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International Accounting Standards Board  
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**Reference: Exposure Draft ED/2010/13 – Hedge Accounting**

Dear Board Members and IASB Staff:

Constellation Energy Group, Inc. (“Constellation Energy”) respectfully submits comments on the International Accounting Standards Board (“IASB” or “Board”) Exposure Draft, *Hedge Accounting* (the “ED”). Constellation Energy is a leading supplier of energy products and services to wholesale and retail electric and natural gas customers in the United States (U.S.). In addition, we own a diversified fleet of generating units located throughout the U.S. and Canada. A FORTUNE 500 company headquartered in Baltimore, Maryland, Constellation Energy had revenues of \$14.3 billion in 2010.

We use hedging strategies extensively in conducting our business and thus we support the IASB and Financial Accounting Standards Board (“FASB”) efforts to simplify hedge accounting. The hedge accounting standards have evolved over the years into complex, rules-driven standards that simultaneously provide challenges for preparers to comply and users to understand. The IASB’s general approach in this exposure draft of replacing rules and bright lines with principles and objectives will improve and simplify the hedge accounting model and we strongly support this approach. However, we believe there are areas where the ED continues to rely on rules which we believe will retain some of the complexity of the current model. Finally, we believe the Boards should continue to work together to reach a converged solution on this topic as hedge accounting can have a significant impact on an entity’s financial statements and thus divergence will detract from a user’s ability to compare companies.

## Comments

We participated in drafting the comment letter submitted by the Edison Electric Institute (EEI), and we fully support the recommendations communicated in that letter. In particular, we emphasize our support for the following provisions in the ED, which we view as superior to the current requirements:

- The elimination of bright lines in assessing whether hedge accounting can be applied to contracts entered into for risk management purposes. Risk management strategies generally do not limit a company to using economic hedging strategies that are greater than 80% effective and thus similarly the accounting requirements should not impose this arbitrary limitation.
- The ability to hedge risk components in non-financial items. This is particularly relevant to the electric industry where we face risks from both volatility in the price of the commodity and the requirement to deliver the commodity to a specific location. It is generally not possible or cost effective to hedge the transportation component of a power contract and thus for risk management purposes only the commodity is hedged. Permitting component hedging for non-financial items will better align risk management and hedge accounting similar to the benefit currently achieved for financial risk components.
- The ability to hedge net positions, whether they are net positions comprised of offsetting exposures or exposures with derivatives. As part of our natural gas delivery business, we make purchases and sales of natural gas at different locations along various pipelines. The gross risks in these transactions include a decrease in price for the sale of gas at location A (the delivery point), which is made up of the underlying price of natural gas and delivery costs for us to move the gas to location A, and an increase in the price for the purchase of gas at location B, which is made of the underlying price of natural gas and the delivery cost for our suppliers to move the gas to location B (the “injection” point). The risk of change in the price of the underlying commodity would naturally offset and thus the net risk from this business is the basis difference between the two locations. In order to achieve hedge accounting under the current requirements, a company would be required to separately hedge the purchase of gas at location A and the sale of gas at location B which involves four separate derivative contracts. In contrast, our company economically hedges the basis difference risk through a single basis difference swap that settles based upon the difference in the price at the two locations. However, because both legs of the basis swap provide for variable payments and do not “fix” the cash flows, currently we are required to mark the derivative to fair value through earnings even though it perfectly offsets the hedged risk. The Board’s proposal to allow net hedging would enable us to achieve hedge accounting for the basis swap and thus align our accounting with our risk management strategy.

- The ability to continue hedge accounting (rebalancing rather than dedesignating) when the hedging relationship is adjusted. Due to the volatile nature of the commodity markets as well as the dynamic nature of customer activity in the industry, we generally consider and potentially adjust our hedge positions on a regular basis through a series of dedesignations and redesignations. This currently requires extensive efforts to redocument and retest each hedging relationship as a new relationship and creates ineffectiveness due to the derivatives then having a non-zero fair value. However, this ineffectiveness is merely a result of applying the accounting requirements and is not due to a break down in the economic relationship between the hedge and the hedged item and thus does not provide meaningful information to investors.
- The ability to designate a previous hedging instrument into a subsequent hedging relationship. This was a main concern our industry had with the FASB's proposal due to the introduction of an arbitrary rule that would increase complexity and documentation requirements. From a risk management perspective, a company does not prohibit itself from 'reusing' a derivative and thus it was unclear why the accounting requirements would impose such a limitation.

While we support many aspects of the ED, we disagree with certain of its proposals for the reasons described below.

We reiterate EEI's concerns about and disagreement with the elimination of the ability to voluntarily dedesignate a hedging relationship. We believe the current framework for cash flow hedge accounting, including dedesignations and redesignations, has worked well and faithfully presents the results of hedging activities consistent with an entity's risk management policy and strategy. Particularly, the current model provides an entity with the flexibility to proactively adjust hedging relationships which is often required due to changes in the markets and changes within the entity. It is unclear whether the rebalancing concept in the ED provides the flexibility needed to keep hedge accounting aligned with an entity's risk management strategy.

We acknowledge a perceived weakness of the current requirements is that an entity can discontinue hedge accounting even when such action is contrary to its risk management objective and strategy. However, we believe the Board could address this issue by linking the dedesignation to the entity's documented risk management strategy instead of by simply eliminating the concept of dedesignations. Specifically, we recommend the Board amend ¶91c. in IAS 39 as follows: "the entity revokes the designation in accordance with its risk management strategy." We believe this amendment will make it clear that dedesignations (and potentially redesignations) are permitted under the framework of hedge accounting but only when such action is consistent with the entity's risk management strategy.

We note the following extreme examples of why an entity may currently dedesignate a hedging relationship:

- An entity dedesignates the hedged item from a hedging relationship that was 80% effective and redesignates the hedged item into a subsequent hedging relationship that is 100% effective, for instance using a compound derivative that includes the original hedging instrument. As the action increases the effectiveness of the hedging relationship this type of transaction would likely be in accordance with the documented risk management strategy and thus would be permitted by our recommendation. Our concern with the Board's proposal is that this increase in effectiveness may not qualify as a rebalance and thus would not achieve hedge accounting.
- An entity has a risk management strategy of fixing the price of forecasted purchases of fuel through the use of derivatives. If the entity elects hedge accounting, then a decrease in the forward market price of the fuel would cause unrealized losses on its derivative hedges that the entity would record in AOCI. If there were a substantial decrease in fuel prices, the risk of future price increases may now be greater than the risk that fuel prices would continue to fall. In this case, if management were to dedesignate the hedge but retain the derivative without redesignating it in another hedging relationship, subsequent increases in fuel prices would be recorded as mark-to-market gains. While there should not be an absolute prohibition against dedesignation in this instance, the action should only be permitted if the entity can demonstrate that it is in accordance with its documented risk management strategy.

In summary, whether called dedesignations and redesignations (current framework), rebalancing (IASB proposal), or modification (FASB proposal), the final proposal needs to permit an entity to maintain hedge accounting for a variety of hedging strategies. We recommend the Board provide additional guidance including examples to ensure that rebalancing and/or discontinuing and reestablishing hedging relationships meets the Board's objective of keeping hedge accounting and risk management aligned. The examples included in the ED generally focus on changes to the hedge ratio and occurrence of a severe credit deterioration but providing additional diverse examples will help demonstrate the principles and objectives of the revised standard.

## **Conclusion**

Constellation Energy appreciates the opportunity to provide comments on these important issues. Hedging activities are significant to our business and we want to ensure the accounting continues to faithfully represent our risk management policy and strategy as well as the underlying economics of the transactions.

Very truly yours,

/s/ Bryan P. Wright

Vice President, Chief Accounting Officer and Controller for Constellation Energy