

Senior Executive Vice-President and CFO

Roissy, on 12 NOV. 2008
DG.DB (AK.DB) 2008.05

Dear Chairman Tweedie,

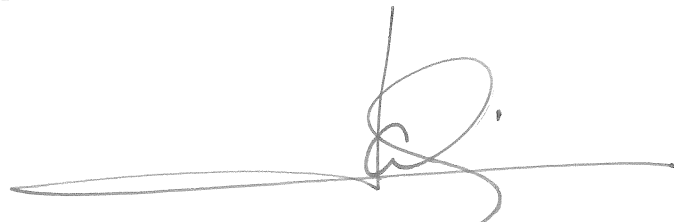
We welcome the approach adopted by the IASB to partially adapt accounting rules to exceptional situations, as has been done on October 13th, 2008 through the amendments of IAS 39 and IFRS 7.

We anyway note that these amendments mostly impacted financial institutions and that impacts induced by the financial markets' crisis on non financial corporations were not quite dealt with, such as sharp changes in hedge accounting effectiveness.

We therefore wish to suggest amendments which in our opinion would allow a better economic transcription of the performance of hedge effectiveness.

Should you wish further explanations, please do not hesitate to contact us.

Truly yours,



Philippe CALAVIA

Sir David Tweedie
Chairman
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APPENDIX: TIME VALUE ACCOUNTING TREATMENT

AIR FRANCE KLM

This letter aims at showing that the current accounting treatment as per IAS 39 « Financial Instruments: Recognition and Measurement » of options qualified for hedge accounting are not consistent with their economic performance.

1- Economic approach of hedging jet fuel price

The Air France-KLM Group is consuming jet fuel, which price fluctuates in correlation with oil market prices.

As a jet fuel purchaser, the Group is therefore exposed to increases in oil market prices. In order to prevent unexpected increases on future expenses, the Group adopts a fuel hedging policy that aims to prevent from impacts induced by increases in market prices.

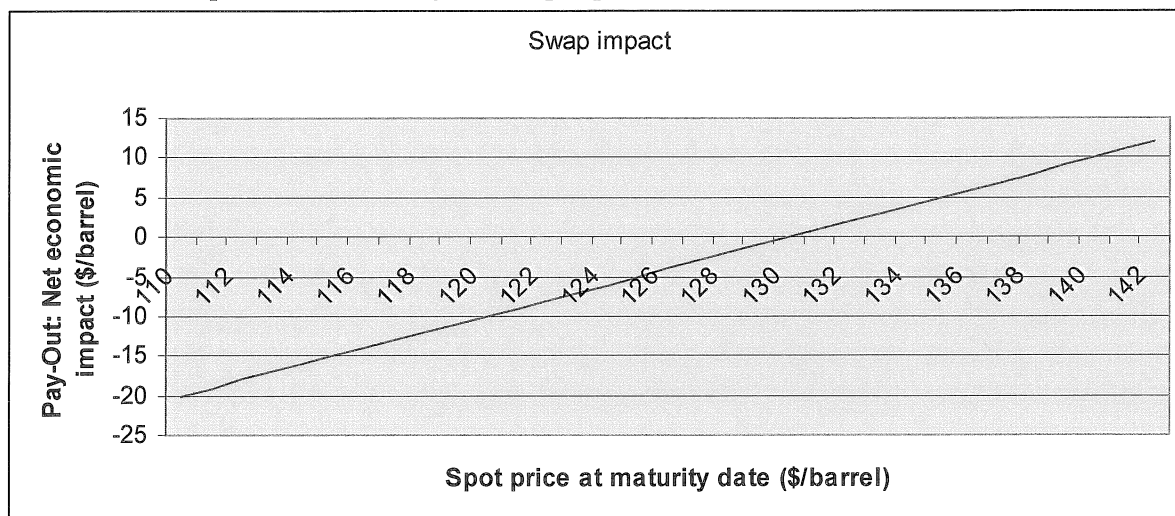
Economically, the Group's target is to be able to anticipate prices upwards fluctuations, and limit their impacts on expenses.

As an example, two strategies can be used to reach this target.

a) *The swap strategy:*

At a given date, the Group enters into a swap agreement with a counterpart. This agreement typically fixes the price to be paid at maturity date.

The graph below illustrates the instrument's "pay-out" profile, i.e. the difference between the swap's strike and the jet fuel spot price.



[In USD, trading date June, 25th 2008 for maturity in 1st Quarter 209 on 100 000 Brent barrels]

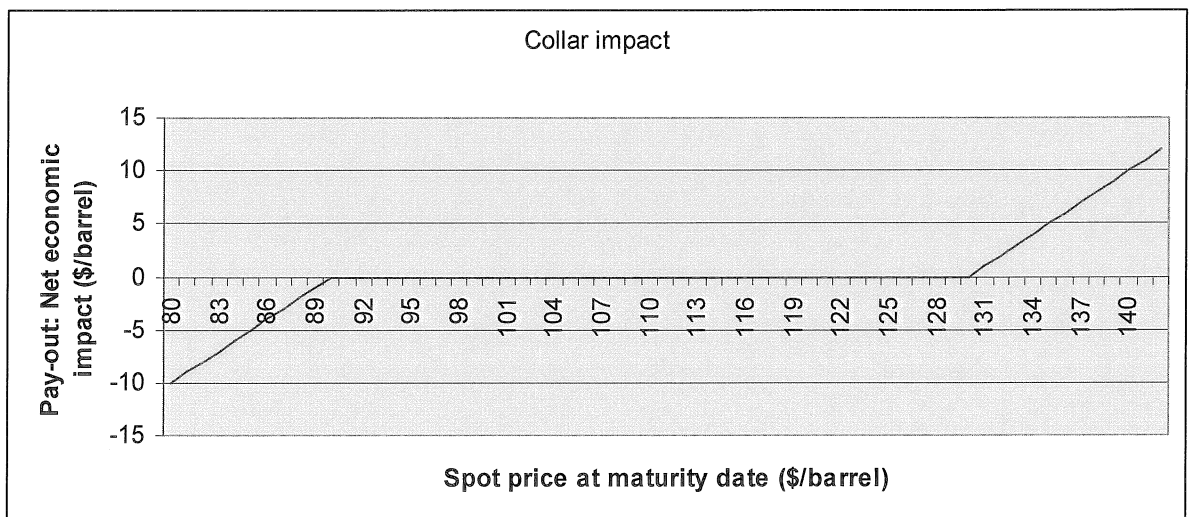
In this strategy, the future expense is fixed: at the maturity date, the Group will pay oil at 130 USD a barrel, whatever the spot price is. In this case, the group will be protected against a raise of jet fuel above 130 USD a barrel but will not benefit from a potential decrease in jet fuel prices.

b) The Collar Strategy:

At a given date, the Group enters into a “collar” agreement, i.e. the combination of a call option purchase and a written put option, at the same maturity but with different strike prices.

The “collar” allows the Group to (i) fix a maximum price to be paid at maturity date, but also (ii) to benefit from a lower price up to a predefined pattern.

The graph below illustrates the instrument’s “pay-out” profile, i.e. the difference between the strike and the jet fuel spot price.



[[In USD, trading date June, 25th 2008 fur maturity in 1st Quarter 209 on 100 000 Brent barrels]

At the maturity date, the Group would pay oil:

- at 130 USD a barrel if the spot price is 130 USD or above ;
- at the market price if the spot price is between 90 USD and 130 USD ;
- at 90 USD per barrel if the spot price is below 90 USD a barrel

In this strategy, the Group is hedged against increases of oil prices above 130 USD a barrel and benefit from a decrease in oil price down till 90 USD a barrel.

On an economic basis (and particularly in a bearish trend market), collar strategies are therefore much more advantageous for hedging jet fuel purchases as they protect against a raise in oil prices (as the swap does) but do not preclude the group to benefit from a decrease in the oil prices (what the swap does not allow). At the end of the day, the risk profile of a collar strategy is then lower than that of a swap.

2. Accounting treatment of both strategies

Jet fuel Swap and collar purchase are eligible as hedging instruments under IAS 39 as they are derivative instruments (see IAS 39 § 72) and as the collar purchase is not a written option (see IAS39 § AG 94).

They can be therefore documented in Cash Flow Hedge relationships as hedging variability of cash flows related to future jet fuel purchases if the conditions set in IAS 39 § 88 are met (formal designation & documentation of the hedging relationship, hedge expected to be highly effective, demonstration that the forecast transaction is highly probable, effectiveness is in the range of [80%-125%]).

a) Accounting impacts for the swap

For the purpose of this note, let’s consider that changes in hedged item Fair Value is fully offset by the changes in swap Marked to Market. At the end of September 30, 2008, changes in swap’s fair value are of € (10) millions as oil prices have decreased. The total change in swap’s fair value would be supported through the OCI and no impact will be recorded into P&L as the hedge is fully effective:

(in M€)	Dt	Ct
OCI	10	
Derivatives Mark to Market		10

b) Accounting impacts for the collar

In order to calculate effectiveness, IAS 39 requires to compare changes in hedged item and hedging instrument Fair Values. In the case of Cash Flow Hedge, hedged item is viewed as a forward transaction with no optional component, which leads to consider time value as ineffective. This point is clarified by paragraph AG 99 BA of “eligible hedged items amendments of IAS 39” : [...] For example, an entity can designate the variability of future cash flow outcomes resulting from a price increase of a forecast commodity purchase. In such a situation, only cash flow losses that result from an increase in the price above the specified level are designated. The hedged risk does not include the time value of a purchased option because the time value is not a component of the forecast transaction that affects profit or loss (paragraph 86(b)).

As of September 30, 2008, Mark to market value of the collar is of € (8) millions, fully made of time value as fuel prices have decreased but are not below the put strike (put and call options are out the money).

As per IAS 39§AG105-113, changes in collar’s fair value will be recorded through the profit and loss as the time value is considered to be ineffective:

(in M€)	Dt	Ct
Profit and loss	8	
Derivatives Mark to Market		8

In comparison with the swap strategy, the impact presented in the profit and loss statement would transcribe a more negative expected impact, while the global pay-out of the hedging strategy remains better. This negative impact is fully related to the consideration of the time value component to be ineffective.

c) Statements

As of maturity date, if the market prices remained at the September 30, 2008 level, this time value component would have decreased to zero, reversing the profit and loss impact supported on the previous closings.

This profit and loss impact will therefore never have any economic reality, and especially never have any cash transcription.

This statement is even stronger as hedging relationships get longer: the longer an instrument is held, the bigger its time value component is along its life and therefore is likely to fluctuate.

The current rule of time value treatment induces volatility in profit and loss, while the hedging policy aims, among other, at reducing volatility in profit and loss.

3. Conclusion

Based on the examples above, we consider that accounting treatment of collar compared to that applied on a swap is not consistent with the hedging economic objective:

- From an economic point of view, a collar strategy is more advantageous than a swap as it allows the Group to benefit from the decrease in oil markets while protecting, as the swap does, against a fuel prices increase
- From an accounting point of view, any changes (downward or upward) in swap Fair Value are systematically recorded into OCI without any volatility into P&L. On the contrary, negative changes in collar Marked to Market when oil prices decrease down till put strike (in this context, option's Fair Value is only made of time value) will be recorded into P&L.
- By the way, this accounting treatment lead to misleading impacts depending on the jet fuel price level : if the spot price is above the put strike, negative impacts are recorded into P&L whereas the negative impacts below the put's strike (put option has an intrinsic value) would be recorded into OCI whereas the economic risk for the Group is higher (i.e. AF KLM would have to pay the difference between the spot price and the put's strike which is not the case for time value)

We therefore recommend the IASB to review its position regarding the ineffectiveness of time value as specified in paragraphs IAS 39-AG105-113 and Hedged Items amendments of IAS 39 AG 99BA in considering that hedged items can be modeled as 'options'. This would allow being consistent with the economic objectives of such strategies, i.e. hedging jet fuel exposures by a specified level of spot rate corresponding to the strike of the call option.