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The Edison Electric Institute (EEI) respectfully submits our comments on the Financial Accounting Standards Board (FASB) Exposure Draft – *Balance Sheet Offsetting*. EEI is the association of United States shareholder-owned electric companies. Our members provide service to 95 percent of the ultimate customers in the shareholder-owned segment of the industry, and represent approximately 70 percent of the United States electric power industry.

For most of our member companies, the provisions of the Exposure Draft would have the greatest impact on the balance sheet presentation of derivatives assets and liabilities, which we use for many business purposes, including hedging and trading activities. Our research has indicated that the primary drivers of differences between gross and net presentation are the number of individual derivative contracts/confirmations with a particular counterparty and market price movements after the contracts have been executed. Therefore, the impact of this proposal is likely to be more significant for companies that transact more frequently (which could be for a combination of reasons, including dynamic or active hedge adjustments, scope of business, or trading activities), while those companies that execute fewer transactions with the same party will be less affected.

We note that, while financial statement users desire information about both the gross and net amounts of eligible assets and liabilities, as the ED acknowledges, they have not expressed a clear preference as to which presentation should be used in the balance sheet. For entities that present derivatives net in the balance sheet, gross information is already available through the extensive footnote disclosures required under existing standards.

EEI Comments and Recommendation¹

EEI appreciates that the FASB and the International Accounting Standards Board (IASB) are seeking convergence on these requirements. We agree that there is a benefit to a single,

¹ The views in this letter reflect the agreement of the majority of EEI member companies. However, certain of our members may have different views and may choose to provide their individual comments separately.



consistent offsetting treatment across reporting entities, and we also concur with the objective of identifying and articulating a principle for netting. We concur with the Boards' observation that both netting approaches (current U.S. GAAP as well as the ED's proposed requirements) have benefits and shortcomings. Thus, the considerations informing this decision require evaluation of both alternatives.

While we agree with these facets of the ED, we strongly disagree (for both conceptual and practical reasons) with the proposed requirements of "simultaneous and unconditional" in order to qualify for netting financial instruments in the balance sheet. The proposal introduces a new "bright-line" rule that will result in significantly different presentation of virtually identical contracts, less transparently reflects an entity's derivative assets and liabilities, and has greater shortcomings than net presentation as currently permitted under U.S. GAAP. We provide conceptual support, practical considerations, and specific examples of each of these views in the discussion below.

By contrast, we believe that permitting net presentation based upon unconditional as well as conditional netting provisions is the most appropriate approach. It provides the most economically useful and relevant information, minimizes the shortcomings inherent in any netting methodology, and is both more practical and less susceptible to misinterpretation than the ED's proposed requirements.

Attributes of derivatives that are relevant to financial statement users include underlying risk, fair value, credit risk, cash flow and liquidity risk. We believe that net presentation when derivative contracts provide for either conditional or unconditional netting (i.e., the basis for netting in current U.S. GAAP) results in the best presentation for each of these attributes as follows:

- Underlying risk regardless of the method used for balance sheet netting, disclosures (such as those presently required for derivatives under U.S. GAAP) are necessary in order to reflect underlying risk clearly. However, gross presentation has been misinterpreted by some users to imply a higher level of underlying risk (i.e., unhedged risk or open positions), but this is inaccurate, and there is no such correlation
 - o The size of gross amounts is solely affected by the number of individual contracts and changes in the price of the underlying after the contracts were executed.
 - An entity with large gross amounts may have fully offset its underlying risk, but changes in prices since inception of the open contracts cause the gross amounts to be large
 - An entity with small gross amounts may have large, open positions that have significant underlying risk for which prices have not yet moved substantially

- o By contrast, the net position is more likely to reflect underlying risk from period to period
 - For an entity that has fully offset its underlying risk with the same counterparty, the net fair value will be unchanged when prices change
 - For an entity that has large open positions, the net amount will change in the same way as the gross amount
 - Thus, changes in net derivatives positions more closely reflect the economic performance of the derivatives (i.e., the change in fair value) than a gross presentation on the balance sheet
- o Taken together, we believe net presentation more closely reflects underlying risk due to changes in fair value between reporting periods and has fewer shortcomings, such as lower potential for misinterpretation
- Fair value the net position more closely reflects the business view of the fair value of the derivatives position
 - O The nature of items presented at fair value is based on the view that a current exit price for the entire amount included in the caption is the most relevant measurement, rather than a liquidity or cash flow attribute that drives the "unit of account" approach
 - o While the "unit of account" distinction underlying the notion of simultaneous netting is one theoretical approach, balance sheet presentation by nature already aggregates multiple units of account so as to provide financial statement users relevant, useful information about the various captions presented
 - o Taken together, we believe that netting under current requirements more closely reflects economic fair value of derivatives with each individual counterparty and is more consistent with the concepts underlying a fair value measurement attribute
- Credit risk disclosures are also required to provide complete credit risk information, which includes not only recognized amounts but also unrecognized executory contracts as well as off-balance sheet credit mitigation such as letters of credit
 - o Net presentation accurately reflects credit risk for recognized assets and liabilities consistent with how the entity manages credit risk
 - Master netting agreements with conditional netting reduce credit risk
 - Entities determine credit risk considering such agreements and evaluate credit exposure and the need for credit support based on net amounts
 - Thus, net exposure reflects a management view of credit risk for recognized assets and liabilities and is more consistent with the objective of presenting fair value
 - o Gross presentation overstates an entity's credit risk and is subject to misinterpretation as a result
 - Gross presentation gives the appearance of higher leverage and credit risk despite contractual arrangements that are designed to reduce, and are effective in reducing, credit risk

- Even when netting is conditional, it is relevant to net such amounts because one of the primary conditions is an event of default, which is the type of circumstance when net settlement is most important from a credit risk perspective
- Taken together, net presentation accurately reflects recognized credit risk while gross presentation substantially overstates credit risk and is inconsistent with how the business is managed
- Cash flow and liquidity risk once again, neither presentation perfectly presents such risks, and disclosures are required to provide such information comprehensively
 - o Cash flow and liquidity information is not accurately presented by either method and should not be controlling in determining balance sheet presentation
 - In our industry, physically settling derivatives are common
 - For physically settling derivatives, actual cash flow equals the contract price multiplied by the notional quantity, and usually far exceeds the fair value
 - Based upon price movements, the actual settlement may be a cash outflow even though fair value is an asset (for example, a derivative sale contract for which prices have increased would be presented as a liability but result in a cash inflow upon sale of the physical commodity) and vice versa
 - o Net presentation more closely reflects cash flows between reporting periods
 - Such a practical approach would be similar to net presentation in the cash flow statement for changes in short-term debt, even though gross flows between reporting periods may be large
 - Net presentation reflects the fact that most exposures between reporting periods are simply a working capital requirement
 - o Gross presentation as proposed by the ED would prohibit netting even for settlements occurring within the same day
 - Most financial information is reported no more frequently than quarterly
 - Gross presentation thus creates the appearance of large gross exposures, many of which will be settled within hours or days of each other between reporting periods
 - o Gross presentation based upon the ED's criteria would introduce a bright line and cause virtually identical contracts to be reported in significantly different ways, as illustrated by these examples:
 - Exchange-cleared contracts that settle simultaneously would be netted, but those settling hours apart would not
 - Bilateral contracts with the same counterparty that settle hours or days apart (for example, because of differences in commodity or physical versus financial) would be reported gross while identical exchange contracts would be reported net
 - o Because liquidity and cash flow risk cannot be accurately reflected in the balance sheet alone under either approach, we believe this should not be a controlling

factor in choosing the method of balance sheet presentation. However, taken together, we believe that net presentation suffers from fewer shortcomings with respect to liquidity and cash flow risk

As a practical consideration, our member companies have noted the potential for confusion and divergent application of the proposal's netting requirements based upon the level at which these provisions would have to be applied. Because this observation would only be pertinent if the ED's provisions are adopted, we discuss it in more detail in the section below. In the examples illustrated below:

- Interpretation 1 results in portions of the same contract being reported on two balance sheet line items if netting is required at the cash flow level. This approach would also be extremely difficult to implement in practice by requiring analysis of forward values by settlement date
- Interpretation 2 results in giving no effect to any netting provisions, even though they are substantive and would meet the criteria underlying the ED's netting requirements.
- As a logical extension of this approach, Interpretation 2 also could result in a single contract being classified partly as an asset and partly as a liability if it has monthly settlements and the fair value attributable to some months is positive and other months is negative
 - o If this interpretation is correct, we believe it would result in an exponential grossup of the balance sheet and would be virtually unworkable to implement while providing meaningless information
 - O Alternatively, if the entire contract is viewed as the unit of account in order to allow the netting of offsetting receipts and payments for different monthly settlements into a single asset or liability, it violates the principle that settlements must be simultaneous in order to qualify for netting, reinforcing our concern that virtually identical contracts would be presented in significantly different ways

We believe that this practical issue clearly illustrates the major shortcomings of the proposal, because regardless of the interpretation applied, one of the derivative attributes discussed above would have to be compromised. By contrast, under the existing provisions that permit derivatives netting even for unconditional offset, each derivative would be presented in its entirety as part of a net derivative asset or liability.

For all of the reasons cited above, we believe that the weight of support for balance sheet presentation falls much more favorably toward current netting requirements for derivatives. The present methodology is well-understood, easily applied, consistent with how entities operate their business activities, and suffers from fewer shortcomings. By contrast, the "simultaneous and unconditional" requirements proposed by the ED do not, in our view, represent an improvement in financial reporting and in fact provide less transparent information and greater potential for misinterpretation while introducing a new, bright-line rule in an era of momentum toward more principles-based standards.

We have provided responses to the specific questions posed in the ED at the conclusion of this letter.

EEI Comments if Proposed Approach Adopted

We recognize, however, that the Boards may decide to proceed with requirements similar to those in the ED, notwithstanding our comments above. Therefore, in the event that the Boards retain the approach in the ED, we offer certain observations for improvement below.

Our observations relate to the following topics:

- Actual versus contractual settlement provisions, particularly for exchange-cleared transactions
- Lack of clarity as to the level at which the netting provisions would be applied
- Excessive disclosure detail

We believe that presentation based upon contractual terms is more supportable as a principle than the ED's proposal for looking to intent to settle simultaneously and/or actual settlements. Using contractual terms provides for an objective basis for determining whether netting should be permitted that is easily verifiable. It also reflects the underlying operations of the business. Conversely, the proposed rules as to whether netting actually occurs create an arbitrary bright line that distinguishes settlements within the same day, week, or month, even though there is economically little difference in the cash flows, particularly within an individual day.

As a practical consideration related to this recommendation, we believe that the final standard should explicitly permit netting of all derivative fair values transacted through a clearinghouse or exchange. We believe that no party (users, preparers, or auditors) benefits from the added complexity, extra work, and potential for error that will result from having to evaluate individual settlements with an exchange to determine if they occur "simultaneously" as literally defined.

We believe that there is potential for substantial confusion and diversity in presentation between the "unit of account" and "unit of reporting" for purposes of determining netting. If the ED's approach is retained, we believe that it would be important for the final standard to clarify specifically, both with principles as well as examples, the level at which the standard should be applied. We note that there are two possible interpretations of the ED's provisions, each of which is less than optimal, in our view:

- For purposes of illustration, consider two contracts with the same party under a master agreement that provides for unconditional netting
 - One contract provides for settlements each month during calendar year 2012 and is "in the money" (an asset) on a fair value basis for each month
 - o The second contract provides for settlements each month for the period June 2011 through May 2012 and is "out of the money" (a liability) for each month

- Interpretation 1 Netting based on periodic cash flow timing
 - O Under this interpretation, the reporting entity would net the fair values of the contracts for the overlapping months for January 2012 through May 2012 since the two contracts would settle simultaneously in those months
 - o If the asset values exceeded the liability values, then the contracts would be presented as a liability for June-December 2011, a net asset for January-May 2012, and a gross asset for June-December 2012
 - o If the liability values exceeded the asset values, then the contracts would be presented as a liability for June 2011-May 2012 and as an asset for June-December 2012
- Interpretation 2 Netting based on overall contract cash flows
 - Under this interpretation, because each and every cash flow under the contracts did not settle simultaneously, the contracts would be presented as gross assets and liabilities with no netting
- A logical extension of this Interpretation 2 could also apply to a single contract
 - o Assume a twelve-month contract for the purchase of power at a single price for all monthly deliveries with cash settlements each month
 - o For a seasonal product such as energy commodities, the fair value attributed to each monthly settlement will be either positive (an asset) in the months when power prices exceed the annual price or negative (a liability) in the months when power prices are less than the annual price
 - o Because each monthly settlement is independent of the other months, our understanding is that the asset values and liability values for this single contract could not be netted under Interpretation 2
 - o This would result in a single contract being split between two or more balance sheet captions

As this example illustrates, how the ED's provisions are interpreted could result in substantially different balance sheet reporting. We believe that this aspect of the ED must be clarified if the Boards were to proceed with the netting criteria that have been proposed.

Finally, while we support a single disclosure that reconciles gross and net balances, we believe that the subtotals included in the proposed disclosure (as discussed more fully in our response to Question 4 below) are impractical and unnecessary. If the standard ultimately permits netting only for unconditional, simultaneous netting, we see no benefit in disclosing subtotals for amounts that may be offset conditionally and amounts that the entity does not intend to offset, even if they are unconditional.

We believe that a simpler reconciliation that shows the following subtotals would provide information users have indicated they desire while eliminating subtotals that are not relevant to the operation of the business:

- Gross amount of assets
- Netting effect of master netting agreements
- Net amount of assets before deducting collateral
- Collateral (segregated between cash and other financial instruments
- Net exposure

Conclusion

We appreciate your consideration of these important topics and our related comments. The balance sheet offsetting proposal will have a significant impact on our industry. We would be pleased to discuss any of these subjects with you and to provide any additional information that you may find helpful in addressing these important matters.

Very truly yours,

Richard F. McMahon, Jr.

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Responses to Questions in the Exposure Draft

Offsetting Criteria – Unconditional Right and Intention to Settle Net or Simultaneously

Question 1: The proposals would require an entity to offset a recognized eligible asset and a recognized eligible liability when the entity has an unconditional and legally enforceable right to setoff the eligible asset and eligible liability and intends either:

- 1. To settle the eligible asset and eligible liability on a net basis
- 2. To realize the eligible asset and settle the eligible liability simultaneously.

Do you agree with this proposed requirement? If not, why? What criteria would you propose instead and why?

We do not agree with the proposals requiring an entity to offset a recognized eligible asset and a recognized eligible liability <u>only</u> when the entity has an unconditional and legally enforceable right to setoff the asset and liability and intends either to settle the positions on a net basis or to realize the asset and settle the liability simultaneously. The net presentation in our balance sheets combined with the current derivative disclosures' requirements for a gross presentation in the footnotes to the financial statements provides the information that financial statement users have requested. As a result, we believe that the needs of financial statement users to have access to both gross and net information as stated in the Exposure Draft are currently being met under U.S. GAAP. Accordingly, we do not believe that the presentation of the derivative assets and liabilities on a gross basis on the face of the balance sheet would provide any incremental benefit to users.

Taken a step further, we believe presenting gross amounts on the face of the balance sheet is a detriment to financial statement users since larger gross amounts obscure the underlying net economic position. We believe gross amounts have been misinterpreted, even in the notes to financial statements, since larger gross amounts have been interpreted as reflecting greater underlying market risk when, in fact, it may actually be lower. Also, larger gross amounts have been interpreted as reflecting higher credit risk, yet the net amount is a more accurate presentation of credit risk. From a practical standpoint, net presentation better reflects actual amounts exchanged between counterparties and timing of cash flows.

Each approach, gross and net, highlights some information and obscures other information. Neither method represents a pure reflection of the entity's ability to generate cash in the future or the entity's liquidity and solvency. Neither approach presents the underlying economic risk exposure because a large open position could have small gross or net amounts but entail significant exposure to underlying price changes. Conversely, a fully hedged position could have large gross amounts based on the number of contracts and price movements but have little underlying risk. We believe an entity's exposure to underlying market risk cannot be properly conveyed other than through the combination of the face of the balance sheet coupled with the footnote disclosures. As a result, we recommend the netting criteria discussed more fully in our letter.

Unconditional Right of Offset Must Be Enforceable in All Circumstances

Question 2: Under the proposals, eligible assets and eligible liabilities must be offset if, and only if, they are subject to an unconditional and legally enforceable right of setoff. The

proposals specify that an unconditional and legally enforceable right of setoff is enforceable in all circumstances (that is, it is enforceable in the normal course of business and on the default, insolvency, or bankruptcy of a counterparty) and its exercisability is not contingent on a future event. Do you agree with this proposed requirement? If not, why? What would you propose instead and why?

As noted in our response to Question 1, we do not agree with the proposals requiring an entity to offset derivative assets and liabilities with the same counterparty if, and only if, they are subject to an unconditional and legally enforceable right of setoff. In this regard we agree with the alternative views expressed by two of the FASB Board members who disagreed that gross presentation is the best way to provide information about the timing and uncertainty of cash flows and other risks for derivatives. We agree with them that the net presentation of derivative assets and liabilities subject to the same master netting agreement appropriately reflects the amount of credit risk exposure under that arrangement. In fact, the widely-accepted commercial requirement to post additional collateral in the event of a credit downgrade event is a function of the net exposure to the counterparty for all positions held with that counterparty covered by a master netting agreement (i.e., including derivative assets, derivative liabilities, and accrual positions) regardless of whether the right of setoff is conditional or unconditional. This distinction between conditional and unconditional setoff is not used in practice. Given this commercial focus on net exposure without regard to the nature of the right of setoff, we do not believe the introduction of this distinction for accounting purposes provides any incremental informational benefit to users.

We also believe that making the distinction between conditional and unconditional rights of setoff would introduce a rules-based bright line based on the legal form of the agreement rather than the economic substance and commercial views of the underlying transactions. For example, common industry practice involves the netting of positions, even when setoff is conditional, for the majority of cash flow settlements. This is especially true for intra-month cash flows. Further, liquidity issues, which represent a stated concern of financial statement users, are most likely to occur in times of distress when, upon an event of default, the conditional right of setoff becomes unconditional. In these circumstances, the conditional right of setoff is just as relevant to users as the unconditional right of setoff because of its enforceability when netting is ultimately desired. Finally, netting arrangements can fail regardless of whether the right of setoff is conditional or unconditional, so the risk is not limited to only conditional rights of setoff. Accordingly, we believe the introduction of a rules-based bright line should not be pursued and we request the Boards to modify the final standard to require the offsetting of derivative assets and liabilities with the same counterparty in cases where either a conditional or an unconditional right of setoff is present.

Disclosures

Question 4: Do you agree with the proposed disclosure requirements in paragraphs 11-15? If not, why? How would you propose to amend those requirements and why?

One of the Boards' stated objectives in the Exposure Draft is to provide information that is useful for assessing the amounts and timing of an entity's future cash flows. While the proposed disclosures are useful in that they provide for a reconciliation between the gross derivative amounts and the net derivative amounts, they do not give any indication as to the timing of the future cash flows associated with such derivatives. In the energy industry, our ultimate future

cash flows associated with physical derivative assets and liabilities, such as those for the purchase and sale of energy commodities, will be based on the notional quantities delivered under the contracts, not on the fair value of the derivative asset and liability balances recorded on the balance sheet. Further, the direction of the ultimate future cash flows also may not coincide with the derivative position reflected on the balance sheet. Accordingly, the proposed disclosures fall short, in our view, of the Boards' objective of providing information to assess the amounts and timing of future cash flows.

We also believe that separate disclosure of the following amounts will be difficult to operationalize and apply in practice:

- Amounts of assets/liabilities subject to conditional rights of setoff
- Amounts of assets/liabilities subject to an unconditional and legally enforceable right of setoff but for which the entity does not intend to settle net or simultaneously
- Amounts of cash collateral or other financial instrument collateral pledged in respect of the entity's eligible assets and liabilities separately for each class of financial instrument

Making these distinctions, especially those related to the intent to net settle and the ability to settle simultaneously requires judgment and would be susceptible to the development of diversity in practice. Further, aggregating and accumulating data to make these distinctions and produce this level of detail will require significant refinements to information systems and we do not believe the usefulness of this information is worth the incremental cost.

Effective Date and Transition

Question 5: Do you agree with the proposed transition requirements in Appendix A? If not, why? How would you propose to amend those requirements and why? Please provide an estimate of how long an entity would reasonably require to implement the proposed requirements.

We understand the Boards' inclination for requiring a retrospective application and a relatively near-term effective date for the proposed offsetting rules. However, if the Boards issue the final standard as proposed we believe the effective date of the Balance Sheet - Offsetting standard should coincide with the effective date of one or more of the major new standards impacting the balance sheet (e.g., either the new Lease accounting standard or the Financial Instruments standard). All of these proposed standards would have significant impacts on the face of companies' balance sheets and would require significant effort on the part of both preparers and users to adjust to the nature and magnitude of the changes. For example, financial metrics based on balance sheet information would be significantly impacted which could impact debt covenants, regulatory requirements, company valuations, and other financial analyses. Accordingly, we believe it would be beneficial for the preparer and user community to make the necessary adjustments to these standards at the same time instead of having to repeat the process separately for each of the new standards. In addition, we believe a retrospective application would be feasible given sufficient lead time to make the technological, procedural, administrative, and contractual changes necessary to facilitate the new requirements. In this regard, we believe a three-year time period would be sufficient to facilitate these changes.