DERIVATIVE ACCOUNTING

I. Purpose

To describe the requirements for and ensure consistent company-wide accounting for derivatives in accordance with generally accepted accounting principles (GAAP) and to document associated responsibilities.

II. Policy Statement

Northeast Utilities accounts for all derivative instruments and provides necessary disclosures in accordance with GAAP. To comply with the requirements of GAAP, responsibilities must be fulfilled by the departments that enter into contracts that may be accounted for as derivative instruments (Initiating Department) and by the Accounting Department.

III. Background and Definition of a Derivative Instrument

Accounting Standards Codification (ASC) Topic 815, “Derivatives and Hedging” (formerly FAS 133) defines a derivative instrument as a financial instrument or other contract with all three of the following characteristics:

a. It has one or more underlyings (e.g., a commodity index or price, rate or other variable) and one or more notional amounts (these terms determine the amount of the settlement, or whether or not a settlement is required).

b. It requires little or no initial net investment.

c. It requires or permits net settlement (e.g. cash payment/receipt in lieu of delivery) by any of the following: no requirement for either party to deliver an asset, a market mechanism that facilitates net settlement, or the transferred asset is readily convertible to cash.

Examples of types of contracts or transactions that may meet the definition of a derivative instrument include but are not limited to:

- Energy contracts
- Capacity contracts
- Financial transmission rights (FTR)
- Interest rate swaps and rate lock agreements
- Physical or financial option contracts

Definitions

- Capacity contract – An agreement by an owner of capacity to sell the right to that capacity to another party so that it can satisfy its obligations. For example, in the electric industry, capacity (sometimes referred to as installed capacity) is the capability to deliver electric power to the electric transmission system of an operating control area. The definition of a capacity contract is important to electing normal, and ASC 815-10-15 also includes guidance as to what qualifies as a capacity contract. Corporate Accounting should be consulted as needed to complete the checklist in Appendix A.

- Underlying - A variable specified in the contract (e.g., a commodity price or interest rate index) that is applied to the notional amount to determine the cash flows or other exchanges required by the contract.

- Notional amount - The quantity specified in the contract. For example, the notional amount can be a number of MMBTUs of natural gas, MWh of power, or the principal amount of debt, etc. ASC 815 states that the contract must contain explicit provisions that support the calculation of determinable amounts. Generally, the notional is multiplied by the underlying to determine the settlement. A notional may be found in the contract's default provisions.

- Initial net investment – A cash outlay to the contract counterparty is required to enter into or amend the contract. (Note: Accounting should be contacted to discuss any significant cash outlays at the inception of the contract or at the time of an amendment, such as option premiums or pay-down provisions.)

- Readily convertible to cash - An asset is readily convertible to cash if it is actively traded in a market that can rapidly absorb the quantity held by the entity without significantly affecting the price. Energy contracts with quoted spot prices are readily convertible to cash (e.g., electric power, natural gas, oil, etc.).

- Default settlement provision - A provision in the contract that allows net settlement in the event that one party to the contract defaults (i.e., either does not accept delivery or does not deliver). If the default settlement payment is based on the change in the price of the underlying, then it is a net settlement provision. A default settlement provision that requires the payment of a large fixed penalty in the event of default does not constitute a net settlement provision.

- Net settlement (ability of an entity to settle a contract based on changes in value of the underlying) - A contract has net settlement if its settlement provisions meet one of the following criteria:

    a. Neither party is required to deliver an asset that is associated with the underlying and that has a principal amount, stated amount, face value, number of shares, or other denomination that is equal to the notional amount (or the notional amount plus a

premium or minus a discount). For example, most interest rate swaps do not require that either party deliver interest-bearing assets.

b. One of the parties is required to deliver an asset, but there is a market mechanism that facilitates net settlement, such as an exchange that offers a ready opportunity to sell the contract or to enter into an offsetting contract.

c. One of the parties is required to deliver an asset, but that asset is readily convertible to cash or is itself a derivative instrument. An example is a forward contract that requires delivery of an exchange-traded equity security. Even though the number of shares to be delivered is the same as the notional amount of the contract and the price of the shares is the underlying, an exchange-traded security is readily convertible to cash.

Bookouts, as that term is commonly used in our industry, are a form of net settlement in that an agreement results in net cash settlement with no delivery.

- Market mechanism - An institutional arrangement or side agreement that provides a party with the ability to be relieved of all of its rights and obligations under the original contract and liquidate its net portion of the contract without incurring a significant transaction cost (e.g., 10% or less loss on the transaction). Examples of a market mechanism include:

  a. An exchange which permits entities to enter into offsetting contracts and thereby relieve them of their obligation to physically receive or deliver the referenced asset (e.g., ISO or NYMEX).

  b. A broker market (i.e., brokers who stand ready to buy and sell the commodity contracts) that allows either party to the contract to be relieved of its rights and obligations under the contract without incurring a substantial fee (other than the difference between the contract price and current market price of the commodity). An example of this is the natural gas market.

IV. Accounting for Derivative Instruments

ASC 815 establishes the accounting if a contract is considered a derivative. NU's accounting policy is that derivatives are marked to market unless they qualify for the normal exception. Contracts that qualify for the normal exception follow accrual accounting and are not on the balance sheet at fair value. Period-to-period changes in the fair value of a marked-to-market derivative instrument must be recorded in earnings unless the normal exception or cash flow hedge accounting can be applied. Derivatives spanning more than the current month are accounted for by one of the following methods.

- Mark-to-market accounting – changes in fair value are recognized on the balance sheet and in earnings. The earnings impact is offset by entries to regulatory asset or liability accounts when recovery from or return to customers is probable.

- Normal purchase or sale exception to derivative accounting - apply accrual accounting. This method is elective and requires documentation at inception of the contract/transaction. Normal purchases and normal sales are contracts that provide for the purchase or sale of something that is expected to be physically delivered to customers or into inventory in quantities expected to be used or sold by the reporting entity over a reasonable period in the normal course of business. The expectation of physical delivery to customers or into inventory (rather than to redirect, such as sell to the spot market or cash settle) must be probable at inception and throughout the term of the contract. Net settlement or lack of physical delivery calls into question the normal exception on the net settled contract and all similarly designated contracts. To qualify for the normal purchase and sale exception, the pricing of the contract must be directly related to the product being purchased or sold.

- Hedge accounting - This method is elective and requires documentation at inception and ongoing effectiveness assessments and measurements. Hedge accounting must be discussed and coordinated with Accounting and must be approved by Accounting in advance. Requirements for the preparation of hedge documents and hedge effectiveness testing are complex and time consuming. Hedge accounting does not change the balance sheet mark-to-market requirement, but for qualifying cash flow hedges allows changes in fair value to be recorded in other accumulated comprehensive income rather than earnings. Hedge accounting is allowed when derivatives are designated, qualify and are deemed highly effective as hedges.

V. Responsibilities

Initiating Department Responsibilities

- Consult with Accounting prior to entering into new contracts or types of contracts.

- Prepare the information outlined in the Contract Derivative Review Checklist (“Appendix A”) and provide this information to Accounting for review, along with the contract or contract amendment, well in advance of signing the contract**.**

- Monitor contracts designated as “normal” for physical delivery to customers or into inventory (vs. net settlement) and report any net settlements to Accounting.

- Maintain an inventory of all open contracts, including amendments.

- Work with Treasury Operations and Credit group and Accounting to provide the appropriate expertise and review process to determine the fair value of derivative contracts that must be valued on the balance sheet. Monitor and communicate to Accounting changes in assumptions or inputs affecting fair values and changes in market conditions for RECs or

commodities to identify if they become readily convertible to cash and potentially subject to fair value accounting.

- A supervisory individual must certify quarterly that new contracts and amendments were documented and communicated to Accounting.

Accounting Responsibilities

- Based on the information provided by the Initiating Department, determine if the contract is a derivative and determine the accounting treatment (mark-to-market or normal).

- Execute journal entries to record derivatives in the general ledger at fair value as applicable. Determine financial statement presentation and disclosures of derivatives and associated collateral.

- Research derivative accounting issues. Provide guidance to Initiating Department on accounting and documentation matters, and approve any exceptions to this policy.

Appendix A

Northeast Utilities
Contract Derivative Review Checklist

Business Unit to Complete

I. General Information:

Company: _____

Business purpose and description of contract: _____

_____

Counterparty: _____

Term: _____

Expected quantity and annual dollar amounts:

_____

Collateral requirements (e.g., cash and letters of credit; for other collateral, give brief description and refer to document for further information):_____

_____

Special terms of contract (e.g., optionality as to dollars, amounts, time, intractability):_____

_____

II. Specific Information:

1. **Does the contract contain each of the following criteria for a derivative (Please refer to APS 24, answer Y or N and explain)?**

   Notional (either explicit or based on how default provisions work): _____

   _____

   Underlying: _____ (Price, etc.)

   Little or No Initial Net Investment: _____

   Net Settlement: _____

2. **Classification questions:**

a. Are the assets under the contract to be delivered:
   i. in quantities expected to be used or sold in the normal course of business and within a reasonable time frame? _____

b. Is it probable at inception and throughout the term that the contract will not net settle and will result in physical delivery? _____

c. Is contract pricing directly related to that of the product being purchased or sold (APS 24 section IV)? _____

d. Does the contract include capacity (see APS 24 for definition of a capacity contract) (Y/N)?_____
   If yes, is the contract subject to bookout (i.e., unplanned netting)? _____
   If yes, consider the following:
   - Are the quantities reasonable in relation to business needs? _____
   - Is the counterparty a load serving entity? _____
   - Is the location for delivery consistent with business needs? _____
   - Is it probable at inception and throughout the contract that it will not net settle and will result in physical delivery? _____

Prepared by: _____ Date _____

Reviewed by: _____ Date _____

Corporate Accounting to Complete

Is the contract a derivative (Y/N)? _____
If yes, does the contract qualify for any of the following (Y/N)?

Normal Exception _____
- 815-10-15-41 (formerly 10(b)(1)) _____ or
- 815-10-15-45 (formerly 10(b)(4)) _____

Hedge Accounting (if yes, attach required information) _____

Mark-to-Market _____
Method used to determine market value and the contact person in the initiating department who will determine value going forward (describe):_____
_____

Prepared by: _____ Date _____

Reviewed by: _____ Date _____

Northeast Utilities
Contract Derivative Review Checklist
for Contract Amendment

Business Unit to Complete

Company: _____

Description and date of contract as appears on original Contract Derivative Review Checklist:

_____

This Addendum dated _____to the referenced Contract Derivative Review Checklist is provided as documentation of an amendment to the original contract.

Please provide a brief description of the amendment:

_____

_____

_____

_____

_____

_____

_____

Are there changes required to the original Contract Derivative Review Checklist for the Amendment? Yes / No

If yes, please document changes to the Contract Derivative Review Checklist below. <u>If the changes affect any responses to Section II of the Contract Derivative Review Checklist, please complete an updated Checklist and forward to Corporate Accounting</u>.

_____

_____

_____

_____

_____

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_____

Prepared by: _____ Date _____

Reviewed by: _____ Date _____

Corporate Accounting to Complete

Does the contract Amendment affect the accounting conclusions in the Contract Derivative Review Checklist? _____

_____

If yes, is the contract as amended a derivative (Y/N)?
_____

If yes, does the contract as amended qualify for any of the following treatment (Y/N)?

Normal Exception _____

- 815-10-15-41 (formerly 10(b)(1)) _____ or
- 815-10-15-45 (formerly 10(b)(4)) _____

Hedge Accounting _____
(if yes attach required information)

Mark-to Market _____

Method used to determine market value and the contact person in the initiating department who will determine value going forward (describe):
_____

_____

Prepared by: _____ Date _____

Reviewed by: _____ Date _____