Working Draft:

Power & Utility Entities Revenue Recognition Implementation Issue

Issue #13-2: Requirements and Similar Contracts with Variable Volumes

Expected Overall Level of Impact to Industry Accounting: Significant

Wording to be Included in the Revenue Recognition Guide:

1. Power and utilities companies often utilize "requirements contracts" for purposes of buying and selling electricity or gas. Such contracts provide for delivery of as much electricity or gas as the customer needs. These types of contracts are necessary and typical for various reasons, including to secure a source of supply sufficient to cover anticipated needs; due to limited storage ability and/or capacity; or because consumption in many cases occurs immediately upon delivery. As a result of these business characteristics, customers may desire to contract for a supply source to meet their expected needs by using such variable-quantity contracts.

2. Such contracts are for discrete deliveries of individual units, and when requested those future deliveries often represent a performance obligation satisfied over time. The pricing for such contracts is generally known at the time the contract is executed and reflects the standalone selling price. While such contracts may take different forms, including a single price for all deliveries or different but specified prices depending upon the time of day and/or season of year, the primary unknown at the time of contract execution is the ultimate quantity to be delivered.

3. Power and utility companies that enter into requirements and similar contracts with variable volumes should first consider whether the arrangement contains a lease in the scope of FASB ASC 840 (or FASB ASC 842 after adoption of that Topic), a derivative in the scope of FASB ASC 815, or both. The analysis that follows assumes that the arrangement contains neither a lease nor a derivative, or if the arrangement does contain a derivative, that the derivative qualifies for and the reporting entity elects to apply the "normal purchases, normal sales" scope exception.

4. FinREC believes that variable quantities in a requirements contract that result from either a material right or a marketing offer do not represent variable consideration. Paragraph 11 of TRG Agenda Ref 48: *Customer Options for Additional Goods and Services*, states that "because a customer option to purchase additional goods or services is either a material right that is paid for by the customer as part of the existing contract or a marketing

offer that is not part of the contract, the additional consideration that would result from the customer exercising its option would not be included in the transaction price."

5. FinREC believes that variable quantities in requirements contracts are options for additional goods and services as discussed in TRG Agenda Ref 48, paragraph 19 because the customer has a current contractual right to choose the amount of additional distinct goods. Prior to the exercise of that right, the vendor is not presently obligated to provide any goods and does not have a contractual right to consideration.

6. FinREC believes that such options for additional goods and services often may be considered a marketing offer[1] for optional purchases. Paragraphs 20-21 of TRG Agenda Ref 48 note that an option that is a marketing offer is not part of the contract and is only accounted for when the customer exercises the option, resulting in the addition of goods and services that are distinct. The customer has no present legally enforceable rights beyond the right to purchase additional goods, and the supplier has no obligation to deliver any goods until and unless the customer requests them. As explained in paragraph 27 of TRG Agenda Ref 48: "[T]he customer's action in an optional purchase results in a new obligation for the vendor to transfer additional distinct goods or services."

7. FinREC believes that the Supply Agreement example in paragraphs 30 and 38-41 of TRG Agenda Ref. 48 may be applied by analogy to requirements contracts in the power and utilities industry. The nature of the promise under a customer option is the delivery of goods, rather than (or in addition to) a service of standing ready, and the contract provides a right to choose the quantity of additional distinct goods. That is, customer purchases under a master supply agreement are not part of the stand ready performance obligation but rather represent the customer contracting for a specific number of distinct goods in which each order creates a new performance obligation.

8. FinREC believes that the services examples in paragraphs 29 and 31-37 of TRG Agenda Ref 48 are not applicable to the accounting for requirements contracts because the fact patterns in those examples include only a single performance obligation; the variability in each contract results from factors that change the payment but do not affect the amount of services to be provided. This is the case even when the variability is created by the actions of the customer's customer (as discussed in paragraphs 35-37 of TRG Agenda Ref 48) because those actions do not change the vendor's performance obligation and existing right to receive payment or create a new performance obligation.

9. FinREC believes that paragraphs 27, 39, and 41 of TRG Agenda Ref 48 include principles that reflect the same fact pattern as requirements contracts[2]. FinREC believes that the services examples in TRG Agenda Ref 48 illustrating variable consideration differ from the fact pattern for requirements contracts because the vendor's performance obligation and right to payment are established in those cases at the outset of the contract; subsequent events (whether actions by the customer or the customer's customers) only change the amount of consideration to which the vendor is entitled for the existing performance obligation and do not create additional performance obligations.

Comments should be received by October 2, 2017, and sent by electronic mail to Kim Kushmerick at kim.kushmerick@aicpa-cima.com, or you can send them by mail to Kim Kushmerick, Accounting Standards, AICPA, 1211 Avenue of the Americas, NY 10036.

[1] FASB ASC 606-10-55-42 and 43 state that a marketing offer exists when an option does not provide the customer a material right that it would not obtain without entering into the contract. The option to acquire goods at the standalone selling price does not convey a material right, even if that option can only be exercised by entering into a previous contract.

[2] Paragraphs 27 and 39 state, in part, that "the customer's action in an optional purchase results in a new obligation for the vendor to transfer additional distinct goods or services" because it "provides the right to choose the quantity of additional *distinct goods*…" Paragraph 41 summarizes the distinctive characteristic of a requirements contract: "When a customer submits a purchase order, it is contracting for a specified number of *distinct goods* and *creates new performance obligations for the supplier*."

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