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LETTER OF COMMENT NO. 3

Technical Director
File Reference No. 1620-100
Financial Accounting Standards Board
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Northeast Utilities appreciates the opportunity to comment on the FASB Exposure Draft (ED), Proposed Statement of Financial Accounting Standards, "Amendments to FASB Interpretation No. 46(R)." While we wholly support the most significant provisions of the ED, we believe that early adoption needs to be allowed with respect to variable interest entities (VIEs) that are not qualifying special-purpose entities (QSPEs). We also believe that the definition of a significant variable interest should be changed and the definition of a variable interest should be clarified.

I. We Agree with the Control Principle

We support the FASB's principles-based approach to consolidation and the requirement for the qualitative factor of control as a prerequisite to consolidation. We believe that control is well defined as the power to direct matters that most significantly impact the activities of a VIE. The requirement for control provides a link to the consolidation guidance of ARB 51 and will produce more meaningful financial reporting results because only VIEs that are controlled by the reporting entity will be reflected in its financial position and results of operations. Under the current guidance, consolidation is determined without regard to an entity's true involvement in or influence over the VIE's activities, which can produce results that are not representative of the true extent of an entity's economic influence. We strongly support the FASB's decision to improve the consolidation model in this way, and we believe it will result in more relevant and reliable financial reporting.

II. Early Adoption for Non-QSPEs Should be Permitted

We believe early adoption of the ED should be permitted for companies that have consolidated VIEs or could be required to consolidate VIEs without regard to control and primarily as a result of a quantitative analysis of the absorption of expected losses and residual returns. The new guidance will permit companies to report their financial position and results including only entities over which they have operational control. This sensible change should be implemented immediately. We recognize that consistency may be an overriding consideration for enterprises (primarily financial institutions) that are caught up in the transition from the QSPE scope exception in FIN 46. We understand that the FASB has identified a need to delay implementation for entities holding QSPEs for various reasons, including

giving companies time to renegotiate agreements before making the determination as to whether consolidation is necessary and maintaining comparability among financial institutions' financial statements. However, for enterprises without QSPEs, but with VIE consolidation requirements based on rules that are about to be changed, there is an overriding need to achieve the most meaningful presentation as soon as possible and thus to eliminate the requirement to consolidate entities over which they have no power or control. A delay such as that proposed in the ED would be counterproductive outside the QSPE arena.

As an example, one of Northeast Utilities' electric utility company subsidiaries has been required by regulation to enter into various contracts, including power purchase agreements and other agreements that are intended to purchase the products and support the operating costs of power plants. The utility company has no control over the power plants' operations. As a result of a strict quantitative analysis under FIN 46(R), in some instances we have concluded that consolidation of the power plant is required under FIN 46(R) but would clearly not be required under the ED. In a situation such as this, where control is not present, it is not meaningful to consolidate, and we believe consolidation should be discontinued as soon as possible (or, in the case of new contracts, not begun). Under the ED, due to the absence of control, an entity such as this would be deconsolidated upon the effective date of the final Statement in 2010. Thus the VIE would be temporarily consolidated from the date the contract is signed until the beginning of 2010. In the past, accounting principles emphasized the need to avoid temporary consolidation by precluding consolidation where control is expected to be temporary, and we believe that perspective should be applied in this circumstance by allowing early adoption of the new accounting principle. Temporary consolidation would be confusing to financial statement users.

As discussed in question 6 in section V. below, we recommend that the transition provisions of the ED clarify that if deconsolidation is required as a result of implementation, a VIE should be derecognized from an enterprise's financial statements without regard to other derecognition principles such as those for the sale of real estate or extinguishment of debt.

III. The Definition of a Significant Variable Interest for Disclosure Should be Changed

We believe a variable interest should be considered significant for disclosure if the interest is significant to the reporting enterprise. Although there are other factors that need to be considered, including the significance of the interest to the VIE, disclosure should not be required if the variable interest is not significant to the reporting enterprise. When making the materiality assessment, if the reporting enterprise determines that its variable interest could have a material impact on its own financial statements, then the reporting enterprise should be required to make the disclosures. It is not practicable to obtain the kind of detailed financial information necessary to fulfill the proposed disclosure requirements when the reporting entity does not control the VIE. The cost of obtaining this information would exceed its benefit if the variable interest is not significant to the reporting enterprise, especially if continuous reconsideration is finalized as proposed.

IV. The Definition of a Variable Interest Should be Clarified

We believe that the definition of a variable interest needs to be expanded from “contractual, ownership or other pecuniary interests” to include other interests that can be definitively demonstrated to absorb the variability of a VIE. In our case in the utility industry, as a result of regulation customers may have the right to receive benefits or the obligation to absorb losses from a VIE through the utility’s regulated contract with a VIE. The utility is authorized and required to pass through the risks and rewards of its regulated contractual arrangements to its customers, with full regulatory recovery. Under current guidance the customers are not viewed as holding a variable interest because they do not have a contractual relationship with the utility or the VIE, resulting in the illogical consequence that a VIE may be consolidated by the utility when all risks and rewards of the utility’s contract with the VIE are passed through to customers. Although customers are a group of parties that do not sign utility company contracts or issue financial statements, we believe they can absorb the majority of the risks and rewards of a contract and as such should be viewed as holding implicit variable interests. We believe that for this and similar circumstances, it would be appropriate to expand the definition of a variable interest to include the interests of customers or other parties that can be definitively demonstrated to absorb the VIE’s variability even though these parties do not have contractual, ownership or other pecuniary interests in the VIE. Please see the Appendix to this letter for suggested changes to pertinent paragraphs of FIN 46(R). We understand that, if the FASB finalizes the concept of control, this redefinition may not be needed, but we believe that a clarification of the definition of a variable interest would nonetheless be valuable.

V. Responses to the Board’s Specific Questions

Following are our additional responses to the specific questions on which the Board has requested feedback:

1. We believe the proposed Statement meets the project’s objectives to improve financial reporting by enterprises involved with VIEs and to provide more relevant and reliable information to users of financial statements. Without the concept of control, consolidation analysis under FIN 46(R) can produce results that detract from the relevance and reliability of financial statements.
2. If the Board issues the proposed Statement in its current form, prohibiting early adoption, we will incur the costs of consolidating entities in 2008 and 2009, including information gathering and associated accounting and disclosures, followed by the costs of deconsolidating these entities in 2010. There will also be significant effort for us to explain to our financial statement readers what is consolidated, why, and when it will be deconsolidated and why. Material amounts would be added to and subsequently removed from our consolidated balance sheets, potentially requiring substantial audit work that would add costs on top of confusion. The Board could further reduce the costs of compliance with the requirements without significantly reducing the benefits to users of financial statements by allowing early adoption (except in the case of existing QSPEs,

for which a single implementation date may be needed to allow reporting entities to change some of their arrangements and apply the consolidation standards as well as to ensure comparability). We believe that there should be a dual effective date that would permit FIN 46(R), as amended by the ED, to be applied in fiscal years beginning after November 15, 2008, for all interests in entities, but that would delay evaluation for consolidation of QSPEs existing as of a specified date after the ED issuance date until fiscal years beginning after November 15, 2009.

3. We believe the principles in paragraphs 14-14B, as amended, are sufficiently clear and operational.
4. We believe that the examples provided are helpful, but would like to suggest an additional example that is included in the Appendix to this comment letter. This example illustrates a circumstance where a power purchase agreement, which subjects an enterprise to the risks and rewards of a VIE, does not provide the enterprise with control over the VIE, and therefore consolidation is not required.
5. We believe that it is unlikely that a quantitative analysis would be necessary. However, in some situations, it may not be possible to determine qualitatively whether the right to receive benefits or the obligation to absorb losses could potentially be significant to the entity. Although we do not expect it to be utilized frequently, the ability to utilize quantitative analysis may be helpful.
6. We believe that it is reasonable to require ongoing assessment when the assessments are primarily qualitative as long as the proposed definition of a significant variable interest is changed as discussed in III. above. Without a change in that definition, there could be frequent changes in disclosure requirements for variable interests that are not material to the reporting enterprise. These disclosure requirements could be very challenging to satisfy because, absent control, it is difficult to obtain confidential financial information from third parties. Even if the information could be obtained, it would be difficult to audit and not add meaningfully to the quality of financial statement disclosures.

We believe that the ED should clarify that, if it is determined through a periodic assessment that consolidation of a previously consolidated VIE is no longer required, then deconsolidation is required without regard to other derecognition principles such as those for the sale of real estate or extinguishment of debt. We recommend that this deconsolidation guidance also be incorporated into the ED's transition provisions.

7. We believe the proposed Statement should be applied to all entities.
8. We believe that a number of the disclosure requirements appear reasonable except that, as discussed in section III. above, the definition of a significant variable interest for disclosure should be changed. A variable interest should

be considered significant for disclosure if the interest is significant to the reporting enterprise. Although there are other factors that need to be considered, disclosure should not be required if the variable interest is not significant to the reporting enterprise. If an enterprise does not have control of a VIE, it is unlikely to be able to obtain the VIE's financial information necessary to determine its maximum exposure to loss or other disclosures. We believe that existing disclosure requirements for commitments, contingencies and guarantees are adequate to address exposure to loss under contractual arrangements that are not significant to the reporting entity. In circumstances where a variable interest is significant to the reporting entity, the additional disclosures may be useful.

9. We believe that there may be circumstances in which the elements of a consolidated VIE should be permitted to be classified separately from other elements in an enterprise's financial statements. For example, in order to clearly represent the enterprise's financial position, the restricted nature of a VIE's assets or the nonrecourse nature of its debt or other liabilities may be best portrayed through separate balance sheet line item presentation rather than in combination with the enterprise's assets or debt. The need for separate classification is particularly evident under the current guidance of FIN 46(R) when the consolidated VIE may not be controlled by the reporting entity and its debt is nonrecourse to the reporting entity. However, under the ED's proposed guidance, whereby a consolidated VIE would be controlled by the reporting entity, separate classification may not always be justified. Because of the complexities involved in establishing disclosure rules, it may be more appropriate to address this topic as part of the longer-term FASB project on consolidation.

We strongly believe that early adoption for non-QSPEs should be permitted and that the definition of a significant variable interest should be changed. We hope that the other comments we have provided are helpful.

Thank you for the opportunity to express our views. If you would like to discuss our comments, please feel free to contact me or my colleagues, Tim Griffin, Assistant Controller (860.665.2973), or Jane Knopf, Manager of Accounting Research (860.665.2035).

Respectfully,



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Vice President – Accounting and Controller

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We propose that the following example be added to the ED to provide guidance for the numerous power purchase agreements that require analysis under FIN 46(R).

Example 10

Facts and Circumstances

A109. An entity is created by a power plant developer to build and operate a generating plant and sell the output of the plant to the local electric utility under a long-term contract called a power purchase agreement (PPA). The entity was created to construct and finance the plant separate and apart from the developer's holding company and other subsidiaries. After negotiating the PPA with the local electric utility, the entity is established with \$40 million of equity, contributed by the developer, and \$60 million of construction financing, which will ultimately be 30-year fixed-rate debt, provided by a financial investor. It is generally recognized in the industry that financing would be extremely difficult in the absence of the PPA with the local electric utility. As such, the entity is designed around the PPA with the local electric utility, and the PPA represents a variable interest in the entity, which qualifies as a variable interest entity because the equity holders lack the obligation to absorb certain expected losses of the entity that are designed to be passed through to the local electric utility via the PPA. The design of the entity precludes the business exception to variable interest accounting. After construction, the developer will be paid an essentially fixed stream of cash flows for running its plant and selling its output to the local electric utility. The local utility will not have any operational responsibilities with the power plant or the entity. The local electric utility expects to pass on costs and benefits of the PPA to its electric customers through rates that are regulated by the state regulatory commission. The PPA does not meet the criteria for derivative or lease accounting.

Evaluation

Purpose and Design of the Entity

A110. An enterprise must determine the purpose and design of the variable interest entity, including the risks that the entity was designed to create and pass through to its variable interest holders. In making this assessment, the variable interest holders of the entity determined the following:

- a. The primary purpose for which the entity was created was to enable the developer to build and operate a power plant and attract investors so that the entity can be financed with long-term debt.
- b. The entity was marketed to the financial investor (debt holder) as a fixed-rate investment in a power plant entity, supported by a long-term contract with the local electric utility.

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- c. The principal risks to which the entity is exposed are operation of the power plant, energy and capacity market price risk, and credit of the local electric utility.

Determination of the Primary Beneficiary

Step 1: Qualitative analysis

A112. The developer, the financial investor (debt holder), and the local electric utility are the variable interest holders in the variable interest entity.

A113. In making a qualitative assessment, an enterprise is required to determine whether it has the power to direct matters that most significantly impact the activities of the variable interest entity, including, but not limited to, activities that impact the entity's economic performance. The economic performance of the entity is impacted primarily by the operations of the entity because the operating cash flows of the entity are used to repay the financial investor and generate a return for the equity holder, which is the developer. The developer has the power to direct all matters that most significantly impact the economic performance of the entity through its abilities and responsibilities to operate the plant and manage all of the day-to-day activities of the entity. The debt holder is secured by the plant assets and is protected by the relatively predictable cash flows from the PPA with the local electric utility.

A114. Neither the debt holder nor the local electric utility has the power to direct matters that most significantly impact the entity's economic performance.

A115. An enterprise also is required to determine whether it has the right to receive benefits that could potentially be significant to the variable interest entity or the obligation to absorb losses that could potentially be significant to the variable interest entity. The developer has the right to receive benefits that could potentially be significant and the obligation to absorb certain losses that could potentially be significant through its equity interest. Operational risks and rewards are absorbed by the developer. The local electric utility has the right to receive benefits that could potentially be significant and the obligation to absorb certain losses that could potentially be significant through its PPA. Changes in future market prices are absorbed by the local electric utility.

A116. Based on the specific facts and circumstances presented above and the analysis performed, the developer would be the primary beneficiary of the variable interest entity because (a) it is the variable interest holder with the power to direct matters that most significantly impact the activities of the variable interest entity (including activities that impact the overall economic performance of the entity) and (b) through its equity interest, it has the right to receive benefits from the variable interest entity that could potentially be significant to the variable interest entity and the obligation to absorb losses of the variable interest entity that could potentially be significant to the variable interest entity. The local electric utility has

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no power to direct matters that most significantly impact the activities of the variable interest entity and is not the primary beneficiary.

Step 2: Quantitative analysis

A117. The quantitative analysis (Step 2) would not be necessary in this example because a primary beneficiary was determined through the qualitative analysis.

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We propose the following changes to FIN 46(R) to reflect our comments in section IV. that the definition of a variable interest should be clarified.

Definition of Terms

- 2.c. *Variable interests* in a variable interest entity are contractual, ownership, or other pecuniary interests in an entity that change with changes in the fair value of the entity's net assets exclusive of variable interests. In some cases, variable interests in a variable interest entity can also include the interests of other parties that can be clearly and definitively demonstrated to absorb the VIE's variability even though these parties do not have contractual, ownership or other pecuniary interests in the VIE. Equity interests with or without voting rights are considered variable interests if the entity is a variable interest entity and to the extent that the investment is at risk as described in paragraph 5. Paragraph 12 explains how to determine whether a variable interest in specified assets of an entity is a variable interest in the entity. Appendix B describes various types of variable interests and explains in general how they may affect the determination of the primary beneficiary of a variable interest entity.

Appendix B

VARIABLE INTERESTS

Introduction

- B2. The identification of variable interests requires an economic analysis of the rights and obligations of an entity's assets, liabilities, equity, and other contracts. Variable interests are contractual, ownership, or other pecuniary interests in an entity that change with changes in the fair value of an entity's net assets exclusive of variable interests. In some cases, variable interests can also include the interests of other parties that can be clearly and definitively demonstrated to absorb the VIE's variability even though these parties do not have contractual, ownership, or other pecuniary interests in the VIE; identifying these interests will require judgment based on all of the facts and circumstances of the variable interest and the entity. This Interpretation uses the terms *expected losses* and *expected residual returns* to describe the expected variability in the fair value of an entity's net assets exclusive of variable interests.
- B4. The identification of variable interests involves determining which assets, liabilities, or contracts create the entity's variability and which assets, liabilities, equity, ~~and other~~ contracts or other interests absorb or receive that variability. The latter are the entity's variable interests. The labeling of an item as an asset, liability, equity, or as a contractual arrangement does not determine whether that item is a variable interest. It is the role of the item—to

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absorb or receive the entity's variability—that distinguishes a variable interest. That role, in turn, often depends on the design of the entity.

- B5. This appendix describes examples of variable interests in entities subject to this Interpretation. The appendix is not intended to provide a complete list of all possible variable interests. In addition, the descriptions are not intended to be exhaustive of the possible forms of variable interest, roles, and the possible variability, of the assets, liabilities, equity, ~~and other contracts or other interests~~. Actual instruments or other interests may play different roles and be more or less variable than the examples discussed. Finally, this appendix does not analyze the relative significance of different variable interests, because the relative significance of a variable interest will be determined by the design of the variable interest entity. The identification and analysis of variable interests must be based on all of the facts and circumstances of each entity.

Other Definitively Demonstrated Variable Interests

- B27. In certain cases, an interest in a variable interest entity can be clearly and definitively demonstrated but not be a contractual, ownership, or other pecuniary interest. These instances should be rare because either the VIE or the entity holding the variable interest would typically protect this interest contractually. However, circumstances can arise where an interest may not be contractual but can be clearly identified and demonstrated with a high level of confidence to be a variable interest. For example, a regulator requires an electric utility on behalf of its customers to enter into a contract that is a variable interest in a variable interest entity. In this case, the customers will absorb all of the variability that the electric utility has as a result of the contract. It can be definitively demonstrated that, as a result of the regulatory requirement, the broad base of customers absorb variability and that the electric utility passes all variability from the contract to these customers. Accordingly, the customers have a definitively demonstrated indirect variable interest in the VIE.