of activities often will settle such position changes internally and only trade externally if there is a net change in the entity's position.

**Example 4** – We note that the proposed prohibition on dedesignations would supersede DIG Issue H7, Foreign Currency Hedges: Frequency of Designation of Hedged Net Investment. That guidance allows entities to use one derivative to hedge its net investment in a foreign entity with full recognition that, as the net investment varies over time as net income, dividends and other capital transactions occur, a portion of the hedge can be dedesignated and redesignated. A common practice is to dedesignate

a portion of the net investment hedge when the subsidiary declares dividends, which reduces the net investment and creates a receivable subject to revaluation under SFAS 52. The change in the value of the dedesignated hedge offsets the earnings effect of the dividend receivable offset. We believe that this practice appropriately reflects the true net economics of the transactions and should continue to be permitted.

As these diverse examples illustrate, hedge dedesignation reflects valid and commonly practiced risk management techniques, and the internal matching of positions before trading externally is also a common and efficient manner for minimizing transaction costs. While in some cases the same effect could be accomplished through external trades, that imposes additional real economic costs (transaction costs and crossing the bid-offer spread) and could be open to criticism as transacting simply to achieve an accounting result.

We also disagree with the implication in Paragraph A11 that entities dedesignate primarily or even incidentally to change measurement attributes or manage the classification of items reported in earnings. This assertion presumes that such entities have the ability to predict with certainty short-term changes in the value of derivatives or hedged risks, which is unlikely in our view. Even if that were the case, however, we believe that Statement 133 includes appropriate provisions to address the potential for uneconomic dedesignation without substantive business purposes. For example (focusing on cash flow hedges):

- Paragraph 28a requires formal documentation of the hedging relationship, risk management objective and strategy. Hedge designation and dedesignation that is inconsistent with this documentation would not be permitted under Statement 133, and hedge strategies that are not reasonably effective could not be executed at all.
- Paragraph 31 requires an entity to report in earnings any portion of losses in accumulated other comprehensive income to the extent that a loss is expected on the overall hedged forecasted transaction. This provision protects against the possible manipulation of hedge accounting to recognize derivative gains in earnings but defer losses in other comprehensive income.
- DIG Issues K1 and F6 provide explicit guidance that, by analogy, would prohibit the management of hedge accounting dedesignations in an attempt either to circumvent the provisions of Statement 133 specifically or the requirements of generally accepted accounting principles.

In entities that have both trading and non-trading risk management operations, it is important to note that these activities are generally governed by strict

compliance and other policies, related procedures, and various limits on risk and position levels. Those controls commonly include prohibitions on transfers of trades simply to achieve an accounting result and subject transfers between trading and non-trading books to heightened scrutiny.

In addition to these concerns, we also note that the proposed dedesignation provisions raise a number of practical issues that reflect a number of underlying inconsistencies in this new requirement. For example:

- The impact of adding a derivative to an existing hedge relationship is unclear. On the one hand, we understand that Statement 133 currently would require dedesignation and redesignation of the new hedging relationship in this circumstance, yet on the other hand, such dedesignation would appear to be precluded by the ED, even though adding a derivative to an existing hedge relationship appears to be permitted.
- An existing derivative can continue to be added to a hedging relationship simply by completing the appropriate documentation, even though the entity has not changed its economic position, yet a new transaction must be executed to dedesignate a hedging relationship.
- Dedesignation without termination of the hedge would be prohibited because it does not change the entity's economic position, yet execution of a trade that would effectively terminate the hedge does not do so unless it is documented as such.
- Dedesignation by terminating the derivative and entering into another transaction at current prices could occur for legitimate business reasons, and even could occur in different areas of an organization without the knowledge of the other, accomplishing the same objective as simple dedesignation accompanied by an internal transfer of the position, but with higher costs.

In summary, we disagree with this substantive, fundamental change in the provisions of Statement 133 for both conceptual and practical reasons. If such a change is adopted, it will severely limit many entities' ability to obtain hedge accounting for dynamic hedging programs or result in those entities incurring additional incremental costs to transact externally to accomplish the same result. We believe these changes are outside the stated objectives of the ED. Accordingly, we strongly recommend that the provisions of paragraphs 13 – 15, which prohibit hedge dedesignation absent settlement or termination of the hedge, be removed from the final standard and that current practice for dedesignation and redesignation be retained.

#### Transition Issues

The transition provisions for cash flow hedges in paragraph 34 state that "an entity shall adjust the balance in accumulated other comprehensive income to equal the difference, if any, between the fair value of a derivative that would provide cash flows that would exactly offset the hedged cash flows and the amount in accumulated other comprehensive income related to the hedge just prior to initial application. The net effect of the adjustment to accumulated other comprehensive income shall be recorded directly to retained earnings." We have several concerns about the mechanics of this transition.

First, while we understand that the essence and intention of this provision is to adjust AOCI to the amount that would have resulted had the company applied the new hedge accounting rules (i.e., recognizing all ineffectiveness) from the inception of the hedging relationship, we believe it would be helpful for the final document to confirm that this is in fact the case.

Second, we also believe that these provisions are somewhat ambiguous as to how to compute the fair value of a derivative that would provide exactly offsetting cash flows. We assume that means a derivative with a fixed price equal to the existing derivatives that have been designated as hedges since the paragraph states that this provision is applied to designations that effectively continue the existing hedging relationship. However, an alternative interpretation would be that the calculation should reflect the fair value of a new derivative executed at market prices at that date which would have a zero fair value. This would result both in the entire reversal of the amounts recorded in AOCI as well as ineffectiveness associated with the non-zero fair value of existing hedges, even though the hedging relationship was continued.

We do not believe that it is FASB's intent to require companies to compute the fair value of a derivative at prices as of the date of transition for purposes of this transition provision, but because of this ambiguity, we recommend that the final document clarify how this provision is intended to be interpreted. We suggest that this could be accomplished by inserting the phrase highlighted in bold below in paragraph 34:

...an entity shall adjust the balance in accumulated other comprehensive income to equal the difference, if any, between the fair value of a derivative that would provide cash flows that would exactly offset the hedged cash flows (as though the derivative existed at the inception of the hedging relationship) and the amount in accumulated other comprehensive income related to the hedge just prior to initial application.

Finally, we do not believe that it is necessary or appropriate to dedesignate and redesignate hedging relationships that are being converted to comply with the amended standard as required in paragraph 32 of the ED. As a practical matter, we believe that this provision would most likely have limited applicability within our, and perhaps other, industries. Given the "reasonably effective" threshold for designation as a hedge, we believe that a majority of such relationships would qualify for hedge accounting after the effective date, and of course those that do not would have to be dedesignated at that time. However, dedesignation and redesignation would require entities to capture and reflect time value associated with the non-zero fair value of their hedges at the time of transition, introducing ineffectiveness unrelated to any substantive change in the hedging relationship. If this provision is retained in the final standard, we believe it would be helpful to enumerate more specific examples of the types of hedging relationships intended to be included within this provision.

Given the considerations discussed above, we believe it would be more practical and less costly simply to require hedging relationships that have to be modified at the effective date to comply in all respects with the substantive provisions of the revised standard – reasonably effective, no bifurcation by risk, measurement and recording of ineffectiveness for all hedges – and to be able to do so simply by changing their hedge documentation as appropriate. We don't believe that any benefit would be obtained by introducing additional ineffectiveness into financial statements for existing hedge relationships when such ineffectiveness really only reflects the mechanics of adopting prospective changes in the computation of ineffectiveness. In fact, for those relationships affected by this provision, it would actually introduce what we believe to be an unnecessary complexity in connection with the implementation of a Standard designed to simplify hedge accounting.

### Convergence with IFRS

We noted the views of the two dissenting Board members regarding the likelihood that U.S. public companies will adopt IFRS in the foreseeable future and the resultant difficulties that companies will face in implementing two major changes in hedge accounting (i.e., first with the proposed amendments to Statement 133 and second with the transition to IFRS). Notwithstanding these real and significant difficulties, we believe that the proposed amendments to Statement 133, taken as a whole and after reflecting our comments above (particularly retention of the Statement's existing dedesignation provisions and deletion of paragraphs 13-15 of the ED), will achieve the Board's objective of simplifying the accounting for hedging activities and we support the Board in moving forward with the issuance of a final standard.

# **Conclusion**

EEI appreciates the opportunity to provide comments on this important ED. If you need additional information or have any questions about these comments, please contact me or EEI Director of Accounting David Stringfellow at 202-508-5494 or dstringfellow@eei.org.

Respectfully submitted,

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