

FINANCIAL ACCOUNTING SERIES



No. 2015-13
August 2015

Derivatives and Hedging (Topic 815)

Application of the Normal Purchases and Normal Sales
Scope Exception to Certain Electricity Contracts within
Nodal Energy Markets

a consensus of the FASB Emerging Issues Task Force

An Amendment of the *FASB Accounting Standards Codification*®

Financial Accounting Standards Board

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FINANCIAL ACCOUNTING SERIES (ISSN 0885-9051) is published quarterly by the Financial Accounting Foundation. Periodicals postage paid at Norwalk, CT and at additional mailing offices. The full subscription rate is \$242 per year. POSTMASTER: Send address changes to Financial Accounting Standards Board, 401 Merritt 7, PO Box 5116, Norwalk, CT 06856-5116. | **No. 420**

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Summary

Why Is the FASB Issuing This Accounting Standards Update (Update)?

Topic 815, Derivatives and Hedging, requires that a derivative contract be recognized at fair value unless the contract qualifies for a scope exception. One of those scope exceptions is the normal purchases and normal sales scope exception. Normal purchases and normal sales contracts are those 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 a reporting entity over a reasonable period in the normal course of business. There are two sets of criteria an entity that purchases or sells electricity could consider to determine whether a contract is eligible for the normal purchases and normal sales scope exception. Both sets of criteria include a criterion related to physical delivery.

Certain contracts for the purchase or sale of electricity on a forward basis meet the definition of a derivative under Topic 815. For example, a forward contract to purchase a stated volume of electricity from a power-generating company at a fixed price at a liquid hub location within a nodal energy market often meets the definition of a derivative. A nodal energy market is an interconnected electricity grid operated by an independent system operator with established price points at each node or hub location.

Questions were raised about whether a contract for the purchase or sale of electricity on a forward basis should be eligible to meet the physical delivery criterion of the normal purchases and normal sales scope exception when either the delivery location is within a nodal energy market or the contract necessitates transmission through a nodal energy market and one of the contracting parties incurs charges (or credits) for the transmission of the electricity based in part on locational marginal pricing differences payable to (or receivable from) an independent system operator.

Some stakeholders said that those types of contracts meet the physical delivery criterion because the terms of the contract require physical delivery or because it is probable at inception and throughout the term of the contract that the contract will result in physical delivery. That is, the substance of those contracts requires the physical delivery of electricity. Thus, in their view, those contracts may be eligible for the normal purchases and normal sales scope exception. Other stakeholders said that those types of contracts do not meet the physical delivery criterion. To them, one of the parties to the forward contract must sell the electricity to the independent system operator at the grid entry point at the locational marginal price at that location and must simultaneously purchase the same quantity of electricity from the independent system operator at the grid exit point at the

locational marginal price at that location. Thus, in their view, the sale of the electricity to the independent system operator results in net settlement of the forward contract making the forward contract ineligible for the normal purchases and normal sales scope exception. The amendments in this Update are intended to resolve the diversity in practice resulting from these two views.

Who Is Affected by the Amendments in This Update?

The amendments in this Update apply to entities that enter into contracts for the purchase or sale of electricity on a forward basis and arrange for transmission through, or delivery to a location within, a nodal energy market whereby one of the contracting parties incurs charges (or credits) for the transmission of that electricity based in part on locational marginal pricing differences payable to (or receivable from) an independent system operator.

What Are the Main Provisions?

The amendments in this Update specify that the use of locational marginal pricing by an independent system operator does not constitute net settlement of a contract for the purchase or sale of electricity on a forward basis that necessitates transmission through, or delivery to a location within, a nodal energy market, even in scenarios in which legal title to the associated electricity is conveyed to the independent system operator during transmission. Consequently, the use of locational marginal pricing by the independent system operator does not cause that contract to fail to meet the physical delivery criterion of the normal purchases and normal sales scope exception. If the physical delivery criterion is met, along with all of the other criteria of the normal purchases and normal sales scope exception, an entity may elect to designate that contract as a normal purchase or normal sale.

How Do the Main Provisions Differ from Current Generally Accepted Accounting Principles (GAAP) and Why Are They an Improvement?

Current GAAP does not contain specific guidance about whether the use of locational marginal pricing by an independent system operator results in net settlement of a contract for the purchase or sale of electricity on a forward basis that necessitates transmission through, or delivery to a location within, a nodal energy market. Thus, the amendments in this Update are an improvement to GAAP because the amendments specify that the use of locational marginal pricing by the independent system operator does not constitute net settlement of the contract.

When Will the Amendments Be Effective?

The amendments in the Update are effective upon issuance and should be applied prospectively. Therefore, an entity will have the ability to designate on or after the date of issuance any qualifying contracts as normal purchases or normal sales.

Amendments to the *FASB Accounting Standards Codification*[®]

Introduction

1. The Accounting Standards Codification is amended as described in paragraphs 2–4. In some cases, to put the change in context, not only are the amended paragraphs shown but also the preceding and following paragraphs. Terms from the Master Glossary are in **bold** type. Added text is underlined, and deleted text is ~~struck out~~.

Amendments to Subtopic 815-10

2. Add paragraph 815-10-15-36A and amend paragraph 815-10-15-45(a), with a link to transition paragraph 815-10-65-7, as follows:

Derivatives and Hedging—Overall

Scope and Scope Exceptions

> > > Probable Physical Settlement

815-10-15-35 For a contract that meets the net settlement provisions of paragraphs 815-10-15-100 through 15-109 and the market mechanism provisions of paragraphs 815-10-15-110 through 15-118 to qualify for the normal purchases and normal sales scope exception, it must be probable at inception and throughout the term of the individual contract that the contract will not settle net and will result in physical delivery.

815-10-15-36 The normal purchases and normal sales scope exception only relates to a contract that results in gross delivery of the commodity under that contract. The normal purchases and normal sales scope exception shall not be applied to a contract that requires cash settlements of gains or losses or otherwise settle gains or losses periodically because those settlements are net settlements. Paragraph 815-20-25-22 explains how an entity may designate such a contract as a hedged item in an **all-in-one hedge** if all related criteria are met.

815-10-15-36A Certain contracts for the purchase or sale of electricity on a forward basis that necessitate transmission through, or delivery to a location within, an electricity grid operated by an independent system operator result in one of the contracting parties incurring charges (or credits) for the transmission of that

electricity based in part on locational marginal pricing differences payable to (or receivable from) the independent system operator. For example, this is the case when the delivery location under the contract (for example, a hub location) is not the same location as the point of ultimate consumption of the electricity or the point from which the electricity exits the electricity grid for transmission to a customer load zone. Delivery to the point of ultimate consumption or the exit point is facilitated by the independent system operator of the grid. The purchase or sale contract and the transmission services do not constitute a series of sequential contracts intended to accomplish the ultimate acquisition or sale of a commodity as discussed in paragraph 815-10-15-41, and the use of locational marginal pricing to determine the transmission charge (or credit) does not constitute net settlement, even in situations in which legal title to the associated electricity is conveyed to the independent system operator during transmission.

> > > Application to Power Purchase or Sale Agreements

815-10-15-45 Notwithstanding the criteria in paragraphs 815-10-15-41 through 15-44, a power purchase or sales agreement (whether a forward contract, option contract, or a combination of both) that is a capacity contract for the purchase or sale of electricity also qualifies for the normal purchases and normal sales scope exception if all of the following applicable criteria are met:

- a. For both parties to the contract, both of the following criteria are met:
 1. The terms of the contract require physical delivery of electricity. That is, the contract does not permit net settlement, as described in paragraphs 815-10-15-100 through 15-109. For an option contract, physical delivery is required if the option contract is exercised. Certain contracts for the purchase or sale of electricity on a forward basis that necessitate transmission through, or delivery to a location within, an electricity grid operated by an independent system operator result in one of the contracting parties incurring charges (or credits) for the transmission of that electricity based in part on locational marginal pricing differences payable to (or receivable from) the independent system operator. For example, this is the case when the delivery location under the contract (for example, a hub location) is not the same location as the point of ultimate consumption of the electricity or the point from which the electricity exits the electricity grid for transmission to a customer load zone. Delivery to the point of ultimate consumption or the exit point is facilitated by the independent system operator of the grid. The use of locational marginal pricing to determine the transmission charge (or credit) does not constitute net settlement, even in situations in which legal title to the associated electricity is conveyed to the independent system operator during transmission.
 2. The power purchase or sales agreement is a capacity contract. Differentiating between 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 paragraph 815-10-55-31 shall be considered in that evaluation; however, other characteristics not listed in that paragraph may also be relevant to that evaluation.

3. Add paragraph 815-10-65-7 and its related heading as follows:

> Transition Related to Accounting Standards Update No. 2015-13, Derivatives and Hedging (Topic 815): Application of the Normal Purchases and Normal Sales Scope Exception to Certain Electricity Contracts within Nodal Energy Markets

815-10-65-7 The following represents the transition and effective date information related to Accounting Standards Update No. 2015-13, *Derivatives and Hedging (Topic 815): Application of the Normal Purchases and Normal Sales Scope Exception to Certain Electricity Contracts within Nodal Energy Markets*:

- a. The pending content that links to this paragraph is effective upon issuance for all entities.
- b. An entity shall apply the pending content that links to this paragraph prospectively.
- c. An entity shall provide the disclosures in paragraphs 250-10-50-1(a) and 250-10-50-2, as applicable, in the period the entity adopts the pending content that links to this paragraph.

4. Amend paragraph 815-10-00-1, by adding the following items to the table, as follows:

815-10-00-1 The following table identifies the changes made to this Subtopic.

Paragraph	Action	Accounting Standards Update	Date
815-10-15-36A	Added	2015-13	08/10/2015
815-10-15-45	Amended	2015-13	08/10/2015
815-10-65-7	Added	2015-13	08/10/2015

The amendments in this Update were adopted by the unanimous vote of the seven members of the Financial Accounting Standards Board:

Russell G. Golden, *Chairman*
James L. Kroeker, *Vice Chairman*
Daryl E. Buck
Thomas J. Linsmeier
R. Harold Schroeder
Marc A. Siegel
Lawrence W. Smith

Background Information and Basis for Conclusions

Introduction

BC1. The following summarizes the Task Force's considerations in reaching the conclusions in this Update. It includes the Board's basis for ratifying the Task Force conclusions when needed to supplement the Task Force's considerations. It also includes reasons for accepting certain approaches and rejecting others. Individual Task Force and Board members gave greater weight to some factors than to others.

Background Information

BC2. Topic 815, Derivatives and Hedging, requires that a derivative contract be recognized at fair value unless the contract qualifies for a scope exception. One of those scope exceptions is the normal purchases and normal sales scope exception. Normal purchases and normal sales contracts are those 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 a reporting entity over a reasonable period in the normal course of business. Any contract may qualify for the normal purchases and normal sales scope exception by meeting the criteria of paragraphs 815-10-15-22 through 15-44, which include a criterion that it is probable that the contract will not be net settled and will result in physical delivery. Power purchase or sale agreements also may qualify for the normal purchases and normal sales scope exception by meeting the criteria of paragraphs 815-10-15-45 through 15-50, which include a criterion that the terms of the contract require physical delivery and do not permit net settlement.

BC3. Certain contracts for the purchase or sale of electricity on a forward basis meet the definition of a derivative under Topic 815. For example, a forward contract to purchase a stated volume of electricity from a power-generating company at a fixed price at a liquid hub location within a nodal energy market often meets the definition of a derivative. A nodal energy market is an interconnected electricity grid operated by an independent system operator with established price points at each node or hub location.

BC4. Questions were raised about whether a contract for the purchase or sale of electricity on a forward basis should be eligible to meet the physical delivery criterion of the normal purchases and normal sales scope exception when either the delivery location is within a nodal energy market or the contract necessitates transmission through a nodal energy market and one of the contracting parties incurs charges (or credits) for the transmission of the electricity based in part on

locational marginal pricing differences payable to (or receivable from) an independent system operator.

BC5. Some stakeholders said that those types of contracts meet the physical delivery criterion because the terms of the contract require physical delivery or because it is probable at inception and throughout the term of the contract that the contract will result in physical delivery. That is, the substance of those contracts requires the physical delivery of electricity. Thus, in their view, those contracts may be eligible for the normal purchases and normal sales scope exception. Other stakeholders said that those types of contracts do not meet the physical delivery criterion. To them, one of the parties to the forward contract must sell the electricity to the independent system operator at the grid entry point at the locational marginal price at that location and must simultaneously purchase the same quantity of electricity from the independent system operator at the grid exit point at the locational marginal price at that location. Thus, in their view, the sale of the electricity to the independent system operator results in net settlement of the forward contract making the forward contract ineligible for the normal purchases and normal sales scope exception. The amendments in this Update are intended to resolve the diversity in practice resulting from these two views.

BC6. At its March 19, 2015 meeting, the Task Force reached a consensus-for-exposure on this Issue. The Board subsequently ratified the consensus-for-exposure and on April 23, 2015, issued a proposed Accounting Standards Update, *Derivatives and Hedging (Topic 815): Application of the Normal Purchases and Normal Sales Scope Exception to Certain Electricity Contracts within Nodal Energy Markets*, for public comment, with a comment period that ended on May 18, 2015. The Board received five comment letters on the proposed Update. Overall, respondents supported the application of the normal purchases and normal sales scope exception as described in the proposed Update.

BC7. The Task Force considered the feedback received on the proposed Update at its June 18, 2015 meeting and reached a consensus. The Board subsequently ratified the consensus, resulting in issuance of this Update.

Scope

BC8. The Task Force reached a consensus-for-exposure that the amendments in the proposed Update should apply to entities that enter into contracts for the purchase or sale of electricity on a forward basis and arrange for delivery to a location within a nodal energy market whereby one of the contracting parties incurs charges (or credits) for the transmission of that electricity based in part on locational marginal pricing differences payable to (or receivable from) an independent system operator.

BC9. Some comment letter respondents had differing views about the proposed scope. Those differing views included basing the scope on a broader principle,

expanding the scope to include certain other specific types of contracts, and leaving the scope as described in the proposed Update.

BC10. The Task Force decided not to create a broader principle because of the unique nature of nodal energy market transactions and because it was concerned about the potential unintended consequence of including in the scope contracts that are not consistent with the Board's intent when it provided the normal purchases and normal sales scope exception for contracts for the physical delivery of nonfinancial assets that are not unlike binding purchase orders.

BC11. The Task Force did not prescribe whether certain other specific types of contracts are eligible for the normal purchases and normal sales scope exception to derivative accounting because of the possible variations in contract terms and regulatory requirements. Rather, the Task Force decided to focus on whether the use of locational marginal pricing by an independent system operator to determine the transmission charges (or credits) constitutes net settlement of the purchase or sale contract, including situations in which legal title to the associated electricity is conveyed to the independent system operator during transmission (that is, whether those types of contracts are eligible to meet the physical delivery criterion).

BC12. However, the Task Force did expand the scope of this Update to include contracts for the purchase or sale of electricity on a forward basis that necessitate transmission *through* a location within a nodal energy market whereby one of the contracting parties incurs charges (or credits) for the transmission of that electricity based in part on locational marginal pricing differences payable to (or receivable from) an independent system operator. That is, the scope of the amendments in this Update applies to both types of contracts; those that necessitate the delivery of electricity to and from locations within a nodal energy market and those that necessitate the delivery of electricity to and from locations outside a particular nodal energy market whereby the electricity must be transmitted through that particular nodal energy market.

Application of the Normal Purchases and Normal Sales Scope Exception to Certain Electricity Contracts within Nodal Energy Markets

BC13. The Task Force reached a consensus that the use of locational marginal pricing by an independent system operator to determine the transmission charge (or credit) does not constitute net settlement of a contract for the purchase or sale of electricity on a forward basis that necessitates transmission through, or delivery to a location within, a nodal energy market, even in scenarios in which legal title to the associated electricity is conveyed to the independent system operator during transmission. Consequently, the use of locational marginal pricing by the independent system operator does not cause that contract to fail to meet the physical delivery criterion of the normal purchases and normal sales scope

exception. If the physical delivery criterion is met, along with all of the other criteria of the normal purchases and normal sales scope exception, an entity may elect to designate that contract as a normal purchase or normal sale.

BC14. The Task Force had various views about whether the language in current GAAP indicates that the use of locational marginal pricing by the independent system operator to determine the transmission charge (or credit) results in net settlement of a purchase or sale contract. However, the Task Force concluded that the consensus is consistent with the Board's intent when it provided the normal purchases and normal sales scope exception for contracts for the physical delivery of nonfinancial assets that are not unlike binding purchase orders.

BC15. Before certain energy markets evolved to a nodal energy market structure, companies could use either owned transmission systems or reserve transmission capacity along certain paths and elect to apply the normal purchases and normal sales scope exception assuming all of the criteria were met. In a nodal energy market, real-time transmission is the only way to move power through the electricity grid. Because there has been no change in the physical nature of electricity transmission before and after the evolution to nodal energy markets, the Task Force concluded that such an evolution should not prevent companies from being able to elect to apply the normal purchases and normal sales scope exception, provided that all of the criteria are met.

BC16. Although the transmission charge (or credit) payable to (or receivable from) the independent system operator is calculated based in part upon the difference between locational marginal prices at the delivery and withdrawal locations and many independent system operators now take title to the electricity during transmission, the Task Force does not view the independent system operator as a market participant engaged in the buying and selling of electricity because independent system operators do not buy and sell electricity for their own accounts. The reason some independent system operators now take title to electricity during transmission is to strengthen their credit standing in the event of default by a member because credit losses are charged back to all of the members of the group.

BC17. Disallowing these types of contracts from being eligible for the normal purchases and normal sales scope exception could result in a significant number of routine physical transactions being accounted for as derivatives because to purchase or sell electricity in a nodal energy market, at least one company must incur transmission charges (or credits) based in part on locational marginal pricing differences. For some companies, that would result in derivative gains (or losses) being recognized in earnings before physical delivery. For regulated companies within the scope of Topic 980, Regulated Operations, that could result in a balance sheet gross up of derivative assets (liabilities) and regulatory assets (liabilities) before physical delivery. The Task Force concluded that this accounting is not consistent with the nature and economics of a physical transaction. Furthermore,

users have indicated that remeasuring contracts for routine physical transactions at fair value is not decision useful.

Transition

BC18. The Task Force reached a consensus that the effects of initially adopting the amendments in this Update should be applied prospectively. Therefore, an entity will have the ability to designate qualifying contracts that are entered into on or after the effective date as normal purchases or normal sales. In addition, because an entity may elect the normal purchases and normal sales scope exception at inception of the contract or at a later date, the entity also will have the ability on or after the effective date to designate qualifying contracts that were entered into before the effective date as normal purchases or normal sales. That is, an entity has the ability on or after the effective date to designate any qualifying contracts as normal purchases or normal sales.

BC19. The Task Force considered whether an entity should be allowed to apply the amendments in this Update on a retrospective or modified retrospective basis. However, the Task Force decided on prospective transition because it is consistent with the transition framework established by the Derivatives Implementation Group in Statement 133 Implementation Issue K5, "Miscellaneous: Transition Provisions for Applying the Guidance in Statement 133 Implementation Issues," for contracts that were previously accounted for as derivatives but are not accounted for as derivatives under newly issued implementation guidance. In addition, because the normal purchase and normal sales scope exception can be made on a contract-by-contract basis, the Task Force was concerned that preparers could use hindsight to evaluate the performance of each derivative and select only certain contracts to designate as normal purchases and normal sales under retrospective or modified retrospective transition.

BC20. In Statement 133 Implementation Issue K5, if an entity had been accounting for a contract as a derivative before the effective date and designates the contract as a normal purchase or normal sale on or after the effective date, the contract's fair value at the date of designation would become its net carrying amount at the date of designation. The entity would apply other GAAP that is applicable to that contract prospectively from the date it was designated as a normal purchase or normal sale. Contracts that were designated as normal purchases or normal sales before the effective date are not affected by the amendments in this Update.

Effective Date

BC21. The Task Force reached a consensus that the amendments in this Update should be effective upon issuance. The Task Force decided that a transition period was unnecessary because comment letter respondents stated that the amendments could be implemented in a short amount of time. In addition, because

the normal purchases and normal sales scope exception is an election that can be made at any time, entities can choose to designate or to not designate qualifying contracts as normal purchases or normal sales at any time after the issuance of this Update.

Benefits and Costs

BC22. The objective of financial reporting is to provide information that is useful to present and potential investors, creditors, donors, and other capital market participants in making rational investment, credit, and similar resource allocation decisions. However, the benefits of providing information for that purpose should justify the related costs. Present and potential investors, creditors, donors, and other users of financial information benefit from improvements in financial reporting, while the costs to implement new guidance are borne primarily by present investors. The assessment of the costs and benefits of issuing new guidance is unavoidably more qualitative than quantitative because there is no method to objectively measure the costs to implement new guidance or to quantify the value of improved information in financial statements.

BC23. The Task Force anticipates that the amendments in this Update will decrease cost and complexity for entities that currently account for contracts for the purchase or sale of electricity on a forward basis that necessitate transmission through, or delivery to a location within, a nodal energy market as derivatives and that decide to designate qualifying contracts as normal purchases or normal sales on or after the effective date. Furthermore, this reduction in costs is justified because users have indicated that remeasuring contracts for routine physical transactions at fair value is not decision useful. The amendments also will provide the benefit of improving consistent application of GAAP by clarifying guidance that already exists within GAAP.

Amendments to the XBRL Taxonomy

The amendments to the *FASB Accounting Standards Codification*[®] in this Accounting Standards Update require changes to the U.S. GAAP Financial Reporting Taxonomy (Taxonomy). Those changes, which will be incorporated into the proposed 2016 Taxonomy, are available for public comment through [ASU Taxonomy Changes](#) provided at www.fasb.org, and finalized as part of the annual release process starting in September 2015.