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University of California

Governmental Accounting Standards Board (GASB) Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments.*

(Issued: February 12, 2010)

Issues Resolution Memo No. 53.2

Assessing Whether the University's Energy Contracts are Derivative Instruments Subject to the Disclosure Requirements of GASB Statement No. 53

Background

In June 2008, the GASB issued Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*. The Statement addresses the recognition, measurement and disclosure requirements for derivative instruments entered into by the University. Such instruments include contracts related to the purchase or sale of a commodity, e.g., electricity or natural gas.

The University regularly enters into energy contracts to purchase electricity and natural gas to moderate the price risks associated with these commodities.

Define Issues

The University must review the disclosure requirements contained in GASB Statement No. 53 to determine whether its energy contracts are derivative contracts, as defined by the GASB, and if so, whether they are investment derivatives or hedging derivatives.

Authoritative Guidance

Paragraph 14 of GASB Statement No. 53 states:

> "*Normal purchases and normal sales contracts.* Some governments enter into contracts that may meet the definition of a derivative instrument, but the contracts are intended to result in the purchase or sale of a commodity, such as natural gas or electricity, used in the normal course of operations. These contracts are distinguished from other purchases and sales contracts by their net settlement feature. That is, the government may have a choice to take or make delivery of the commodity or exchange the cash value of the contract to terminate the government's rights or obligations. These contracts are not

> included in the scope of this Statement, provided that it is probable the government will take or make delivery of the commodity specified in the derivative instrument. Indicators or normal purchases and normal sales contracts are (a) the government has entered into such a contract in the past, (b) the government has a practice of taking delivery or selling the commodity, and (c) the quantity of the commodity in the contract is consistent with the volume used in the government's activities. For example, a government's natural gas utility enters into a contract to purchase natural gas from a regional transportation pipeline. Settlement provisions of the contract permit the utility either to take delivery of the gas or to pay or receive a settlement price. This government routinely enters into similar contracts and takes delivery of the gas. The volume of gas specified in the contract is consistent with the volume expected to be sold to its customers for this time period. This contract is a normal purchase contract and, therefore, if outside the scope of this Statement."

The GASB Statement No. 53 Implementation Guide provides the following guidance:

Q4 A government enters into a take-or-pay contract for a commodity. Under this contract, the government agrees to pay a specified price for specified quantity of the commodity, whether or not it takes delivery. The government uses the commodity in its operations, and the quantity specified in the contract is consistent with the government's activities. It is probable that the government will take delivery of the commodity specified in the contract. Does this form of take-or-pay contract meet the definition of a derivative instrument in Statement 53, and, if so, should it be reported according to its requirements?

A4 Yes, this form of take-or-pay contract meets the definition of a derivative instrument (paragraph 7). However, as long as the government plans on taking delivery, and the quantity specified is consistent with what is used in the government's operations, the contract qualifies for the normal purchases and normal sales scope exception in paragraph 14 and should not be reported according to the requirements of Statement 53.

Q15 For a contract to meet the normal purchase and normal sales scope exception, it should be "probable that the government will take or make delivery of the commodity specified in the derivative instrument" (paragraph 14 of Statement 53). How often should a government evaluate whether a contract qualifies for the normal purchases and normal sales scope exception in paragraph 14?

A15 An evaluation of whether a contract meets the normal purchases and normal sales scope exception should be conducted as often as financial statements are prepared in conformity with generally accepted accounting principles.

Q16 A government applies the normal purchases and normal sales scope exception in paragraph 14 of Statement 53 to a purchase contract that is a derivative instrument. Even though the government expects to take delivery of the commodity, it ultimately does not. Instead, the contract is cash settled and the quantity of the commodity contemplated in the purchase contract is acquired through another contract. Under Statement 53, how should the government report the settlement of the purchase contract?

A16 The normal purchases and normal sales scope exception does not apply because the government does not take delivery of the commodity. Any fair value increase or decrease on the contract should be evaluated to determine whether the contract was an effective hedging derivative instrument (paragraphs 49-62). If the contract was an effective hedge, the fair value increase or decrease should be included as an adjustment to the cost of the commodity. If not, the fair value increase or decrease should be reported within the investment revenue classification.

Q20 A government utility enters into a gas contract that gives the utility the option to vary the volume of natural gas purchased, depending on its operational needs. May a contract that allows for variable quantities qualify for the normal purchases and normal sales scope exception?

A20 There are two requirements for a contract to qualify for the normal purchases and normal sales scope exception. First, it should be probable that the government will take delivery of the commodity specified in the contract. Second, the commodity delivered is expected to be used in the government's normal course of operations. A contract with variable quantities meets this requirement, provided that the quantity expected to be received from the contract is consistent with the volume used in the government's activities (paragraph 14 of Statement 53). If the government, however, plans to take delivery of a commodity in an amount greater than what is typically used in the government's activities, the contract does not qualify for the normal purchases and normal sales scope exception.

Discussion

Natural Gas

The University participates in the Natural Gas Services Program (NGS) operated by the California Department of General Services (DGS) for a portion of its natural gas needs. In one of two ways:

- *General Procurement Pools:* The DGS through the NGS program purchases natural gas through general procurement pools for a wide variety of participants throughout the state at competitive prices to moderate price risk and minimize price fluctuations.

- *Special Purchase Agreements:* Individual campuses and medical centers have entered into special purchase agreements with the DGS designed to meet the natural gas requirements specific to their individual operations.

Natural gas contracts through the DGS are entered into to meet the regular operational needs of the University. DGS policy is to purchase natural gas sufficient to meet, not exceed, the needs of its participants. Current contracts clearly indicate purchases are for operational needs and are not speculative.

Per the NGS Program Manager, it is DGS's internal policy to limit monthly forward contract purchases to no more than 75 percent of monthly forecasted volume requirements for the general procurement pools. For special purchases, DGS policy does not allow forward purchases of more than 80 percent of forecasted requirements for the month.

Electricity

The University enters into energy contracts with direct access provider(s) to meet its electricity load requirements. These agreements are used to mitigate price volatility associated with the purchase of electricity.

Electricity contracts are entered into to meet the regular operational needs of the University. Current contracts clearly indicate purchases are for operational needs and are not speculative. Current electricity contracts fall in two types:

- *Type A:* The University enters into take-or-pay electricity contracts that combine the electricity needs for all campuses into one consolidated contract. As summarized in Section 3.1 of Exhibit D, the University must pay the price specified in the contract within its total projected electricity usage and will pay an adjusted price per hour outside of this projected usage.

- *Type B:* These contracts apply to individual campus co-generators and are included as an additional provision in Exhibit D, Subsection 3.2. These entities have the right to purchase additional electricity throughout the year in one of two ways:

    1. They can enter into a separate forward contract for their forecasted usage, or
    2. They can choose to have the contractor provide energy based on the spot market price.

    Under the scenario in item 1, the campus has entered into a take-or-pay derivative contract. Under the scenario in item 2, no derivative contract has been entered into.

Conclusion

Paragraph 14 of GASB Statement No. 53 sets forth three indicators for identifying normal purchases or sales contracts:

1) Contract has been entered into in the past
2) Participant normally takes delivery of the commodity;
3) Quantity purchased is consistent with volume used in normal operations.

The University's natural gas contracts with the DGS are derivative contracts that meet these criteria and, therefore, are excluded from the scope of GASB Statement No. 53.

The University's electricity contracts with direct access providers may not be derivatives or may be derivative contracts that meet the criteria set forth in Paragraph 14. Therefore, these contracts are excluded from the scope of GASB Statement No. 53.

Next Steps—Required Actions

Responsibility	Required Completion Date	Action Item/Task
UCOP/ Campuses	May of each fiscal year	During the annual assessment of derivative instruments, review natural gas or electricity energy contracts to ensure that they are entered into for normal operations and should continue to be excluded from the scope of GASB Statement No. 53.
Campuses	May of each fiscal year	Add a fiscal closing step for the campuses as follows: "Each campus should review and document the following: - Review the natural gas or electricity purchases under contracts for the year. - Document that the Campus has taken delivery of the natural gas or electricity under contract and has not paid an amount to terminate the contract, and - The quantity purchased is consistent with the volume used in normal campus operations. If any of these circumstances are answered in the negative, contact UCOP Financial Management for assistance in determining the appropriate treatment for financial reporting purposes.