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

Dear Sandra,

EFET is pleased to comment on the International Accounting Standards Board's (the Board's or IASB's) Exposure Draft of Proposed Amendments to IAS 39, *Financial Instruments: Recognition and Measurement, Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk* (the Exposure Draft). Our response to Question 1 raised in the Exposure Draft is set out in the Appendix.

Overall, we support the proposals in the Exposure Draft and commend the Board for its efforts to enhance the hedge accounting rules under IAS 39 to allow greater flexibility in achieving accounting results that substantively represent the economic realities of operational hedging strategies currently utilised in practice by a number of companies.

However, as indicated in our response to Question 1, we believe that the proposed amendment should be broadened to allow macro hedging for other risk aggregations, including aggregations of cash flow risk. While we understand that the proposed exposure draft would allow companies subject to interest rate risk to aggregate contractual positions and designate the net exposure as the hedged item in a fair value hedge relationship, we believe certain energy commodity contracts (including firm commitments) and anticipated commodity transactions present a risk profile similar to the exposure presented by interest rate-sensitive instruments. We therefore suggest that the Board consider broadening the scope of the proposed amendment to include cash flow hedge accounting for risk pools that are economically similar to those present in portfolios of interest rate risk.

We appreciate the opportunity to provide our comments. If you have any questions concerning our comments, do not hesitate to us on +31(20) 520 79 70 or [secretariat@efet.org](mailto:secretariat@efet.org)

Sincerely,



Jan Van Aken  
Secretary General  
EFET

## **APPENDIX**

### **QUESTION 1**

Do you agree with the proposed designation and the resulting effect on measuring ineffectiveness? If not,

- (a) in your view how should the hedged item be designated and why?
- (b) would your approach meet the principle underlying IAS 39 that all material ineffectiveness (arising from both over- and under-hedging) should be identified and recognised in profit or loss?
- (c) under your approach, how and when would amounts that are presented in the balance sheet line items referred to in paragraph 154 be removed from the balance sheet? If you do not agree that the situation outlined in (b) is the result, how would you characterise the change in value of the hedged item?

### **RESPONSE**

We agree; however, as is posited in the following response, we believe the proposed designation should be broadened.

Current hedge accounting rules under IAS 39 do not allow an entity to aggregate dissimilar risks in a portfolio of instruments that are then designated as the hedged item in hedging relationship. Those rules additionally preclude an entity from netting offsetting contractual positions to determine a net exposure amount, which is then designated as the hedged item in a hedging relationship. However, we understand that the proposed exposure draft would allow financial institutions and others with contracts containing interest rate risk to combine those positions and designate the net exposure as the hedged item in a fair value hedge relationship.

We believe certain energy commodity contracts (including firm commitments) and anticipated commodity transactions present an entity with a risk profile that is similar to the exposure that an entity wears relative to interest rate-sensitive instruments due to similar market pricing structures. The term structures of forward prices in commodity markets and forward interest curves represent a range of independent risk exposures. This differs fundamentally from both equity-based and foreign currency exchange rate-based exposures, where forward prices are primarily driven by spot prices, with forward rates extrapolated using interest rate term structures. We therefore believe that the extension of hedge accounting treatment for portfolios of interest rate risk should be extended to include other similar portfolios of risk, specifically inclusive of risks presented by energy commodity contracts.

We also believe that the proposed exposure draft's discussion should include reference to portfolios of risk related to cash flow hedging alternatives, as opposed to its current limitation only to fair value hedge relationships.

### **BACKGROUND**

The following two examples provide background to how macro-hedging might be applicable to the energy commodity contracts held by integrated utility companies.

Example 1: A natural gas retail company has various long-term purchase contracts to buy natural gas for its retail customers. For purposes of this example, assume the company has committed to purchase 1 million British thermal units ("therms" of natural gas per day over the three-year period from 2004 to 2006. The pricing of the contracts is linked to crude oil prices. The company also has commitments to sell natural gas to various industrial customers for the next three years, but the total sales volumes are only 750 thousand therms per day. The pricing of the sales contracts is similar to

those of the purchase contracts (i.e., linked to crude oil). The contracts often result in net settlement and thus do not receive executory contract treatment under paragraphs 6 and 7 of IAS 39. The company has performed an analysis and determined that it has a net long exposure to oil of 250 thousand therms equivalent (i.e. the oil exposure in the purchase and sales contracts only offset by 750 thousand therms). The company enters into a derivative instrument (or series of derivative instruments) to hedge the future cash flows related to this net exposure.

Example 2: A utility company with available generation capacity may execute a sales contract with retail customers to sell a portion of its capacity, and later enter into a sale into the forward market for the remaining available units. For example, on November 1, 2003 assume a utility company has 100 megawatts of capacity available for delivery in February 2004. The utility asserts and is able to support the conclusion that the forecasted transaction (i.e., the sale of 100 megawatts of electricity in February 2004) is probable of occurring, and therefore presents cash flow risk. In order to hedge this risk, the utility enters into forward long-term sales commitments to deliver 75 megawatts to its retail customers in February 2004. As the company remains in a net long position by 25 megawatts on a macro basis, the company enters into a derivative instrument (a short position in electricity) to hedge the remaining 25 megawatt long position.

In this case, applying a “macro-hedging” view, the company is perfectly hedged as the total 100 megawatts of sales are backed by the utility’s asset (a 100 megawatt natural long position), which is capable of generating this full amount. However, in order to apply hedge accounting at a macro level, the company must be able to include the natural long position by virtue of its generation asset in the total hedge relationship (i.e., a “natural hedge”, similar to that contemplated in the Exposure Draft, paragraph BC 11). Put differently, the application of macro-hedge accounting would allow the company to designate the exposure of 25 megawatts as the hedged risk rather than 25% of the forecasted generation from the plant.

## **CONSIDERATIONS FOR EXTENDING MACRO HEDGING TO UTILITY COMPANIES**

Physical commodity delivery is an essential ingredient of the utility business on both the fuel procurement and the power sales sides. Many utility companies have implemented or are implementing a business model that is not dissimilar from the Asset and Liability Management (“ALM”) business model of an integrated bank, active in both retail banking activities and in the wholesale financial markets. Therefore, the systems issues cited in the Exposure Draft as a reason for allowing interest rate risk portfolio hedging are equally present in the case of utility companies.

In an integrated utility, a central portfolio management (“CPM”) system may be used to monitor procurement, sales and the generation assets of the company, which allow it to convert the fuels to power. The CPM may be analogised to the ALM models referred to above. Excesses or shortages in fuel supplies and in power output are determined by the CPM entity and appropriate transactions are executed in the market via a trading desk to rebalance contractual positions and anticipated needs. This desk may or may not manage proprietary positions in the markets in which it operates. This same structure may be implemented in different geographical regions, which are not necessarily well connected.

Very often, the functioning of the CPM is based on the following principles:

- Risks are measured in separate “time buckets”, per commodity, per location. The time buckets used are often dictated by the market pricing practice (for instance, it is difficult to manage the exposure on a month by month basis if the market quotes only prices per quarter). Each time, commodity, and/or location bucket represents an independent risk factor.
- For a given time bucket, exposures created by physical delivery contracts (firm commitments), pure financial derivatives, and anticipated transactions (forecasted sales and generation forecasts), are aggregated and the net exposure is managed/hedged via the trading desk.

As with net exposures hedged in an ALM, the utility's external hedge positions may not change even though the underlying economic exposures are changing. Corrections recorded on the balance sheet (for fair value hedges) or in equity (for cash flow hedges) would be recorded on an aggregate basis. While we acknowledge that this presents challenges for cash flow hedging strategies due to the need to track amounts deferred in equity for proper reclassification into earnings, we believe this can be remedied by simply reclassifying amounts into earnings in the period in which the hedged time bucket is actually results in physical delivery.

## **ACCOUNTING VERSUS ECONOMIC CONSIDERATIONS**

In the situations described in the examples above, the economic hedging relationships may be proven to be perfectly effective, and it is therefore our assertion that the accounting ramifications of these activities should not present an unbalanced view of the economic reality of the utility's activities by disallowing hedge accounting solely on the basis of the use of a portfolio approach to hedging risk.

Further, both fair value and cash flow hedge accounting should be permitted on a portfolio basis to the extent the portfolio used as a hedge (or being designated as the hedged item) complies with the other underlying principles of IAS 39, including documentation of hedging relationships, assessment of hedge effectiveness, and separate measurement of ineffectiveness for recognition of amounts in income, as appropriate.

## **OTHER COMMENTS**

We further believe that the following precepts should be considered in implementing and utilising a portfolio hedge approach for commodity-based contracts:

- Apart from the separation of time value, a derivative must be designated as a hedging instrument either in its entirety, or on a proportional basis, as required by IAS 39, paragraphs 144 and 145. However, as different delivery months constitute independent risk exposures in commodity markets, we believe it would be appropriate to allow an entity to indicate a single delivery time bucket (for instance, one month within a one-year contract) as the hedging instrument. Notice that the granularity is dictated by the time buckets for which market price quotations are available. This is consistent with the conclusions reached in the Exposure Draft, paragraph BC 9.
- Changes in time bucketing should be allowed over the life of a contract as market conditions change. For example, suppose that a forward contract is concluded for a one-year delivery, starting in one year. It is possible that only an annual price is quoted. As time evolves, the contract can be broken up in quarterly buckets, and later even in months, as the actual delivery period approaches.
- Hedged items, including firm commitments and anticipated sales and purchases, should also be broken up in similar time buckets, as dictated by the market price quotation curves.
- For every given geographical market or delivery location, and for every commodity, for any defined time bucket, the balance of firm commitments and forecasted flows should be inventoried. All exposures in one such bucket are to be considered as sharing the same risk exposure as required under IAS 39, paragraph 132.
- For every such bucket, companies should segregate exposures that are already marked to market (financial instruments), and those under accrual accounting rules (firm commitments, fixed-price executory contracts, anticipated sales and purchase), as the former comprise a naturally compensating pool, whereas the latter require hedge accounting on a portfolio basis.

- (a) Fair value hedge of a portfolio of firm purchase or sale commitments –Since firm commitments and executory contracts are not recognised on the balance sheet unless they are onerous contracts, the gain or loss on the portfolio should be recorded separately as an asset or liability.
- (b) Cash flow hedge of the forecasted portfolio exposures –Amounts deferred in equity for a given cash flow exposure and related to a predetermined time bucket should be reclassified into earnings in the periods in which the hedged forecasted transaction(s) affect income.