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Vice President

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International Accounting Standards Board
30 Cannon Street
London, EC4M 6XH
United Kingdom

Email: www.ifrs.org

Reference: Exposure Draft ED/2010/13 – Hedge Accounting

Dear Sir or Madam:

The Edison Electric Institute¹ (EEI) respectfully submits our comments on the IASB's Exposure Draft on Hedge Accounting (ED). EEI appreciates the opportunity to comment on the above-referenced ED.

EEI supports the issuance of high quality accounting standards that provide transparency in financial statements and meet the needs of investors and other readers. We further support the goal of attaining a single set of high quality global standards through convergence efforts with the Financial Accounting Standards Board (FASB). While the majority of our member companies presently apply U. S. generally accepted accounting principles (GAAP), we strongly encourage the IASB and the FASB to reach a converged standard that will improve transparency and comparability upon adoption. We have made this same appeal to the FASB. It is in this light that we offer our comments.

Summary

We concur with the assessment of both IASB and FASB that the existing hedge accounting guidance is highly rules-based, complex and inflexible. Achieving hedge accounting treatment is often difficult, even while accomplishing a rational risk management strategy. As such, the current hedge accounting model often does not adequately portray an entity's risk management activities. These deficiencies, in turn,

¹ EEI is the association of United States shareholder-owned electric companies. Our members provide service to 95 percent of the ultimate customers in the shareowner-owned segment of the industry and represent approximately 70 percent of the United States electric power industry.

have led many investors to look to companies to make additional, unaudited disclosures that recast accounting results as economic results in order to report the entity's hedging activities consistent with its risk management strategy and objectives. Transparency, relevance, and faithful representation of these activities within financial statements, as well as comparability across reporting entities, is compromised.

Fundamentally, we agree with the IASB's principles-based approach underpinning a revised hedge accounting model. We believe that the articulation of a clear objective for hedge accounting is a necessary, important foundation for establishing appropriate specific guidance. In that regard, we strongly support the objective in Paragraph 1 of the ED that hedge accounting should "represent...the effect of an entity's risk management activities" and "convey the context of hedging instruments in order to allow insight into their purpose and effect." We believe it is critical to acknowledge that many entities use derivatives for hedging purposes, particularly to manage risks associated with forecasted transactions, and that the guidance for derivatives should reflect an entity's risk management activities rather than establishing significant impediments to applying hedge accounting.

Conceptually, we also support much of the specific approach to hedge accounting proposed in the ED. Overall, these provisions effectively implement the objective of establishing a hedge accounting framework that more faithfully represents risk management activities in the financial statements.

Specific provisions of the ED that we support and key considerations for our member companies include:

- Elimination of bright lines in assessing whether hedge accounting can be applied to contracts entered into for risk management purposes
 - We believe the elimination of bright lines acknowledges the real-life complexity of risk management and will result in improved financial reporting that reflects entities' risk management activities. Entities face many risks, some of which may be mitigated through hedging activities, some may be mitigated through additional controls, and some cannot be mitigated at a reasonable cost. Each entity must continually assess the risks it faces and the costs of mitigating those risks against its risk appetite. Additionally, the types of instruments available to hedge a risk exposure may be several or few, perfect or imperfect, and/or traded in liquid or illiquid markets. Risk management is complex, requires significant judgment and needs the flexibility to adjust to changing conditions. We support accounting standards that take these realities into account.

- Ability to hedge risk components in non-financial items
 - The utility industry regularly uses various inputs (fuel) to create outputs (electricity), and it also purchases and delivers products that are priced based upon an underlying commodity (electricity, natural gas, and other fuels) plus a transportation cost. The ability to achieve hedge accounting for fuel costs in a coal transportation contract or to hedge gas commodity prices without the related transportation (basis) costs will result in accounting results that reflect economic results.
 - We strongly believe that component hedging should include relationships where the hedged component may exceed the total value of the forecasted transaction. We describe these situations and the reason for our view in more detail later in this letter.
- Ability to hedge net positions, whether they are net positions comprised of offsetting exposures or exposures with derivatives
 - This change will allow accounting documentation to align with actual risk management activities. For example, a utility may sell the forecasted output of its generation units on a forward basis by entering into a calendar-year electricity contract, which is a common instrument. However, for most generating plants, a maintenance outage is planned for a few weeks during the year. Overall, the calendar-year contract is still an effective hedge, but the addition of a forward purchase to offset the period of the maintenance outage perfects the hedge. Currently, unless the contracts were entered into simultaneously, it was difficult to achieve hedge accounting for the net position.
- Hedge accounting treatment for option premiums
 - We concur with the view that, when options are used for risk management purposes, the premiums are, economically, similar to insurance premiums. We further agree that the ability to reflect the cost of option premiums in a like manner will improve accounting results.
- The ability to continue hedge accounting (rebalancing rather than dedesignating) when the hedging relationship is adjusted
 - Our member companies have encountered instances when the hedging instrument changed, which has “created” ineffectiveness or even resulted in the discontinuation of hedge accounting treatment. Current requirements to dedesignate and redesignate a hedging relationship are administratively burdensome and artificially give rise to ineffectiveness for accounting purposes even though neither the hedged item nor the hedging instrument has been terminated. We believe this proposal better reflects the underlying economics where an existing relationship was continued and not terminated.

- Designating a previous hedging instrument into a new hedge relationship
 - This proposal is in accordance with the objective that risk management should be reflected in hedge accounting and does not introduce a rule that could cause an unnecessary breakdown in this link. As more fully explained in our comment letter on the FASB's hedge accounting proposal, which would prohibit this approach, the result of such a prohibition would be to (1) prevent entities from achieving hedge accounting in instances where they were economically hedged or (2) cause an entity to transact externally for the sole purpose of achieving hedge accounting.
(EEI comment letter to the FASB link– <http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175821405903&blobheader=application%2Fpdf>)

However, while we support many of the overall aspects of the ED, we believe that a few of the proposed changes need to be revised in order to meet the document's objective of enhancing entities' ability to reflect more transparently the economic results of risk management activities within their financial reporting. We discuss our specific concerns and recommendations below.

Voluntary Rebalancing and Discontinuing Hedge Accounting

We believe that provisions related to rebalancing and discontinuing hedging relationships need to be clarified or revised in order to accommodate common risk management strategies if the ED's objective is to be achieved. Many entities frequently adjust the level of their cash flow hedges voluntarily in order to achieve their risk management objective. Failure to permit hedge accounting for normal risk management adjustments would reduce, rather than increase, the alignment between hedge accounting and risk management activities.

Therefore, we believe that the rebalancing provisions should explicitly recognize and permit hedge accounting for voluntary changes in hedge levels consistent with an entity's risk management objective, even when those changes might reduce the hedge level or be executed with offsetting derivatives. As noted in our comment letter to the FASB, we strongly disagree with overly restrictive limitations on adjustment of hedging relationships when those adjustments are consistent with an entity's risk management objective and are permitted under existing accounting requirements. Absent clarification of the ED, we believe it is possible that reporting entities could decrease their use of hedge accounting if the final standard is interpreted to exclude some of the most common dedesignation and rebalancing activities that presently are eligible for hedge accounting.

Risk management commonly involves “risk selection” rather than simply risk reduction, as noted earlier in our comments. At times, continuing to maintain a hedge may increase the risk of adverse price movements to an entity, and as a result there are instances where effective risk management involves reducing hedge levels. IFRS and U.S. GAAP presently permit adjustment of hedge levels (increases as well as decreases) by means of dedesignation and/or redesignation of hedges to continue to be accounted for as cash flow hedges. We provide specific examples of these circumstances later in this letter.

We note that the ED includes a number of provisions regarding required or permissible rebalancing or discontinuation of hedging relationships. The ED states that an entity must discontinue hedge accounting if the hedging relationship (entirely or only a part of it) ceases to meet the qualifying criteria, which includes expiration, sale, termination, or exercise of the hedging instrument. It also states that an entity may voluntarily discontinue hedge accounting only to apply a different method of assessing hedge ineffectiveness or to adjust the hedge ratio following a change in the relationship between the hedged item and the hedging instrument.

We evaluated whether the ED would allow continued use of hedge accounting for activities that involve the voluntary adjustment, including reduction, of hedge levels consistent with a documented risk management strategy or objective. While it is possible that the provisions described above could be interpreted to accommodate current hedge accounting practices, we believe it is not clear whether an entity voluntarily could adjust (increase or reduce) the hedging relationship in accordance with its risk management objective and still apply hedge accounting.

Following are several common circumstances in which electric utilities and other energy companies currently may discontinue hedge accounting voluntarily in part or in total.

Example 1 – A company that is obligated to supply electricity to customers in a region where it does not own physical power generation plants forecasts the need to make future purchases of power to serve those customers. In order to hedge price risk associated with those forecasted purchases, the company initially purchases gas derivatives to hedge power price risk because the forward gas market is highly correlated with, and is more liquid than, the forward power market. As the delivery period approaches and the forward power market becomes more liquid, the company dedesignates the near-term gas hedges and replaces them with new near-term power derivatives. The effectiveness of the hedge relationship would be increased through this transaction. The gas derivatives that were dedesignated could then either be used as hedges of

another forecasted transaction or sold if no longer needed within the context of the overall regional portfolio.

Under existing accounting rules, this rebalancing would be achieved by a series of dedesignations and redesignations as needed. We believe that the ED's provisions regarding voluntary prospective rebalancing could be interpreted to permit discontinuation of hedge accounting for the gas hedges and initiation of hedge accounting for the power derivatives because it improves effectiveness. However, we also believe that some might conclude that hedge accounting for the gas derivatives could not be discontinued if they were not terminated. We believe the final guidance should be clarified to accommodate hedge accounting for this type of risk management activity.

Example 2 - The same company as in Example 1 uses derivatives to hedge the price risk of its probable forecasted purchases of electricity. Accordingly, it has executed a number of forward power purchase derivatives to reduce its exposure to price increases. Due to price changes in the power markets (similar to what occurred through the middle of 2008), forward power prices have increased substantially, providing the entity significant economic gains on its hedges. As a result of the changes in market prices, the company now determines that power prices are much more likely to decrease than to increase in the future. In accordance with its risk management objective, it sells some of its power derivative hedges, thereby lowering its hedge ratio but remaining within its risk management objective.

Under existing accounting rules, the entity could reduce its hedge level to reflect these expectations. We believe that the ED's provisions regarding voluntary prospective rebalancing could be interpreted to permit discontinuation of hedge accounting for the power derivatives that were sold because the hedging instrument has been sold. However, in our industry, hedging primarily occurs in bilateral or over the counter markets, and the original hedge levels are likely to be reduced by executing an offsetting derivative with a different party; sale or termination of the original derivative is uncommon. Because of these mechanics, we believe that some might conclude that hedge accounting for the reduction in hedge level by executing offsetting derivatives would not be permitted.

In considering these examples, we also note that entities often aggregate forecasted transactions and hedge them with combinations of derivatives that are adjusted over time. In order to adjust the hedge level, the entity may enter into additional derivatives that offset part or all of the risk of the existing derivatives.

Example 3 – The same company as in Example 2 has executed a number of forward power purchase derivatives to reduce its exposure to price increases for a full calendar year because monthly derivatives are not liquidly traded. As the delivery year approaches, monthly power derivatives are traded more frequently. In accordance with its risk management objective, it buys additional derivative quantities for forward months when demand is expected to be high and sells forward derivative quantities for other months when demand is expected to be lower. The forward sale contracts effectively replace portions of the calendar-year derivative hedge in order to “shape” the hedge for the year to reflect expected purchase levels more closely.

The entity would dedesignate the existing hedging instrument and redesignate a compound derivative consisting of the prior hedging instrument combined with the additional, newly executed derivatives. While this is simply an extension of the above examples, we have similar concerns to those expressed above that an entity may be in a position where economically it has closed out a risk but, for accounting purposes, one derivative continues to receive hedge accounting (despite management’s intent to discontinue) and the offsetting derivative is being marked to fair value through profit and loss (despite management’s intent to adjust its hedge levels).

The types of hedging activities described above are consistent with common, fundamental risk management strategies used for hedging in our industry, and we believe they should continue to be eligible for hedge accounting consistent with the objective articulated in the ED. Absent clarifications to the ED to address these issues, we believe it is likely that practices currently accommodated under what are deemed to be more restrictive hedge accounting rules might be interpreted to be ineligible for hedge accounting in the future.

Therefore, we request the Board to include explicit guidance and examples in its final hedge accounting standard that would clarify and definitively permit the application of the new hedge requirements to circumstances such as these. One method for doing so would be to clarify that these types of activities fall within the provisions of the standard, and this could be accomplished by indicating that rebalancing includes when the hedging instrument has been sold, terminated, or effectively terminated. The standard could define effective termination as when a new derivative is executed that is expected to offset future changes in the fair value or cash flows of the all or a portion of derivatives designated as hedging instruments. We also believe that examples illustrating these provisions, similar to the examples we have provided, should be included.

Required Rebalancing

The ED states that if a hedging relationship ceases to meet the objective of the hedge effectiveness assessment but the risk management objective remains the same, the entity must rebalance the hedge so that it meets the qualifying criteria.

We believe that this provision needs to be clarified so that it is not interpreted to require rebalancing simply because ineffectiveness occurs. In all but a few hedging relationships, some level of ineffectiveness is likely. Further, executing additional transactions to rebalance hedging relationships also usually requires an entity to incur transaction costs. Most risk management policies and activities anticipate and accommodate a modest level of ineffectiveness without necessarily requiring rebalancing.

We believe it would be inefficient and costly to require rebalancing that is not consistent with an entity's risk management policy. Such a requirement would impose incremental costs considered unnecessary by management and would result in divergence between hedge accounting and the entity's risk management activities.

Component Hedging

We support the extension of component hedging to non-financial hedging relationships, and we strongly believe that the final standard should permit component hedging even if the value of the component that is hedged may exceed the total value of the forecasted transaction. This can often occur in both electricity and gas hedging, where the end product to be delivered at a specific location is priced with two components:

- The commodity price at a liquid (hub) location
- The differential in price between the hub location and the actual delivery location.

Energy prices at physical delivery locations are often correlated to prices at other locations. The strongest correlation is usually to the nearest "hub" with liquid pricing. As a result, physical delivery locations may reflect pricing at either a premium or a discount to the hub price. It is important to note that the delivery component generally is relatively small compared to the commodity component of the price, rarely resulting in the potential for a negative overall price.

To accurately portray actual risk management activity, the final standard must permit hedging of the hub component, which otherwise would meet the proposed criteria, even if the remaining component is a deduction from the hub price. In some cases, this component will be contractually specified, but in our industry, the existence of markets and the nature of the underlying commodities are such that the physical commodity

component of the overall product is generally easily and objectively identifiable. While we understand that the exposure draft would prohibit such treatment for financial instrument hedging relationships, we believe that the nature of physical commodity operations and pricing as we have described above is sufficiently different to support our recommendation.

Disclosures

We do not agree with the disclosures proposed in paragraph 46 of the ED for several reasons.

- Conceptually, we do not believe that it is necessary or appropriate to include in the footnotes the individual quantities or amounts of each of the risks to which the entity is exposed as proposed by subparagraph (a). Such disclosure is not required for a fair presentation of the historical financial statements. Similarly, we do not believe it is appropriate to include the analysis proposed by subparagraph (c) that would require disclosure of how hedging changes the risk exposure.
- From a practical perspective, such disclosures (when combined with other information about the volume of financial instruments used) inappropriately provide significant competitively sensitive information that should not be required to be presented.
- Additionally, defining what exposures should be included (for example, from physical assets, recognized financial instruments and derivatives, or firm commitments) and how they would be measured poses many definitional issues and complexities that render this proposal not operational.

We understand how the information proposed for disclosure by this paragraph could be helpful to an investor in assessing an entity's future earnings prospects or exposure to risk prospectively. However, we believe that neither of those objectives is within the function of the audited financial statements and footnotes because such an assessment is forward looking based upon consideration of projections and possible future events. This type of forward-looking information is not required in order to provide a fair presentation of historical financial results and, in our view, is not appropriate for inclusion in the footnotes to audited financial statements.

Rather, we believe qualitative aspects of the information proposed in paragraph 46 most appropriately would be included in a discussion of earnings, financial condition, and risk expectations for the future. We note that, for public entities registered with the U. S. Securities and Exchange Commission, these types of discussions presently are included under other filing requirements (outside the audited financial statements), including Form 10-K Item 1, Business; Item 1A, Risk Factors; Item 7, Management's

Discussion and Analysis of Financial Condition and Results of Operations; and Item 7A, Quantitative and Qualitative Disclosures About Market Risk.

Contracts for Physical Delivery of Non-Financial Items

We believe that entities should be able to elect to account for contracts that are eligible to 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 ("own use" contracts) as derivative contracts when the contract is entered in connection with an entity's risk management strategy and when failure to account for the own use contract as a derivative would create an accounting mismatch.

For the sake of clarity, we believe that the treatment of such contracts should be made explicitly clear and should incorporate the following provisions:

- Accounting for an own-use contract as a derivative should be based upon the entity's election
- The default accounting treatment for own use contracts should be retained, absent an election for derivative accounting
- Such an election should be available for both cash-flow and fair-value risk management strategies
- Such an election should be available at a granular level (as low as the individual contract) consistent with the entity's election at the inception of the contract in accordance with its risk management policy

To elaborate, in our industry many companies manage a net position of derivatives, executory contracts, and physical long positions, as described in paragraphs BC213 and BC214 of the Basis for Conclusions and Illustrative Examples. The ability to account for own use contracts as derivatives would eliminate the accounting mismatch that can occur, without the administrative burden of applying and monitoring hedge accounting.

We note that the Board considered this approach as an alternative to the ED's provisions. We believe that this approach is preferable, and it has the added benefit of resulting in an outcome that is more similar to current U. S. GAAP. Because derivative accounting is the default treatment under U. S. GAAP, there are companies in our industry that choose not to make the normal purchases and normal sales election and therefore account for those contracts as derivatives when they are in circumstances similar to the criteria the Board has set forth for accounting for own use contracts as derivatives.

We also believe that further clarification in the criteria for treating own use contracts as derivatives is necessary due to the reference to entities managing their *entire business* on a fair value basis (Appendix C and paragraph BC218). Entities may have multiple risk management strategies for different lines of business or product lines within their total operations and similar contracts might be used in different ways for different lines of business or product lines. For example, some of our member companies have a variety of lines of business including regulated delivery of electricity and gas, nonregulated sales of physical electricity and gas in wholesale and retail markets, and energy trading activities. Some of these lines of business relate to products involving physical delivery for which own-use accounting is most transparent, while others relate primarily to activities for which mark-to-market through earnings treatment best reflects the economics of the activity. Therefore, the ability to elect derivative treatment for own use contracts should be permitted at a level consistent with the entity's risk management activities.

We do not believe that own use contracts should be eligible to be accounted for as derivatives solely when a fair value-based risk management strategy is used for all aspects of an entity's operations, but that an entity should be eligible to apply derivative accounting to own use contracts in cash flow hedge relationships as well and failure to do so would result in an accounting mismatch.

Conclusion

Overall, we are very encouraged by the IASB's and FASB's efforts to simplify the criteria to apply and maintain hedge accounting, which we believe will be a significant benefit to financial statement users and preparers. We strongly encourage the continuation of convergence efforts in this area, and we appreciate your consideration of these issues and our comments.

Very truly yours,

A handwritten signature in black ink, appearing to read 'R. McMahon', followed by a period.

Richard F. McMahon, Jr.