Edison Electric INSTITUTE

American Gas Association

November 22, 2016

Technical Director
Financial Accounting Standards Board
401 Merritt 7
Norwalk, CT 06856-5116

File Reference No. 2016-310 – Exposure Draft
Proposed Accounting Standards Update—*Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*

Dear Ms. Cosper:

The Edison Electric Institute (EEI) and the American Gas Association (AGA) appreciate the opportunity to respond to the Financial Accounting Standards Board's (FASB or Board) Exposure Draft of the Proposed Accounting Standards Update—*Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*, File Reference No. 2016-310.

EEI is the association that represents all U.S. investor-owned electric companies. EEI members provide electricity for 220 million Americans, operate in all 50 states and the District of Columbia, and directly and indirectly employ more than one million workers. Safe, reliable, affordable, and clean energy powers the economy and enhances the lives of all Americans. EEI has dozens of international electric companies as International Members and hundreds of industry suppliers and related organizations as Associate Members. Organized in 1933, EEI provides public policy leadership, strategic business intelligence, and essential conferences and forums.

AGA, founded in 1918, represents 202 local energy companies that deliver clean natural gas throughout the U.S. There are more than 70 million residential, commercial, and industrial natural gas customers in the U.S., of which almost 93 percent – more than 65 million customers – receive their gas from AGA members. AGA is an advocate for natural gas utility companies and their customers and provides a broad range of programs and services for member natural gas pipelines, marketers, gatherers, international gas companies, and industry associates. Today, natural gas meets almost one-fourth of the energy needs in the U.S.

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EEI and AGA regularly work together on projects of mutual interest and impact to the energy utility sector broadly. We provide our comments below on certain specific questions in the Exposure Draft that are most relevant to our members.

General Support for the Project

EEI and AGA support the overall objectives of the Exposure Draft. Many of our members which had previously applied hedge accounting discontinued its use for a combination of reasons which are addressed in the Exposure Draft. Those reasons included the complexity and administrative burden of applying the existing requirements as well as the punitive nature of some provisions that have had the practical effect of discouraging the use of hedge accounting.

Our members particularly support a number of the Exposure Draft's major provisions, including elimination of recording ineffectiveness in the income statement for cash flow hedges until the forecasted transaction occurs; allowing component hedging for commodities; the option to assess effectiveness qualitatively after an initial quantitative test; and flexibility in timing for documenting the initial effectiveness test.

We offer comments on several specific aspects of the Exposure Draft below.

Allowing Component Hedging Based on Market Conventions

While we agree with the proposal to allow component hedging for commodities, we believe allowing component hedging when there is a supportable market convention would significantly reduce the complexity and cost of applying the new standard. In the Basis for Conclusions, the Board noted that it rejected the concept of a market convention due to the lack of comparability across industries as well as the difficulty in demonstrating the unspecified component to objective third parties. Further, the Board noted that contracts could be rewritten to contractually specify the convention.

We believe that market conventions are appropriate and should be allowed, and we disagree with the reasons given for requiring the component to be contractually specified. We believe that lack of comparability is not a significant issue, particularly in the energy industry where there are clear, widely accepted market conventions. For example, the forward natural gas price at each delivery location can be calculated by combining the Henry Hub price and the basis differential price between Henry Hub and the respective delivery location. Support for these two components can be easily validated using transactional information and third party pricing (e.g., pricing services and exchange pricing for natural gas basis differences).

With regard to rewriting contracts, altering contracts to specify a market convention may be difficult for regulated electric and gas utilities. Hedgeable cash flows may be set forth in a tariff or other agreement mandated by the presiding regulatory body. Altering the tariff or other agreement to incorporate a previously unspecified component may involve significant cost, time, and risk for the utility that may not be justified by the possibility of adopting an optional accounting treatment.

Additionally, our members purchase or sell physical commodities through brokered exchanges. These exchanges currently price purchases and sales using the all-in delivery location price for the commodity with no specification of the components that are embedded in the price. Changing the pricing utilized by the exchange to incorporate documentation of the various components defined by market convention may be complex, time-consuming, and costly.

We believe that renegotiation of bilateral contracts may also be difficult to achieve in certain situations. Counterparties may have little or no incentive to renegotiate preexisting contracts. Even if they agree to do so, such renegotiation easily could lead them to require a *quid pro quo* change in terms. Further, many companies in the energy industry now eschew hedge accounting, instead allowing economic hedges to remain freestanding. An entity that wishes to apply hedge accounting to a component may have difficulty convincing a counterparty of the need to incur legal, IT, and other costs required to modify the existing contract.

For these reasons, we believe that market conventions should be allowed when there is objective, verifiable information that validates the existence of those conventions. Objective information such as the existence of a market for financial or physical derivatives priced under the market convention as well as third party pricing information for the component could be used to support the validity of the market convention. For example, an entity would be able to support hedging the Henry Hub component of a physical natural gas purchase or sale due to the existence of transactions that settle based on the difference between the Henry Hub price and delivered location price. This could be readily validated by auditors and external parties.

Qualitative Effectiveness Testing

We support the proposal that an entity would be required to perform quantitative effectiveness testing (after an initial successful test) only if facts and circumstances change to an extent that the entity may no longer assert on a qualitative basis that the hedging relationship was and continues to be highly effective. However, we believe that some of the detailed aspects of this proposal will serve as a significant disincentive to applying it.

One major disincentive is the provision that would require an entity to perform a quantitative test back to inception of the hedge if no specific event can be identified that caused the hedge to cease being effective. If the quantitative test shows the hedge is not highly effective in any period other than the current period, an entity is required to assess whether a material error exists under Topic 250. The risk of an error correction and associated implications for internal control reporting, even if rare, would be a significant impediment to reporting entities adopting the qualitative approach.

We disagree with this approach. If the entity had properly performed and documented its ongoing qualitative assessment in prior periods, we do not believe that the accumulation of small periodic changes in effectiveness that are material in the aggregate at a later date should call into question the validity of those prior assessments or imply that an error had occurred. Rather, we believe that hedge accounting should be discontinued prospectively in the period in which the quantitative test is reinstituted (and failed), with amounts that had accumulated in hedge accounting in previous periods frozen as of the date of the previous qualitative effectiveness test.

We also disagree with the proposal that, if qualitative effectiveness is elected but an entity determines that a quantitative assessment of effectiveness is required, the entity would then be prohibited from returning to qualitative testing in subsequent periods in all circumstances. Temporary changes in market relationships (for example, due to extreme weather events, short-term supply disruptions, etc.) may cause an entity not to be able to assert that a hedge is effective on a qualitative basis in the period in which such events occur. However, such relationships may revert to longstanding norms after these events, and an expectation of qualitative effectiveness may be reasonable again.

We believe that an entity should be allowed to resume use of the qualitative method if the specific event that caused the hedge to be ineffective is the result of a temporary change in the market relationship and effectiveness can be demonstrated anew through the quantitative test.

Timing of Initial Quantitative Effectiveness Test

We agree with the proposed amendment that would allow an entity to perform the initial quantitative testing portion of hedge documentation at any time between hedge inception and the quarterly effectiveness testing date using data applicable as of the date of hedge inception. This removes a punitive "contemporaneous" documentation requirement and replaces it with a practical solution linked to typical financial reporting intervals.

Disclosure of Quantitative Goals for Hedging

Conceptually, we disagree with the notion that the notes to financial statements should report on the success (or lack thereof) of the entity's hedging strategy. Such reporting does not relate to the fair presentation of the entity's results of operations. Business performance analysis, including the results of an entity's hedging program, most appropriately belong in disclosures designed for such purposes, such as the Management's Discussion and Analysis section required in SEC Exchange Act filings.

From a practical perspective we believe that the proposed disclosure of quantitative hedging goals and whether the entity met those goals involves significant complexity, could potentially result in proprietary market information being disclosed to third parties, and may be misleading to investors and other financial statement users. Entities may change quantitative goals for hedging periodically as part of a regular assessment of market conditions and exposure to market risks.

For example, an entity may begin the year with a targeted hedge price of $50 per megawatt hour for electric sales. During the year, electric market conditions may change such that the entity reduces its quantitative goals one or more times during the year. As currently proposed in ASC 815-10-50-1A(e), the entity may be required to disclose each goal and measure its performance in reaching each goal, even if the goal changed many times during the year. We believe this is overly complex and would likely be confusing to financial statement users.

Additionally, we believe that disclosing quantitative goals for hedging will require, in some instances, the disclosure of non-public, proprietary information. Although the proposed disclosure requires that only retrospective information be disclosed, many entities in our industry utilize block (i.e., calendar average) pricing in cash flow hedges.

Due to the fact that an entity must make interim disclosures of quantitative goals, it may be required to disclose proprietary forward-looking pricing information for the remainder of the year if it uses block pricing. Our members consider all quantitative goals for hedging related to budgeted or expected pricing, whether retrospective or prospective, to be proprietary market information that could influence the current and future markets.

Further, an entity's hedging program may utilize a mixture of non-derivative contracts, contracts which utilize the scope exception for normal contracts as well as cash flow hedges. Requiring a measurement of quantitative goals only for cash flow hedging may be misleading as it does not encompass the entirety of potential hedging instruments.

We believe a more valid measurement of hedging performance is a comparison of how an entity's hedges performed against the market or settlement price. We believe that existing quantitative disclosures that require disclosure of hedging gains and losses to be sufficient to indicate an entity's performance in cash flow hedge accounting.

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EEI and AGA appreciate the opportunity to provide our input on the Exposure Draft. We would be pleased to discuss our comments and to provide any additional information that you may find helpful.

Very truly yours,

/s/ Richard F. McMahon, Jr.

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