

IFRS Foundation/ IASB
30 Cannon Street,
London,
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United Kingdom

09.03.11

Dear Sir/Madam,

Centrica plc - Response to IASB ED on Hedge Accounting

We welcome the opportunity to respond to the Exposure Draft on Hedge Accounting. This Exposure Draft is vitally important to Centrica as we undertake a significant amount of hedging activity predominantly to hedge the price we will pay to procure the gas and power required to meet our end customer demand.

The magnitude of the fair value movements on these future hedging contracts from period to period is often highly material in the context of our income statement (in 2010 it was of the order of £1.1bn; in 2008 it was of the order of £(1.3)bn). There is a fundamental mis-match in our income statement if we are unable to remove these fair value gains and losses, as the end customer demand is not reflected in our financial statements. In reality, virtually all of our hedging activity is for our 'own use' customer demand requirements but we currently cannot use the IAS 39 exemption for the majority of these contracts because of the specific rules in paragraph 6 of the standard in relation to net settlement. The scope of the 'own-use' exemption has not been addressed in the development of IFRS 9 to this point.

We urge the IASB to review the scope of the 'own use' exemption and align it where possible to the risk management objectives of the business. In particular we feel investors and readers of the financial statements would instead be better served with full disclosure of the mark to market fair values and movements on all of our commodity contracts rather than recognition in all instances in the primary financial statements. This would be more meaningful than the current state where an almost arbitrary selection of mark to market fair value movements (i.e. from those contracts that fail the 'own use' test) is being posted to the income statement if hedge accounting is not applied. There are certain instances in our speculative trading business where we are currently prohibited from applying fair value accounting to the hedged item contract. Being able to chose in these instances to fair value the underlying hedged item contract would reduce mis-matches in the income statement and align the accounting presentation better to the risk management strategy being implemented.

Currently there are several situations where hedge accounting cannot be applied as it is prohibited by the standard, and further, even in the circumstances where it can be applied, the administrative and process burden is high and does not add value to the business. Where hedge accounting is not applied, we currently strip out the effect of the volatility caused by the mis-match discussed above from our IFRS income statement in order to present our underlying earnings to our investors. This is achieved through a 3 column income statement showing underlying results, IAS 39 re-measurements, and IFRS results.

The Exposure Draft is helpful in allowing more hedging relationships entered into by Centrica to be within the scope of hedge accounting, as a consequence of allowing components of non-financial items to be designated as hedging items, the relaxation of the effectiveness range, and also the grouping criteria for hedged items. The rebalancing principles and ability to not have to discontinue hedge relationships if they still meet the hedge objective are also beneficial to the application of hedge accounting for Centrica. However, as a business, we do not usually think of hedging in terms of individual trades, rather we hedge on a portfolio basis which aligns with the dynamic nature of the trades we enter into in order to hedge expected customer demand. Portfolio hedge accounting is not addressed in this Exposure Draft, which is a significant omission in our opinion.

Administering the hedge accounting principles of the Exposure Draft as it stands would still require a significant level of burden through expensive system upgrades and the employment of significant numbers of extra administrative staff, which would not add value to our business. Unless we are forced to apply hedge accounting, then our current financial statement presentation aligns to the requirements of our investors by providing them with information which fairly presents the underlying performance of the business, and also requires significantly less administrative burden to implement than hedge accounting.

Please find attached our detailed responses to the ED questions. Should you have any further questions in relation to our responses, do not hesitate to contact us.

Yours faithfully,



Jeff Bell
Director of Financial Control

Question 1

Do you agree with the proposed objective of hedge accounting? Why or why not? If not, what changes do you recommend and why?

Response 1

We agree with the Board's proposed objective for hedge accounting in particular that it should represent in the financial statements the effect of an entity's risk management activities and welcome the attempts by the board to move to a more principles rather than rules based approach to hedge accounting. It is important that the income statement provides readers with a clear and consistent presentation of a Group's underlying performance in any reporting period – it is therefore imperative that any fair value movements required to be recognised by the standards do not mask the underlying performance of the Group. Any attempt to isolate and remove fair value movements from the IFRS income statement which result in an IFRS income statement which is better aligned to underlying earnings is commendable.

Question 2

Do you agree that a non-derivative financial asset and a non-derivative financial liability measured at fair value through profit or loss should be eligible hedging instruments? Why or why not? If not, what changes do you recommend and why?

Response 2

No comments. Hedging instruments entered into by the business predominantly fall into the category of derivatives.

Question 3

Do you agree that an aggregated exposure that is a combination of another exposure and a derivative may be designated as a hedged item? Why or why not? If not, what changes do you recommend and why?

Response 3

No comments. This would not be significant to our business.

Question 4

Do you agree that an entity should be allowed to designate as a hedged item in a hedging relationship changes in the cash flows or fair value of an item attributable to a specific risk or risks (i.e. a risk component), provided that the risk component is separately identifiable and reliably measurable? Why or why not? If not, what changes do you recommend and why?

Response 4

We agree that an entity should be allowed to designate risk components of contracts as a hedged item in a hedging relationship. It is important to note that this is only on the basis that it is reliably measurable and separately identifiable.

Allowing risk components such as price indexation features (fuel oil, gas oil, PPI, electricity and coal) in gas and electricity purchase contracts to be separated and designated as hedged items would result in better alignment of hedge accounting to risk management strategies and give rise on application of hedge accounting to IFRS income statements that better represent underlying earnings. For each of the indices discussed above there are established methodologies and price curves which would allow the fair values of these risk components to be reliably measured.

Further, there are instances in North America particularly where hedging contracts are priced at a hub, whereas physical contracts are priced at local locations through a basis differential. This hub component has not previously been able to be isolated in a hedging relationship as it was not permitted by the standard, however, being able to do this would align hedge accounting with underlying risk management strategies resulting in an IFRS income statement where hedge accounting is applied which better represents underlying earnings. Again there are reliable price curves at the hub locations which mean the fair value of these risk components could be reliably measured.

Question 5

- (a) Do you agree that an entity should be allowed to designate a layer of the nominal amount of an item as the hedged item? Why or why not? If not, what changes do you recommend and why?
- (b) Do you agree that a layer component of a contract that includes a prepayment option should not be eligible as a hedged item in a fair value hedge if the option's fair value is affected by changes in the hedged risk? Why or why not? If not, what changes do you recommend and why?

Response 5

- (a) We agree that an entity should be allowed to designate a layer of the nominal amount of an item as a hedged item. It is not always possible to demonstrate that the entire notional of a contract is a highly probable forecast transaction for the purposes of hedge accounting, whereas it is often possible to demonstrate that a layer of the notional is. Hence being able to designate a layer of the notional of a contract as a hedging item gives more flexibility in relation to hedge accounting, and again will better align hedge accounting with the underlying objectives of risk management.
- (b) No comments. There are no significant instances in our business where this is applicable.

Question 6

Do you agree with the hedge effectiveness requirements as a qualifying criterion for hedge accounting? Why or why not? If not, what do you think the requirements should be?

Response 6

We agree with the Board's approach to remove the rigid 80-125% range and move the hedge effectiveness determination to an objective-based assessment. There are some instances within our business where hedge accounting cannot be applied due to this rule, although it is not by any means the majority. These hedges were prohibited from being in hedging relationships despite being entered into to achieve a risk management objective to reduce exposures potentially giving rise to income statement volatility. Due to the nature of the majority of the hedging trades not being significantly complex and the critical terms matching to the underlying hedged item contract, it is predominantly the case that they are expected to be 100% effective at the outset. Assuming there is less focus on quantitative analysis, and more on qualitative measures it does appear that relaxation of this effectiveness range would reduce the burden of implementing hedge accounting. However, there would still likely be significant burden overall in carrying out this hedge accounting activity particularly when there are significant volumes of trades such is the case in our trading business.

Question 7

- (a) Do you agree that if the hedging relationship fails to meet the objective of the hedge effectiveness assessment an entity should be required to rebalance the hedging relationship, provided that the risk management objective for a hedging relationship remains the same? Why or why not? If not, what changes do you recommend and why?
- (b) Do you agree that if an entity expects that a designated hedging relationship might fail to meet the objective of the hedge effectiveness assessment in the future, it may also proactively rebalance the hedge relationship? Why or why not? If not, what changes do you recommend and why?

Response 7

We welcome the opportunity to be able to rebalance hedge relationships by adjusting the hedging instrument or the hedged item without having to automatically discontinue the hedging relationship. This mirrors the hedging strategy adopted in our business whereby the original hedging instrument is continually adjusted, particularly as time approaches the final delivery point, in response to changes in anticipated demand from the end consumer. It would only be in extremely infrequent cases that the hedging instrument would not be modified throughout its life. The sheer volume of transactions and the continual adjustment and tracking of the hedging instrument in reaction to fluctuating customer demand means that the burden of documentation of the hedging relationships is exceptionally high, as is the monitoring and demonstration of effectiveness.

- (a) We do not agree with this statement. Rebalancing of the hedging relationship should not be driven by a hedge accounting requirement – the rebalancing of the hedging relationship is a consequence of a commercial decision to adjust the relationship. The accounting should follow on from this decision. It is important to determine that the risk management objective has not changed, however.
- (b) In our business, if the designated hedging relationship might fail to meet the objective of the hedge effectiveness assessment, this would mean that the economic hedge would need to be modified; upon modification of the economic hedge the hedge relationship would then be rebalanced usually through adjusting the hedging instrument. It is important to note that it is the commercial transactions that should drive the hedge relationship rebalancing, not the hedge accounting requirements driving the commercial transactions.

Question 8

- (a) Do you agree that an entity should discontinue hedge accounting prospectively only when the hedging relationship (or part of a hedging relationship) ceases to meet the qualifying criteria (after taking into account any rebalancing of the hedging relationship, if applicable)? Why or why not? If not, what changes do you recommend and why?
- (b) Do you agree that an entity should not be permitted to discontinue hedge accounting for a hedging relationship that still meets the risk management objective and strategy on the basis of which it qualified for hedge accounting and that continues to meet all other qualifying criteria? Why or why not? If not, what changes do you recommend and why?

Response 8

- (a) We disagree. The decision to discontinue hedge accounting should be based on the commercial decision to no longer continue the hedging relationship not whether it still meets the hedge effectiveness objective. We believe that discontinuing hedge accounting should remain a choice since hedge accounting has such high administrative costs and burdens associated with its application. An entity should have the ability to determine at any stage in the hedge relationship whether these costs outweigh the benefits obtained and adjust the accounting accordingly. This is linked to being able to rebalance the hedging relationship without having to discontinue and restart the hedge accounting relationship.
- (b) We disagree. Again the decision to discontinue a hedging relationship should be based on the commercial decision to no longer continue the hedging relationship including assessing whether the benefits still outweigh the costs of application.

Question 9

- (a) Do you agree that for a fair value hedge the gain or loss on the hedging instrument and the hedged item should be recognised in other comprehensive income with the ineffective portion of the gain or loss transferred to profit or loss? Why or why not? If not, what changes do you recommend and why?
- (b) Do you agree that the gain or loss on the hedged item attributable to the hedged risk should be presented as a separate line item in the statement of financial position? Why or why not? If not, what changes do you recommend and why?
- (c) Do you agree that linked presentation should not be allowed for fair value hedges? Why or why not? If you disagree, when do you think linked presentation should be allowed and how should it be presented?

Response 9

- (a) We agree with the proposal, on the basis that it simplifies the hedge accounting model with hedging gains/losses taken through other comprehensive income in a consistent manner as for cash flow hedge accounting. This is on the basis that they will be separately identified in other comprehensive income as being fair value hedge accounting related.
- (b) We agree with the proposal that gains or losses on the hedged item attributable to the hedged risk should be identified to aid the reader's understanding of the statement of financial position and its relationship to items in fair value hedge relationships, but we do not agree that this is required on the face of the statement of financial position. This is on the basis that in comparison to the magnitude of the balance on the statement of financial position, the adjustments are not likely to be material. We would recommend that this level of detail is provided in the notes to the accounts instead.
- (c) No comments. As a business the most significant fair value hedging relationships where hedge accounting is applied are in relation to interest rate swaps on our issued bonds.

Question 10

- (a) Do you agree that for transaction related hedged items, the change in fair value of the option's time value accumulated in other comprehensive income should be reclassified in accordance with the general requirements (e.g. like a basis adjustment if capitalised into a non-financial asset or into profit or loss when hedged sales affect profit or loss)? Why or why not? If not, what changes do you recommend and why?
- (b) Do you agree that for period related hedged items, the part of the aligned time value that relates to the current period should be transferred from accumulated other comprehensive income to profit or loss on a rational basis? Why or why not? If not, what changes do you recommend and why?

- (c) Do you agree that the accounting for the time value of options should only apply to the extent that the time value relates to the hedged item (i.e. the 'aligned time value' determined using the valuation of an option that would have critical terms that perfectly match the hedged item)? Why or why not? If not, what changes do you recommend and why?

Response 10

- (a) No comments. There is no significant use of options to implement the hedging strategy within the business.
- (b) No comments. There is no significant use of options to implement the hedging strategy within the business.
- (c) No comments. There is no significant use of options to implement the hedging strategy within the business.

Question 11

Do you agree with the criteria for the eligibility of groups of items as a hedged item? Why or why not? If not, what changes do you recommend and why?

Response 11

We predominantly agree with the criteria discussed in relation to eligibility of groups of items as a hedged item, particularly in relation to foreign exchange hedging. In this instance, just as a consequence of the existing hedge accounting rules, more derivative contracts were being entered into than was necessary to economically hedge the net exposure, with increased cost and risk of error. Through documentation methods previously, the same net exposure was being hedge accounted for in anycase, however, this part of the Exposure Draft will remove the requirement to artificially draft the documentation in order to meet the requirements.

However, paragraph 34(c) currently prohibits groups of items being designated as hedged items in a cashflow hedge relationship if they do not affect "the profit or loss in the same and only in that reporting period". This is illogical and divorced from risk management and economic reality. As an example, a Group Treasury function will generally hedge net exposures to spot foreign exchange rates and these exposures can potentially be over a number of months/years. Fundamentally, the Treasury function do not initially need to know the actual timing of when each of the underlying items will occur because they can use foreign exchange swaps to marry up when the exposures crystallise and ensure the business is economically hedged (from a spot perspective). Therefore, this paragraph would prohibit cashflow hedge accounting for the most efficient way of managing risk and exposure to foreign exchange rates. Secondly, it seems arbitrary to base the ability to cashflow hedge account grouped items on when a business's year-end falls. Two identical businesses with identical exposures and hedging policies but with different year-ends could potentially end up with different accounting treatments/options – this does not make sense.

We welcome the ability to designate groups and net items as hedges, ultimately allowing hedge accounting principles to be applied at a higher grouped level. However we request that the Board looks further into the principles of open portfolio and macro-hedging arrangements, which would better align to the portfolio hedging strategy adopted in commodity trading businesses backed by physical assets and a customer base.

Question 12

Do you agree that for a hedge of a group of items with offsetting risk positions that affect different line items in the income statement (e.g. in a net position hedge), any hedging instrument gains or losses recognised in profit or loss should be presented in a separate line from those affected by the hedged items? Why or why not? If not, what changes do you recommend and why?

Response 12

We disagree. Where such a hedge of a group of items has been entered into, the risk management objective applies as much to the underlying gross positions as to the overall net position. We therefore believe it is appropriate that entries in relation to hedging instrument gains or losses are made to the respective line items in the income statement where the underlying hedged items are presented, not a separate line item.

Question 13

- (a) Do you agree with the proposed disclosure requirements? Why or why not? If not, what changes do you recommend and why?
- (b) What other disclosures do you believe would provide useful information (whether in addition to or instead of the proposed disclosures) and why?

Response 13

- (a) We broadly agree with the proposed disclosure requirements in the ED, particularly that the disclosures are objective based which should mean that they are not boilerplate, but are tailored to the individual business model or hedging strategy undertaken by the business. We agree that it is vital that users of the financial statements should clearly be able to understand how the entity's hedging activities may affect the amount, timing and uncertainty of its future cashflows, as this is vital to understanding the future viability of the business. We appreciate the flexibility being granted in relation to the level of aggregation in the disclosures, as this will ensure that an appropriate level of detail is provided which is suitable to each specific business, without being overly detailed which would likely be administratively burdensome and would not help the user to appreciate easily the most significant impacts of hedging.

Having all of the disclosures in one place in the financial statements (or detailed references to other parts of the financial statements) should aid the user to understand how hedging affects the entities financial information.

Demonstrating a clear linkage between the financial statements and hedge accounting information is vital to ensure that the user understands the impact that hedge activity has had on the accounting for specific items. However, in relation to non-proprietary trading activity which is deemed as 'own use' by the business to supply customer demand, we believe that any fair values associated with these contracts should not be recognised in the statement of financial position, but should form part of the disclosures in relation to hedging activities in the notes to the accounts.

Discussion of the risk management strategy in relation to each category of risk (i.e. Currency risk, interest rate risk, commodity price risk, inflation risk) is vitally important in order to enable a user to understand the hedging activities of the company and the effect that this will likely have on the cashflows and performance of the business.

Providing tabular analysis by risk category and also by type of hedge accounting applied would certainly ensure that the effect of hedging relationships where hedge accounting has been applied is easy to understand, however, we also believe that providing information like this for hedging situations where hedge accounting has not been applied is also vitally important.

- (b) Each business is best placed to determine what information is most appropriate to disclose in its own particular circumstances. There are merits to specific guidance being given in relation to a particular sector, however, we believe that it is likely that each business in a particular sector would provide similar information to its peers due to how fundamental understanding hedging is to the operations of the business.

Question 14

Do you agree that if it is in accordance with the entity's fair value-based risk management strategy derivative accounting would apply to contracts that can be settled net in cash that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements? Why or why not? If not, what changes do you recommend and why?

Response 14

We appreciate the attempts to provide matching in the IFRS income statement in cases where the end customer demand forms part of the 'own use' requirements of the entity and so is out of the scope of IAS 39, and when the economic hedge takes the form of a derivative, so is required to be fair valued through the income statement. We agree with the proposal to allow these own use contracts to be recognised at fair value through profit or loss at the election of the entity.

Centrica's non-proprietary trading is for energy procurement purposes to meet the demand of our external customers whilst minimising the cost of holding assets and long term contracts acquired for the purpose of meeting external customer demand.

As part of its Energy procurement activities the Group enters into a range of commodity contracts designed to achieve security of Energy supply. These contracts include both purchases and sales and cover a wide range of volumes, prices and timescale. Purchases comprise long-term contracts complemented by shorter-term arrangements, which are entered into for the purpose of balancing energy supplies and customer demand and to optimise the price paid by the Group. Short term demand can vary significantly as a result of factors outside of the Group's control such as weather, power generation and gas production profiles and short term movements in market prices. A number of these hedging contracts are considered to be derivative financial instruments and are required to be fair valued under IAS 39, primarily because their terms include the ability to trade elements of the contracted volumes on a net-settled basis. Centrica sees these hedging contracts as 'own use' contracts and as such in order to represent underlying earnings in our income statement presentation, treat these contracts using accrual accounting effectively ignoring any fair value movements which are taken through another column in the presentation of the income statement to reconcile to IFRS profit. This is because management intends to use these energy supplies to meet customer demand.

Fair valuation is always inherently uncertain and judgemental, and making entries in the current year that account for profits/losses on future transactions in this situation is not going to lead to an income statement that gives useful and reliable information to users of the financial statements.

In the situation where the trading activity as described above is for energy procurement activities to meet the demand from an end customer, disclosure could be provided in relation to the fair value of the contracts entered into, however, we disagree that the fair value balances themselves should be recognised on the face of the statement of financial position with movements over the year taken through the income statement, or statement of changes in equity where hedge accounting is applied.

In addition to non-proprietary trading, Centrica engages in certain speculative trading activities via the use of physical and financial contracts. The performance of these speculative activities are evaluated and reported to management on the fair value basis.

For certain physical contracts relating to storage and transportation, accrual accounting has to be applied because of the difficulty in establishing an underlying variable for the storage or transportation capacity to qualify these contracts as derivatives despite the speculative nature of the trading strategy. However, as these storage and transportation contracts are economically hedged by instruments qualifying as derivatives, an accounting mis-match results between the economic hedges and the underlying value of the contracts. Furthermore, the storage and transportation contracts do not meet the definition of a financial asset in IAS 32 paragraph 11(c) as they are not contractual rights to receive cash or another financial asset from another entity, or rights to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity. As such the accounting mis-match between the economic hedges and the storage contracts do not qualify for the election of fair value through profit or loss option as prescribed under IAS 39 or IFRS 9.

Therefore, in situations where contracts were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item (in accordance with the entity's expected purchase, sale or usage requirements), but can be settled net in cash and are managed on a fair value based risk management strategy, having the option to elect application of derivative accounting would eliminate the accounting mis-match and significantly reduce the recognition inconsistencies across the assets/liabilities that are managed together.

Question 15

- (a) Do you agree that all of the three alternative accounting treatments (other than hedge accounting) to account for hedges of credit risk using credit derivatives would add unnecessary complexity to accounting for financial instruments? Why or why not?
- (b) If not, which of the three alternatives considered by the Board in paragraphs BC226–BC246 should the Board develop further and what changes to that alternative would you recommend and why?

Response 15

No comments. We do not hedge credit risk using hedging derivatives.

Question 16

Do you agree with the proposed transition requirements? Why or why not? If not, what changes do you recommend and why?

Response 16

We agree with the proposal to account for the proposed changes on a prospective basis to all hedging relationships, as this will reduce the complexity of having to monitor two different models concurrently. It is important that the transitional provisions do not make the process overly onerous.