



LETTER OF COMMENT NO. 101

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Technical Director
File reference No. 1590-100
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: File reference No. 1590-100 – Proposed Statement of Financial Accounting Standards – *Accounting for Hedging Activities – An Amendment of FASB Statement No. 133*

Sirius Solutions appreciates the opportunity to comment on the proposed FASB Exposure draft on the *Amendment of FASB Statement No. 133*. Sirius Solutions is a professional service firm headquartered in Houston, TX. The firm's technical accounting group provides advisory services to a variety of industries but primarily provides services to the energy and financial services sectors. We appreciate the Board's efforts to simplify the standard while making it more user and practitioner friendly. Our comments on each of the issues will attempt to point out an area of concern, reason for the position, and an alternative suggestion.

Hedged Risk

Issue 1: *For the reasons stated in paragraph A16 of this proposed Statement, the Board decided to eliminate (with two exceptions) the ability of an entity to designate individual risks as the hedged risk in a fair value or cash flow hedge. As a result of that*

change, the financial statements would reflect information about the risks in the hedged item or transaction that an entity both chooses to manage and not to manage as part of a particular hedging relationship.

Do you believe that the proposed Statement would improve or impair the usefulness of financial statements by eliminating the ability of an entity to designate individual risks and requiring the reporting of the risks inherent in the hedged item or transaction?

In certain instances there are operational differences between the energy sector and other sectors that require different rules. Bifurcation by risk does not seem appropriate where there is sufficient instruments and liquidity available to hedge all risks. For example, there is a burgeoning derivative market to hedge credit risk on top of market risk such that a company can choose to hedge all the risk associated with debt or forecasted interest rate of foreign currency risks. In the energy/commodity sector there are two issues that I believe the FASB should consider in terms of exceptions to the bifurcation by risk.

The first is calendar spread risk. Liquidity in the energy/commodity sector limits a company's ability to hedge all risks at a given time. Index risk may be hedged by specific month out a number of years by individual month on an exchange or through brokers. While the specific delivery location, grade, or product might have a basis swap that trades a limited amount of time or in strips (quarter, season, or calendar). This may not match up with the liquidity available to hedge index risk. This difference in liquidity presents a few issues under the current rules as well as the proposed rules. All of the hedged risks outstanding are not hedgeable economic risks which mean that they will not have a readily determinable fair value if required for fair value.

The second is contracts that are quarter, season, or calendar strips. Most companies break up the contracts internally in their deal capture and accounting systems into monthly exposures to manage the exposures to the best of their ability on a monthly basis. Because SFAS 133 is implemented on a contract by contract basis and you cannot bifurcate by risk, there are often mismatches in the availability of index based contracts and basis contracts that leave a company over or under hedged on a calendar versus seasonal basis. This affects effectiveness testing when viewed by contract. Split into individual months the risks may be perfectly hedged for a calendar year with basis overhedged for the remainder of the season. The overhedged portion should go to income, but should not affect whether the previous months are effective.

The suggestion is that there should not be bifurcation by market risk allowed, but bifurcation by calendar risk should be allowed. For energy/commodity contracts that do not have an embedded financing element, a company should be able to designate a monthly cash flow exposure as a risk and split derivatives into monthly exposures as hedges against those risks. The effectiveness tests will accurately capture total cash flow exposure for the month and any months that are overhedged will go to earnings. Designating a portion of contracts in lieu of breaking a contract into monthly exposures is less reflective of calendar spread risk. The risk is hidden in the change in derivative asset under the current rules. Energy/Commodity companies manage their economic

exposures as separate monthly exposures. The desired accounting result can be accomplished by those companies executing 12 separate monthly contracts at the same price as opposed to 1 contract that spans all 12 months. Allowing energy/commodity companies a special exception for contracts that do not contain embedded financing elements will meet the goals of the amended standard and still comply with the basis for conclusions in A16.

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. For those two exceptions, the financial statements would not reflect information about the risks that an entity chooses not to manage as part of a particular hedging relationship.*

Do you believe the Board should continue to permit an entity to designate those individual risks as a hedged risk?

We believe that these individual risks should be allowed to be designated as individual hedged risks along with the exception described under Issue 1 that allows energy/commodity companies the ability to separate contracts that do not contain an embedded financing element into monthly cash flow exposures. We also believe that the exception for interest rate risk related to its own issued debt should not be limited to the inception of the debt.

Capturing changes in credit risk as a portion of fair value at the inception of the debt is not simpler than capturing the credit risk as a portion of fair value at any other time. If at any time a company has debt exposure and enters into a swap to hedge that exposure regardless of whether the debt has been in existence, the simplicity of capturing the changes in the interest rate risk exposure simplify the accounting. Users of financial statements are not better informed of credit risk whether a company has elected to hedge at inception or at a later time. This will also eliminate variances in accounting post mergers and acquisitions when a company under the current and amended rules would have a change in accounting due to the merger and acquisition when the economics have not changed.

The suggestion is to implement an exception that will be consistent and simple to apply, which is to allow the individual interest rate risk exposure to be the designated hedged risk at any time when the hedged risk is based on the company's own debt.

Hedge Effectiveness

Issue 3: *This proposed Statement would eliminate the shortcut method and critical terms matching. Therefore, an entity would no longer have the ability upon compliance with strict criteria to assume a hedging relationship is highly effective and recognize no ineffectiveness in earnings during the term of the hedge. As a result, when accounting for*

the hedging relationship, an entity would be required, in all cases, to independently determine the changes in fair value of the hedged item for fair value hedges and the present value of the cumulative change in expected future cash flows on the hedged transaction.

Do you foresee any significant operational concerns or constraints in calculating ineffectiveness for fair value hedging relationships and cash flow hedging relationships?

Do you believe that the proposed Statement would improve or impair the usefulness of financial statements by eliminating the shortcut method and critical terms matching, which would eliminate the ability of an entity to assume a hedging relationship is highly effective and to recognize no ineffectiveness in earnings?

We do not believe that the board should allow the short cut method or critical terms match method. We agree that ineffectiveness associated with the privilege of hedge accounting should be calculated. We do not believe that this will cause significant operational concerns as most of our clients have found the short cut method and critical terms match requirements to be onerous and risky and have already moved away from these methods.

We believe theoretically that the usefulness of financial statements should not be impacted by this rule as the income impact for companies that had perfectly effective hedge relationships should still be zero. It should give users more comfort that the risks of hedge relationships are all captured in earnings without any concern for whether a company has complied with strict criteria.

Issue 4: *This proposed Statement would modify the effectiveness threshold necessary for applying hedge accounting from **highly effective** to **reasonably effective** at offsetting changes in fair value or variability in cash flows.*

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

For situations in which interest rate risk is currently designated as the hedged risk for financial instruments but would no longer be permitted under this proposed Statement (except for an entity's own issued debt at inception), do you believe you would continue to qualify for hedge accounting utilizing your current hedging strategy? If not, would you (a) modify your hedging strategy to incorporate other derivative instruments, (b) stop applying hedge accounting, (c) elect the fair value option for those financial instruments, or (d) adopt some other strategy for managing risk?

We agree with the Board's proposed amendment to adjust the effectiveness threshold from highly effective to reasonably effective. Too many hedge relationships where companies had no other alternative for hedge instruments did not qualify under the highly effective requirements. For example, Jet Fuel in the West Coast does not qualify under the current highly effective requirements against NYMEX No. 2 Heating Oil (HO). HO is a switching fuel for Kerosene which is a switching fuel for Jet Fuel. This represents

that best exchange traded hedging instrument for Jet Fuel in the West Coast. Under the current rules, this does not always qualify.

The current requirements are extremely difficult to pass because highly effective has been interpreted as an R-squared of .80 or higher. R-squared is actually correlation squared. This means that if a hedge relationship is correlated at .893, the R-squared is .798. This would not qualify for hedge accounting. There must be a bright line that is drawn somewhere, but we believe that the correlation of .894 and an R-squared of .80 is too high.

We believe that given a change in the effectiveness requirements that our client's new interest rate risk hedges that may not qualify under the bifurcation by risk method will generally qualify for hedge accounting despite a highly volatile credit environment. If they would not qualify, we would recommend our clients to execute other instruments to use in conjunction to qualify for hedge accounting.

Issue 5: *This proposed Statement always would require an effectiveness evaluation at inception of the hedging relationship. After inception of the hedging relationship, an effectiveness evaluation would be required if circumstances suggest that the hedging relationship may no longer be reasonably effective.*

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 do not foresee any significant operational concerns in creating processes that will determine when circumstances suggest that a hedging relationship may no longer be effective. We do not believe that removing the effectiveness test requirement unless circumstances change would not reduce the number of times a hedge relationship will be discontinued because the reduced effectiveness test requirement to reasonably effective should allow for appropriate hedge relationships to qualify.

Issue 6: *The Board considered but decided against eliminating any assessment of effectiveness after the inception of the hedging relationship. The Board believes that eliminating such an assessment of effectiveness could result in the continuation of hedge accounting even when situations suggest that the hedge relationship may no longer be reasonably effective. Some observe that an implication of the decision to not eliminate any assessment after the inception of the hedging relationship could be that hedge accounting results would be reflected in some reporting periods and not in other reporting periods throughout the life of the relationship. Also, in a hedge accounting*

model that generally does not permit hedging of individual risks, changes in the relationship between the individual risks being managed and those not being managed could increase the likelihood that the hedging relationship would no longer be reasonably effective. That would result in hedge accounting no longer being permitted for a portion of an expected hedge term. That “in and out” of hedge accounting would make it more difficult for users to interpret financial statements.

Do you agree with the Board's decision to continue to require that hedge accounting be discontinued if a hedge becomes ineffective? Alternatively, should an effectiveness evaluation not be required under any circumstances after inception of a hedging relationship if it was determined at inception that the hedging relationship was expected to be reasonably effective over the expected hedge term?

We agree with the board that hedge accounting should be discontinued if a hedge becomes ineffective. We believe that continued monitoring that requires occasional hedge effectiveness tests is appropriate.

We do not have any comments on issues 7 through 11 and agree with the Board on Presentation, Effective Date and Transition, and the Benefit-Cost Considerations. We do have a comment related to the decision to make hedge accounting an irrevocable election and a comment on the decision to allow for OCI to be greater than the change in fair value of the hedging instrument.

Sirius Comment on hedge accounting being irrevocable

Many of our energy/commodity clients manage their monthly exposures using a portfolio approach also known in other sectors as dynamic hedging. We believe that many of our clients that qualified for hedge accounting under the current rules may not qualify under a strict interpretation of the amended rules. Because hedge instruments that no longer qualify because of a changed forecast are prohibited from a new hedge accounting election. In this case a company that forecasts well and has to adjust the hedged item for quantity, grade, or location will be penalized while a company that does not forecast well will end up realizing ineffectiveness when revenue is recognized that should have been reflected earlier.

For example, Company E&P may be a producer of natural gas in the Rockies and sell along the pipeline going into the Mid-Continent. They can forecast my production and hedge my sales in the Mid-continent. It is difficult to forecast where exactly among 5 locations in the Mid-continent they will sell the natural gas. They hedge with NYMEX futures contracts and take the least effective location as the delivery location to calculate ineffectiveness. If the pipeline has unscheduled maintenance or newly scheduled maintenance and the forecast for delivery changes, this would cause the forecasted transaction to no longer be probable in the Mid-Continent and the hedges to no longer qualify for hedge accounting. This would limit the hedges from being applied to the same gas being delivered in the Rocky Mountains. The financial statements would best reflect the economics of this if hedge accounting was dedesignated and redesignated to

the Rocky Mountains and OCI was adjusted for the change in forecasted cash flows assuming that the forecasted transaction was always designated against sales in the Rocky Mountains. The proposed rules limit companies who are economically responsible and forecast regularly and accurately to match the timing of their hedge revenues to the revenue recognition of their forecasted transaction. A similar example is an end user of feedstock. The forecasted purchase may change frequently and economic hedges of those forecasts should also change. The amended rules may require a company to enter into offsetting transactions and new transactions to regain hedge accounting, which requires transaction costs, margin/collateral requirements, and internal resource costs. We suggest that dedesignation of a hedge relationship should be allowed with contemporaneous documentation to allow for portfolio hedging. Without this ability, hedge accounting will not work for most energy/commodity companies.

Sirius Comment on cash flow hedge accounting ineffectiveness calculation

We do not believe that allowing for OCI related to forecasted transactions to be greater than changes in the fair value of the hedging instrument is appropriate and in line with the goal of minimizing SFAS 133 as a tool for changing measurement attributes. It will offer companies the ability to stay within the reasonably effective requirements and reflect earnings related to forecasted transactions before they occur. We suggest that the calculation of cash flow hedge ineffectiveness remain the same as under the current rules.

In general we agree with the Board's goals, but we believe that the proposal to amend FASB statement no. 133 should be further deliberated to consider the comments above specifically and generally consider portfolio hedging, allowed bifurcation of energy/commodity contracts without an embedded financing element into monthly exposures, and removing any at inception only rules. We agree with the change from highly effective to reasonably effective, removal of the short cut and critical terms match methods, and the reduced requirement of quarterly effectiveness testing.

If you have any questions about our comments please contact Chandu Chilakapati at (713) 888-7232.

Sincerely,



Chandu Chilakapati