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Technical Director  
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Financial Accounting Standards Board  
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**File Reference: 2011-100 Balance Sheet - Offsetting**

The American Gas Association (AGA) respectfully submits our comments on the Financial Accounting Standards Board (FASB or “Board”) Exposure Draft – *Balance Sheet Offsetting* (the ED). The American Gas Association, founded in 1918, represents 199 local energy companies that deliver clean natural gas throughout the United States. There are more than 70 million residential, commercial and industrial natural gas customers in the U.S., of which 91 percent — more than 64 million customers — receive their gas from AGA members. Today, natural gas meets almost one-fourth of the United States' energy needs. We understand there are significant quantitative differences in the presentation of balance sheets prepared under U.S. GAAP vs. IFRSs, which impairs global comparability. Therefore, we appreciate the FASB and the International Accounting Standards Board (IASB) are seeking convergence on these requirements.

Many of our member companies utilize financial and nonfinancial derivative instruments for risk management, hedging, and/or trading activities, which represent a majority of the financial instruments that many of our members currently elect to net where existing offsetting criteria are met. As a result, a large number of our members will be affected by the proposed guidance within the ED if it is finalized without substantial modification. Further, although some of our member companies currently present these instruments on a gross basis, both these organizations and those which do currently qualify for and elect net presentation will be significantly affected by the proposed disclosure requirements.

**Comments and Recommendation**

We support a single, consistent offsetting framework across reporting entities which is required to be applied (versus elective), and we also concur with the objective of identifying an underlying principle for netting. As the Boards’ have observed, both netting approaches (current U.S. GAAP as well as the ED’s proposed requirements) have benefits and shortcomings.

While we agree with these facets of the ED, we strongly disagree with the proposed “simultaneous and unconditional” requirements in order to qualify for net presentation of financial instruments on the balance sheet. Such a rigid “bright-line” rule will result in significantly different presentation of virtually identical contracts, less transparent reflection of an entity’s actual derivative asset and liability exposures and risks, and has greater shortcomings than net presentation as currently permitted under U.S. GAAP. Alternatively, we believe net presentation should be based upon both unconditional as well as conditional netting provisions, and that contractual terms should govern the criteria for requiring either net vs. gross presentation as opposed to added consideration of actual ongoing settlement or intent-based settlement criteria. We believe this approach is more practical and less susceptible to misinterpretation than the ED’s proposed requirements.

We note that the electric utility industry (through the Edison Electric Institute, or EEI) has provided a number of practical considerations, specific examples, and conceptual support analyzing the pros and cons of each framework (existing U.S. GAAP and the ED’s proposal), ultimately supporting the current criteria to achieve net presentation under U.S. GAAP. These examples and considerations are applicable to our industry as well given both the gas and electric utility sectors make use of physical and financial commodity derivatives (as well as treasury-related derivatives) and the governing terms within these agreements are largely similar across our sectors. We have not attempted to restate all of the EEI’s observations within this letter. However, we reaffirm those points broadly, specifically with respect to the following attributes:

- Underlying risk – regardless of the method used for balance sheet netting (ED’s proposal or current U.S. GAAP), disclosures such as those presently required for derivatives under U.S. GAAP are necessary in order to reflect underlying risk clearly. However, the proposed gross presentation requirements are likely to overstate such risk as there is no correlation between unhedged underlying risk (open positions) and gross presentation.
- 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. However, net presentation accurately reflects credit risk for recognized assets and liabilities and is consistent with how entities actually manage credit risk. Entities determine credit risk considering netting agreements (including those with both conditional and unconditional netting provisions), and evaluate credit exposure and the need for credit support based on such net amounts. Conversely, gross presentation overstates an entity’s credit risk and is subject to misinterpretation as a result.

- Cash flow and liquidity risk – again, neither presentation perfectly presents such risks, and disclosures are required to provide such information comprehensively. Specifically, given the prevalence of nonfinancial commodity derivative instruments in our industry, cash flows and fair values are often uncorrelated (i.e., out-of-the-money sales positions still result in gross cash inflows). Therefore, we believe these risks should not be a controlling factor in choosing the method of balance sheet presentation.

Considering the above factors taken together, we believe that existing net presentation criteria are superior to the ED’s proposed requirements. The present methodology is well-understood, easily applied, consistent with how entities operate their business activities, and suffers from fewer shortcomings. We recognize, however, that the Boards may decide to proceed with requirements similar to those in the ED, notwithstanding our comments above.

If the Boards proposals move forward largely as proposed, at a minimum we believe that the presentation criteria should be based solely upon contractual terms rather than (or in addition to) requiring analysis of a reporting entity’s intent to settle net or simultaneously. 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. Further, we also support the EEI’s recommendation that as a practical consideration, the final standard should explicitly require 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.

Finally, while we are also in agreement with the EEI’s belief that the proposed disclosures (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,

Jose Simon [s]

Jose Simon, Vice President and Controller, Piedmont Natural Gas  
Chairman of the American Gas Association Accounting Advisory Council

## 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?*

As more fully discussed above, we do not agree with the proposals requiring an entity to offset a recognized eligible asset and a recognized eligible liability only 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 of in the footnotes to the financial statements provides the information that financial statement users have requested. 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.

### 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 above, 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. We believe 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, counterparties frequently exchange cash collateral (either based on change in fair value, or in the event of a credit downgrade event) based on 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. The distinction between conditional and unconditional setoff is not used in practice. 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.

## 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. However, the proposed disclosures would appear to fall short of the Boards' objective of providing such information as it relates to physical derivative instruments, given their cash flows 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.

Nonetheless, the proposed disclosures are useful in that they provide for a reconciliation between the gross derivative amounts and the net derivative amounts. However, we also believe that separate disclosure of the following amounts within that reconciliation 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 believe the final provisions of the ED 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), particularly if its provisions are adopted largely unchanged. 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. In addition, we believe a retrospective application would be feasible given sufficient lead time to make the technological, process, and administrative changes necessary to facilitate the new requirements. In this regard, we believe a three-year time period would be sufficient to facilitate these changes.