Project **Tentative agenda decisions**

Topic **IAS 39 – Forward contracts with volumetric optionality on non-financial items that are readily convertible to cash**

Introduction

1. In July 2009 the IFRIC received a request to add an item to its agenda on providing guidance on whether a contract that (a) obliges an entity to deliver (sell) at a fixed price a fixed number of units of a non-financial item that is readily convertible to cash and (b) provides the counterparty with the option to purchase, also at a fixed price, a fixed number of additional units of the same item, can be assessed as two separate contracts for the purpose of applying paragraphs 5-7 of IAS 39 *Financial Instruments: Recognition and Measurement* (IAS 39).

2. The IFRIC agenda submission set out three views on this issue.

   (a) **View 1:** Split the contract into a forward component and a written option component, and apply IAS 39.5-7 to these components separately.

   (b) **View 2:** Apply IAS 39.5-7 to the contract in its entirety.

   (c) **View 3:** Make an accounting policy choice and apply either View 1 or View 2 consistently to all similar contracts.

3. At the IFRIC meeting in November 2009, the staff recommended that the IFRIC not take the issue onto its agenda. The basis for the staff's recommendation was that the staff believed that, even though different views on the issue had been adopted in practice, IAS 39 was a contract-based standard, and so it was clear on the appropriate unit of account for assessing whether a contract was within the

This paper has been prepared by the technical staff of the IASCF for discussion at a public meeting of the IFRIC.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IFRIC or the IASB. Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRIC or the IASB can make such a determination.

Decisions made by the IFRIC are reported in *IFRIC Update*.

Interpretations are published only after the IFRIC and the Board have each completed their full due process, including appropriate public consultation and formal voting procedures. The approval of an Interpretation by the Board is reported in *IASB Update*.

scope of IAS 39 or not. Consequently, the staff believed that a reading of IAS 39 did not support any other view but View 2, and so any guidance that the IFRIC could provide would be in the form of application or implementation guidance (rather than an interpretation).

4. Some of the IFRIC members disagreed with the staff's recommendation. Some were of View 1, while others held View 3. Some also noted that they were aware of some entities that accounted for these types of contracts as being outside the scope of IAS 39 in their entirety (for the purpose of this paper, this accounting is labelled View 4).

5. At the November meeting, the IFRIC did not make any tentative decisions on whether to add the issue to its agenda, but instead directed the staff to research the issue further. In particular, the IFRIC asked the staff (a) to confirm that View 4 is a view adopted in practice and (b) to determine whether the issue is also relevant for industries other than the energy industry. One member indicated that she would like to know the accounting for these types of contracts under US GAAP.

6. This paper:

   (a) describes some observations from the staff's outreach;

   (b) discusses the staff's view on the way forward; and

   (c) makes a recommendation to, and asks for a decision from, the IFRIC.

7. The staff have proposed wording for a tentative IFRIC agenda decision in Appendix A. Furthermore, the staff have reproduced, in Appendix B, the guidance in US GAAP that would apply to this issue.

Staff outreach

8. Since the November meeting, the staff have had discussions with some accounting firms and a preparer to find out whether View 4 is indeed a view adopted by some entities in practice, and also whether companies in industries other than the energy industry have forward contracts with volumetric optionality on non-financial items that are readily convertible to cash.

9. On the basis of its discussions, the staff make the following observations:

   (a) In practice, entities, and the accounting firms, have different views on how to apply IAS 39.5-7 to these types of forward contracts, those views being described in this paper as Views 1-4.

   (b) As to View 4 in particular, some hold this view because they believe that the entity that is obligated to deliver (sell) the commodity under a forward contract with volumetric optionality does not have the ability to readily convert the commodity to cash. In their view, it is the buyer who might have that ability. In support of this view, they would perhaps point to the IFRIC Update – March 2007: *Written options in retail energy contracts*, in which the IFRIC noted that energy supply contracts to retail customers were not capable of net cash settlement as laid out in paragraphs 5 and 6 of IAS 39, and thus would not be considered to be within the scope of that standard. The staff papers related to this IFRIC Update indicate that the reason why these contracts fail the net cash settlement criteria in paragraphs 5 and 6 of IAS 39 is that the retail customers do not have the ability to readily convert the energy to cash.

   (The staff understand that others would disagree with that view. They would argue that to the extent one of the parties can readily convert the commodity to cash, the contract is deemed to be net-cash settleable in accordance with IAS 39.6(d). For forward contracts with volumetric optionality where the buyer has the ability to readily convert the commodity to cash, the buyer receives an asset that is like cash in exchange for paying cash to the seller. Because the definition of a financial instrument refers to a 'contract that gives rise to a financial asset of one entity'[1] and the definition of a financial asset includes 'any asset that is cash'[2], these types of forward contracts involve the exchange of one financial instrument for another financial instrument.

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[1]Paragraph 11 of IAS 32 Financial Instruments: *Presentation*.
[2]See footnote 1.

Hence, those who disagree with the view that from the seller's perspective the commodity that underlies these forward contracts is not readily convertible to cash would argue that the contracts would qualify under IAS 39.6 as being settleable net by exchanging financial instruments.)

(c) Some who hold View 1 (assess the scope provisions in IAS 39.5-7 to the forward and option components separately) would apply View 4 to forward electricity contracts with volumetric optionality for which the written option qualifies as a 'capacity contract', as that term is defined in US GAAP in Statement 133 Implementation Issue No. C15 *Scope Exceptions: Normal Purchases and Normal Sales Exception for Option-Type Contracts and Forward Contracts in Electricity* (see Appendix B).[3] Those who look to the guidance in US GAAP would conclude that for forward electricity contracts with volumetric optionality if the nature of the written option is that of a capacity contract (applying the indicators in DIG Issue No. C15), the entire contract is outside the scope of IAS 39. If the nature of the written option is that of a financial option, they would conclude that the option is within the scope of IAS 39 (provided that the underlying commodity is readily convertible to cash).

(d) The staff also note in some instances that the outcome of applying View 1 might be the same as that of applying View 4. For example, the written option component, accounting for it as a derivative at fair value through profit or loss, might be immaterial at inception and over the term of the contract. In this case, the preparer that the staff spoke to would account for the entire contract as being outside the scope of IAS 39.

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[3]For contracts to buy or sell electricity that are, or that include, options, DIG Issue No. C15 makes a distinction between options that in nature are financial options and those that are not. The latter options might be judged as 'capacity contracts' under the guidance in DIG Issue No. C15. In that case, they would qualify for the 'normal purchases and normal sales' exception (the 'own use' exception in US GAAP). On the other hand, financial options would not qualify for that exception.

(e) Forward contracts with volumetric optionality exist not only in the energy industry but also in other industries that use commodities in their production (eg chemicals and precious metals). Consequently, to the extent that a market exists on which the commodities are actively traded, the issue of whether to apply IAS 39.5-7 to these contracts in their entirety, or to the option and non-option components separately, is broader in scope and not only confined to the energy industry.

Staff's view on the way forward

10. Clearly diversity exists in practice as to the accounting for forward contracts with volumetric optionality on non-financial items that are readily convertible to cash. Some companies account for these contracts as being completely outside the scope of IAS 39. Some account for the contracts as being completely within the scope of IAS 39. Others account for the written option component as being within the scope of IAS 39 and the forward component as being outside the scope of IAS 39.

11. The fact that there is diversity in practice on how to apply IAS 39.5-7 to forward contracts with volumetric optionality, together with an assessment of the other agenda criteria in IFRIC's *Due Process Handbook* (see the staff's assessment of those criteria in Staff Paper 5, discussed at the IFRIC meeting in November), would lead the staff to recommend that the IFRIC add the issue to its agenda and issue an interpretation. However, in light of some developments and also the staff's outreach since the November meeting, the staff have reconsidered their assessment of the criterion in paragraph 24(f) of the IFRIC's *Due Process Handbook*. That paragraph states:

    > If the issue relates to a current or planned IASB project, there is a pressing need to provide guidance sooner than would be expected from the IASB's activities. The IFRIC will not add an item to its agenda if an IASB project is expected to resolve the issue in a shorter period than the IFRIC requires to complete its due process.

12. Since the last November meeting, the IASB has issued IFRS 9 *Financial Instruments* (IFRS 9), which replaces the classification and measurement

guidance for financial assets in IAS 39. In paragraph 5 of the Basis for Conclusions, the IASB noted:

> The Board has not yet considered the scope of IFRS 9. The scope of IFRS 9 and its interaction with other IFRSs have resulted in some application and interpretation issues. However, the Board believes that it should address the issue of scope comprehensively rather than only in the context of classification and measurement. The scope of IAS 39 has not been raised as a matter of concern during the financial crisis and, hence, the Board believes that the scope of IFRS 9 should be based on that of IAS 39 until it considers the scope more generally in a later phase of the project to replace IAS 39.

13. With the issuance of IFRS 9 (and consistent with the Exposure Draft ED/2009/7 *Financial Instruments: Classification and Measurement*), the Board has publicly acknowledged that it is aware of issues in practice with respect to the scope of IAS 39. The Board also reaffirmed its commitment to address the scope of that standard as part of a later phase of the IAS 39 replacement project. The Board's intention is to have IAS 39 (including its scope) replaced by the end of 2010. Because IFRS 9 has an effective date of 1 January 2013, but permits earlier application, the staff believe that it is likely that the Board will align the effective date and early adoption option of the other phases of the project – impairment, hedge accounting and scope – with those of IFRS 9. This would mean that entities could apply the changes to the scope of IAS 39 (the new scope) starting on 1 January 2011.

14. Also since the IFRIC meeting in November, the staff have found out that the IASB staff on the IAS 39 replacement project have already had discussions with an energy industry group about issues in practice with respect to the scope of IAS 39, in particular relating to the application of the scope to forward contracts with volumetric optionality. The staff on the IAS 39 replacement project is thus aware of the issue of the IFRIC submission. Accordingly, the staff would expect the IAS 39 replacement staff to consider this issue as part of addressing the scope of IAS 39.

15. If the IFRIC were to decide to add the issue to its agenda, the staff believe that the earliest that the IFRIC could issue an interpretation would be in July or September 2010 (considering the time it would take to agree on an acceptable

interpretation; drafting that interpretation; exposing the draft interpretation with a reasonable comment period; analysing and the redeliberating the comments received on the draft interpretation; and drafting and issuance of the final interpretation, including ratification by the IASB). With this timing in mind, the staff would expect the interpretation to have an effective date of 1 January 2011 at the earliest.

16. The effective date of the IFRIC Interpretation would thus likely not be earlier than the date on which entities could apply the replacement standard for IAS 39. As a result, the staff do not regard it as efficient for the IFRIC to take on the issue and provide an interpretation, even if the IFRIC permitted earlier application of the interpretation.

17. The staff also note that the issue of the submission is only one of many practice issues with respect to the scope provisions in IAS 39.5-7. These paragraphs, which are based on US GAAP (but which do not include the many detailed implementation guidance), are difficult to apply in practice. For example, there is divergence in practice not only over when a commodity is readily convertible to cash but also how that notion is to be applied to the parties to the contract (as the staff have observed in its outreach – see paragraph 9(b) of this paper). Consequently, the staff believe that the best course of action is for the IFRIC to recommend to the IASB that it should comprehensively address the issues experienced in practice concerning the scope of IAS 39 as part of the replacement of that standard.

Staff recommendation

18. For reasons set out in paragraphs 12-17, **the staff recommend that the IFRIC not take the issue onto its agenda.**

19. For the IFRIC's consideration, the staff have proposed in Appendix A to this paper a wording for a tentative agenda decision.

Question
Does the IFRIC agree with the staff recommendation in paragraph 18? If not, why not and what approach would the IFRIC like to follow?

[Appendix A has been omitted from this Observer note]

Appendix B — US GAAP

B1. The paragraphs below represent guidance in US GAAP on the accounting for forward contracts with volumetric optionality.

B2. The staff have included this guidance for information purposes. The staff do not plan to discuss the US GAAP guidance as part of this meeting, unless IFRIC members have questions about it.

B3. Generally, under US GAAP, a contract with volumetric optionality does not qualify for the 'normal purchases and normal sales' scope exception, and provided that the item to be delivered under the contract is readily convertible to cash, the contract would be required to be accounted for as a derivative at fair value through profit or loss.[4]

B4. The exception from this general observation is an electricity contract that qualifies as a 'capacity contract'. This contract might qualify to be accounted for in its entirety under the accrual basis of accounting, if the volumetric optionality feature (ie the written option component) is in nature not a financial option, and if some other criteria are met.[5]

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[4]See Derivatives Implementation Group (DIG) Statement 133 Implementation Issues No. C10 *Scope Exceptions: Can Option Contracts and Forward Contracts with Optionality Features Qualify for the Normal Purchases and Normal Sales Exception?* and No. C16 *Scope Exceptions: Applying the Normal Purchases and Normal Sales Exception to Contracts That Combine a Forward Contract and a Purchased Option Contract*.

[5]See DIG Statement 133 Implementation Issue No. C15 *Scope Exceptions: Normal Purchases and Normal Sales Exception for Option-Type Contracts and Forward Contracts in Electricity*.

Derivatives Implementation Group

Statement 133 Implementation Issue No. C10

Title:	Scope Exceptions: Can Option Contracts and Forward Contracts with Optionality Features Qualify for the Normal Purchases and Normal Sales Exception?
Paragraph references:	10(b), 58(b)
Date cleared by Board:	March 21, 2001
Date posted to website:	April 10, 2001
Date latest revision posted to website:	May 1, 2003
Affected by:	FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities* **(Revised March 26, 2003)**

QUESTIONS

In what instances can the normal purchases and normal sales exception in paragraph 10(b) (as amended) be applied to (1) purchased option contracts (including net purchased options) and written option contracts (including net written options) that would require delivery of the related asset at an established price under the contract only if exercised, and, (2) forward contracts with optionality features?

BACKGROUND

Paragraph 10(b) of Statement 133 (as amended by Statement 149) states, in part:

> Normal purchases and normal sales are contracts that provide for the purchase or sale of something other than a financial instrument or derivative instrument that will be delivered in quantities expected to be used or sold by the reporting entity over a reasonable period in the normal course of business. The following guidance should be considered in determining whether a specific type of contract qualifies for the normal purchases and normal sales exception:
>
> (1) *Forward contracts (non-option-based contracts).* Forward contracts are eligible to qualify for the normal purchases and normal sales exception. However, forward contracts that contain net settlement provisions as described in either paragraph 9(a) or paragraph 9(b) are not eligible for the normal purchases and normal sales exception unless it is probable at inception and throughout the term of the individual contract that the contract will not settle net and will result in physical delivery.* Net settlement (as described in paragraphs 9(a) and 9(b)) of contracts in a group of contracts similarly designated as normal purchases and normal sales would call into question the classification of all such contracts as normal purchases or normal sales. Contracts that require cash settlements of gains or losses or are otherwise settled net on a periodic basis, including individual contracts that are part of a series of sequential contracts intended to accomplish ultimate acquisition or sale of a commodity, do not qualify for this exception.
>
> (2) *Freestanding option contracts.* Option contracts that would require delivery of the related asset at an established price under the contract only if exercised are not eligible to qualify for the normal purchases and normal sales exception, except as indicated in paragraph 10(b)(4) below.

(3) *Forward contracts that contain optionality features.* Forward contracts that contain optionality features that do not modify the quantity of the asset to be delivered under the contract are eligible to qualify for the normal purchases and normal sales exception. Except for power purchase or sales agreements addressed in paragraph 10(b)(4), if an option component permits modification of the quantity of the assets to be delivered, the contract is not eligible for the normal purchases and normal sales exception, unless the option component permits the holder only to purchase or sell additional quantities at the market price at the date of delivery. In order for forward contracts that contain optionality features to qualify for the normal purchases and normal sales exception, the criteria discussed in paragraph 10(b)(1) must be met.

(4) *Power purchase or sales agreements.* Notwithstanding the criteria in paragraph 10(b)(1) and 10(b)(3), a power purchase or sales agreement (whether a forward contract, option contract, or a combination of both) that is a **capacity contract** also qualifies for the normal purchases and normal sales exception if it meets the criteria in paragraph 58(b).

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*Contracts that are subject to unplanned netting (referred to as a “book out” in the electricity utility industry) do not qualify for this exception except as specified in paragraph 58(b).

The contracts addressed in this Issue do not have a price based on an underlying that is not clearly and closely related to the asset being purchased, nor do they require cash settlement of gains or losses as stipulated in paragraph 10(b).

In some circumstances, an option contract may be combined with a forward contract. In some cases, the optionality feature in the forward contract can modify the quantity of the asset to be delivered under the contract. In other cases, the optionality feature in the forward contract can modify only the price to be paid or the timing of the delivery.

RESPONSE

Paragraph 10(b) of Statement 133, as amended by Statement 149, indicates that purchased option contracts (including net purchased options) and written option contracts (including net written options) that would require delivery of the related asset at an established price under the contract only if exercised are generally not eligible to qualify for the normal purchases and normal sales exception, except as indicated in paragraph 10(b)(4) and the related guidance in paragraph 58(b), as amended, and Statement 133 Implementation Issue No. C15, “Normal Purchases and Normal Sales Exception for Option-Type Contracts and Forward Contracts in Electricity.” The normal purchases and normal sales exception applies only to contracts that provide for the purchase or sale of something other than a financial instrument or derivative instrument that will be delivered in quantities expected to be used or sold by the reporting entity over a reasonable period in the normal course of business. Option contracts only contingently provide for such purchase or sale since exercise of an option contract is not assured. Thus, in accordance with paragraph 10(b)(2) of Statement 133, as amended, freestanding option contracts (including in-the-money option contracts) are not eligible to qualify for the normal purchases and normal sales exception. Furthermore, because of the contingent nature of an option contract (whose potential exercise is typically dependent upon future changes in the underlying), an entity cannot determine at the inception of the option contract that it will be probable throughout the term of the contract that physical delivery will result. Thus, option contracts cannot meet the requirement in paragraph 10(b) that it be “probable at

inception and throughout the term of the individual contract that the contract … will result in physical delivery." The normal purchases and normal sales exception applies only to forward contracts. However, as indicated in paragraph 10(b)(3), forward contracts that contain optionality features would be eligible to qualify for the normal purchases and normal sales exception only if the optionality feature could not modify the quantity of the asset to be delivered under the contract. (Refer to the following discussion.)

The following are examples of forward contract with optionality features:

1. Company A enters into a forward contract to purchase on a specified date a specified quantity of a raw material that is readily convertible to cash. The purchase price is the current market price on the date of purchase, not to exceed a specified maximum price (a cap) nor to be less than a specified minimum price (a floor).
2. Company B enters into a forward contract to purchase on a specified date a specified quantity of a raw material that is readily convertible to cash. The contract's purchase price is a fixed amount per unit that is below the current forward price; however, if the market price on the date of purchase has fallen below a specified level, Company B's purchase price would be adjusted to a higher fixed amount significantly in excess of the current forward price at the inception of the contract. (The contract entered into by Company B is a compound derivative consisting of a forward contract to purchase raw material at the original fixed price and a written option that obligates Company B to purchase the raw material for the higher adjusted price if the market price of the raw material falls below the specified level. In exchange for the written option, Company B received a premium representing the difference between the purchase price in the contract and the forward market price of the raw material at the inception of the contract.)
3. Company C enters into a forward contract to purchase on a specified date a specified quantity of a raw material that is readily convertible to cash. The contract's purchase price is a fixed amount per unit that is below the current forward price. However, if the market price on the date of purchase has fallen below a specified level that is below the contract's fixed purchase price, Company C would be required to purchase a specified additional quantity of the raw material at the contract's fixed purchase price (which is above the current market price on the date of purchase). (The contract entered into by Company C is a compound derivative consisting of a forward contract to purchase raw material at the original fixed price and a written option that obligates Company C to purchase additional quantities of the raw material at an above-market price if the market price of the raw material falls below the specified level.)

In the above cases, the optionality feature must be analyzed to determine whether it could modify the quantity of the asset to be delivered under the contract. In doing so, the conclusion as to whether the contract is eligible for the normal purchases and sales exception applies in the same way to both counterparties—the purchaser and the writer of the option (within the forward contract).

In cases in which the optionality feature in the forward contract can modify the quantity of the asset to be delivered under the contract, if that option feature has expired or has been completely exercised (even if delivery has not yet occurred), there is no longer any uncertainty as to the quantity to be delivered under the forward contract.

Accordingly, following such expiration or exercise, the forward contract would be eligible for designation as a normal purchase or normal sale, provided that that the other conditions in paragraph 10(b) are met.

In Example 1, the optionality feature cannot modify the quantity to be delivered; thus, the contract is eligible to qualify for the normal purchases and normal sales exception.

Similarly, the contract in Example 2 is also eligible to qualify for the normal purchases and normal sales exception because the optionality feature in the contract cannot modify the quantity to be delivered.

The contract in Example 3 is not eligible to qualify for the normal purchases and normal sales exception since the optionality feature in the contract can modify the quantity of the asset to be delivered under the contract.

EFFECTIVE DATE

The effective date of the revised implementation guidance in this Issue for each reporting entity is the first day of its first fiscal quarter beginning after June 29, 2001, the date that the Board-cleared revised guidance was posted on the FASB website. The revisions made on March 26, 2003, do not affect the effective date.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Derivatives Implementation Group

Statement 133 Implementation Issue No. C15

Title:	Scope Exceptions: Normal Purchases and Normal Sales Exception for Option-Type Contracts and Forward Contracts in Electricity
Paragraph references:	10(b), 58(b)
Date cleared by Board:	June 27, 2001 **(Revised December 19, 2001)**
Date posted to website:	June 29, 2001
Date latest revision posted to website:	November 10, 2003
Affected by:	FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities* **(Revised November 5, 2003)**

QUESTION

Can the normal purchases and normal sales exception be extended to power purchase or sale agreements (whether forward contracts, option contracts, or combinations of both), including capacity contracts, for the purchase or sale of electricity?

BACKGROUND

In many situations, companies in the electric industry enter into contracts that permit one party to purchase electricity (also referred to as "power") from another. Such contracts can vary substantially in terms, with some requiring delivery of a specific quantity or power and others providing optionality regarding the quantity to be delivered.

The types of contracts typically used to buy and sell power are driven by the characteristics of the electric power industry. A unique characteristic of the industry is that electricity cannot be readily stored in significant quantities. As a result, some of the contracts to buy and sell electricity permit the buyer some flexibility in determining when to take electricity and in what quantity in order to match power to fluctuating demand.

Another characteristic of the industry is that fixed costs are a very high percentage of the total cost of producing power. In order to provide for recovery of such fixed costs, power contracts that are option contracts typically include a specified charge (sometimes referred to as the capacity or demand charge) to provide for recovery of the cost of the plant (or, in some cases, recovery of the market-based value of the plant) and related financing. An option contract will also include a variable charge to recover, among other things, the variable cost of producing power (the energy charge). Option contracts that contain a specified capacity charge that is based on recovering the cost of the plant and a variable energy charge are often referred to as capacity contracts, although that term is also used for certain forward contracts.

In a regulated electric industry, regulators set rates in order to recover plant fixed costs and variable costs plus a reasonable return. Tariffs are established that generally separate the capacity charge and the energy charge, among other charges. With the introduction of independent power plants, some contracts to buy and sell power also include capacity charges and energy charges, which in the past were generally established by regulators. The intent to physically deliver power at rates that will

recover the cost of plant and energy while giving the purchaser the ability to have some control over when and in what quantity power is delivered is a consistent characteristic of these contracts.

With the deregulation of the electric utility industry, the above industry characteristics continue to drive how contracts to buy and sell power are structured. The buyer of power needs some flexibility in when to take power and in what quantity, and the seller needs to price such arrangements in order to cover the high fixed costs of producing electricity. In some cases, the purchase price of the electricity is entirely fixed, as in a forward contract or in an option contract that involves an initial premium payment for the time value of the option. More commonly for option contracts, the purchase price of the electricity is composed of an initial specified element and a variable element that is payable only if the option is exercised and electricity is delivered.

RESPONSE

Paragraph 10(b)(4), as amended by Statement 149, permits power purchase or sales agreements (whether forward contracts, option contracts, or combinations of both) for the purchase or sale of electricity to qualify for the normal purchases and normal sales exception (in paragraph 10(b)(4)) provided that all of the applicable criteria in paragraph 58(b), as amended, are met. Those criteria are presented below, with supplemental comments for criterion 2.

Criteria applicable to both parties to the contract:

1. The terms of the contract require physical delivery of electricity. That is, the contract does not permit net settlement, as described in paragraphs 9(a) and 57(c)(1). For an option contract, physical delivery is required if the option contract is exercised.
2. The power purchase or sales agreement (whether a forward contract, an option contract, or a combination of both) is a capacity contract, as defined in Statement 133 (as amended). Differentiating between an option contract that is a capacity contract and a traditional option contract (that is, a financial option on electricity) is a matter of judgment that depends on the facts and circumstances. For power purchase or sale agreements that contain option features, the characteristics of an option contract that is a capacity contract and a traditional option contract, which are set forth in the appendix to this Issue, should be considered in that evaluation; however, other characteristics not listed in the appendix may also be relevant to that evaluation.

Criterion applicable only to the seller of electricity:

3. The electricity that would be deliverable under the contract involves quantities that are expected to be sold by the reporting entity in the normal course of business.

Criteria applicable only to the buyer of electricity:

4. The electricity that would be deliverable under the contract involves quantities that are expected to be used or sold by the reporting entity in the normal course of business.

5. The buyer of the electricity under the power purchase or sales agreement is an entity that is engaged in selling electricity to retail or wholesale customers and is statutorily or otherwise contractually obligated to maintain sufficient capacity to meet electricity needs of its customer base.
6. The contracts are entered into to meet the buyer's obligation to maintain a sufficient capacity, including a reasonable reserve margin established by or based upon a regulatory commission, local standards, regional reliability councils, or regional transmission organizations.

Because electricity cannot be readily stored in significant quantities and the entity engaged in selling electricity is obligated to maintain sufficient capacity to meet the electricity needs of its customer base, an option contract for the purchase of electricity that meets the above criteria qualifies for the normal purchases and normal sales exception in paragraph 10(b). In contrast, Statement 133 Implementation Issue No. C10, "Can Option Contracts and Forward Contracts with Optionality Features Qualify for the Normal Purchases and Normal Sales Exception?" prohibits that exception from being applied to a contract for the purchase of an asset other than electricity if the contract contains an optionality feature that can modify the quantity of the asset to be delivered under the contract.

Power purchase or sales agreements that meet only the above applicable criteria qualify for the normal purchases and normal sales exception even if they are subject to being booked out or are scheduled to be booked out. Forward contracts for the purchase or sale of electricity that do not meet the criteria in this Issue as well as other forward contracts are nevertheless *eligible* to qualify for the normal purchases and normal sales exception in paragraph 10(b)(1) by meeting all the criteria in that paragraph, unless those contracts are subject to unplanned netting (that is, subject to possibly being booked out).

The above guidance does not affect the accounting for requirements contracts that would not be required to be accounted for under the guidance in Statement 133 pursuant to Statement 133 Implementation Issue No. A6, "Notional Amounts of Commodity Contracts." Contracts that qualify for the normal purchases and normal sales exception based on the guidance in this Issue do not require compliance with any additional guidance in paragraph 10(b). However, contracts that have a price based on an underlying that is not clearly and closely related to the electricity being sold or purchased or that are denominated in a foreign currency that meets neither of the criteria in paragraphs 15(a)–15(d) shall not be considered normal purchases and normal sales.

For contracts that qualify for the normal purchases and normal sales exception provided by this Issue, the entity shall document the basis for concluding that the agreement is a capacity contract.

The guidance in this Issue should not be applied by analogy to the accounting for other types of contracts not meeting the criteria in the above paragraphs.

EFFECTIVE DATE

The effective date of the implementation guidance in this Issue for each reporting entity is the first day of its first fiscal quarter beginning after June 29, 2001, the date that the Board-cleared guidance was first posted on the FASB website. Revisions were

subsequently made on October 10 and December 19, 2001. The effective date of those revisions to the implementation guidance in this Issue for each reporting entity is the first day of its second fiscal quarter beginning after December 28, 2001, the date that the revised cleared guidance was posted on the FASB website. Revisions were also made on November 5, 2003. The effective date of those revisions to the implementation guidance in this Issue for each reporting entity is the first day of its first fiscal quarter beginning after November 10, 2003, the date that the most recently revised cleared guidance was posted on the FASB website. The revised implementation guidance applies to all power purchase or sales agreements existing on or after that effective date. Early application is permitted. The revisions made on March 26, 2003, do not affect the effective date.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Appendix to Implementation Issue No. C15

Characteristics of both Option Contracts That Are Capacity Contracts and Financial Options on Electricity

	Option Contract That Is a Capacity Contract	Financial Option Contract on Electricity
1	The contract usually specifies the power plant or group of power plants providing the electricity.	No reference is made to the generation origination of the electricity.
2	The strike price (paid upon exercise) includes pricing terms to compensate the plant operator for variable operations and maintenance costs expected during the specified production periods.	The strike price is structured based on the expected forward prices of power.
3	The specified quantity is based on individual needs of parties to the agreement.	The specified quantity reflects standard amounts of electric energy, which facilitate market liquidity (for example, exercise in increments of 10,000 KwH).
4	The title transfer point is usually at one or a group of specified physical delivery point(s), as opposed to a major market hub.	The specified index transfer point is a major market hub (liquid trading hub), not seller- or buyer-site specific.
5	The contract usually specifies certain operational performance by the facility (for example, the achievement of a certain heat rate).	No operational performance is specified (not plant specific).
6	The contract sometimes incorporates requirements for interconnection facilities, physical transmission facilities, or reservations for transmission services.	None specified.
7	The contract may specify jointly agreed-to plant outages (for example, for maintenance) and provide for penalties in the event of unexpected outages.	Penalties for outages are not specified (not plant specific).
8	Damage provisions upon default are usually based on a reduction of the capacity payment (which is not market based). If default provisions specify market liquidating damages, they usually contain some form of floor, ceiling, or both. The characteristics of the default provision are usually tied to the expected generation facility.	Damage provisions upon default are based on market liquidating damages.
9	The contract's term is usually long (one year or more).	The contract's term is not longer than 18 to 24 months because financial options on electricity are currently illiquid beyond that period.

Additional Details

Derivatives Implementation Group

Statement 133 Implementation Issue No. C16

Title:	Scope Exceptions: Applying the Normal Purchases and Normal Sales Exception to Contracts That Combine a Forward Contract and a Purchased Option Contract
Paragraph references:	10(b)
Date cleared by Board:	September 19, 2001
Date posted to website:	October 10, 2001
Date latest revision posted to website:	May 1, 2003
Affected by:	FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities* **(Revised March 26, 2003)**

QUESTION

If a purchased option that would, if exercised, require delivery of the related asset at an established price under the contract is combined with a forward contract in a single supply contract and that single supply contract meets the definition of a derivative, is that single supply contract eligible to qualify for the normal purchases and normal sales exception in paragraph 10(b)?

BACKGROUND

Some utilities and independent power producers (also called IPPs) have fuel supply contracts that require delivery of a contractual minimum quantity of fuel at a fixed price and have an option that permits the holder to take specified additional amounts of fuel at the same fixed price at various times. Essentially, that option to take more fuel is a purchased option that is combined with the forward contract in a single supply contract. Typically, the option to take additional fuel is built into the contract to ensure that the buyer has a supply of fuel in order to produce the electricity during peak demands; however, the buyer may have the ability to sell to third parties the additional fuel purchased through exercise of the purchased option. Due to the difficulty in estimating peak electricity load and thus the amount of fuel needed to generate the required electricity, those fuel supply contracts are common in the electric utility industry (though similar supply contracts may exist in other industries). Those fuel supply contracts are not requirements contracts that are addressed in Statement 133 Implementation Issue No. A6, "Notional Amounts of Commodity Contracts."

Many of those contracts meet the definition of a derivative because they have a notional amount and an underlying, require no or a smaller initial net investment, and provide for net settlement (for example, through their default provisions or by requiring delivery of an asset that is readily convertible to cash). For purposes of applying Statement 133 to contracts that meet the definition of a derivative, it is necessary to determine whether the fuel supply contract qualifies for the normal purchases and normal sales exception, whether bifurcation of the option is permitted if it does not qualify for the normal purchases and normal sales exception, or whether the entire contract is accounted for as a derivative.

Statement 133 Implementation Issue No. C15, "Normal Purchases and Normal Sales Exception for Certain Option-Type Contracts and Forward Contracts in Electricity," indicates that power purchase or sales agreements (including combinations of a

forward contract and an option contract) that meet the criteria in that Implementation Issue qualify for the normal purchases and normal sales exception in paragraph 10(b).

Although the above background information discusses utilities and independent power producers, this Implementation Issue applies to all entities that enter into contracts that combine a forward contract and a purchased option contract, not just to utilities and independent power producers.

RESPONSE

The inclusion of a purchased option that would, if exercised, require delivery of the related asset at an established price under the contract within the single supply contract that meets the definition of a derivative disqualifies the entire derivative fuel supply contract from being eligible to qualify for the normal purchases and normal sales exception in paragraph 10(b) except as provided in paragraph 10(b)(4) of Statement 133, as amended, and Implementation Issue C15 with respect to certain power purchase or sales agreements. Statement 133 Implementation Issue No. C10, “Can Option Contracts and Forward Contracts with Optionality Features Qualify for the Normal Purchases and Normal Sales Exception,” states? “Option contracts only contingently provide for such purchase or sale since exercise of the option contract is not assured. Thus, in accordance with paragraph 10(b)(2) of Statement 133, as amended, freestanding option contracts (including in-the-money options contracts) are not eligible to qualify for the normal purchases and normal sales exception.” Paragraph 10(b)(3) of Statement 133, as amended, and Implementation Issue C10 further indicate that forward contracts with embedded optionality can qualify for the normal purchases and normal sales exception only if the embedded optionality (such as price caps) does not affect the quantity to be delivered. The fuel supply contract cannot qualify for the normal purchases and normal sales exception because of the optionality regarding the quantity of fuel to be delivered under the contract.

An entity is not permitted to bifurcate the forward contract component and the option contract component of a fuel supply contract that in its entirety meets the definition of a derivative and then assert that the forward contract component is eligible to qualify for the normal purchases and normal sales exception. Paragraph 18 indicates that an entity is prohibited from separating a compound derivative in components representing different risks. (The provisions of paragraph 12 require that certain derivatives that are embedded in non-derivative hybrid instruments must be split out from the host contract and accounted for separately as a derivative; however, paragraph 12 does not apply to a contract that meets the definition of a derivative in its entirety.)

An entity may wish to enter into two separate contracts—a forward contract and an option contract—that economically achieve the same results as the single derivative contract described in the background section and determine whether the exception in paragraph 10(b) applies to the separate forward contract.

Similar to the option contracts discussed in Implementation Issue C10, this Issue addresses option components that would require delivery of the related asset at an established price under the contract. If the option component does not provide any benefit to the holder beyond the assurance of a guaranteed supply of the underlying commodity for use in the normal course of business and that option component only permits the holder to purchase additional quantities at the market price at the date of delivery (that is, that option component will always have a fair value of zero), that

option component would not require delivery of the related asset at an established price under the contract.

If an entity's single supply contract included at its inception both a forward contract and an option contract and, in subsequent renegotiations, that contract is negated and replaced by two separate contracts (a forward contract for a specific quantity that will be purchased and an option contract for additional quantities whose purchase is conditional upon exercise of the option), the new forward contract would be eligible to qualify for the normal purchases and normal sales exception under paragraph 10(b), whereas the new option contract would not be eligible for that exception. From the inception of that new separate option contract, it would be accounted for under Statement 133. However, the guidance in this Implementation Issue would not retroactively affect the accounting for the combination derivative contract that was negated prior to the effective date of this Implementation Issue.

If on the effective date of this Implementation Issue, an entity was party to a combination derivative contract that included both a forward contract and an option contract but the entity had not been accounting for that derivative contract under Statement 133 because it had documented an asserted compliance with paragraph 10(b), that combination derivative contract would be reported at its fair value on the effective date of this Implementation Issue, with the offsetting entry recorded in current period earnings. The combination derivative contract cannot be bifurcated into a forward contract that would have been eligible to qualify for the normal purchases and normal sales exception and an option contract.

EFFECTIVE DATE

The effective date of the implementation guidance in this Issue for each reporting entity is the first day of its second fiscal quarter beginning after October 10, 2001, the date that the Board-cleared guidance was posted on the FASB website. The revisions made on March 26, 2003, do not affect the effective date.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.