American Petroleum Institute
1220 L Street, Northwest
Washington, DC 20005-4070
202-682-8000

November 15, 2004

Lawrence W. Smith
Director of Technical Application and Implementation Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Re: EITF Issue No. 04-13, *Accounting for Purchases and Sales of Inventory with the Same Counterparty* (Issue 04-13)

Dear Mr. Smith:

The Accounting Committee of the American Petroleum Institute (API) is appreciative of the Emerging Issues Task Force (EITF) adding this topic to its technical agenda. Buy/sell transactions are an important part of the oil and gas industry's supply chain activities. We look forward to continued participation in the EITF process, and providing any additional information, if needed, as the EITF deliberates the accounting for buy/sell transactions. The following sections of this letter give more background information on buy/sell transactions and how our industry has predominantly interpreted the application of existing GAAP to these transactions.

We are concerned, however, with how Issue Summary No. 1 has presented the technical issues for discussion at the November meeting of the EITF. As you will see in the remainder of this letter, API member companies predominantly believe that buy/sell transactions are not nonmonetary transactions and thus do not fall within the scope of paragraph 21(a) of APB 29. This is the technical issue that is being asked in question 1(a) of Issue Summary No. 1. We believe all legitimate alternative views, including the view of our industry, should be described in the Issue Summary before the EITF begins its deliberations. Apparently in the interest of moving Issue No. 04-13 along quickly, the preparers of Issue Summary No. 1 have decided to defer deliberation of question 1(a) until a future meeting and therefore have not yet prepared summaries of alternative views on that question. We have no concern with the FASB staff taking more time to prepare the Issue Summary materials on question 1(a) and having the EITF deliberate that question at a later date. However, we are concerned with the recommendation that deliberations begin on question 1(b) at the November meeting.

The use of our industry's buy/sell transaction as the example upon which to base the deliberations of question 1(b) could be construed that the FASB staff has reached the conclusion that buy/sell transactions do fall within the scope of paragraph 21(a) of APB 29, without the benefit of having all legitimate alternative views on that question fully described in the Issue Summary. Additionally, if the EITF were later to conclude that our industry's predominant practice is correct on question 1(a), the EITF would be in the position of having to revisit question 1(b) with an alternative example for deliberating the issues. Therefore, we recommend that the EITF temporarily delay deliberation of Issue No. 04-13 until such time that the Issue Summary has progressed to a point where question 1(a) can be addressed first in the deliberations.

Background and Discussion Related to Buy/Sells

For many years, the oil and gas industry has used a type of transaction commonly called a buy/sell. In a typical buy/sell transaction, Company A enters into a contract to sell a particular grade of crude oil at a specified location to Company B on a future date, and simultaneously agrees to buy from Company B a particular grade of crude oil at a different location at the same or another specified date. The characteristics of buy/sell transactions include gross cash settlement, and nonperformance by one party to deliver generally does not relieve the other party's obligation to perform except for events of force majeure. Both transactions require physical delivery of the crude oil and the risk and reward of ownership are evidenced by title transfer, assumption of environmental risk, transportation scheduling, credit risk, and counterparty nonperformance risk. Buy/sell transactions may also have a timing difference such that the purchase and sale could occur in different months. The contract prices of the two transactions reflect the quality and location differences of the crude oil being sold, and the two companies invoice each other gross (i.e., Company A sends an invoice to Company B for the number of barrels delivered times the price per barrel, and Company B does likewise). Furthermore, there typically is no link of the two transactions within the accounting systems. Usually, all the documentation for buy/sell transactions appears in the accounting system as any other purchase and sale. The two companies report the sale of the barrels as revenue and the purchase of the barrels as cost of sales or inventory, assuming: 1) the indicators of EITF Issue No. 99-19, *Reporting Revenue Gross as a Principal versus Net as an Agent* (Issue No. 99-19), support gross reporting; and 2) the transactions are not entered into or held for trading purposes, as discussed in EITF Issue No. 02-3, *Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities*.

One of the major challenges facing vertically integrated oil and gas companies is keeping their systems in balance (i.e., ensuring that the right crudes are at the appropriate refineries at the right time and that the appropriate products are being refined to meet all seasonal and other demands). Buy/sell transactions are an important tool for managing this supply chain. Though it would be advantageous for a company with both upstream and downstream operations to refine all of the crude oil it produces, this is usually not logistically practical. A company may produce a grade of crude oil not suitable for its refineries, or the location of a company's production in relation to its refineries may make it more efficient to sell the crude oil close to where it is produced and then buy the crude oil feedstock needed near the refinery. It is frequently not possible, however, to purchase crude oil where it is needed without simultaneously agreeing to sell crude oil at another location (via a buy/sell transaction). This occurs because the United States consumes more crude oil than it produces, so the domestic refining operations of even integrated oil companies are always short of crude oil. For this reason, many companies are unwilling to do an outright sale of crude oil, which would exacerbate their short position, without lining up a purchase of crude oil at the same time but at a different location and/or grade.

In the previous example of a buy/sell, Company A was able to find a counterparty, Company B, who had oil for sale where Company A needed it and who also needed oil where Company A had it for sale. In actual practice, this matching of positions can be difficult to accomplish, so for some time our industry has been using barrels at Cushing, one of the most liquid crude oil storage and transportation hubs, to overcome this obstacle. To illustrate, assume the following:

- From nearby production, Company A has crude oil at Location 1 where it is not needed.
- Company A needs a barrel of crude oil at its refinery for processing. Company A could transport a barrel of crude oil from Location 1 through a series of pipelines to its refinery, but believes it

would be cheaper to use a buy/sell transaction to obtain a barrel of crude oil at Location 2, which is very close to its refinery.

- Company B has a barrel of crude oil at Location 2 that it does not need, but Company B does not need a barrel of crude oil at Location 1. However, Company B will sell its barrel at Location 2 if Company A will also sell a barrel at Cushing to Company B.
- Company C has a barrel of crude oil at Cushing that it is willing to sell and is also willing to buy Company A's barrel at Location 1.

These assumptions are shown in the first table below, "Before Repositioning," in which barrels owned are shown as positive numbers and barrels needed are shown as negative numbers.

To obtain the barrel of crude oil Company A needs at Location 2, it sells its barrel at Location 1 to Company C and buys Company C's barrel at Cushing using a buy/sell transaction. Company A then sells this barrel at Cushing to Company B and buys Company B's barrel at Location 2 with another buy/sell transaction. These transactions are shown in the second table below, "Buy/Sell Transactions to Reposition."

The third table below, "After Repositioning," shows the effects of these buy/sell transactions that repositioned Company A's barrel from Location 1 to Location 2.

Before Repositioning

	(Need a barrel)/Have a barrel		
	Location 1	**Cushing**	**Location 2**
Company A	1		(1)
Company B		(1)	1
Company C	(1)	1	

Buy/Sell Transactions to Reposition

	(Sold a barrel)/Bought a barrel		
	Location 1	**Cushing**	**Location 2**
Company A	(1)	1 + (1)	1
Company B		1	(1)
Company C	1	(1)	

After Repositioning

	Have a barrel		
	Location 1	**Cushing**	**Location 2**
Company A			1
Company B		1	
Company C	1		

Company A receives invoices for the full price of the barrels purchased from Company B and Company C, and these will appear on Company A's financial statements as either inventory or purchased crude oil and products. Company A sends invoices to Company B and Company C for the full price of the barrels sold to them, and these will appear in sales and other operating revenues in Company A's statement of income. If not settled before quarter end, the resulting payables and receivables will appear as accounts payable and accounts receivables, respectively, on Company A's balance sheet.

The buy/sell transactions discussed in the preceding paragraphs are very similar to the "barrel back" example in EITF No. 03-11, *Reporting Realized Gains and Losses on Derivative Instruments That Are Subject to FASB Statement No. 133 and Not "Held for Trading Purposes" as Defined in Issue No. 02-3* (Issue No. 03-11). Addressing the issue of net versus gross reporting, Issue 03-11 states, "In evaluating the facts and circumstances for purposes of determining whether an transaction should be reported on a gross or net basis, the Task Force acknowledged that the economic substance of the transaction as well as the guidance set forth in Opinion 29 relative to nonmonetary exchanges and the gross versus net reporting indicators provided in Issue 99-19 may be considered in making this determination." Beyond this, no further guidance was provided in Issue No. 03-11.

Furthermore, in Derivatives Implementation Group Statement 133 Implementation Issue No. K1, *Miscellaneous: Determining Whether Separate Transactions Should be Viewed as a Unit* (DIG K1) the first example contains a fact pattern similar to the "barrel back" example in Issue No. 03-11, except the DIG K1 example uses the same delivery location for both the buy and the sell, while in the Issue No.03-11 example physical delivery for the buy and the sell are at different locations. The DIG stated that two or more separate transactions should be viewed as a single unit and not separately if "there is no apparent economic need nor substantive business purpose for structuring the transactions separately that could not also have been accomplished in a single transaction." However, the DIG further indicated that a substantive business purpose may exist if the two transactions require gross physical delivery at different locations that are significantly distant from one another. Based on this guidance in DIG K1 and the gross versus net indicators in Issue No. 99-19, we believe the "barrel back" example in Issue 03-11 should be presented gross on the income statement. Similarly, the above buy/sell illustration should also be presented on a gross basis.

The accounting for buy/sell transactions shown in the preceding example is the predominant accounting practice in our industry, and we disagree with any assertion that paragraph 21(a) of APB 29 is the governing authoritative literature on buy/sell transactions. Our industry counters that assertion based on the observation that, except for events of force majeure, in the above example, Company A generally is not relieved of its obligation to deliver barrels at Cushing to Company B even if Company B fails to deliver barrels at Location 2 to Company A.

Further, our industry disagrees with any assertion that buy/sells are nonmonetary transactions. The separate title transfer, gross invoicing and gross cash settlement of both sides of the buy/sell transaction evidence that these transactions are monetary in nature and thus outside the scope of APB 29, in accordance with Footnote 1 of Issue Summary No. 1 for Issue No. 04-13. In addition, FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts* (FIN 39), prohibits a receivable from being netted against a payable when the receivable is subject to credit risk unless a right of offset exists that is enforceable by law; therefore, netting the separate components of a buy/sell transaction in the income statement seems inconsistent with the gross presentation that FIN 39 requires for the resulting receivables and payables in the balance sheet.

Background and Discussion Related to Crude Oil Exchanges

As a matter of clarification, our industry does follow a predominant practice of presenting crude oil exchanges on a net basis in the income statement. This distinction from our predominant industry practice on buy/sell transactions is based on the view that paragraph 21(a) of APB 29 is applicable to crude oil exchanges because they are nonmonetary transactions. Although similar in certain regards, crude oil exchanges differ from crude oil buy/sell transactions in several critical ways. In a typical exchange transaction, one company agrees to exchange crude oil that it holds title to in one location for the same quantity of crude oil held by another company in a differing location. Upon transfer of the crude oil, the parties generate an invoice for the net differential for the location and quality/grade of the crude oil barrels exchanged. Unlike buy/sells, the obligations of each counterparty to deliver are not independent. The final settlement of an exchange agreement is based on volumes; there is not a similar settlement with a buy/sell. In addition, many exchange agreements are evergreen contracts with minimal credit risk, whereas buy/sells are discrete purchases and sales, which have credit risk based on the full sales value of the crude oil.

Conclusion

The API believes buy/sell transactions should continue to be reported on a gross basis because, consistent with what we believe was the intent of the EITF in Issue No. 03-11, we assert that the sale component of a buy/sell closes out an existing position and is the culmination of the earnings process for those barrels. The FASB staff's Issue Summary needs to fully describe our industry's predominant practice before the EITF begins deliberations on Issue No. 04-13. If the FASB staff or the EITF needs more information about our industry practice regarding buy/sell transactions, we would be pleased to discuss the issue at your convenience.

Finally, should the EITF conclude that a change is required, API would support the prospective transition method suggested by the FASB staff in Issue Summary No.1. However, more time would need to be given for transition in order to allow companies to make the system changes that will be required to identify these buy/sell transactions and prospectively net them on the income statement. This is in recognition of the practical aspects of complying with the consensus and should not be construed that API is lessening its strong support for the predominant industry practice of gross fair value reporting for buy/sell transactions.

Very truly yours,

R. H. Stock
Chair, Accounting Committee
American Petroleum Institute

Cc: API Accounting Committee Members