Power Purchase Agreements
Issues paper

Objective

1 The objective of this session is to have a discussion about power purchase agreements ('PPAs') in your jurisdictions in order to prepare for the ASAF meeting that will be held on 28 September.

(a) Are they prevalent? If yes,

(i) What is their nature (physical or/and virtual)?

(ii) What are the expected effects of PPAs on financial statements (physical/virtual)?

(b) How should the scope of any potential narrow-scope amendments be defined?

Introduction and Background

2 The IFRS IC received a submission about the application of paragraph 2.4 of IFRS 9[1] to contracts for the procurement of renewable energy as part of a company's commitment to reduce the effects of climate change and to decarbonise their production and products.

3 These types of contracts are emerging and becoming more common recently and there may not be (sufficient) information on them in historical financial statements.

4 The IASB Staff had conducted a request for information ('RFI') on the prevalence and materiality of the issue (i.e., only relating to physical PPAs as per the submission). The EFRAG Secretariat responded to this RFI based on input collected from EFRAG FR TEG-CFSS and the joint EFRAG FR TEG-User Panel meeting on 10 May 2023 and this input focusses on physical PPAs. The EFRAG Secretariat's response to the RFI is in agenda paper 05-03. The ASCG had also collected extensive feedback in Germany and their feedback to the RFI can be found here.

[1] Paragraph 2.4 states '*This Standard shall be applied to those contracts to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, as if the contracts were financial instruments, with the exception of contracts that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements. However, this Standard shall be applied to those contracts that an entity designates as measured at fair value through profit or loss in accordance with paragraph 2.5.*'

5 In June 2023, the IFRS IC discussed the submission and the IFRS IC recommended the IASB consider undertaking a narrow-scope standard-setting project to clarify how entities apply the own-use exception (refer to paragraph 2.4 of IFRS 9, the text of which is in footnote 1 to this paper) to some physical PPAs to buy energy.

6 Subsequent to this, on 26 June, the EFRAG Secretariat discussed the topic with EFRAG FIWG members including the outcome of the June IFRS IC discussion.

7 A summary of the feedback received from the above EFRAG meetings can be found in the Appendix below.

8 In July 2023, the IASB decided to add a project to the work plan to research whether narrow-scope amendments could be made to IFRS 9. When deciding to add a project to its workplan, the IASB also considered stakeholders' concerns about the accounting for virtual PPAs. During the outreach phase for physical PPA similar issues were reported to the IASB regarding the accounting for virtual PPAs (VPPAs). The IASB's research will therefore focus on:

(a) applying the own-use exception to physical PPAs; and

(b) applying the hedge accounting requirements in IFRS 9 using a virtual PPA as the hedging instrument.

9 The EFRAG Secretariat is in the process of gathering input also from the EFRAG Academic Network.

Physical versus virtual PPAs

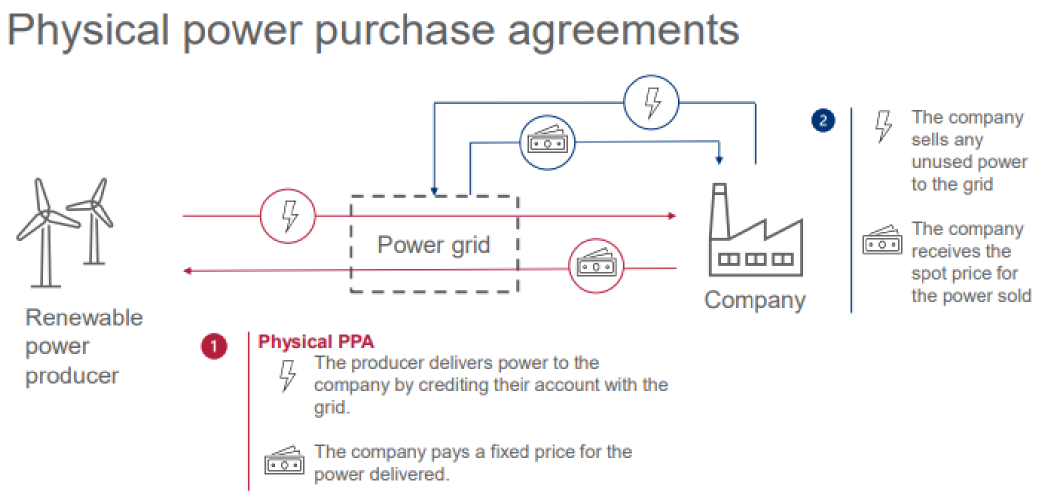
10 The IFRS IC submission had focussed on physical PPAs. An example of this, as per the submission, is as follows:

(a) To secure the company's own demand for energy from renewable sources, the company enters into a physical power purchase agreement with a wind park operator.

(b) The contract obliges the company to acquire a fixed share of the energy produced (for example 50% of the production) at the time it is produced at a price per unit of energy that is fixed throughout the contract duration of 25 years. When the energy is produced, the energy provider feeds the energy produced to the grid and transfers the "energy credits" to the account of the company in exchange for the fixed priced per unit.

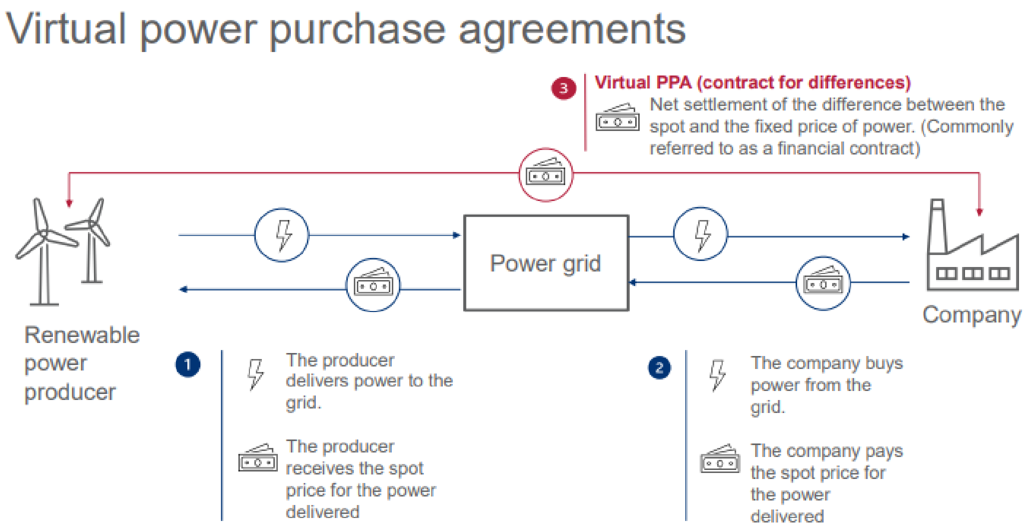
(c) Due to the company's production schedules, there are times when the company is unable to consume the energy that is delivered (i.e., over weekends or during the night when facilities are closed). As there are no feasible options to store the energy, the company has to sell unused amounts from its account to third parties. The process of selling and repurchasing is delegated to a service provider for a fixed or formula-based fee and is designed to be on autopilot that acts without the intention of trading to realise profits. The sole purpose of this is to enable the company's operations. There is no explicit net settlement option within the contract.

11 The below diagram, from the September 2023 ASAF paper 05-02, provides an overview of physical PPAs:



12 Based on the RFI, respondents also noted a similar issue regarding the accounting for virtual PPAs (VPPAs). VPPAs are not contracts for the purchase or delivery of energy, but are typically structured as a 'contract for difference' between the fixed price (per MW of energy) determined in the VPPA and the spot price at which energy could be purchased from the grid (i.e., net settled swaps). These differences are financially settled directly between the counterparties of the VPPA, separately from the purchase of energy from the spot market.

13 The below diagram, from the September 2023 ASAF paper 05-02, provides an overview of virtual PPAs:



14 It is our understanding that VPPAs are most likely to be derivatives that are measured at fair value through profit or loss, unless the entity applies hedge accounting. However, given variances between the green energy produced and the actual energy consumed at spot prices, it is often difficult to establish the economic relationship between the VPPA as a hedging derivative and the underlying actual energy consumed at spot price from the grid, and thus difficult to meet the requirements for hedge accounting as they are currently laid down within IFRS 9. We would like to understand what accounting requirements are applied in your jurisdiction.

15 Often, embedded in a PPA is the delivery of Renewable Energy Certificates (RECs) (or similar attributes) that can be traded separately from the renewable energy. RECs are market-based instruments certifying that the bearer owns electricity generated from a renewable energy facility and can be sold to others separate

from the electricity purchased (e.g., sold to other entities as a carbon credit to offset their own emissions).

16 RECs, even if embedded within the VPPA or the PPPA, can be accounted for separately from the host contract. Own-use also depends on whether the entity resells some or all of the RECs received or collects them for use as a credit for its own emissions.

Questions for EFRAG FR TEG-CFSS

Prevalence:

17 EFRAG's response to the RFI, which focussed only on physical PPAs, indicated that PPAs are common and widespread or are currently becoming increasingly common.

(a) What is the nature of PPAs in your jurisdiction, e.g., physical versus virtual PPAs?

18 EFRAG's response to the RFI indicated that if physical PPAs would fail the own-use criterion, then the effects on the financial statements are expected to be material if fair value accounting needs to be applied.

(a) Is this expectation for both physical and virtual PPAs?

(b) What accounting requirements for VPPAs are applied in your jurisdiction?

(c) How do PPAs effect financial statements and if the effects of physical and virtual PPAs are not yet apparent in financial statements, why is this and when are the effects expected to become more apparent?

19 Are you aware of the types of industries that are most impacted? Which industries are most affected? Are there differences for virtual and physical PPAs?

Scope:

20 In your view, how should the scope of any potential narrow-scope amendments be determined? For example, the potential amendments could apply to:

(a) underlying items with specific characteristics;

(b) PPAs; or

(c) renewable energy contracts.

21 If the scope is determined based on the characteristics of the underlying items, which characteristics do you suggest we use and why?

Agenda Papers

22 In addition to this paper, agenda papers for this session are:

(a) Agenda paper 05-02 – ASAF paper on power purchase agreements; and

(b) Agenda paper 05-03 – EFRAG Secretariat response to the IASB Staff's RFI – for background only.

Appendix – Summary of EFRAG meetings

June 2023 EFRAG FIWG meeting

23 The objective of the session was to discuss the IFRS IC submission on the application of the 'own-use' exemption/exception in IFRS 9 including the outcome of the June IFRS IC discussion.

24 Members, in general, agreed to have a narrow-scope project as the issue needed to be addressed. Some members (with audit background) noted that the IASB Staff analysis might have the potential to change the understanding of IFRS rules for some. This could actually contribute to an increase of diversity in practice. There could be transition challenges as it was mentioned in the IASB Staff paper that IFRS 9 does not provide an adequate basis to determine the appropriate accounting. Therefore, there may be challenges for auditors. Because of the increasing number and importance of these contracts, the need for rapid action by the IASB was highlighted.

25 Some members considered lack of storage to be one of the key features of these types of power purchase agreements with one indicating that it was not the technical storage per se, but the cost related to the storage.

26 A few members were concerned with the bright line regarding scope and suggested for a different treatment if the contracts failed the own-use exemption test. Some indicated that disclosures will be needed as there was a need to minimise the gap between applying IFRS 9 (where there would be full recognition, measurement and disclosures needed as per IFRS 7) versus not applying IFRS 9 which would result in off-balance sheet accounting, mainly as per IAS 37.

May 2023 Joint EFRAG FR TEG and User Panel meeting

27 The objective of the session was to:

(a) provide EFRAG FR TEG and EFRAG UP with a summary of the submission received by the IFRS Interpretation Committee about the application of paragraph 2.4 of IFRS 9 to contracts for the procurement of renewable energy;

(b) provide a summary of the feedback received by the EFRAG CFSS members on prevalence; and

(c) seek EFRAG UP inputs on the users' information needs and observations in response to the IFRS IC request for information received by EFRAG.

28 EFRAG FR TEG highlighted that because of the energy transition, these types of contracts will become more and more frequent in the next years. Therefore, the accounting output could be more relevant than in the past and, as a consequence, the IASB should further discuss this issue.

29 EFRAG FR TEG and some users generally expressed preference to accounting for these contracts as executory contracts which are out of the scope of IFRS 9 instead of derivate contracts at fair value through profit or loss. Indeed, the fair value accounting will increase the volatility of the entity's performance, reducing its understandability and increasing complexity for preparers and users.

30 In addition, some FR TEG members highlighted that the concept of "own-use exception" has been inherited by the previous IAS 39 and partially from US GAAP. Therefore, these members suggested the IASB to revise the "own-use exception" in light of the business practices.

31 Some specific comments included:

(a) One user noted that fair value accounting for complex contracts already occurs. The contracts create risk due to the nature of the contracts (contractual commitment to purchase any energy produced) and its long duration. However, the company would have to consider as a cost that it would end up having to measure what the risks / opportunities are. This user also raised a concern whether contracts could be captured which should not normally be in scope, for e.g., dairy contracts which wastes very rapidly. From the governance perspective, having the fair value and the volatility of that fair value would be relevant for a company to understand the risks.

(b) Conversely, another EFRAG FR TEG member noted that similar long-term contracts with similar associated risks (e.g., capacity purchase agreements) will never be accounted for using the fair value. Therefore, this member questioned whether the fair value method would be the most appropriate for these transactions and stated that currently there is a general lack of guidance for disclosing off-balance sheet items.

(c) One EFRAG FR TEG member suggested the IASB adding in paragraph 2.6.(b) of IFRS 9 the same wording included in paragraph 2.6.(c) "for the purpose of generating a profit from short-term fluctuations in price or dealer's margin". This change could help entities not to account for such an electricity power purchase agreement at fair value. Another EFRAG FR TEG member questioned whether limited practices (e.g., once or two times) could meet the requirement in paragraph 2.6.(c) of IFRS 9 relating the development of past practices.

(d) Another EFRAG FR TEG member noted that instead of either accounting for these contracts applying IAS 37 or applying IFRS 9, there could be another alternative, i.e., to identify the portion whereby the 'own-use exception' would be applied and the remaining portion applying IFRS 9.

(e) A user indicated that any information on economic consequences, e.g., taxes on the overproduction of renewable energy would be relevant.

(f) A suggested solution from a user was to reflect in the accounting fair value evaluations performed by the risk managers of a company.