

IASB
30 Cannon Street
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UK
Brussels, March 8, 2011

Exposure Draft ED/2010/13 Hedge Accounting

Dear Sir David,

The International Energy Accounting Forum (IEAF) consists of the major international companies in the utility business mainly from Europe but also newly from overseas (Cf the list of our members in appendix).

The goal of the IEAF is to discuss and formulate best practices, to seek to narrow areas of difference in accounting in the sector, to advocate the energy industry's point of view, and to make specialist energy industry knowledge available to the International Accounting Standards Board and other standard setters. These objectives were particularly reached when we sent you end of 2009 a common position paper on Financial Instruments describing the issues the energy industry faces when applying IAS 39. That position paper dealt with several topics: own use scope, written options, embedded derivatives and hedge accounting. We also appreciated the outreach session we did together with you in London in May 2010 that gave us the opportunity to illustrate our views and we are pleased that some ideas have been retained in the Exposure Draft on Hedge Accounting.

Therefore we thank you for the opportunity to provide comments on the ED dealing with Hedge Accounting. We strongly support the IASB's intent to align risk management and accounting by proposing a more principle-based approach for hedge accounting. In the energy industry this will help to present the economic characteristics of the business more adequately and thus improve the information presented in the financial statements. We also welcome the continuation of the IASB's discussions with regard to open portfolios and macro hedges in a later phase of the project. Nevertheless, we think that the present exposure draft is an important step in improving the presentation of the business models and risk management strategies in the financial statements of the entities so that we strongly support the IASB's intent to issue the new requirements for hedge accounting even without having finished the deliberations on macro hedging if this is not possible in the short term.



Further to this general approval, we would like to help the IASB to improve its approach to make it even more principle-based by solving some pending issues that are of a high importance for the users of financial statements. In that perspective, we have emphasised the following main improvement areas:

- as a general statement, we believe that all economic hedge strategies should be eligible to hedge accounting on the basis of an adequate documentation. We have noticed that some items/instruments, even if deemed to be economic hedges, do not qualify for hedge accounting (e.g. instruments designated at FVTOCI under IFRS 9 are not eligible hedged items, written options are not eligible hedging instruments);
- then since hedge accounting will not be available for all economic hedges, we believe that hedge accounting should remain optional and hence revocation of hedge accounting should still be based on a voluntary basis as well (“scope of hedge accounting”, “optionality of hedge accounting” and “voluntary revocation” are interdependent and cannot be considered separately);
- regarding the application of fair value accounting on “own use” contracts, we think that the issue is not adequately solved and requires that the following should be considered:
 - derivative accounting should be allowed as an option only ; and
 - it should be considered that a contract may be composed of two or more separate contracts for the purpose of IFRS 9 under certain conditions.

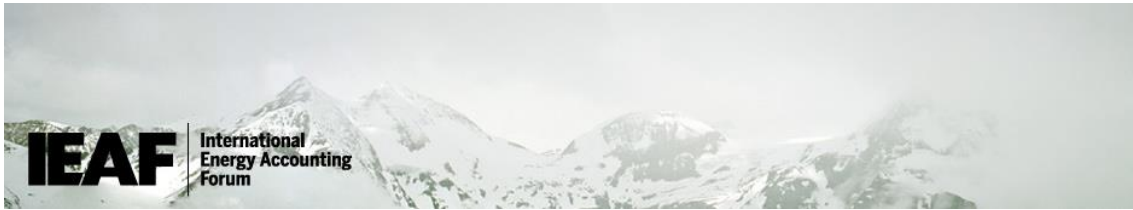
Furthermore, we have proposed additional guidance to the IASB to clarify some principles that were not clearly explained in the Exposure Draft. These clarifications concern the following areas:

- even if we welcome the removal of the 80%-125% bright line, we think that “achieving other than accidental offsetting” and “minimising expected hedge ineffectiveness” should be clarified;
- even if we feel that the rebalancing principle is intended to reduce complexity in applying hedge accounting, we think that this principle should be clarified.

Finally, we suggest the IASB to use the proposed examples in a dedicated part of the Exposure Draft (e.g. in the “illustrative examples” part) and ask the IASB to make it clear that the examples are deemed to be used for “understanding” purposes and are therefore not to be considered as a rule. Indeed, we previously faced this issue on other IFRS projects where examples were part of the standard itself which led to misinterpretation (especially by auditors).

Should you require further comments or explanations, please do not hesitate to contact us.

Best regards



On behalf of the International Energy Accounting Forum,

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Appendix 1: Answers to the specific questions raised in the invitation for comments on the ED Hedge Accounting

Objective of hedge accounting

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?

We strongly support the intent of the IASB to align risk management and accounting by proposing a more principle-based approach for hedge accounting.

On that crucial point, it should be noted that the problems of IAS 39 in the energy industry are often referred to as “artificial” volatility, i.e. profit and loss volatility that is only accounting-driven, but does not exist in economic reality.

The purpose of financial statements is to provide useful information to their users, in particular to investors and financial analysts. Their interests lie in recurring income and real cash flows, not one-off issues.

As they are interested in the economic view (or “risk management view”) of a company, they eliminate “artificial” volatility from the statement of comprehensive income when analysing a company’s performance.

As a consequence, this ED represents a significant positive step forward to achieve hedge accounting, especially on the following matters:

- (a) eligibility of hedged items and hedging instruments, a.o.:
 - a. designation of specific risk components in a non-financial item;
 - b. designation of a combination of an exposure and a derivative as a hedged item.
- (b) groups of items and net positions, i.e. permitting hedge accounting for relationships other than between a single hedging instrument and a single hedged item.

However, we think that in order to achieve an even better alignment of risk management and accounting it would be necessary to extend hedge accounting to open portfolio and macro hedging as these strategies are fully part of the risk management and risk mandates of our entities (see below our specific point on open portfolio and macro hedge issue). We therefore welcome the continuation of the IASB’s discussions with regard to these issues, but – as indicated in our cover letter – we also support the IASB’s intent to issue new requirements for hedge accounting even without having finished the deliberations on macro hedging.



(c) Effectiveness qualification, i.e.:

- a. no retrospective test anymore;
- b. no “80% -125%” bright line anymore;
- c. strong link made with risk management

(d) Accounting for the time value of an option that qualifies for hedge accounting: accounting treatment will avoid non-economically profit or loss volatility.

Although the proposed approach is principle-based and should align accounting and risk management activities some strategies still cannot be accounted for as hedging instruments (some written options – see our dedicated point below). We propose to include a general statement that all hedging strategies on the basis of an adequate documentation should be eligible to hedge accounting.

However, we believe that a non-economically justified restriction is still pending in the proposal. Indeed, we understand that the exposure draft proposes that the objective of hedge accounting is to represent in the financial statements the effect of an entity’s risk management activities that use financial instruments to manage exposures arising from particular risks **that could affect profit or loss**.

There are numerous examples where the risk management purpose is to hedge one or more risks attributable to equity instruments that will be (through IFRS 9) designated at fair value through other comprehensive income and that will therefore no longer affect profit or loss (except for dividends). The following examples would not be eligible to hedge accounting in the proposed guidance while they do represent economic hedges. We therefore believe that the intent of the IASB to make a link between risk management policy and hedge accounting is not fully reached.

Example 1

Entity A (EUR currency) buys in USD equity shares in entity B (shares listed in USD). Entity A measures the shares at fair value and elects to present gains and losses in other comprehensive income in accordance with IFRS 9.

According to its risk management policy, the entity decides to protect itself against the exposure to changes in the foreign exchange rate associated with the shares by concluding a forward contract to sell USD and buy EUR. The entity intends to roll over this forward contract for a long time as it retains the shares.

This transaction is economically hedging the fair value of the foreign exchange exposure of the acquired shares (or it is a cash flow hedge if the forecast sale of the shares and its timing are highly probable) and should therefore be accounted for accordingly.



Example 2

Entity A (EUR currency) buys in EUR equity shares in entity B (shares listed in EUR). Entity A measures the shares at fair value and elects to present gains and losses on other comprehensive income in accordance with IFRS 9.

According to its risk management policy, the entity decides to protect itself against the fall in value (one-sided risk) of its quoted equity investments by concluding a put option.

This transaction is economically hedging the fair value of the acquired shares and should therefore be accounted for accordingly.

In that perspective, the Board wrote that *“extending eligibility to non-derivative financial instruments in categories other than fair value through profit or loss would give rise to operational problems and be inconsistent with its decision not to allow hedge accounting for investments in equity instruments designated as at fair value through other comprehensive income”* (IN 15).

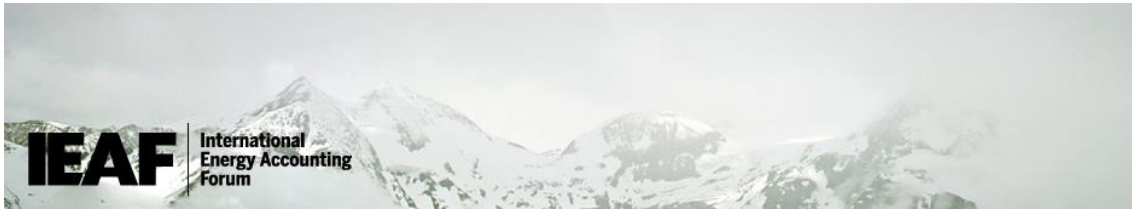
Especially, we feel that the arguments in the Basis for Conclusions are not strong enough to disable equity instruments designated at fair value through OCI (under IFRS 9) to be eligible hedged items.

Among others, BC25 refers to ineffectiveness: *“Conversely, if the hedge ineffectiveness were recognised in profit or loss it would:*

- (a) be consistent with the hedge accounting principle that hedge ineffectiveness should be recognised in profit or loss; but*
- (b) contradict the prohibition of reclassifying from other comprehensive income to profit or loss gains or losses on investments in equity instruments accounted for as at fair value through other comprehensive income”.*

We believe that hedge ineffectiveness cannot be considered as a gain or loss on investments in equity instruments accounted for as at fair value through other comprehensive income (if it relates to a CFH relationship) but rather as a gain or loss on an instrument that is a hedging instrument. It is a characteristic of hedge accounting to deviate from the “normal” accounting principles.

As a consequence, we ask the IASB to reconsider this issue so that it does not restrict application of hedge accounting by reason of a rule-based measure.



Instruments that qualify for designation as hedging instruments

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?

Yes, we agree.

Derivatives that qualify for designation as hedged items

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?

Yes, we agree and again strongly support the intent of the IASB to align risk management and accounting by removing inconsistent rule-based measures from IAS 39.

Nevertheless, we believe that the following more complex examples should be used by the IASB as illustrative examples in the new standard to illustrate the principle of designation of a derivative as a hedged item.

These following examples ensure that the interpretation of this principle-based measure will apply to all situations where an entity is hedging an aggregated exposure that includes one or more derivatives.

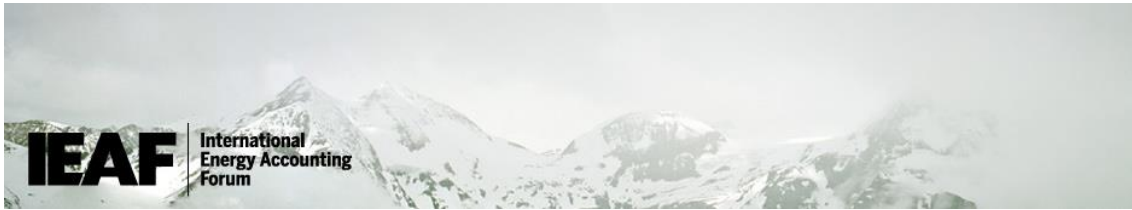
Example 1

An entity has concluded a fixed-rate debt of 10 years in foreign currency. The risk management policy of the entity is:

- to conclude a 3-months cross-currency interest rate swap in order to transform this fixed-rate debt in foreign currency into a floating-rate debt in local currency. The entity intends to roll over this CCIRS each three months;
- to conclude a 10-years interest rate swap to transform a floating-rate debt in local currency into a fixed-rate debt in local currency;

The exposure is then composed of:

- a 10-years floating debt in foreign currency; **and**



- a 3-months CCIRS rolled over each three months (i.e. they are forecast transactions).

We understand from the ED that these future CCIRS are forecast transactions that can be designated as hedged items as far as they meet IFRS 9 criteria (i.e. highly probable criterion).

Example 2

An entity has concluded a purchase of gas (at variable price) in foreign currency. The risk management policy of the entity is:

- to hedge the foreign currency exposure;
- and then to hedge price risk exposure in local currency;

The exposure is then composed of:

- a forecast transaction to buy a non-financial item; **and**
- a currency swap.

We understand from the ED that this combination of exposure and derivative is eligible to hedge accounting.

Example 3

An entity executes commodity derivative trades externally towards NordPool (NordPool is a EUR market, i.e. all derivatives are in EUR).

The electricity sales division of the entity has activities in Sweden in local currency (SEK). The EUR entity sells to the Swedish subsidiary electricity derivatives in SEK. This electricity has been bought from NordPool in EUR.

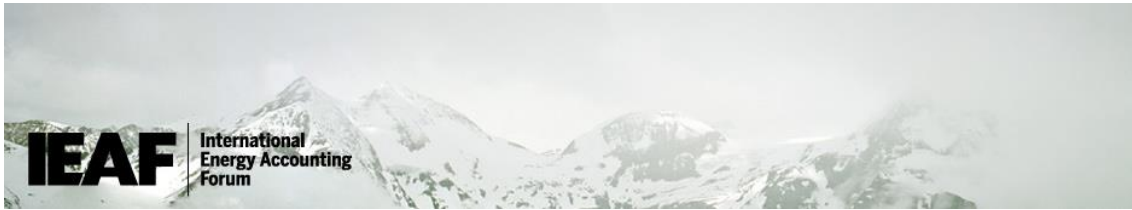
The EUR entity hedges EUR/SEK with FX derivatives via group treasury.

According to IFRS 9, the exposure that includes derivatives (electricity derivatives in SEK and EUR) can henceforth be designated as hedged item.

Example 4

A power plant has future, forecasted gas purchases. To secure the physical supply, it contracts an index physical derivative with a gas producer. We assume that own use accounting cannot be achieved (because of practice of net settlement).

To fix the price, it executes a separate fixed-for-floating swap. All criteria of IFRS 9 are met (a.o.: the hedged item is highly probable).



According to IFRS 9, the exposure that includes derivatives (forward contract to buy gas) can henceforth be designated as hedged items.

Example 5

An entity enters into a forward contract at a fixed price to hedge the variability of the consideration to be received on the sale of the underlying. The forward contract qualifies as a derivative because of a practice of net settlement. The forward contract is the contract under which the commodity will be sold.

We understand that “all in one hedges” as stated in IAS 39 Implementation Guidance F.2.5. apply in the same terms under IFRS 9.

In this example, the entity may designate the contract as a cash flow hedge of the variability of the consideration to be received on the sale of the asset. The cash flow hedge is considered 100% effective throughout its lifetime.

Further to the above-mentioned examples, we do not know how the IASB intends to deal with derivatives that are embedded in a host contract. In particular, we would like to ask the IASB to clarify the accounting treatment of the following example:

- IFRS 9 phase I has retained the IAS 39 guidance on the embedded derivatives on non-financial items;
- An entity is selling electricity at floating price. The indexation is based on both coal and gas. The assessment of the entity is that the contract contains an embedded derivative that should be accounted for at fair value through profit or loss, separately from the host contract;
- The risk management objective is to hedge the coal/gas exposure by concluding swaps. The exposure is then composed of a highly probable transaction and a derivative (embedded derivative more precisely). This combination should be eligible to hedge accounting in IFRS 9;
- What would be the accounting treatment of such a situation since in IAS 39, a zero net P&L effect is achieved (the change in fair value of the embedded derivative perfectly offsets the change in fair value of the economic hedging instrument). In that perspective, we also refer to question 8 on optionality of hedge accounting.

On that matter, we would appreciate if the IASB could handle this issue with respect to the risk component (we refer to Q4) so that the accounting treatment proposed would be appropriate under all aspects.



Designation of risk components as hedged items

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 (ie 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?

Yes, we strongly agree.

We strongly support the intent of the IASB to align hedge accounting requirements for both financial and non-financial items.

As we have explained in the past, it is important to have a close match between the operational hedging strategy of an entity and its financial reporting. That is why we think that hedge accounting should be applicable to almost all cases where hedging is economically justified.

Although the following transactions are hedges of specific risks and are therefore economically justified, such hedges did not achieve hedge accounting under IAS 39. As from now, the following examples will according to our understanding be eligible for cash flow hedge accounting according to IFRS 9.

Example 1

Many contracts to sell electricity contain pricing terms linked to their production costs, including ingredients in the generation process, such as gas and coal. A characteristic of the industry is that the fixed costs represent a large part of the total costs of generating electricity. This is why typical electricity contracts contain a fixed price component, generally referred to as the capacity charge in order to allow for the recovery of those fixed charges, including a proper return on investment. In addition to the capacity charge, the electricity contracts also include a variable price component linked to fuel indexations and to other factors such as labor costs and wholesale prices.

Such pricing methods of electricity contracts make economic sense as these factors are commonly used in the fixed and variable costs incurred to produce electricity and therefore comprise the most significant portion of the cost of generation. It is customary that energy companies hedge their exposure to some of their fuel indexations, to the extent that there is a market that allows doing so. Other price components, on the other hand, are not tradable and are left unhedged. In many circumstances, energy companies also benefit from natural hedges in their portfolio of contracts, for instance where fuel purchase and electricity sales contracts contain some common indexations.



Economically it makes sense to hedge only those pricing elements that are not naturally balanced in the portfolio of contracts, and that are related to variable production costs for which a liquid market exists, and that can be reliably isolated and measured.

Example 2

Contractual gas prices often cover both the commodity (gas, indexed on fuel or on gas) and its transport. The risks related to these two elements are different and need to be covered separately.

Example 3

An LNG importer in the United States has a long-term contract to purchase LNG for import. That contract is a floating price contract indexed to Nymex natural gas prices. The LNG importer has an LNG regasification facility in the northeast US and intends to take delivery of LNG under the long-term contract, regasify the LNG, and deliver the resulting natural gas to customers in the northeast US. The importer will receive a price that is Nymex + northeast basis. Importer wishes to hedge the variability in future forecasted margin. Due to the indexation of the supply contract, the Nymex variability in the supply contract offsets the Nymex component of future forecasted sales, leaving only the basis risk. Basis risk is a separately identifiable, measurable, and hedgeable component of the total price risk. Under IAS 39, basis derivatives executed to hedge this component would not be eligible for hedge accounting without additionally executing a corresponding Nymex derivative, as the basis-only hedge does not effectively offset the cash flow variability of the forecasted transaction at its actual delivery location. However, IFRS 9 would allow the designation of the separate component, thus allowing the accounting to follow economic reality.

Designation of a layer component of the nominal amount

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?*



(a) designation of a layer of the nominal amount

Yes, we agree since this improvement ensures that risk management policy will be adequately translated into accounting.

(b) restriction in a layer component that includes a prepayment option

We are concerned that although the IASB intends to apply a principle-based approach it has nevertheless introduced new restrictions in its proposed guidance. And particularly, arguments used in BC69 are similar to those used to exclude specific risk components in a non-financial item in IAS 39.

BC69: “(...) The Board noted that if the prepayment option’s fair value changed in response to the hedged risk a layer approach would be tantamount to identifying a risk component that was not separately identifiable (because the change in the value of the prepayment option owing to the hedged risk would not be part of how hedge effectiveness would be measured)”.

We would rather propose a positive principle-based approach explaining that a layer component including a prepayment option is eligible to hedge accounting only to the extent that the risk component can be separately identifiable and meets all the requirements to be accounted for as such.

Hedge effectiveness requirements to qualify for hedge accounting

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?

We welcome the removal of the 80%-125% bright line test to assess whether the hedging relationship qualifies for hedge accounting.

We support the IASB’s view to link risk management objectives with hedging documentation in ED/2010/13 par. 19.:

Furthermore, the ED requires that the hedging relationship should meet the objective of the hedge effectiveness assessment and **is expected to achieve other than accidental offsetting**. The objective of the hedge effectiveness assessment is to ensure that the hedging relationship will produce an unbiased result and **minimise expected hedge ineffectiveness**.



1. Achieving other than accidental offsetting

On that topic, there needs to be some sort of high-level conceptual requirement for statistical support when not hedging the exact forecasted item. While we all agree that the 80-125 bright line test should be removed, the ED is not strong enough to lead to an appropriate interpretation of that criterion. We provide the IASB with the following examples:

Example 1

It should be allowed to hedge NY Zone J electricity with NY Zone G electricity, as the two are highly correlated. But, hedging NY Zone J with ERCOT (in Texas) should not be allowable, as the markets are independent of one other.

Example 2

Hedging electricity with gold futures should not meet the criterion to achieve other than accidental offsetting.

2. Minimising expected hedge ineffectiveness

On that topic and subject to our first point expressed above, we believe that the IASB should clarify that since the entity should rely on its risk management to determine the hedging instrument, the hedging instrument will not necessarily be the most effective but could be an alternative instrument (because it will be traded in a more liquid market or that is less expensive). Otherwise, some could believe that minimising ineffectiveness is not achieved if other more effective instruments exist on the market.

The fundamental objective of any risk management policy is **risk reduction**, as it is not always possible to know ‘ex-ante’ whether hedging strategies adopted by the risk management will actually succeed in minimising expected hedge ineffectiveness. Therefore, minimising hedge ineffectiveness as well as achieving other than accidental offsetting should be presumed when the transaction is part of the risk management strategy.

Rebalancing of a hedging relationship

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?

We strongly support the IASB in its efforts to align risk management objectives with hedge accounting and therefore agree with the proposed approach subject to what follows.

Accounting consequences of rebalancing

Even if we feel that the rebalancing principle is intended to reduce complexity in applying hedge accounting, we ask the IASB to clarify this principle with respect to the application guidance that is provided in B46-60 and that should follow the way we interpret it (see below).

Particularly, we have listed several parts of application guidance that raise some questions and on which we propose an interpretation that could be used as illustrative examples. Our remarks will mainly focus on cash flow hedging.

In order to leave the document straightforward and to ensure clarity of our comments, we refer to appendix 2 that gives our understanding regarding accounting treatment consequences of rebalancing principle in complex situations. We would like to ask the IASB to consider them carefully since application of rebalancing is of a huge importance.

Regarding the risk management objectives

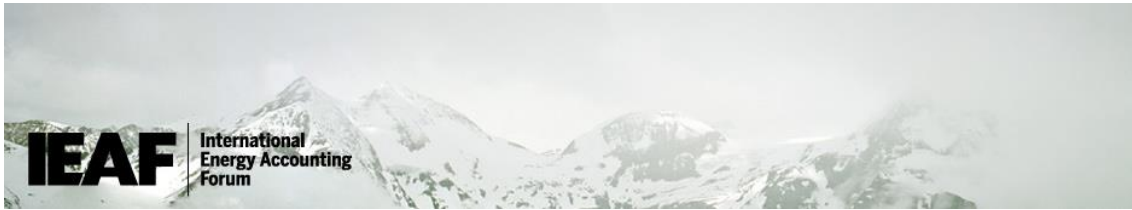
We strongly support the link made between risk management objectives and accounting.

We have noted that concepts such as risk management policy/objective or change in risk management policy/objective are nowhere defined in the Exposure Draft. Since we believe that entities should use judgment to assess whether the risk management objective does remain or not the same for the hedging relationship and should rely on strong internal controls to make sure that (**and how**) risk management objectives are put in place, we ask the IASB to confirm that this assessment is subject to judgment.

According to us, a change of the risk management is likely to be a sustainable change of the risk management structure or strategy and not only a slight change due to operational events or marginal (and not lasting) market movements. This statement would avoid that a “Rube Goldberg machine” (in terms of documentation) is created because of a misinterpretation (by auditors especially) of the rebalancing principle.

General illustrative examples of hedging forecast power production from generating assets

As a conclusion of this question and as a general remark on how risk management policy has to be applied and on which the accounting consequences would be, we would ask the IASB to



more adequately illustrate IFRS 9. We will provide below two examples of hedging forecast power production from generating assets as well as one example illustrating how coal purchase can be hedged.

1. Generic strategy

Risk Management Objective

Power producers are commonly exposed to commodity price risks linked to their:

- power plants:
 - ✓ nuclear plants (power price risk);
 - ✓ gas fired power plants (power, gas & CO₂ price risks – ‘spark spread’);
 - ✓ coal fired power plants (power, coal & CO₂ price risks – ‘dark spread’).
- long term fuel procurement contracts (e.g. gas & oil indexations);
- sales contracts (e.g. power, gas, oil price risks).

As a consequence, power producers want to hedge against these risks in order to protect their assets and sales margins.

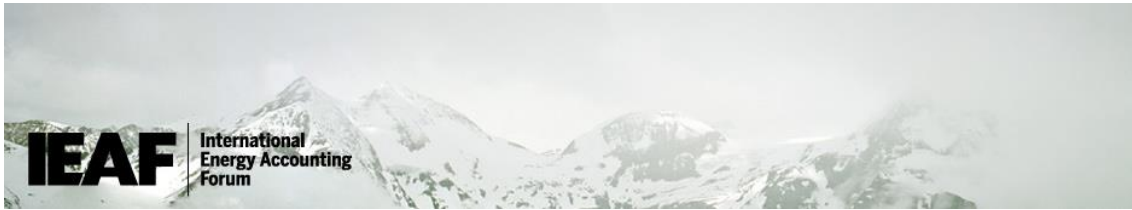
Let us take the example of power price risk hedging. Utilities will traditionally hedge their forecasted power production over the market liquidity horizon by selling electricity forward. Selling electricity forward significantly reduces the exposures to the volatility of the electricity spot markets. The risk management objective can be depicted as the desired “hedge cover ratio” target structure over the power market horizon, for instance:

	Y + 1	Y + 2	Y + 3
Maximum	100%	70%	40%
Reference	90%	60%	30%
Minimum	80%	50%	20%

The level of the desired hedge cover ratio is determined by the management, in line with **prevailing market circumstances** (e.g. the level of the spark spread). Accordingly, the management decides to hedge part of the physical electricity that will be produced by the assets over the next 3 years by selling standard OTC fixed price power contracts on the market with the objective to reach the desired hedge cover ratio.

Hedging Strategy

Because generation forecasts vary with forward market prices, the resulting hedge cover ratio needs to be adapted frequently: buying back when forecasts (based on prevailing market prices) are reducing and selling again when forecasts are going up again (hence, frequent rebalancing of the hedge cover ratio).



However since all power plants are not pure merchant¹ (i.e. production will not be based only on prevailing market prices²), it is important to emphasize that this hedging strategy entails increases/decreases in the hedge cover ratio, as a defined percentage of the forecast production. But since the forecast production is still highly probable (all other things remaining constant), this has to be seen as rebalancing, hence as a continuation of the hedging relationship.

If, for any other reason, a portion of the forecast production should disappear, i.e. seems to be not highly probable any longer, discontinuation of part of the hedging strategy must be considered.

Hedge effectiveness

It is assumed that when the hedged item and the hedging instrument's characteristics are matched, the hedge should be fully effective.

Accounting impacts

It is our understanding that, provided that the forecast production is still highly probable and considering that elective de-designation (see our answer to question 8 below) is not permitted as long as the risk management criteria are met, the accounting impacts of the above described strategy will be fully booked in OCI, i.e. all the hedging derivatives, including any subsequent accreting or offsetting derivatives, that belong to the designated hedging strategy.

2. Variation of the generic strategy

Risk Management Objective

The overall risk management objective is the same as above, but we suppose that in order to optimise hedge execution, the management allows cross location hedging in a neighbour market that offers increased depth and liquidity and that the management considers as sufficiently correlated to designate it as a “proxy” for selling forward power in its own domestic market.

Hedging Strategy

The hedging strategy remains unchanged, except that the hedge cover ratio can be achieved with a mix of domestic and foreign forward power sales.

¹ Pure merchant power plants will run if the (dark or spark) spread is positive and will not run if it is negative.

² Because of technical constraints (e.g. no or little generation flexibility for other than gas-fired assets) and end-customers demand (final electricity demand is rather inelastic in many circumstances).



Hedge effectiveness

It is assumed that the hedging instruments executed in the foreign market will generate ineffectiveness due to the non-perfect correlation between the prices of electricity between the domestic and the foreign markets.

Since the 80% - 125% bright line test is no longer retained, this ineffectiveness will not affect the qualification of the hedging relationship, provided that the risk management criteria remain unchanged.

Accounting impacts

All the ineffectiveness from the 'proxy' hedging strategy will have to be taken to profit or loss.

3. Example dealing with how coal purchase can be hedged

This example has been provided because diversity in practice has been observed in the industry. Therefore, we would like that the IASB confirms the accounting treatment of the operation.

Risk Management Objective

An entity operates a coal-fired power plant and wants to hedge its exposure in the variability of coal prices.

Hedging Strategy

The risk management global strategy is to firstly hedge its exposure by concluding a "paper" financial instrument before entering into a physical forward contract. This risk management objective is applied in practice as follows:

Step 1: an entity is hedging its forecast transaction to purchase coal by concluding a swap to fix the price (the coal is not yet physically purchased since the market is not liquid enough).

Step 2: when the physical coal market gets liquid, the entity risk management objective is to enter into an offsetting swap as well as into forward contract to purchase coal at a fix price.

Hedge effectiveness

It is assumed that when the hedged item and the hedging instrument's characteristics are matched, the hedge should be fully effective.



Accounting impacts

At step 1, the swap is designated as a hedging instrument according to the entity's risk management objectives and therefore the relationship is eligible to hedge accounting.

At step 2, we assume that:

- the risk management objective has not changed, i.e. aim is still to purchase coal at a fix price;
- hedge relationship is rebalanced and it is considered that eligible hedging instruments and hedged item are as follows:
 - all swaps have been concluded in the framework of the same risk management policy. Therefore both should be accounted for as hedging instruments, i.e. all changes of fair value – to the extent the hedge is effective – are accounted for in OCI;
 - physical forward to purchase coal at a fix price is eligible to own use accounting.

Discontinuing hedge accounting

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?*

(a) Discontinuance of hedge accounting when hedging criteria are no longer met

Yes, we agree that an entity should discontinue hedge accounting when the hedging relationship ceases to meet the qualifying criteria (see however below our concern regarding the optionality of hedge accounting).



(b) Discontinuance of hedge accounting when hedging criteria are still met

We agree that the introduction of rebalancing would help to achieve more appropriate accounting requirements and would help to better reflect the developments of the entity's risk management activities in the financial statements.

On that specific point, it should be noted that the problems of IAS 39 in the energy industry are often referred to as “artificial” volatility, i.e. profit and loss volatility that is only accounting-driven, but does not exist in economic reality.

The purpose of financial statements is to provide useful information to their users, in particular to investors and financial analysts. Their interests lie in recurring income, not one-off issues and real cash flows.

As they are interested in the economic view (or “risk management view”) of a company, they eliminate “artificial” volatility from the statement of comprehensive income when analysing a company's performance.

The industry has found a practical solution to deal with the problem of “artificial” income volatility:

- the profit and loss components concerned are eliminated from the operating result; and
- either reclassified to non-GAAP measures (e.g. non-operating result) or disclosed separately, e.g.:
 - separate line item in the statement of comprehensive income, e.g. under “Revenue”;
 - separate line item in the statement of comprehensive income together with a column “Remeasurements”;
 - separate disclosure in the notes.

The industry uses different non-GAAP measures to increase the informative value of operating results. However, this is only a “less-than-ideal” solution. As a consequence, an accounting solution leading to an informative operating result would be preferable.

In that perspective, we again strongly support the intent of the IASB to align risk management objectives and accounting. But since hedge accounting will not be available for all economic hedges (e.g.: hedging an instrument designated at FVTOCI, use of written options, macro hedging), we believe that this non-GAAP measure will still be necessary. That would lead to the conclusion that the revision of hedge accounting is still incomplete to offer a full consistent principle-based approach to apply hedge accounting to all existing economic hedges.

As a consequence of what precedes, we do believe that designation in hedge accounting should remain optional (optionality of hedge accounting) and therefore revocation of hedge accounting should still be based on a voluntary basis as well.



Further to the arguments to emphasise that they are interdependent (scope of hedge accounting ; optionality of hedge accounting model ; voluntary revocation), we do not understand this anti-abuse measure since:

1. it is generally not the aim of entities to avoid application of hedge accounting when it is allowed because applying hedge accounting would reduce in many cases non-economically justified volatility in its profit and loss (the entity is likely to rebalance its hedging relationship and would therefore not revoke its designation);
2. the voluntary revocation of hedge accounting (when all criteria are otherwise still met) is not an incentive to generate P&L effects since it does not lead to a reclassification of Mark-to-Market previously recognised in other comprehensive income into profit or loss.

Accounting for fair value hedges

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?*

As a general comment, we strongly support the intent of the IASB to retain a dedicated accounting treatment for fair value hedges. Indeed, we believe that the underlying fundamentals of fair value hedges are quite different from cash flow hedges since:

- cash flow hedges are related to highly probable transactions that are not yet accounted for on the face of the statement of financial position;
- while fair value hedge accounting (except for unrecognised firm commitments – for which we agree that this represents a “strange animal”), applies to items that are already recognised in the statement of financial position.

Furthermore, alignment to one single hedge accounting model (no revaluation of the hedged item):

- would really have made it difficult to identify the type of risk management strategy applied by the entity;



- would have led to volatility in other comprehensive income.

(a) fair value hedge mechanics

We believe that the introduction of a two-step approach (recognising all changes in fair value of both hedged items and hedging instruments and then recycling immediately ineffectiveness into profit or loss) does not add any value. Furthermore:

- there is no rationale/principle that supports the recognition of the gain or loss of the hedged items and hedging instruments in other comprehensive income;
- the immediate reclassification of ineffectiveness from other comprehensive income to profit or loss is in substance not a change compared to IAS 39 which already requires ineffectiveness to be recognised in profit or loss.

We furthermore do not believe that the proposed approach has eliminated the mixed measurement for the hedged item since the total amount that would be accounted for according to IFRS 9 (hedged item + the gain or loss on the hedged item attributable to the hedged risk) is not different from the amount recognised under IAS 39.

As a consequence, we ask the IASB to reconsider the cost-benefit of this measure that does not depart significantly from IAS 39 (we believe that IAS 39 mechanics should remain) and that would not reduce complexity in applying hedge accounting.

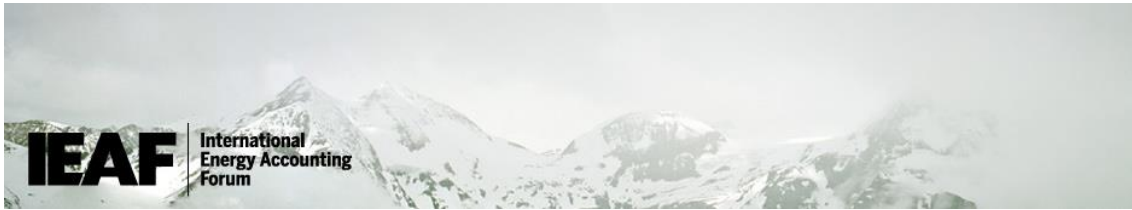
(b) presentation of the gain or loss of the hedged item on a separate line

Even if we agree that the proposal intends to avoid a measurement attribute that is neither at amortised cost nor at fair value, we however ask the IASB to reconsider the use of a separate line for the following reasons:

- we fear that most of these separate assets and liabilities (those related to the gain or loss on the hedged items attributable to the hedged risk) would not meet the definition of an asset or liability according to the framework in themselves but should rather be related to another asset or liability;
- this information in itself (i.e. in the statement of financial position) is not necessary to understand the risk management policy of an entity since it is redundant with the information provided in the disclosures. On the contrary, in the case of an entity that uses hedge accounting for several asset and liability items, it would lead to a huge number of additional line items which would make the statement of financial position look complex and confusing.

(c) linked presentation

Yes, we agree. Linked presentation would not reduce complexity in preparing financial statements when risk policy is complex and would be redundant with the information provided in the disclosures.



Accounting for the time value of options for cash flow and fair value hedges

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 (eg 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 (ie 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?*

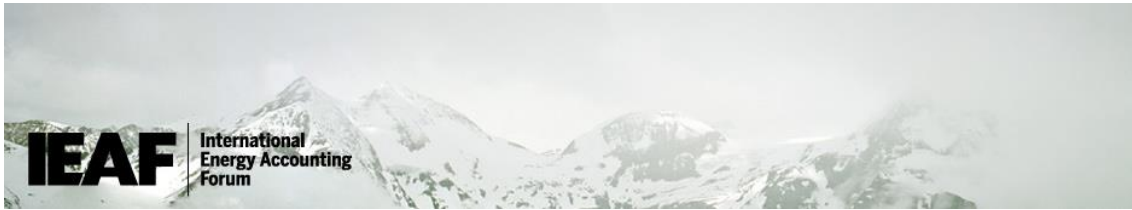
As a general comment, we strongly support the IASB in its intent to align optimal business decisions with accounting. Indeed, the accounting treatment of time value under IAS 39 has often led the entities to avoid the use of option derivatives for the benefit of linear derivatives such as forward contracts or swaps that were often considered less optimal economically (giving away upside as well as protecting downside risk), but more optimal from an accounting perspective.

In addition, we feel that the proposed accounting treatment is sometimes complex (see our comments below) and we would propose the IASB to eventually reconsider it with respect to DIG issue G20 in US GAAP that actually deals with options very well and that could be used as a framework.

Furthermore, we have understood from our meeting with Board Member Philippe Danjou and Bob Garnett that the guidance applicable to the time value of an option will also be applicable for the time value of a forward contract (interest element). However we believe that this clarification is not straightforward in the proposal. Therefore we propose that the guidance related to the accounting treatment of time value of an option should be applied by analogy to the interest element of a forward contract.

(a) transaction related hedged items

Yes, we agree with the proposed approach since the accounting treatment related to time value in IAS 39 was disconnected from risk management. Indeed, risk management typically considers the time value of an option as a cost of hedging. As the Board has noted in BC144,



“it is a cost of obtaining protection against unfavourable changes of prices, while retaining participation in any favourable changes”.

Furthermore, reclassification as a basis adjustment (in case of a recognition of a non-financial asset) or in profit or loss when the hedged item affects profit or loss ensures a matching principle that was otherwise not reached in IAS 39.

(b) period related hedged items

Yes, we agree with the proposed approach. Such as for the transaction-related hedge relationship, this accounting treatment avoids volatility in profit or loss and ensures a coherent matching principle that was otherwise not reached in IAS 39.

(c) align time value issue

Even if we understand the underlying economics of such an accounting treatment, we are concerned that this would (usually) add unnecessary complexity when applying hedge accounting.

Actual time value larger than aligned time value

On the particular case of actual time value larger than the aligned time value, we believe that this will have few impacts in reality since the risk management is not likely to conclude a hedging instrument with a premium that is larger than the premium that would have been paid with another existing hedging instrument. We also suggest that the IASB clarified that this would only be the case if the alternative instrument (with aligned time value) can be reliably measured.

Actual time value smaller than aligned time value

On the particular case of actual time value smaller than the aligned time value, we ask the Board to reduce complexity of accounting treatment so that the “lower of cumulative variation” principle (as it is explained in the ED) applies in such a way that if the actual time value of the hedging instrument is lower than the time value of the aligned instrument, all the change in the MtM of the time value would be recognised in other comprehensive income. We have illustrated this proposal by the following example (staff example retreated).

Example 1B

Transaction related hedged item

Actual time value is smaller than aligned time value

Option

Term (periods)

Time value

actual	aligned
5	5
10	12

The aligned time value is determined using the valuation of an option that would have critical terms that perfectly match the hedged item (see ED.B68).

The life of the option equals the hedged period.

Fair value (of actual time value)

Fair value (of aligned time value)

Lower of

Balance sheet

Financial asset (option)

Retained earnings

Accumulated OCI

Reflects changes in the fair value regarding the lower of the cumulative change of the actual and aligned time value.

	t ₀	t ₁	t ₂	t ₃	t ₄	t ₅
Fair value (of actual time value)	10	12	9	8	5	0
Fair value (of aligned time value)	12	15	11	11	7	0
Lower of	10	12	9	8	5	0
Financial asset (option)	10	12	9	8	5	0
Retained earnings	0	0	0	0	0	0
Accumulated OCI	0	<2>	1	2	5	10
	10	10	10	10	10	10

Fair value of only the time value of the actual option (ie excluding any intrinsic value).

This amount will be removed from accumulated OCI as a basis adjustment or a reclassification adjustment (see ED.33(b)).

Statement of comprehensive income

Gain/loss

Profit or loss

OCI

Total comprehensive income

	0	0	0	0	0	0
	0	0	0	0	0	0
	<2>	3	1	3	5	10
	<2>	3	1	3	5	10

This is the difference between the amount recognised in OCI and the fair value change of the actual time value.

Hedges of a group of items (1)

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?

Yes, we agree and strongly support the overall proposal of the IASB to extend hedge accounting to groups of items and net positions.

However, as we have said before, we think that in order to achieve an even better alignment of risk management and accounting it would be necessary to extend hedge accounting to open portfolio and macro hedging as these strategies are fully part of the risk management and risk mandates of our companies (see below our specific point on open portfolio and macro hedging issue). We therefore welcome the continuation of the IASB's discussions with regard to these issues as indicated in our cover letter.

Furthermore, we are concerned about the fact that the IASB – while it has intended to fully align risk management and hedge accounting – continues to pursue an accounting approach based on individual items. We believe that interpretation of this guidance will lead to diversity in practice. Indeed:



according to ED/2010/13 BC178, “*The Board considered how an entity that applies net position hedge accounting should identify the hedged item. The Board concluded that an entity would need **to designate a combination of gross positions** if it were to apply the hedge accounting mechanics to the hedged position. Consequently, the Board decided that an entity could not designate a merely abstract net position (ie without specifying the items that form the gross positions from which the net position arises) as the hedged item*”.

We instead believe that an entity will designate **a net position**. But for internal control purposes, it would need to know the items that constitute this net position. Indeed, we feel that our proposed statement will avoid confusion about the intent of the IASB to allow net position as eligible hedged item.

Hedges of a group of items (2)

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 (eg 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?

Yes, we agree with the proposal to present on a net basis in a separate line the gains or losses attributable to the hedging instruments. That would indeed avoid artificial grossing up of gains or losses (that do not exist). Furthermore, this net presentation would usually have no impact on the relevant non-GAAP measures (such as EBITDA).

We are however concerned that this principle does not apply to fair value hedges where the proposal requires that the gain or loss shall be presented on a gross basis next to each line item that includes the related asset or liability. Since the disclosures provide the users with sufficient information about the risk management policy (and its consequences in the financial statements), we believe and ask the IASB that the change in fair value should be aggregated into a single line in the statement of financial position.

Disclosures

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?*

(a) proposed disclosures



(b) other disclosures

Yes, we agree that the disclosures play a fundamental role in understanding the risk management policy of an entity. We also support the IASB that intends to require more judgment compared to IAS 39 (paragraph 40-43).

On that perspective, we would like to draw the attention of the IASB on the importance of use of judgment and therefore would like that these points are emphasised:

- leaving the disclosures “up to” the judgment of the entity is crucial since disclosing all existing information directly or indirectly linked to hedge accounting would “drown” the users of financial statements especially in a situation when the entity has many and often complex activities;
- using judgment will also enable the entity to make a trade-off between existing disclosures already foreseen in its reference document (that includes consolidated financial statements but also – due to regulatory reasons – disclosures on risk management) so that some information do not become redundant because of a rule-based approach on disclosures;
- at last, judgmental approach will ensure that a trade-off is made for confidentiality purposes. In this respect, we are concerned that the disclosure requirements will lead to the publication of sensitive information about the entities’ business strategies. This is in particular true with regard to the provisions concerning the amount, timing and uncertainty of future cash flows, which require to disclose detailed quantitative information about the risk exposures of the entities.

In addition, we would rather have included paragraphs 44-52 in the application guidance (and not in the standard itself). That would avoid rule-based interpretation of the requirements (these paragraphs being understood as a checklist to be fully filled in by each entity) and would rather enable the entity to prepare a relevant information to the users of financial statements.

At last, we are concerned about the wording used by the IASB and which reinforces this “checklist” approach, i.e. the wording “shall” is used instead of “may or may not”.

Accounting alternatives to hedge accounting (1)

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?



1. Confirmation that accounting treatment should be based on management intention

We agree that if an entity has similar contracts with different business purposes, the entity should confirm their purpose through designation as “at fair value through profit or loss” or as “in accrual accounting”.

Indeed, for most utilities in the energy market the use of energy commodity contracts is twofold :

- 1) To provide a physical contract to sell expected generation and purchase for retail demand in the energy market. Those contracts are intended for physical delivery and are not net settled for the purpose of short-term profit making (type 1).
- 2) To provide a liquid traded market where traders can obtain dealer margins and benefit from short-term price fluctuations (type 2).

In that perspective, we support the intent of the IASB to demonstrate that “own use” contracts and “trading” contracts are dissimilar by different business purposes.

This dissimilarity by different business purpose can indeed be demonstrated through the use of appropriate organizational and portfolio structures, covering risk management policies and procedures and potentially people for the separation of trades performed for ‘own use’ and ‘trading’ purposes.

2. Need of more adequate “unit of account” of a contract

In this context, we think that there may be situations in which the fair valuation of own use contracts can provide for a better representation of the entities’ business models than accrual accounting. However, in our opinion this issue is not adequately solved since it results from the proposal that fair value accounting would apply mandatorily to any own use contracts that are managed based on fair value. This would inevitably result in higher volatility in the financial statements.

As an alternative, we believe that this issue would be more adequately solved if :

- (a) derivative accounting would be allowed as an option only ; **and**
- (b) if it can be considered that contracts may be composed of two or more separate contracts for the purpose of IFRS 9 under certain conditions.

(a) Derivative accounting option

Applying derivative accounting for contracts that otherwise meet all requirements for application of the “own use” exception should be left as an option since automatic application of fair value accounting for contracts managed at fair value would lead to profit and loss mismatch and volatility in some situations. This is especially occurring when contracts are



managed together with assets that are not in the scope of IAS 39 and are not fair valued (example: power plant accounted for according to IAS 16).

Example 1

In order to maintain a sufficient level of flexibility in terms of gas customers demand and power generation, it is customary for utilities to lease or own storage assets or purchase gas storage capacity contracts. Such storage facilities are mostly for the entity's own usage and will be primarily allocated to the actual gas storage needs of the entity. However, the capacities that exceed the expected usage requirements can be optimized or re-sold to another party, for instance, by buying physical summer gas and selling physical winter gas, or under the form of a written option for the usage of storage capacity.

Not all storage capacities fall under the scope of IAS 39 and are rather accounted for in accordance with IAS 16. While these physical assets are managed based on their fair value together with optimization transactions (transactions linked to the excess capacity), compulsory fair value accounting of these optimization transaction may in some circumstances create a P&L mismatch if "all legs" are not accounted for on the same measurement basis.

Example 2

In the energy industry, it is common practice to manage power plants and related electricity sales on a fair value basis. In this case, the fair valuation of the sales contracts would lead to an accounting mismatch and therefore "artificial" volatility in profit or loss, as the power plants are still subject to accrual accounting according to IAS 16.

On the other hand, there are cases where it can make sense to apply the same accounting treatment to all contracts within a portfolio. This could be the case when for example electricity or gas supply contracts have to be fair valued because part of the volume is economically managed by using derivatives. In this case, it could be appropriate to fair value physical supply contracts to end-customers that actually qualify for own use accounting under IAS 39 at fair value as well in order to avoid accounting mismatches.

Against this background, we propose to introduce a fair value option for own use contracts in particular for the purpose of avoiding accounting mismatches that is similar to the fair value options for financial assets and financial liabilities as governed by IFRS 9 par. 4.1.5 and 4.2.2.



(b) Composed contracts issue

Furthermore, commodity contracts often contain volume flexibilities, and in some circumstances³ it would be appropriate to consider them separately from the rest of the contract. For long term commodity purchase or sales contracts, it can also be appropriate to consider different blocks of volumes within one single contract.

The separate treatment can be adequate because of a different business purposes, e.g. physical delivery for own use purposes of a fixed quantity and profit-taking activities for an additional optional volume (so that accrual accounting for one part and fair value accounting for another part is possible), or because of a different hedging strategy that will be applied to the different components of a contract.

A contract has two (or more) components that could have been the subject of two (or more) separate contracts in the following examples :

Example 1

An energy sales contract with a volume of 100, of which a minimum quantity of 75 and a flexibility of 25, can be considered as a combination of two separate contracts: a forward sale of 75 and a written option that allows the customer to purchase a quantity of 25.

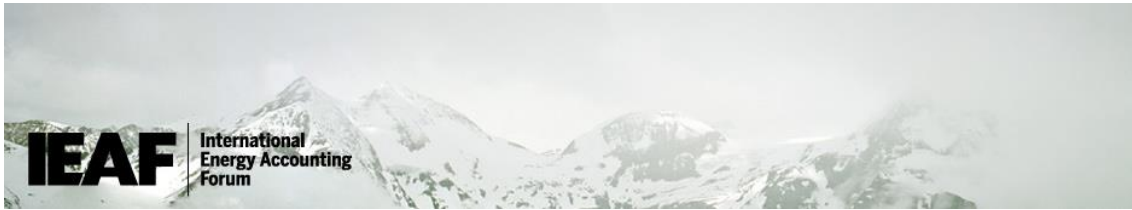
Example 2

An energy sales contract with a volume x and a price y, with a term of 2 years and an option to prolong 1 year at the same conditions, can be considered as a combination of two separate contracts: an energy sales contract with a volume x, a price y and a 2 year term, and a written option that allows the customer to buy at the same conditions (volume x, price y) during year 3.

Example 3

A long term gas purchase contract with an annual volume of 1000 take or pay, a price indexed on fuel and a term of 10 years, can be considered as a combination of two separate contracts: one with a volume of 800, and one with a volume of 200. The business intention of both contracts may be different. For example: 800 in accordance with the entity's expected purchase, sale or usage requirements, and 200 for trading activities.

³ This separation should be analysed on case-by-case basis since volume flexibilities can comply with different management intentions, i.e. one being made for "own use" purposes and others being concluded for optimization purposes (and managed therefore based on its fair value).



Example 4

In the course of their activities, it is customary for energy companies to enter into gas storage contracts that allow for the needed flexibility in terms of gas customers demand and power generation.

Storage contracts can fall in the scope of IAS 39 and be fair valued if it can be demonstrated that they meet the following criteria:

- the contracts respond to the definition of a derivative (their value change in response to an underlying; little or no initial investment; they settle at a future date),
- they can be net settled (which comes down to the existence of an active market), and
- the contract is not designated for 'own use'.

Storage capacity contracts are generally concluded over several years, for pre-determined fixed maximum quantities and are subject to strict operational constraints (e.g. in terms of injections and withdrawals). Though such contracts are mostly for the entity's own use and will be used to meet the actual gas storage needs of the entity, the contractual volumes that exceed the expected usage requirements can be optimized or re-sold to another party.

Split designation of such contracts, based on volumes, should be possible at the inception of the contracts and provided that the entity can ensure that the volumes sold to the market do not exceed the volumes designated as financial instruments.

We have noted that the IFRIC received in January 2010 a (quite similar) request to add an item to its agenda on providing guidance on whether a contract can be seen as two separate contracts for the purpose of applying paragraphs 5-7 of IAS 39. At that time, the IFRIC decided not to add this issue to its agenda arguing that the IASB would answer it through its project to replace IAS 39. This request has not been taken into account in the IFRS 9 proposal.

As a consequence, we propose that the following would be added to paragraph 8 of IAS 32 and would replace IFRS 9 proposal:

For the purpose of this Standard, a composed contract to buy or sell a non-financial item can be considered as two (or more) separate contracts under the following conditions:

- a) the contract has two (or more) components that could have been the subject of two (or more) separate contracts, which together would have had exactly the same impact as the composed contract*
- b) the cash flows and the risks of the separate components can be clearly identified and measured*



The choice to consider such a contract as two (or more) separate contracts has to be made at inception and cannot be revised afterwards.

Accounting alternatives to hedge accounting (2)

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?*

We believe that prohibiting hedge accounting for credit risk is a rule-based measure that does not fit to the objectives followed by the IASB. Rather, we would propose that hedge accounting should be applied if all criteria are otherwise met (i.e. eligibility of hedged item, consistency with risk management...).

However, we acknowledge that it may be difficult to achieve hedge accounting in practice for the reasons raised in the ED (hedge item cannot be reliably identified and measured). Therefore, we support the IASB in its efforts to investigate further in the development of the proposed alternatives.

We also ask the Board to consider this issue with respect to net investment hedges. The following example can provide useful information about instruments used in our groups.

Example

In the framework of its activities in Brazil, an entity (functional currency EUR) has decided to hedge its currency exposure in an optimal way. Because of a too huge difference between EUR and BRL, the risk management policy is to hedge this exposure through CDS. The entity considers this instrument as an insurance for which an annual premium is paid. Currently, this instrument is not eligible to hedge accounting while it is part of a documented risk management strategy.

Effective date and transition

Question 16

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



No, we do not agree with the proposal.

We instead propose to the Board to ask for an elective transition (either prospective or retrospective) that will enable the entity to

- either prospectively adopt requirements of hedge accounting.

Rationale behind this decision is coming from the significant change induced by the proposal;

- or to retrospectively adopt requirements of hedge accounting.

We believe that the argument in BC249 (“(...). *However, in accordance with the proposals, a hedge accounting relationship can be designated only prospectively. Consequently, retrospective application is not applicable*”) is not adequately used since we believe that prospective hedging designation would be applied at the first day of the restatement period if retrospective application was authorised (and therefore restatement necessary).

We think that an entity should generally apply the new requirements for hedge accounting prospectively, unless retrospective application would be practicable and allow for a better representation of the entity’s business model in the financial statements, i.e. when the retrospective application would directly reinforce the link between risk management policy and (hedge) accounting.

At last, we believe that transition requirements are moreover not clear enough and we are not sure to understand how the following example should be treated (simplistic assumptions have been taken).

Example:

Let us assume that the entity has a forecast transaction to purchase gas at a floating price. According to its risk management policy, the entity decides to protect itself against the exposure to changes in the variable price associated with this forecast transaction by concluding a swap to fix the price (T0). Since the entity is hedging only one component of the pricing formula, it cannot apply hedge accounting under IAS 39 (while all other criteria are met) so that the economic hedging instrument is accounted for at fair value through profit or loss.

According to IFRS 9, the risk being economically hedged can be designated in a hedging relationship.

	T0	T1	T2
Market price of underlying	20	25	30
Change in FV of hedged item	0	<5>	<10>
Change in FV of hedging instrument	0	5	10
"+" = gain ; "-" = loss			
T0 = trade date of the hedging instrument			
T1 = Effective date of IFRS 9			
T2 = First closing date after IFRS 9 is applied			
<u>Balance sheet</u>			
Financial asset	0	5	10
Retained earnings	0	<5>	<5>
Accumulated OCI	0	0	<5>
<u>Statement of comprehensive income</u>			
Gain/loss	0	<5>	0
Profit or loss	0	<5>	0
OCI	0	0	<5>
Total comprehensive income	0	<5>	<5>
"+" = debit ; "-" = credit			

In T3, when the hedged item impacts profit or loss, taking into account that market price remains constant (i.e. = 30 CU), the net result of the entity will be <25> CU composed of:

- 30 CU paid with respect to the sale at floating price; and
- 5 CU received with respect to the settlement of the swap.

Allowing retrospective application would result in accounting for a “net purchase” of 20 CU which is the hedged price:

	T0	T1	T1'	T2
Market price of underlying	20	25	25	30
Change in FV of hedged item	0	<5>	<5>	<10>
Change in FV of hedging instrument	0	5	5	10
"+" = gain ; "-" = loss				
T0 = trade date of the hedging instrument				
T1 = financial statement according to IAS 39 principles				
T1' = restatement of T1 according to IFRS 9 principles				
T2 = First closing date after IFRS 9 is applied				
<u>Balance sheet</u>				
Financial asset	0	5	5	10
Retained earnings	0	<5>	0	0
Accumulated OCI	0	0	<5>	<10>
<u>Statement of comprehensive income</u>				
Gain/loss	0	<5>	0	0
Profit or loss	0	<5>	0	0
OCI	0	0	<5>	<5>
Total comprehensive income	0	<5>	<5>	<5>
"+" = debit ; "-" = credit				

Our other concerns

1. Use of written option as hedging instrument

We believe that written options should also qualify as hedging instruments if they are designated as an offset to purchased options or to owned assets that have similar characteristics.

Power generating assets, such as gas-fired power plants represent real options for the owner of the plant because of the flexibility to let them run or not, based on the prevailing market prices. The embedded option in a gas fired-power plant can be referred to as a Clean Spark Spread Option⁴. Therefore, the revenues generated from a gas fired power plant can be characterized as a portfolio of clean spark spread call options.

It is customary to identify different economic hedging strategies that will achieve a risk-reward level consistent with the owner's risk aversion:

1. Fixed-price electricity and natural gas contracts such as forward contracts and swaps.

⁴ The annotation 'Clean' refers to the inclusion of costs for CO₂ into the plants economic value calculation.



These hedging strategies will usually meet the criteria to be accounted for as hedging instruments in a cash flow hedge relationship.

2. Tolling agreements⁵

These tolling agreements are often favoured by risk-averse entities who prefer to lock-in the capacity revenues. These are usually options with characteristics very similar to that of the power plant and are best described as “**synthetic power plant**”. This economic hedging instrument is rarely in the scope of IAS 39 and is therefore accounted for on an accrual basis.

We believe this accounting treatment is also appropriate.

3. Financial spark spread options, call/put options on electricity and on natural gas

The entity may have the market view that the electricity and natural gas prices will diverge, resulting in high natural gas prices and low electricity prices. That means an increase in the spark spread risk for the power plant. In this case, the entity will choose to sell electricity call options that pay out to the buyer when prices rise above the contracted strike power price. The entity can then use a portion of the sales proceed to purchase natural gas call options to protect against a rise in fuel costs.

This sale of options may not achieve hedge accounting in all circumstances, neither in IAS 39 or in IFRS 9.

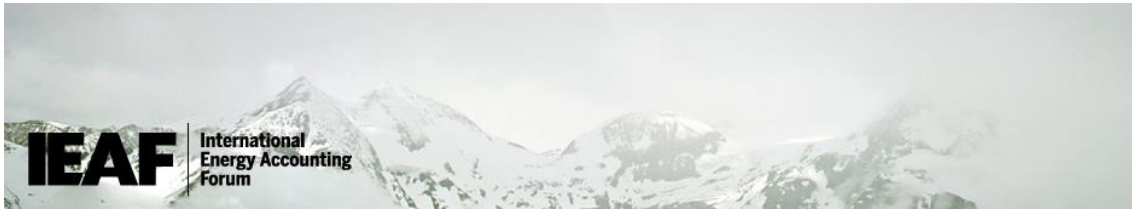
Since all strategies are entered into to reduce entity’s risk (even if using different ways) and are considered as economic hedges by risk management, we believe that all should be eligible to hedge accounting.

2. Guidance on written options is not clear

As it has sometimes led to issues when applying hedge accounting to certain (not net) written options, we would appreciate if the IASB clearly clarifies that a written option can qualify as hedging instrument if it aims to offset a purchase option (and when the combination does not constitute a net written option). Indeed we believe that paragraph 11 of IFRS 9 is misleading and is not clarified by any application guidance so far:

- However, a derivative instrument that combines a written option and a purchased option (eg an interest rate collar) does not qualify as a hedging instrument if it is, in effect, a net written option...

⁵ A tolling contract is essentially an option, whereby Party A sells to Party B the right to ‘call’ power from Party A in exchange of cash and gas and EUAs delivered by Party B to Party A on the expiry date.



- ... Similarly, two or more instruments (or proportions of them) may be designated as the hedging instrument only **if none of them** is a written option or a net written option.

We also suggest that judgment should be applied to assess whether a combination of a purchased option and a written option in substance constitutes a net written option. Compared to application guidance F.1.3. of IAS 39 and since hedge accounting has been sometimes difficult to apply (while economically justified), we believe that the most relevant factors in this assessment would be the following :

- except for the strike prices, the critical terms and conditions of the written option component and the purchased option component are the same (including underlying variable or variables, currency denomination and maturity date).
- the notional amount of the written option component is not greater than the notional amount of the purchased option component.

Indeed, we believe that the “net premium paid” criterion is highly subject to discussions and sometimes leads to disqualification of hedge accounting while the structure is economically hedging a risk. Furthermore, it would be appropriate to consider this criterion of net premium as the net cost of hedging so that accounting is aligned with risk management.

3. Open portfolio and macro hedging issue

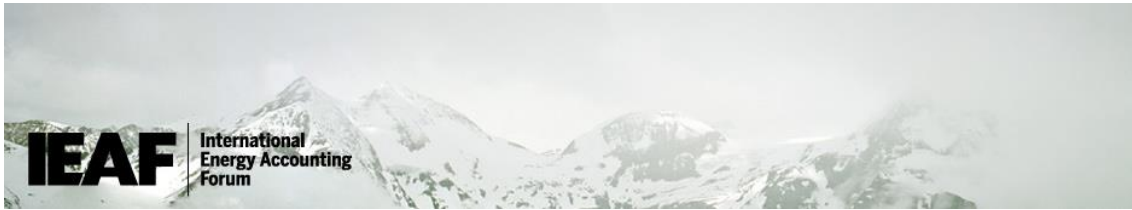
Even if we support the intent of the IASB to extend hedge accounting to groups of items and net positions, we regret that IASB decided to postpone improvements on open portfolio and macro hedging as these strategies are fully part of the risk management and risk mandates of our entities (see below our specific point on open portfolio and macro hedging issue).

We are also concerned that the arguments used to disallow hedge accounting for a net position in which the hedged items affect profit or loss in different periods are not robust enough. Among others, we point out BC169-173 explaining that allowing hedge accounting – and therefore deferring recycling of part of the MtM recognised in OCI – would be a “*significant departure from general IFRSs regarding the items that result from the forecast transactions*”. We believe instead that the issue has not been explored sufficiently and that the reasoning behind this decision requires a better explanation.

Moreover, as an alternative, we believe that in some situations hedge accounting should still be achieved (as it was in IAS 39):

Example

An entity has a net position of FC50 consisting of forecast purchases of FC150 in 12 months’ time and forecast sales of FC100 in 20 months’ time. This could be hedged



for 12 months using a forward foreign exchange contract under which the entity receives FC50 and pays CU25 (i.e. a 2:1 forward exchange rate).

Even if the net position consists of transactions that do not impact the profit and loss at the same reporting period, the entity will correctly argue the following:

- risk management is to hedge FC50 purchases out of FC150 in a 12 months period in accordance with ED/2010/13 par. 35 (designation of a component of a nominal amount);
- risk management is to leave at that moment the remaining position unhedged (i.e. remaining FC100 purchases and FC100 sales);

As a conclusion, hedging FC50 purchases should be still possible in that case since this transaction corresponds to the risk management policy that intends to achieve optimal offsetting and minimise ineffectiveness.

We ask then to the IASB to clarify accounting treatment in such a case.

4. Hedges of a net investment in a foreign operation

We are concerned about the lack of clarity of this ED with respect to the improvements made to hedge accounting and that are closely linked to net investment hedges. Especially, we would appreciate that the IASB clarifies that the following also applies to NIH.

According to paragraph 15, the Board has decided that an aggregated exposure that is a combination of another exposure and a derivative may be designated as a hedged item (see also question 3).

There are some situations where the hedging instrument in a NIH relationship is also the hedged item in a CFH relationship. We believe that a principle-based approach should allow the following structure to qualify for hedge accounting

Example

An entity has a translational exposure in USD in foreign subsidiaries.

According to its risk management, entity has concluded:

- a currency swap with a short-term maturity: this swap is rolled over each maturity period so that this instrument is a synthetic debt → this hedging instrument has been concluded in a NIH relationship and is eligible to hedge accounting (both in IAS 39 and in IFRS 9);
- a long-term swap (IRS): this swap has been concluded to transform the synthetic floating-rate debt in a fixed-rate debt → this hedging instrument has



been concluded in a CFH relationship and the exposure is composed of a number of currency swap (one contracted and the others being highly probable)

We understand from the ED that these future currency swaps are forecast transactions that can be designated as hedged items as far as they meet IFRS 9 criteria (i.e. highly probable criterion). However, we fear that the interaction with NIH would lead to different interpretations and practices. Therefore, we ask the IASB to clarify the accounting treatment of such a structure.

5. Sub-libor issue

We are concerned about the restriction that mentioned in B24 that if a component of the cash flows of a financial asset or financial liability is designated as the hedged item, that component must be less than or equal to the total cash flows of the asset or liability (e.g sub-libor example).

We think that this restriction is rule-based. Our industry would only be impacted by such a rule when commodity transactions become financial assets or liabilities (this is the case when an own use transaction does no longer qualify for own use, e.g. because of practice of net settlement). On that discrepancy especially, we believe that two contradictory accounting models should not remain and since we think that this restriction is rule-based, we would like to ask the IASB to remove it.

Example 1

An entity may decide to hedge a component of a highly probable transaction that is greater than the total cash flows of the highly probable transaction.

The company sells LNG ex-ship that is delivered at the regasification terminal. The sales price is a “net back price” of the reference market price of the area (e.g. NBP or Henry Hub indexes). The sales price is usually designed as being “x% index +/- y”.

whereby:

- “X” is constant and represents the “retainage percentage” of the terminal
- “Y” may be a fixed amount, usually negative and representing the access costs to the market (such as pipe gas transport from the terminal to the market) and the margin. Or “Y” may also be a basis between the area of delivery and the market, then it is variable and may be either positive or negative.

The risk management objective regarding these contracts is to hedge the variability of the cash flows attributable to the sales price (and thus hedging only the variable indexes).



We believe that hedge accounting should be available in such a situation.

Example 2

The physical coal market has grown up over the last years, but it remains characterised by a lack of maturity and transparency that is difficult to manage because there are many different qualities of coal and that all the market participants don't have the same interest for one coal or for another one. Therefore, it is difficult for traders to see clearly in the coal's price and to create a market.

In order to institute a market and to allow/facilitate trades to take place, indexes have been created, such as:

- API#2 (API stands for "All Publications Index"). It shows the "CIF" (Cost, insurance and freight) delivered price in the region of ARA (Amsterdam, Rotterdam, Antwerp) which is Europe's main gateway for imported coal. It is the most followed European physical index.
- API#4 shows the "FOB" (Free On Board) coal price for deliveries at Richards Bay (South Africa). It is the other important price index for coal.

Adjacent to the physical market, there is a financial swap market on these indexes that offers more liquidity and allows "paper trades" to take place and hedging the price of physical coal contracts.

For instance, it happens that some lower coal qualities (e.g. Indonesia) are traded at spreads of API#4 minus 10 to 15 USD/Ton, that will then be hedged at a later date using API#4 financial swaps, which could give rise to a situation where the cash flow related to the hedged component (in notional amount) is greater than the total cash flows related to the highly probable transaction (as a whole).

6. Hedging a forecast transaction to acquire a business

We have listed the following paragraphs available in IFRS 9 regarding transaction to acquire a business:

B7 A firm commitment to acquire a business in a business combination cannot be a hedged item, except for foreign currency risk, because the other risks being hedged cannot be specifically identified and measured. Those other risks are general business risks.

BC118 The Board did not consider new designations of any hedging relationships of the acquiree in the consolidated financial statements of the acquirer following a



business combination. The Board noted that this is a requirement of IFRS 3 Business Combinations and hence not within the scope of its project on hedge accounting.

We are concerned about the fact that some could interpret these paragraphs as a restriction to apply hedge accounting when an entity decides to protect itself against the exposure to changes in the foreign exchange rate associated with the forecast transaction to acquire a business.

Even if we agree that the highly probable criterion would not be met in some cases, we however think that there is no rational basis to exclude a transaction from hedge accounting through a rule-based approach to the extent that all criteria in IFRS 9 are met (being especially highly probable forecast transaction and consistency with risk management policy).



Appendix 2: accounting treatment consequences of rebalancing principle (question 7)

Regarding rebalancing itself

B47 If a hedging relationship ceases to meet the objective of the hedge effectiveness assessment, or is expected to do so, an entity determines whether the risk management objective for that hedging relationship remains unaltered. If so, the hedging relationship is adjusted so that the new hedge ratio again meets, or is no longer expected to cease to meet, the objective of the hedge effectiveness assessment (rebalancing). Rebalancing is accounted for as a continuation of the hedging relationship in accordance with paragraphs B48–B60. On rebalancing, the hedge ineffectiveness of the hedging relationship is determined and recognised in profit or loss immediately before adjusting the hedging relationship.

This determination of hedge effectiveness is further detailed in B50-52 and it follows that the entity should analyse the sources of hedge ineffectiveness in two kinds of situations:

1. Fluctuations around the hedge ratio that remains valid

This situation is not a case of rebalancing but rather a matter of measuring and recognising hedge ineffectiveness.

Our understanding is that the risk management objectives are still in line with the instruments used. But due to the effectiveness test realised (e.g. through the dollar offset method), ineffectiveness should be recognised. In a cash flow hedge, this situation happens when a proxy hedge is used and only to the extent the hedging instrument is overhedging the hedged item (due to the “lower of” principle to be applied in accordance with paragraph 29, ineffectiveness only occurs when the absolute value of change in fair value of the hedging instrument is larger than the absolute value of the change in fair value of the hedged item).

Example

Let us assume that the entity has a forecast transaction to buy gas at floating price at T0. According to its risk management policy, the entity decides to protect itself against the exposure to changes in the cash flows associated with the forecast transaction by concluding a swap to fix the price. The instrument used is a proxy that will minimise ineffectiveness. All other IFRS 9 criteria are met at inception of the hedge.

Forecast purchase transaction	T0	T1	T2
Market price of underlying	20	25	30
Change in FV of hedged item	0	<5>	<10>
Change in FV of hedging instrument	0	4	12
"+" = gain ; "-" = loss			
Ineffectiveness	0	0	2
Financial asset	0	4	12
Retained earnings	0	0	<2>
Accumulated OCI	0	<4>	<10>
"+" = debit ; "-" = credit			

Application guidance B51 is therefore limited to the calculation of ineffectiveness in a situation where the hedge ratio is not expected to change (no rebalancing, neither on the hedging instrument nor on the hedged item).

We would therefore ask the IASB to clarify the application guidance B51 in that way so that the accounting treatment is made clear.

2. *The hedge ratio no longer appropriately reflects the relationship between the hedging instrument and the hedged item*

This situation is a case of both rebalancing the hedging relationship but also measuring and recognising hedge ineffectiveness.

Our understanding is that the risk management objectives are or are expected to be no longer in line with the instruments used. In that situation, the risk management is expected to rebalance accounting wise (but economic wise as well if appropriate instruments are available) its hedge relationship by adjusting its hedge ratio.

Example 1: underhedging relationship

Let us assume that the entity has a forecast transaction to buy gas (10 quantities) at floating price at T0. According to its risk management policy, the entity decides to protect itself against the exposure to changes in the cash flows associated with the forecast transaction by concluding a swap to fix the price (the whole forecast transaction is hedged as from T0). The instrument used is a proxy that will minimise ineffectiveness at T0. All other IFRS 9 criteria are met at inception of the hedge.

Risk management objectives are assessed not to be in line anymore as from T3 since there is a trend leading away from the hedge ratio.

The entity is then calculating any ineffectiveness before adjusting the hedging relationship. According to the "lower of" principle set out in paragraph 29, the entity does not recognise any ineffectiveness (underhedging relationship).

Furthermore, the entity is recalculating at that time (T3) the new hedge relationship and is therefore rebalancing its hedge ratio by designating the following:

- the hedging instruments (with a notional of 10 quantities) remain unchanged;
- the hedged item is being economically hedged only for a notional of 9 quantities.

Forecast purchase transaction	Notional	T0	T1	T2	T3
Market price of underlying		20	23	25	27
Change in FV of hedged item	10	0	<30>	<50>	<70>
Change in FV of hedging instrument	10	0	30	46	63
Ineffectiveness		0	0	0	0
"+" = gain ; "-" = loss					
Financial asset		0	30	46	63
Retained earnings		0	0	0	0
Accumulated OCI		0	<30>	<46>	<63>
' "+" = debit ; "-" = credit					
Hypothetical new hedged item					
Change in FV of hedged item	9	0	<27>	<45>	<63>

Example 2: overhedging relationship

Let us assume that the entity has a forecast transaction to buy gas (10 quantities) at floating price at T0. According to its risk management policy, the entity decides to protect itself against the exposure to changes in the cash flows associated with the forecast transaction by concluding a swap to fix the price (the whole forecast transaction is hedged as from T0). The instrument used is a proxy that will minimise ineffectiveness at T0. All other IFRS 9 criteria are met at inception of the hedge.

Risk management objectives are assessed not to be in line anymore as from T3 since there is a trend leading away from the hedge ratio.

The entity is then calculating any ineffectiveness before adjusting the hedging relationship. According to the "lower of" principle set out in paragraph 29, the entity does recognise (on a cumulated basis between T1 and T3) 9 CU of ineffectiveness (overhedging relationship).

Furthermore, the entity is recalculating at that time (T3) the new hedge relationship and is therefore rebalancing its hedge ratio by designating the following:

- the hedged item (with a notional of 10 quantities) remains unchanged;
- the hedge relationship will then be based on hedging instruments with a notional of 9 quantities (these instruments still qualify for hedge accounting);

- therefore the remaining hedging instrument (notional of 1 quantity) will be considered as trading and will then be measured at fair value through profit or loss (or will be considered in another new hedging relationship);

Forecast purchase transaction	Notional	T0	T1	T2	T3
Market price of underlying		20	23	25	27
Change in FV of hedged item	10	0	<30>	<50>	<70>
Change in FV of hedging instrument	10	0	31	54	79
Ineffectiveness		0	1	4	9
"+" = gain ; "-" = loss					
Financial asset		0	31	54	79
Retained earnings		0	<1>	<4>	<9>
Accumulated OCI		0	<30>	<50>	<70>
' "+" = debit ; "-" = credit					
Hypothetical new hedging instrument					
Change in FV of hedging instrument	9	0	28	49	71

We would like to ask the IASB to clarify the application guidance B52 in that way so that the accounting treatment is made clear and confirm that the example is directly linked to application guidance B54 and B56.

B54 (...) *Changes in volume refer to the quantities that are part of the hedging relationship. Hence, decreases in volumes do not necessarily mean that the items or transactions no longer exist, or are no longer expected to occur but that they are not part of the hedging relationship. For example, decreasing the volume of the hedging instrument can result in the entity retaining a derivative but only part of it might remain a hedging instrument of the hedging relationship. This could occur if the rebalancing could be effected only by reducing the volume of the hedging instrument in the hedging relationship, but the change in the volume is such that it does not allow the entity to unwind the part of the hedging instrument that is no longer needed (eg because of the minimum lot size of a standardised derivative contract). In that case the undesignated part of the derivative would be accounted for at fair value through profit or loss (unless it was designated as a hedging instrument in a different hedging relationship).*

B56 *Adjusting the hedge ratio by decreasing the volume of the hedging instrument does not affect how the changes in the fair value of the hedged item are measured. The measurement of the changes in the value of the hedging instrument regarding the volume that continues to be designated also remains unaffected. However, from the date of rebalancing, the volume by which the hedging instrument was decreased is no longer part of the hedging relationship. For example, if an entity originally hedged the price risk of a commodity using a derivative volume of 100 tonnes as the hedging instrument and reduces that volume by 10 tonnes on rebalancing, a notional amount of 90 tonnes of the hedging instrument volume would remain (see*



paragraph B54 regarding the consequences for decreasing the derivative volume (ie the 10 tonnes) that is no longer a part of the hedging relationship).

→ to clarify the application guidance based on our example (this issue is indeed critical): is the remaining forecasted transaction in the hedging relationship after rebalancing deemed to be 90 or 100?

Regarding rebalancing due to dynamic hedging

We would also ask the IASB to confirm our interpretation of rebalancing transactions being applied to dynamic hedging, i.e. transactions concluded in view of increasing or decreasing the hedging instruments with respect to market prices changes considerations.

We assume in the following two examples that critical terms between hedged items and hedging instruments are perfectly matched (no source of ineffectiveness is observed). All other IFRS 9 criteria are met at inception of the hedge.

1. Increasing the hedging relationship

Let us assume that the entity has a forecast transaction to buy gas (10 quantities) at floating price at T0. According to its risk management policy, the entity decides to protect itself against the exposure to changes in the cash flows associated with the forecast transaction by concluding a swap to fix the price. At that time, the hedge cover ratio of the entity is 60% (i.e. 60% of the forecast transaction should be hedged)

At T2, the risk management objective is to increase the hedge cover ratio to 70% so that a new hedging instrument (notional amount of 1) is concluded to fix the price on the additional hedged forecast transaction.

The entity is first calculating any ineffectiveness before adjusting the hedging relationship. Since all critical terms match, there is no ineffectiveness attributable to the transactions.

Furthermore, the entity is then recalculating at that time (T2) the new hedge relationship and is therefore rebalancing its hedge ratio by designating the following:

- the hedged item is increased from 6 quantities being hedged to 7 quantities;
- the existing hedging instruments are still accounted for as cash flow hedges, i.e. the change in its fair value being recognised in OCI for the effective portion (being assumed fully effective in this illustrative example);
- the new hedging instrument is being designated in a new hedging relationship and is therefore accounted for as a cash flow hedge.

Forecast purchase transaction	Notional	T0	T1	T2	T3
Market price of underlying		20	23	25	27
Change in FV of hedged item	6	0	<18>	<30>	<42>
Change in FV of hedged item	1	-	-	0	<2>
Change in FV of hedging instrument	6	0	18	30	42
Change in FV of hedging instrument	1	-	-	0	2
Ineffectiveness		0	0	0	0
"+" = gain ; "-" = loss					
Financial asset		0	18	30	44
Retained earnings		0	0	0	0
Accumulated OCI		0	<18>	<30>	<44>
' "+" = debit ; "-" = credit					

We ask the IASB to clarify the application guidance by developing such an example and confirm interpretation of B57, i.e. confirming that concluding different hedging instruments at different points in time with different critical terms does not preclude for the change in fair value of hedging instruments to be fully recognised in other comprehensive income.

B57 *Adjusting the hedge ratio by increasing the volume of the hedging instrument does not affect how the changes in the fair value of the hedged item are measured. The measurement of the changes in the value of the hedging instrument regarding the previously designated volume also remains unaffected. However, from the date of rebalancing, the changes in the value of the hedging instrument also include the change in the value of the additional volume of the hedging instrument. The changes are measured starting from and by reference to the date of rebalancing instead of the date on which the hedging relationship was designated. For example, if an entity originally hedged the price risk of a commodity using a derivative volume of 100 tonnes as the hedging instrument and added a volume of 10 tonnes on rebalancing, the hedging instrument after rebalancing would comprise a total derivative volume of 110 tonnes. The change in the fair value of the hedging instrument is the total change in fair value of the derivatives that make up the total volume of 110 tonnes. These derivatives could (and probably would) have different critical terms, such as their forward rates, because they were entered into at different points in time (including the possibility of designating derivatives into hedging relationships after their initial recognition).*

Based on what precedes, we therefore understand from this ED that the accounting treatment mechanics and the assessment of hedge effectiveness in the framework of dynamic hedging is simplified.

2. Decreasing the hedging relationship

Let us assume that the entity has a forecast transaction to buy gas (10 quantities) at floating price at T0. According to its risk management policy, the entity decides to protect itself against the exposure to changes in the cash flows associated with the



forecast transaction by concluding a swap to fix the price. At that time, the hedge cover ratio of the entity is 60% (i.e. 60% of the forecast transaction should be hedged)

At T2, the risk management objective is to decrease the hedge cover ratio to 50% so that a new hedging instrument (notional amount of 1) is concluded to partially offset the existing hedging instrument. The hedged item is expected to remain unchanged.

The entity is first calculating any ineffectiveness before adjusting the hedging relationship. Since all critical terms match, there is no ineffectiveness attributable to the transactions.

Furthermore, the entity is then recalculating at that time (T2) the new hedge relationship and is therefore rebalancing its hedge ratio by designating the following:

- the hedged item is decreased from 6 quantities being hedged to 5 quantities;
- the existing hedging instruments as well the new hedging instrument are accounted for as cash flow hedges, i.e. the change in their fair values being recognised in OCI for the effective portion (being assumed fully effective in this illustrative example).

Forecast purchase transaction	Notional	T0	T1	T2	T3
Market price of underlying		20	23	25	27
Change in FV of hedged item	6	0	<18>	<30>	<42>
Change in FV of hedged item	-1	-	-	0	2
Change in FV of hedging instrument	6	0	18	30	42
Change in FV of hedging instrument	-1	-	-	0	<2>
Ineffectiveness		0	0	0	0
"+" = gain ; "-" = loss					
Financial asset		0	18	30	40
Retained earnings		0	0	0	0
Accumulated OCI		0	<18>	<30>	<40>
'"+" = debit ; "-" = credit					

We ask the IASB to clarify the application guidance by developing such an example and confirm that in that situation, all “legs” would be accounted for as cash flow hedges.



Appendix 3: Members of the International Energy Accounting Forum

Atel	www.atel.eu
BG Group	www.bg-group.com
EDF	www.edf.com
EGL	www.egl.ch
EnBW	www.enbw.com
EWE	www.ewe.de
Fortum	www.fortum.com
Gas Natural	www.gasnatural.com
Gazprom	www.gazprom-mt.com
GDF SUEZ	www.gdfsuez.com
OMV	www.omv.com
OPG	www.opg.com
RWE	www.rwe.com
Scottish Power	www.scottishpower.com
Union Fenosa	www.unionfenosa.es
Vattenfall	www.vattenfall.com

Appendix 4: Utilities are a major industry in Europe

