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Wolf Klinz  
EFRAG FRB Chairman  
35 Square the Meeûs  
5<sup>th</sup> Floor  
Brussels  
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**Re: IASB's Exposure Draft Contracts for Renewable Electricity – Proposed amendments to IFRS 9 and IFRS 7**

Dear Mr. Klinz,

I am a solo practitioner with extensive experience in both financial instruments and power purchase agreements. I want to share with you my views on EFRAG's draft response on the IASB's exposure draft *Contracts for Renewable Electricity Proposed amendments to IFRS 9 and IFRS 7 (the 'ED')*, issued on 8 May 2024.

The urgency in increasing clean energy production in the European Union (EU) requires action and all the tools available should be deployed to achieve maximum impact. The proposed amendments are an improvement to the status quo. This is the main reason why I am supportive of these amendments.

My response and comments to EFRAG's Questions to Constituents are set out in Appendix A. They are strictly limited to the scope of the current ED. However, I also include a proposal for how the IFRS 9 could be amended to be closer aligned to that of US GAAP without triggering an upheaval in current practice in Annex 1 to this letter.

From this you can see that I consider that the discussion around the accounting treatment of Renewable Energy contracts should not end with the adoption of these amendments. There are several reasons that justify continuing to work to solve both conceptual and practical issues. In the following paragraphs, I will discuss some of those issues.

***Level playing field with US GAAP:***

As indicated in my 2022 [letter](#) to EFRAG regarding the PIR of IFRS 9 *Classification and Measurement*, there is a need to level the playing field between IFRS and US GAAP-preparers as under US GAAP most of these contracts are not classified as derivatives. Even with the proposed amendments, Virtual Power Purchase Agreements (VPPAs) would still be a derivative under IFRS and not under US GAAP. This unfair treatment by IFRS results in:

- an increased burden for preparers (such as valuation of these and attempting to apply hedge accounting), without clear benefits for investors and users of financial statements given the highly judgemental nature of the assumptions and valuation inputs;
- potential P&L volatility arising from hedge ineffectiveness caused by, among other factors, basis risk in the European Energy Market;
- potential additional EMIR reporting requirements.

***Definition of derivative:***

The source of the unfair treatment described above is the difference in the definition of derivative under IFRS compared to US GAAP. In the context of Renewable Energy contracts, the difference can be summarized as follows:

US GAAP: for a contract to be a derivative, it must have a **notional** which is readily determinable or it can be derived from the contractual clauses. However, a **notional** cannot be an internal estimate even if reasonable. It also provides further guidance to limit anti-avoidance behaviour.

IFRS: *in principle*, a derivative does not require a **notional**. The goal is to have a clear watermark between instruments that behave like a derivative and contracts that are executory in nature.

Both approaches are respectable. However, regarding to nature-dependent Renewable Energy contracts, the difference in approach will often result in different outcomes. In my view, the definition under IFRS is too broad and could benefit from additional guidance. The current ED is, partially, addressing this fact.

However, I would suggest that we should be bolder and solve the issue of definition of derivative in a more fundamental way, as part of a future IASB project. My proposal is set out in Annex 1.

***PPAs are still evolving:***

One of the reasons why we should not settle for the current status quo is the fact that power purchase agreements (PPAs), both delivered and virtual, are still evolving. Originally, PPAs started in the fossil fuel industry. However, in the early 2000s PPAs start being applied to the generation of clean energy and then in the early 2010s, VPPAs were designed to overcome limitations posed by market regulations. The evolution resulted in 2018 in Proxy Generation PPA as championed by Microsoft.

Given the urgency of the challenges posed by Climate Change and that PPAs being repurposed for Renewable Energy are relatively recent, it is reasonable to expect further innovations in the coming years. It should be a priority to develop accounting standards that contribute to the adoption of innovative solutions that are economically sound, while promoting the generation of clean energy.

***Compliance with current IFRS 9:***

I welcome ESMA's enforcement priorities for 2023, namely those focusing on **Accounting for emission trading schemes and renewable energy certificates**. I hope this will answer questions such as:

- Is the definition of derivative as it pertains to the accounting of PPAs and VPPAs well understood?
- Is the own-use exemption and its application to Renewable Energy contracts, especially in the context of Regulated vs Unregulated markets, Gross-pool vs Net-pool markets well understood?
- How useful is the fair value of PPAs / VPPAs to investors and financial statements users, considering the highly judgemental nature of key inputs?
- How does the information in sustainability reporting aligns with the disclosures in the financial statements, thus providing clarity to investors, avoiding "greenwashing" and resulting in connectivity?

**Principle-based vs Rule-based:**

IFRS purports to be principle-based. However, a significant number of questions submitted to the IFRS Interpretations Committee, among other things, demonstrate that preparers need more guidance. Furthermore, it is difficult to argue that the following amendments are principle-based:

- Expanding the own-use exemption only to certain type of contracts such as pay-as-produced, but not for instruments with inherently less variability such as baseload contracts
- Changing the mechanics of hedge accounting just for a specific type of contract by allowing the hedged item to derive its volume from the hedging instrument.

Another example is the decision in IFRS 16 to exempt variable lease payments from the measurement of lease liabilities. This decision was based primarily on practical considerations.

As accounting choices are a human creation and not a universal truth, they should be constantly evolving to reflect changing circumstances, priorities and transactions. I consider principles in this debate not to be a supreme value to be preserved at all costs. And where insufficient, as is the current case, it should be complemented with further guidance/rules.

**Disclosures on Purchase Commitments:**

I stressed the need for a level playing field between IFRS-preparers and US GAAP-prepares, however, the quality of disclosures around Purchase Commitments for these contracts should be revisited and improved.

Considering that PPAs contracts have a long duration and two underlyings (quantity of energy to be generated and energy forward price curve), it exposes the entity to significant risks. This is especially true in circumstances where the energy market is not working efficiently, such as when the war in Ukraine started. Therefore, conditional on further research, it seems appropriate that, even when a PPA contract qualifies as own-use, entities should, at least, disclose the following:

- Average duration of PPA contracts (as at the reporting date)
- Average price / KWh and market indexation
- Expected quantity of energy to be generated over the remaining life of the contracts
- Type of contracts (pay-as-produced, take-or-pay, baseload, etc)
- Energy source (Solar, Wind, Geothermal, etc)
- Geographical location

Such disclosures will allow investors and users of financial statements to make a more informed decision about their investments.

If you would like to further discuss the views expressed in this letter, please contact me.

Yours sincerely,



Ermelindo Varela

**Annex 1: Proposal for addition to scope paragraphs**

I consider that the current problem arises from the definition of a derivative being too broad, or conversely that the own-use exemption in paragraph 2.4 of IFRS 9 is too narrow. Therefore, I propose an alternative to rectify the situation which will eliminate the unlevel playing field with US GAAP.

My proposal is to add **paragraph 2.4A** as follows:

*Contracts for renewable energy where the notional amount is not determinable, i.e. where the quantification of such notional would be highly subjective and relatively unreliable (for example, if a contract does not contain settlement and default provisions that explicitly reference quantities or provide formula based on historical usage) are deemed to meet the requirements in paragraphs 2.4 to 2.7 and therefore fall outside the scope of this standard. The same principle applies to contracts for difference for renewable energy.*

Additional **Application Requirement B2.7A** *When determining whether a renewable energy contract has a determinable notional amount, the following should be taken into account:*

- a. All the contractual terms should be evaluated to assess whether the notional is determinable or not. For example, default provisions often refer to anticipated quantities to be used when calculating penalties in the event of non-performance. Average historical usage quantities may also be specified in the penalty amounts. Where such specification is present, such contracts fall under the scope of this standard.*
- b. Where a contract specifies a maximum quantity, that quantity shall be deemed to be the notional.*
- c. Where a contract specifies a minimum quantity, the notional amount is at least equal to the required minimum number of units and that portion of the contract would be accounted for as a derivative under this standard.*
- d. Where a contract specifies both maximum and minimum quantities, the notional amount is at least equal to the required minimum number of units.*

1) While my comments in the letter are aimed at a broader discussion of PPA contracts, the answer to the questions below are strictly limited to the scope of the current ED.

2) My answer to IASB's questions is guided by the fact that the ED is an improvement on the current status quo and it should be implemented without any further delay.

3) Whenever my comments are already covered in EFRAG's draft letter, I indicate my agreement, instead of repeating the same arguments.

#### **Question 1 – Scope of the proposed amendments**

Paragraphs 6.10.1–6.10.2 of the proposed amendments to IFRS 9 would limit the application of the proposed amendments to only contracts for renewable electricity with specified characteristics.

Do you agree that the proposed scope would appropriately address stakeholders' concerns (as described in paragraph BC2 of the Basis for Conclusions on this Exposure Draft) while limiting unintended consequences for the accounting for other contracts? Why or why not?

*In general, I agree with the comments made in the EFRAG's draft letter.*

If you disagree, please specify with which aspect of the proposals you disagree. What would you suggest instead and why?

#### **Questions to Constituents**

Question 1.1: Are you aware of power purchase agreements (PPAs) where there is uncertainty of whether the agreement meets or fails the requirements in the proposed text in paragraph 6.10.1 of the ED? If so, please provide a description of these PPAs and let us know if these are prevalent.

*To my knowledge, the current amendments should cover most of the contracts where energy generation is nature dependent.*

Question 1.2: Do you consider appropriate using the term 'renewable electricity' in the proposed amendments taking into account that:

- the term 'renewable' is not defined in the ED;
- the RECs (or similar certificates) are not considered within the proposed amendments.

Why or why not? Do you foresee any challenges if the term 'renewable' is omitted and the proposals only refer to "electricity"?

*In my view, this is a small issue considering this field is still evolving.*

Question 1.3: Paragraph 6.10.1(a) of the ED provides a non-exhaustive list of sources of production of nature-dependent renewable electricity including wind, sun and water. Should the proposed amendments instead include a complete list of sources of production to make the narrow-scope proposals clear and specific?

*I am not sure it is possible or sensible to provide a complete list. Once again this is an evolving field.*

**Question 2 – Proposed ‘own-use’ requirements**

Paragraph 6.10.3 of the proposed amendments to IFRS 9 includes the factors an entity would be required to consider when applying paragraph 2.4 of IFRS 9 to contracts to buy and take delivery of renewable electricity that have specified characteristics.

Do you agree with these proposals? Why or why not?

*I agree with these proposals. In order to avoid unintended consequences and not cause further delays, the amendments should have a clear and limited scope.*

If you disagree, please specify with which aspect of the proposals you disagree. What would you suggest instead and why?

**Questions to Constituents**

Do you agree with the requirements related to the own-use exception for the specific contracts in scope of the ED? Do you foresee any adverse economic consequences in short, medium or long term?

*Yes, I agree with the proposed requirements.*

**Question 3 – Proposed hedge accounting requirements**

Paragraphs 6.10.4–6.10.6 of the proposed amendments to IFRS 9 would permit an entity to designate a variable nominal volume of forecast electricity transactions as the hedged item if specified criteria are met and permit the hedged item to be measured using the same volume assumptions as those used for measuring the hedging instrument.

Do you agree with these proposals? Why or why not?

*Yes, I agree with the proposed requirements, since it will allow entities to reduce P&L volatility and better align the accounting with their risk management strategies.*

If you disagree, please specify with which aspect of the proposals you disagree. What would you suggest instead and why?

**Questions to Constituents**

Question 3.1: As a producer of electricity that may be sold in a contract within the scope of paragraph 6.10.1 of the ED, have you identified issues preventing you from using hedge accounting for contracts within the scope of paragraph 6.10.1 of the ED? If so, please explain.

*Not applicable, I am not a producer of electricity.*

Question 3.2: As a purchaser of electricity in a contract within the scope of paragraph 6.10.1 of the ED do you expect that the regulation in paragraphs 6.10.4 and 6.10.6 of the ED will allow you to perform more hedge accounting in the future? If not, please explain why.

*Not applicable, I am not a purchaser of electricity.*

Question 3.3: If you are aware of any other features of the relevant contracts which are prevalent and are not currently addressed in the ED, please provide the description of those features and where the application uncertainty is.

*I am not aware of any other features.*

**Question 4 – Proposed disclosure requirements**

Paragraphs 42T–42W of the proposed amendments to IFRS 7 would require an entity to disclose information that would enable users of financial statements to understand the effects of contracts for renewable electricity that have specified characteristics on:

- (a) the entity's financial performance; and
- (b) the amount, timing and uncertainty of the entity's future cash flows.

Do you agree with these proposals? Why or why not?

*I agree with these proposals because these contracts expose companies to significant financial risks for a prolonged period of time. Furthermore, most of the disclosures required should be readily available since these contracts are currently being fair valued.*

If you disagree, please specify with which aspect of the proposals you disagree. What would you suggest instead and why?

**Question to Constituents**

Question 4.1: Do you see a need for the additional disclosure related to the contracts in scope of the ED in case where such contracts are measured at fair value through profit or loss or are designated in the cash flow relationship or do you deem that the current disclosure requirements in IFRS 7 and IFRS 13 are sufficient?

*I agree with the additional disclosures proposed in the ED. In my view, the fair value of this type of contracts has little, if any, additional value to investors and users of financial statements, given all the uncertainties around key valuation inputs (i.e. amount of energy to be generated over the lifetime of long-term contracts, forward energy price curve, basis risk, etc).*

Question 4.2: Do disclosures required for contracts for renewable electricity that qualify for own purposes strike the right cost-benefit balance between users' needs and preparers' costs for obtaining such information?

*In my view, the level of disclosure required in the ED is appropriate given the financial risks companies are exposed to when entering into this type of contracts, even when they meet the own-use exception requirements.*

**Question 5 – Proposed disclosure requirements for subsidiaries without public accountability**

Paragraphs 67A–67C of the proposed amendments to the forthcoming IFRS 19 Subsidiaries without Public Accountability: Disclosures would require an eligible subsidiary to disclose information about its contracts for renewable electricity with specified characteristics.

Do you agree with these proposals? Why or why not?

*I agree with these proposals for the following reasons:*

- *the information should be readily available*
- *due to the long-term nature of these contracts, reporting entities are exposed to significant risk and investors and financial statements users should receive adequate information in this regard*

If you disagree, please specify with which aspect of the proposals you disagree. What would you suggest instead and why?

**Question 6 – Transition requirements**

The IASB proposes to require an entity to apply:

- (a) the amendments to the own-use requirements in IFRS 9 using a modified retrospective approach; and
- (b) the amendments to the hedge accounting requirements prospectively.

Early application of the proposed amendments would be permitted from the date the amendments were issued.

Do you agree with these proposals? Why or why not? *I agree with these proposals as they will allow preparers to comply with IFRS 9 requirements without undue effort.*

If you disagree, please specify with which aspect of the proposals you disagree. What would you suggest instead and why?

**Question 7 – Effective date**

Subject to feedback on the proposals in this Exposure Draft, the IASB aims to issue the amendments in the fourth quarter of 2024. The IASB has not proposed an effective date before obtaining input about the time necessary to apply the amendments.

In your view, would an effective date of annual reporting periods beginning on or after 1 January 2025 be appropriate and provide enough time to prepare to apply the proposed amendments? Why or why not?

*Yes. In my view, under the current IFRS 9 guidance, these contracts are being fair value. Therefore, the additional information required from preparers is incremental. Even in the case of applying hedge accounting, the most critical element is the fair value calculation, which shouldn't be new. The rest is basically documenting the hedge relationship.*

**Question to Constituents**

Question 7.1: Do you agree with the IASB's proposed effective date considering the endorsement process in the EU and considering that some EU entities are also foreign public issuers subject to the IFRS requirements in other jurisdictions? Why or why not?

*In my view, in the same way that IASB is speeding its internal procedures to have the amendments ready before the end of 2024, EU entities should also speed up their endorsement process. Given the urgency of this project, it would be difficult to understand that, due to administrative procedures, preparers would be deprived of the benefits these amendments bring with them.*