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Re: EFRAG's draft comment letter on ED Hedge Accounting

Dear Mrs Flores,

We appreciate the opportunity to comment on EFRAG's draft comment letter on the IASB's exposure draft on hedge accounting.

RWE is one of the leading utilities in Europe, focussing on the electricity and gas sector. Our activities cover all of the major elements of the energy value chain. Headquartered in Germany and with external revenues amounting to 48 bn. EUR we are providing work for more than 70,000 full-time employees (as of 31 December 2009).

We agree to almost all of EFRAG's statements made in the draft comment letter. We have, however, one major concern which relates to EFRAG's statement that the IASB "should not finalise a standard on the general hedge accounting model, before developing a model for macro hedging." As explained in the following, we are of the opinion that the proposed amendments to hedge accounting are an important step towards a better representation of the business models and risk management strategies of entities in the energy industry and should therefore be finalised even if some more changes will be necessary in a later phase of the project.

For RWE as for the entire energy industry, the standards on financial instruments are amongst the most important accounting standards. This is in particular true with regard to the requirements for own use contracts, written options and embedded derivatives as well as for hedge accounting. The main reason is that energy commodities like electricity and gas are products with specific characteristics, in particular they are not or not to a large extent storable. These characteristics lead to high price volatility in the energy markets and therefore imply specific risks for the utilities.

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In order to protect themselves against this volatility and the resulting risks, energy companies are active in forward and derivative markets. The aim of these risk management strategies is the reduction of risks, not speculation (except for the proprietary trading divisions of the companies). The forward and derivative transactions are usually economic hedges of assets, e.g. generation capacities or long-term supply or purchase contracts.

However, the accounting for these transactions often leads to income volatility, because the own use criteria are not met or hedge accounting is not possible due to the restrictions under the current IAS 39. This income volatility is often solely accounting driven and cannot be explained economically. Therefore, the entities often have to solve this problem with the help of non-GAAP-measures.

We therefore strongly support the IASB's efforts to align accounting and risk management in the exposure draft on hedge accounting. We expect that in particular the new proposals on the hedging of risk components and for effectiveness testing will help us to apply hedge accounting to economic hedges for which hedge accounting is not possible today and thus avoid accounting-driven income volatility. As mentioned above, we therefore 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 in the energy industry. This is also stated in EFRAG's draft comment letter in the response to question 1.

For these reasons, we are concerned by EFRAG's advice not to finalise the hedge accounting standard until an overall hedge accounting model has been developed. We welcome the continuation of the IASB's deliberations with regard to open portfolios and macro hedges, because this will allow for an even better representation of dynamic hedging strategies in the financial statements, but we do not expect that the IASB will come to a solution on that in the short term. The deferral of a new standard on hedge accounting until this point in time would in our opinion prevent an improvement of the accounting for risk management strategies in financial statements.

Moreover, we think that the now proposed requirements are not directly linked to the macro hedging issues that the IASB plans to discuss in a later phase of the project. For instance the above mentioned proposals on hedging of components in non-financial contracts or effectiveness testing are very suitable for aligning accounting and risk management, but they do not interfere with possible future regulations for macro hedges. Additionally, subsequent changes of accounting standards always have to be taken into account; it is rather a common practice that the IASB regularly amends IFRSs or even issues interim standards (e.g. IFRS 4, IFRS 6).

We therefore ask EFRAG not to object to the finalisation of the new requirements on hedge accounting as proposed in the exposure draft, but instead encourage the IASB to continue with their efforts to align accounting and risk management.

Apart from these general remarks, we agree to almost all of EFRAG's statements in the draft comment letter. Based on our experience in the energy industry, we would, however, like to comment on the following issues:

- **Question 8:** We think that it should be allowed furthermore to discontinue hedge accounting voluntarily; this would also be in line with the optional character of hedge accounting. It is our experience that hedges may become very complex over time, e.g. when they have to be rebalanced regularly. In such a situation, an entity could decide to revoke the designation of the hedge and include the effects in profit or loss from this point in time in order to avoid complex and error-prone accounting. As the voluntary revocation of hedge accounting (when all criteria are still met) does not lead to a reclassification of the OCI components into profit or loss (in the case of cash flow hedges), this is not a driver to generate income effects.
- **Question 14:** We generally welcome the IASB's efforts to align accounting and risk management also with regard to the own use exemption. We are, however, concerned that the proposal does not really help to address practical problems in this area for the following reasons:

For us it is not clear whether the IASB intends to introduce an obligation to fair value commodity contracts if the preconditions mentioned in the exposure draft are fulfilled or if this shall be optional. In our opinion, applying derivative accounting should be left as an option since automatic application of fair value accounting for contracts managed at fair value would lead to an accounting mismatch and resulting income volatility in some situations. This is especially occurring when contracts are managed together with assets that are not in the scope of IAS 39.

In the energy industry, it is e.g. a 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.

We hope that our comments are helpful for your considerations. If you have any questions please do not hesitate to contact Fred Riedel, Head of Group Accounting (fred.riedel@rwe.com), or Britta Leippe, Head of IFRS Competence Center (britta.leippe@rwe.com) of RWE AG.

Sincerely yours,

RWE Aktiengesellschaft



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(CFO)



Riedel
(Head of Group Accounting)