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23 September 2003

Mr. Kevin Stevenson
Director of Technical Activities
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH, United Kingdom

Dear Kevin

Exposure Draft of Proposed Amendments to IAS 39 Financial Instruments: Recognition and Measurement — Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk

We endorse the decision of the IASB in proposing the application of portfolio hedging within the hedge accounting framework of IAS39. Given the complexity of IAS39 and the significant lack of familiarity many first time adopters of International Accounting Standards will encounter with its concepts, it is critical that all forms of hedge accounting ultimately permitted by IAS39 operate on the same principles and premise.

In light of the desire for consistent and transparent application of underlying principles, we are concerned that the concept of portfolio hedging has been restricted to only interest rate risk. We acknowledge that development of the portfolio hedging proposals have been driven by the finance sector reflecting specific concerns around the ability to otherwise achieve hedge accounting for (fixed) interest rate risk. However, limiting the portfolio hedge solution to interest rate risk results in an accounting standard that fails to meet the needs of a much broader audience of preparers and users of financial statements. Furthermore, we believe that restriction of the portfolio hedging solution currently proposed is in breach of the spirit of a principles based accounting standards solution.

For the above reasons, we encourage the IASB to enable the portfolio hedging solution for other risks types, such as foreign currency risk, commodity risk, equity-price risk and credit risk, that are inherent in financial instruments or in recognised or committed but unrecognised non-financial assets and liabilities.

Consideration of these other risks is not in contravention to the IAS principles referred to within the proposed amendments, and reduces the cost of compliance.

In this regard we refer to the background section of the Exposure Draft, where the Board says

"The Board decided to explore whether and how IAS 39 might be amended to enable fair value hedge accounting to be used more readily for a portfolio hedge of interest rate risk. The Board's aim was to develop an approach that:

(a) Meets the principles that underlie IAS 39's requirements on derivatives and hedge accounting, and

(b) Is workable in practice for entities that manage interest rate risk on a portfolio basis, allows data captured for risk management to be used in preparing financial statements and would not require entities to make major systems changes."

If the IASB is truly basing its standards on principles then it seems to be that the underlying principle is whether an entity engages in hedges of net position/exposures and that interest rate exposure is merely an example. The principles should be applicable to entities in other industries such as extractive, manufacturing and services, not just financial institutions. These industries, like the financial sector, aim to reduce their transaction fees by measuring and managing their commodity price risk and foreign exchange risk centrally and on a net basis. Principally this allows the business to net-off all the long and short fixed price positions it may have and to hedge out the resultant exposure and hence conform to its risk management framework. Other accounting bodies currently endorse this principle, and allow the hedging of a net exposure. FRS 5 for instance specifies that a group of transactions or series of transactions that achieves or is designed to achieve an overall commercial effect should be viewed as a whole. Thus where an entity uses derivatives as a risk management tool for fixed priced risk in say inventory and physical contracts, viewing these as a whole and fair valuing both is an appropriate method of accounting.

An example of BHP Billiton's risk management strategies currently in place includes the management, on a portfolio basis, of price risk for physical trades in resources such as aluminium, copper, iron ore, coal, and crude oil. Most physical trades are principal-to-principal trades in the wholesale market, and all contracts go to physical delivery at a specified forward delivery date and price. The fixed price risk in these contracts is countered by hedging with a paper contract on a specific exchange (eg. LME paper contract for Aluminium)

Under the original proposed amendments to IAS 39, the substance of the abovementioned risk management strategy would not be reflected in the financial statements. Instead, the result would be either:

- These trades do not qualify for hedge accounting, resulting in increased profit and loss volatility due to only one side of the movement in value being recognised, being the derivative impact (e.g. the paper LME contract),and the complementary impact of the physical contract being ignored, or
- An extensive change in the risk management strategy and system complexity to allow for a one-to-one hedging relationship with excessive increase in costs.

With the volume of transactions being undertaken by the Group at any point in time, the system, support and resource requirements to appropriately maintain, document and regularly test each of these one-to-one hedging relationships would be practically impossible. This also holds true should we for accounting purposes, be able to designate as a hedge, individual items which collectively are equivalent in amount and risk exposure to the net position, of a gross position related to assets, liabilities, forecasted cash inflows or forecasted cash outflows. Further, the degree of turnover within the hedge portfolio arising from the need to continually remeasure risk exposures and modify the risk management response would in practice make it impossible to establish and maintain the required degree of designation. The current approach under UKGAAP, like that proposed by the IASB in the exposure draft for interest rate exposure, would eliminate most of this enormity and allow the Group to focus on its core business and risk management objectives rather than how to manage an accounting and administrative burden.

We note that in the Basis For Conclusions section of the Exposure Draft, the Board considered their limitation to applying fair value hedge accounting to a hedge of interest rate risk on a portfolio of items. A dominant basis for that conclusion was that the three issues discussed in paragraph BC5 do not arise in combination for other hedging arrangements, being:

- Typically, many of the assets that are included in a portfolio hedge are prepayable, i.e. the counterparty has a right to repay the item before its contractual maturity.

- IAS 39 prohibits the designation of an overall net position as the hedged item, but allows individual assets (or liabilities) or groups thereof that share the risk exposure equal in amount to the net position, be designated as the hedge item.

- Fair value hedge accounting requires the carrying amount of the hedged item to be adjusted for the effects of changes in the hedged risk.

Our experience demonstrates that the three issues do apply to a number of other risk management scenarios for which portfolio-hedging arrangements are undertaken. An example is industry prevalent practice of portfolio hedging of commodity risk - where there is schedule risk (i.e. timing delivery risk, similar to prepayment risk). In this example, the net position changes each period as items reprice or are derecognised and new items added, and within the portfolio adjusting the carrying amounts of all of the hedged items for the effect of changes in the hedged risk, will again require significant allocation of resources.

We also note that paragraph BC4 states that". implementation guidance on IAS 39 already sets out how cash flow hedge accounting is applied to a hedge of the interest rate risk on a portfolio of items." In analysing the Implementation Guidance this paragraph refers to — IGC 121 & 122 - we note that the net position must be designated for accounting purposes as a hedge of a gross position related to assets, liabilities, forecasted cash inflows, or forecasted cash outflows giving rise to the net exposure. The standard thus requires entities to determine which individual items in the gross position are equivalent to the net position, and assess these individual items for effectiveness in accordance with the effectiveness tests. Therefore, we do not understand how the portfolio approach prescribed by the Exposure Draft for fair value hedging of interest rate risk, has already been prescribed for cash flow hedges, when individual items within the gross position need to be designated and assessed for effectiveness.

In relation to the two invitations to comment in the exposure draft we agree:

- With the proposed designation in paragraph 128A and the resulting effect on measuring ineffectiveness. We do have further commentary relating to hedge accounting principles, which we draw to the IASB's attention referred to below.

- With a financial liability where the counterparty can redeem on demand not being able to qualify for hedge accounting for any time period beyond the shortest period in which the counterparty can demand payment.

Hedge Accounting Principles

The amendments to IAS39 proposed by the IASB in this current exposure draft are premised on the preservation of hedge accounting principles contained in the current draft of IAS39. Hedge accounting methods have been designed by the IASB in response to the desire to permit financial statements to present fairly the financial outcomes of risk management objectives of enterprises that choose to enter into derivatives as a commercial risk management technique. Thus, hedge accounting solutions are true to the principle of recognising and measuring derivative financial instruments at fair value, while at the same time allowing presentation of a financial outcome that reflects the overall commercial risk management activity of a hedge operation. Despite this, we have two fundamental concerns with the hedge accounting methods offered by IAS39 even after taking into consideration the current proposed amendments:

Firstly, entities that undertake large-scale hedge activity across a portfolio of transactions will incur significant cost and effort in meeting the designation, effectiveness and consequential accounting requirements of IAS39. We envisage situations in which risk management activity will have to be modified in order to meet the accounting rules, leading to a true economic cost because of less effective and more costly risk management transactions

Secondly, hedge accounting methods are a compromise between a fair value accounting objective and the need for meaningful financial results. The model of fair value and cash flow hedging is cumbersome and in our view deficient — the fact that a hedge could be of either type depending on the perspective of the preparer demonstrates the conceptual deficiencies of the hedge accounting model. For many organisations, the need for a hedge accounting solution is driven by the failure of the broader accounting framework to permit the financial statements to convey the risk and value of the underlying transactions to which an entity is exposed and which the entity may choose to mitigate.

A far simpler solution is to permit entities to mark to market those transactions giving rise to a clearly measurable financial risk, even though the transactions are not themselves entirely of a financial nature. For example, where an entity enters into physical delivery transactions for commodities that are traded in a liquid market (such as LME traded metals and energy commodities), and that entity undertakes cash settled transactions for the purpose of modifying the overall financial risk exposure, a much simpler and more transparent accounting solution would be for all contracts, physical and cash settled, to be marked to market. The concept of effectiveness within the hedge accounting model becomes redundant, as any deficiency in the effectiveness of the risk management programme will be displayed directly through net income. Designation of contract relationships is irrelevant as all contracts that meet the fair value measurement criteria (for example, contracts over LME traded commodities) are measured on a consistent basis.

Within IAS39 in its present form, the only element preventing the above solution is the exclusion from mark to market accounting, of those embedded derivatives that are clearly and closely related to the host contract. For example, a fixed price contract to deliver aluminium at a future date is equivalent to a floating rate contract with an embedded floating to fixed price contract. The seller may enter into a cash settled contract involving the payment of the fixed price in return for a floating price. If the entity were able to mark to market the physical contract, or alternatively mark to market the embedded derivative in that contract, together with marking to market the cash settled contract, the financial statements would convey all exposures to price risk on the same commodity, and convey any failure of the risk management strategy to achieve mitigation of that risk.

We believe the IASB should continue with the hedge accounting model in its present form as for entities with relatively simple risk profiles and risk management activities, the hedge accounting methods can be made to work with reasonable efficiency and effectiveness. However, we also believe the IASB should reconsider its position regarding the availability of fair value accounting for physically settled contractual arrangements over highly liquid commodities.

Yours sincerely,

Nigel Chadwick
Vice President Group Accounting / Controller

cc: Ruth Picker — Acting Chairperson, AASB.