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# Accounting Standards Advisory Forum (ASAF) meeting

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| Date | **29 January 2024** |
| Project | **Power Purchase Agreements** |
| Topic | **Potential Amendments to IFRS 9** |
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# Purpose of this meeting

At its December 2023 meeting, the International Accounting Standards Board (IASB) tentatively decided:

a. to undertake narrow-scope standard-setting to amend IFRS 9 *Financial Instruments* to ensure financial statements faithfully represent the substance of Power Purchase Agreements (PPAs) and include relevant information about their effects on the entity in the financial statements; and

b. to explore an approach that includes amending:

   i. the ‘own-use’ requirements; and

   ii. hedge accounting requirements.

The purpose of this meeting is to share with ASAF members our preliminary thinking about a potential amendment to the own use requirements and our analysis of the challenges with applying the hedge accounting requirements in IFRS 9.

We will use your input from the questions on slide 4 and continue informal discussions with stakeholders, including investors, to further develop potential amendments to be discussed with the IASB at a future meeting.

# Question for ASAF members

## Questions to ASAF members

1. Do ASAF members have any questions or observations on the potential amendments proposed on slides 14, 17 and 27?

2. Do ASAF members think there are any other potential amendments to the own use and hedge accounting requirements they think we should consider?

# Recap on the project to date

# Project history

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 to address concerns from stakeholders about the accounting for PPAs.

This matter arose from a submission (that included three fact patterns) to the IFRS Interpretations Committee (the Committee). The Committee discussed the matter and recommended the IASB consider undertaking a narrow-scope standard-setting project.

Since then, we have consulted ASAF, the large accounting firms and stakeholders (more than 30 participants) across multiple jurisdictions that provided insights into what both producers and off-takers of power consider when entering into PPAs.

In November 2023, we asked for input from the Committee.

In preparation for this meeting, we also had informal discussions with some members of our Capital Markets Advisory Committee (CMAC).

We reported our findings to-date at the December 2023 IASB meeting. For ease of reference, we summarised our research findings on the next slides.

# Summary of research findings

At the IASB's December 2023 meeting, we reported that:

- PPAs are used by entities across multiple geographical regions and industries and of different sizes and levels of sophistication.
- accounting concerns with regards to PPAs do not relate to IFRS Accounting Standards other than IFRS 9. Therefore, this project focuses on amendments to IFRS 9.
- a typical PPA for renewable power includes delivery of a quantity of Renewable Energy Certificates (RECs). Because the IASB has on its reserve list a project on pollutant pricing mechanisms, this project will not include accounting requirements for RECs.
- questions about accounting for PPAs arise because of the unique features (or characteristics) of the non-financial item (for example electricity) and the legal structure of markets in which these non-financial items are bought and sold.
- PPAs are an important tool for entities to not only hedge the price of future sales and purchases of electricity, but more importantly to secure the access to renewable power.

# Summary of research findings (cont'd)

At the IASB's December meeting, we also reported that:

- PPAs can be broadly grouped into 'physical PPAs' and 'virtual PPAs'.[1]
- our research confirmed that each group of PPAs (physical and virtual) has its own predominant accounting challenges. These challenges include:
  a. *physical PPAs*—how to assess an entity's expected usage requirements when the non-financial item is purchased or sold in markets where the non-financial item delivered must be used within a short period of delivery or sold to market participants at the spot price−for example electricity markets.
  b. *virtual PPAs*—how to designate virtual PPAs as a hedging instrument in a cash flow hedging relationship that better reflect the results of the entity's risk management strategy.

[1]For more information about the differences between physical and virtual PPAs, see paragraph 12 of Agenda Paper 3 of the IASB December 2023 meeting.

# Application of the ‘own-use’ requirements

# The challenge—can PPAs qualify for own-use?

The fact patterns considered by the Committee (see slides 5–6) indicated that the accounting challenge arises mainly in the context of the type of transactions to which own-use requirements apply (paragraph 2.4 of IFRS 9), although one fact pattern also related to the application of the requirements for net settlement (paragraph 2.6 of IFRS 9).

Although there have been some questions about the application of the 'own-use' requirements previously, in general the requirements are working well for most contracts to buy non-financial items for the purpose of an entity's own usage requirements.  However, for PPAs the challenge arise because of the unique nature/characteristics of the non-financial item, coupled with the market structure in which the non-financial item is transacted in. With regards to the 'own-use' requirements, questions are only arising in the context of future purchases and not future sales.

Even though the purpose of a physical PPA is to ensure the supply of power to the entity and fixing the price at which power is purchased, when the entity is not able to use the power delivered within a short period, the power has to be sold back to the market at spot.  Although these sales occur because of the market structure and not to profit from short-term price fluctuations, they do not appear to be consistent with the 'own-use' requirements and could result in the contract being accounted for as a derivative and measured at fair value through profit or loss.

# The challenge—can PPAs qualify for own-use?

Paragraph 2.4 of IFRS 9 states [emphasis added]:

> 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**.

Paragraph 2.6 states that there are various ways in which a contract can be settled net in cash, including:

a. when the terms of contracts permit either party to settle it net;

b. the ability to settle net is not explicit in the terms but the entity has a practice of settling similar contracts net;

c. the entity has a practice of taking delivery of the item and selling it within a short period to profit from short-term price fluctuations; and

d. the non-financial items is readily convertible to cash.

# The challenge—can PPAs qualify for own-use?

Consistent with our preliminary views in Agenda Paper 12 for the July 2023 IASB meeting, we think most of the accounting challenges with physical PPAs can be resolved by adding application guidance to IFRS 9 that explains how the 'own-use' assessment in paragraph 2.4 is applied, rather than amending the requirements for net settlement in paragraph 2.6 of IFRS 9. This is because, in our view, potential clarifications to paragraph 2.4 could be based on the unique characteristics, thereby limiting the effects of any potential amendments to only those arrangements that gave rise to the questions. In contrast, we don't think it would be possible to limit the effects of potential amendments to paragraphs 2.6 to only these arrangements and therefore risk having unintended consequences to other contracts to buy or sell a non-financial item.

Similarly, for the reasons explained in paragraph 59 of the December 2023 paper, we continue to be of the view that potential amendments based on applying the 'own-use' requirements to a proportion of a contract is not a feasible because:

a. the effects of such an approach cannot be limited to particular non-financial items; and

b. would most likely give rise to similar questions/application challenges to those that lead to the IASB taking on this project.

We include a description of what we consider the unique characteristics to be on slide 12.

# The unique characteristics

Non-financial items with all of the following characteristics:

a. the supply/production of the item is weather (and location) dependant such that the timing and/or volume of the item supplied are not necessarily aligned with the demand for the item;

b. the purchaser cannot avoid taking delivery of the non-financial item when produced due to the legal structure of the market the non-financial item is transacted in; and

c. the market structure requires any quantities of the item that an entity is unable to use within a specified short period following delivery, is put back into the market at the prevailing market rate at that point. For this purpose, the timing of any resulting sales are determined by the market structure and the entity has no control/discretion over the timing or price of resulting sales.

**Staff note**

In our view, contracts to buy or sell non-financial items in markets that have these characteristics *could* be held 'for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements.'

# Potential additional application guidance

Our preliminary proposals are to add application guidance to require that a contract to buy a non-financial item with the characteristics described on slide 12, is and continues to be held for the entity's expected purchase, sale or usage requirements only if:

a. the purpose, design and structure of the contract is to ensure the supply of the non-financial item in quantities that are consistent with an entity's expected own use requirements over the life of the contract. For example, a contract would fail the own use requirements if the entity contracted for more than its expected purchase requirements;

b. sales of the non-financial item shortly after delivery arising from short-term mismatches between supply and demand are not be inconsistent with an entity's own usage requirements if:
    i. the contracted volumes over the remaining life of the contract are still based on the entity's expected usage requirements;
    ii. the entity has used a volume of the non-financial item that is equal to, or more than, the volumes of the non-financial items delivered since inception of the contract; and
    iii. sales are not made to generate a profit from short-term fluctuations in the market price of the non-financial item.

# Potential additional application guidance

**Staff note**

The own use requirements in IFRS 9 (and IAS 32) are already an exception to the general requirements in IFRS 9 for derivatives. However, we are of the view that the potential amendments discussed on slides 12–13 will:

- enable entities to overcome the accounting challenges described on slides 9–11 by putting the emphasis on the entity's expected usage over the remaining life of the contract and the actual usage to date rather than on each delivery point or short interval that the entity could be contractually required to take deliveries.
- enable entities to faithfully represent these contracts—that is, the accounting faithfully represents the economic substance of these contracts. Consequently, the amendments will also be ring-fenced by these characteristics.
- reduce the risk of unintended consequences because the proposed amendments only apply to those contracts with the characteristics described on slide 12 but at the same time…
- maintain consistency as far as possible with the current application of the 'own-use' requirements to other contracts to buy non-financial items, including the requirement to continuously assess whether the contract is still held for own-use purposes.

# Potential new disclosure requirements

Many IASB members asked us to consider the need for transparency about PPAs that, when applying the proposed amendments, will be accounted for as executory contracts as opposed to derivative contracts—the latter being subject to the requirements of IFRS 7 *Financial Instruments: Disclosures*.

**Staff note**

In preparation for this meeting, we had informal discussions with some members of our Capital Markets Advisory Committee (CMAC). We plan to continue to have informal meetings with investors to further develop our recommendations for additional disclosure requirements.

# Potential new disclosure requirements

Those investors that we have consulted so far, informally told us that the following information will be useful for long-term PPAs (that are not accounted for in accordance with IFRS 9 and subject to IFRS 7):

## Specific disclosure objective[1]

The information need to enable investors to understand the effect of the contracts on an entity's future cash flows.

## Items of information[1]

- the type of pricing (fixed vs variable);
- the price agreed in the PPA (and possibly the market price as at the reporting date);
- the proportion of such contracts compared to total sales or purchases of the same non-financial item;
- the effect of the PPA on the revenue and expenses during the reporting period, for example what revenue and expenses would have been in the absence of the PPA; and
- an indication of the fair value of the contract at the reporting date.

[1]These terms are described in the IASB's project summary) for its project *Disclosure Initiative—Targeted Standards-level Review of Disclosures*.

# Application of the hedge accounting requirements

# The challenge—is hedge accounting possible?

A hedging relationship qualifies for hedge accounting under IFRS 9 if all of the following criteria are met (paragraph 6.4.1 of IFRS 9):

a. the hedging relationship consist only of eligible hedging instrument(s) (paragraphs 6.2.1−6.2.3 and 6.4.1(a)) and eligible hedged item(s) (paragraphs 6.3.1−6.3.6 and 6.4.1(a) of IFRS 9);

b. at the inception of the hedging relationship there is a formal designation and documentation (paragraph 6.4.1(b)); and

c. the hedging relationship meet all of the hedge effectiveness requirements (paragraph 6.4.1 (c) of IFRS 9, including that there is an economic relationship between the hedged item and hedging instrument.

Meeting the qualifying criteria for hedge accounting may be different depending on the perspective of the counterparty. For example, the considerations for forecasted sales of power could be different from the considerations for forecasted purchases of power.

We think the accounting challenges in the context of PPAs are best illustrated through examples—slides 20–21 describe two examples based on simplified assumptions (one illustrating forecasted sales and the other forecasted purchases) in which a virtual PPA (vPPA) could be used and the resulting economic effects.

# What does a virtual PPA achieve economically?

| Forecasted sales | Forecasted purchases |
|---|---|
| • An entity produces a non-financial item where the volume of the output is inherently uncertain because it is weather dependent (similar to the characteristics as described on slide 12).<br>• Due to the market structure in which the non-financial item is transacted in, all output is required to be sold to the market at the spot price (spot sales).<br>• Although actual output is weather dependent, the entity can reliably estimate the expected output for each period (ie month) over the life of the production facility at a given probability level.<br>• The entity enters into a long-term vPPA over a proportion of the non-financial item output, ie x% of all electricity produced by a specified production facility.<br>• The vPPA net settles in arrears the difference between the specified fixed price per unit of output produced by the referenced production facility and the relevant spot price. | • An entity uses a non-financial item (similar to the characteristics as described on slide 12) as an input into its manufacturing process.<br>• Due to the market structure in which the non-financial item is transacted in, all purchases are required to be obtained from the market at the spot price (spot purchases).<br>• The entity can reliably forecast its demand for the non-financial item over a long period with a high degree of certainty, which may be based on stable demand.<br>• The entity enters into a long-term vPPA over a proportion of the non-financial item output, ie x% of all electricity produced by a specified production facility.<br>• The vPPA net settles in arrears the difference between the specified fixed price per unit of output produced by the referenced production facility and the relevant spot price. |

# What does a virtual PPA achieve economically?

| Forecasted sales | Forecasted purchases |
|---|---|
| • Economically the vPPA achieves an offset between the variability in cash flows the entity is exposed to through the forecasted sales in the spot market.<br>• This offset is achieved for the volume of output either for the contractually specified proportion of all sales from the referenced production facility (ie pay-as-produced) or up to the volume referenced in the vPPA.<br>• For example, if the vPPA is structured as pay-as produced over the entire output of a windfarm, if 100 units are produced, 100 units will be sold into the spot market and the vPPA will require net settlement of the difference between the specified fixed price and spot price based on 100 units.<br>• This means that economic offset is achieved for the volume or capacity of output that are subject to vPPAs—the windfarm will achieve 100% offset even if the volume of output varies from period to period. | • Economically the vPPA achieves an offset between the variability in cash flows the entity is exposed to through the forecasted purchases in the spot market.<br>• This offset is achieved for the volume of electricity purchased either for the specified proportion of all output produced by the windfarm (ie pay-as-produced) or up to the volume referenced in the vPPA.<br>• Although the extent to which forecasted purchases are offset by the output produced by the windfarm will vary, this volume is the same as the volume on which the difference between the fixed and spot price will be net settled.<br>• For example, if the vPPA is over 25% of the capacity of the windfarm and the windfarm produces 100 units, the entity will achieve economic offset on 25 units of purchases and will net settle the difference between the fixed and spot price for 25 units.<br>• This means economic offset is achieved for all the future spot purchases which can be matched to the settled volumes as referenced in the vPPA. |

# Meeting the qualifying criteria—the hedged item (1/2)

For the hedged item to be an eligible designation paragraph 6.3.7 IFRS 9 states that:
An entity may designate an item in its entirety or a component of an item as the hedged item in a hedging relationship. An entire item comprises all changes in the cash flows or fair value of an item. A component comprises less than the entire fair value change or cash flow variability of an item. In that case, an entity may designate only the following types of components (including combinations) as hedged items:

a. only changes in the cash flows or fair value of an item attributable to a specific risk or risks (risk component) [..]
b. one or more selected contractual cash flows.
c. components of a nominal amount, ie a specified part of the amount of an item (See paragraphs B6.3.16–B6.3.20).

Paragraph B6.3.16 of IFRS 9 states:
There are two types of components of nominal amounts that can be designated as the hedged item in a hedging relationship: a component that is a proportion of an entire item or a layer component. The type of component changes the accounting outcome. An entity shall designate the component for accounting purposes consistently with its risk management objective.

With the designation of a layer component being described in paragraph B6.3.18 of IFRS 9: A layer component may be specified from a defined, but open, population, or from a defined nominal amount. Examples include: […]

c. a part of a physical or other transaction volume, for example, the first 100 barrels of the oil purchases in June 201X or the first 100 MWh of electricity sales in June 201X

**Staff note:**
For a forecast transaction (the spot sale or purchase of electricity) to qualify as a hedged item the identified transaction (or proportion of the transaction to be designated) has to be highly probable (paragraph 6.3.3 of IFRS 9).

# Meeting the qualifying criteria—the hedged item (2/2)

**Assessment**

- Typically, in a hedging relationship, the nominal amount is a fixed or specified quantity so that most of the uncertainty in the relationship is coming from the price component changes. But in vPPAs, there are also uncertainty about the nominal amount as it can be variable. For the purpose of designating the hedged item in this paper, we are therefore focussing only on the determination of the component of the nominal amount (see slide 21) and not the price component.
- The component of the nominal amount could be identified as, for example, the first 100 MWh of electricity sales or purchases in June 201X, which is a specified amount of an open portfolio.
- If the entity uses a P90 estimate to designate a volume of future spot sales and is required to sell all output volume to the local spot market, the volume and timing of these sales may be determined as highly probable. For example, the production facility is highly probable to be available for a period of for example 25 years supporting this estimate.
- Similarly, the buyer can estimate, based on its future (stable) demand of electricity, the volume of spot purchases that is considered to be highly probable and designate that volume as the hedged item.

**Conclusion:**

- Both forecasted sales and purchases that are highly probable are eligible to be designated a qualifying hedged item in a hedging relationship

**Staff note:**

- We do, however, acknowledge that designation based on a P90 estimate, would not reflect the economic position an entity would be in, after contracting a vPPA. This is because the designated quantity needs to be specified at designation of the hedge and remains fixed for that period (ie June) and therefore would not be aligned to the settled quantity of the vPPA for the month of June on which economic offset would be achieved as illustrated on slide 19.
- Such as designation and may cause other difficulties when evaluating the remaining hedge accounting requirements (see slide 24).

# Meeting the qualifying criteria—the hedging instrument

**Assessment**

- A derivative measured at fair value through profit or loss may be designated as a hedging instrument, except for some written options (see paragraph B6.2.4 of IFRS 9).

**Conclusion:**

- Both the buyer and the seller can currently designate a virtual PPA as qualifying hedging instrument in a hedging relationship.

**Staff note**

- A vPPA meets the definition of a derivative in IFRS 9 and is measured at fair value through profit or loss.
- Typically, the volume assumptions of vPPA for fair value measurement of these derivatives are based a probability of 50% (P50 estimate).

# The effectiveness requirements

**Staff note**

Paragraph B6.4.4–B6.4.6 of IFRS 9 explain that the requirement for there to be an economic relationship, means that the hedging instrument and hedged item have values that generally move in the opposite direction because of the hedged risk. This assessment includes an analysis of the possible behaviour of the hedging relationship during its terms to determine if it is expected to meet the risk management objective.

Paragraph B6.4.12 requires hedge effectiveness to be assessed at inception of the hedging relationship and on an ongoing basis. As this assessment relates to expectations about hedge effectiveness, it is a forward-looking assessment.

Paragraph B6.4.13 requires that an entity uses a method to assess hedge effectiveness that captures the relevant characteristics of the hedging relationship including the sources of hedge ineffectiveness. Depending on these factors, the method can be qualitative or quantitative.

**Assessment**

- For both the forecasted sales or forecasted purchases the designated volumes in the hedge item must prospectively achieve offset with the designated hedging instrument depending on the assumption inherent in the volume estimates.

**Conclusion:**

- As a result, the planned hedging relationships may currently <u>not</u> qualify due to the economic relationship requirement not being met.

# How can the challenge with vPPAs be solved?

The hedge accounting requirements in IFRS 9 represents an exception to the measurement of the hedging instrument when designated in a cash flow hedge because to the extent that the relationship is effective, changes in the fair value of the derivative are recognised in other comprehensive income (OCI) instead of profit or loss. Therefore, we think any amendments to the hedge accounting requirements need to be considered very carefully even if they are only applied to hedging relationships in which particular instruments are designated as the hedging instrument or hedged item.

When considering the application of the current hedge accounting requirements to the examples, in combination with the economic effects arising from using vPPAs as illustrated on slides 19–20, we acknowledge stakeholders' views that the current requirements might not fully reflect the economic offset that is achieved in all circumstances.

We think this primarily due to the fact that the variability in the cash flows of the hedged item is not only impacted by changes in the price component but also by changes in the volume component.

# How can the challenge with vPPAs be solved?

In our view, potential amendments to the hedge accounting requirements that could be further explored, include:

- Designation of a proportion (including 100%) of the total but uncertain volume of sales or purchases of non-financial items (with particular characteristics). For example, 90% of the total output sales of a facility (ie 90% of every sale) for a specified period.
- Designation of a quantity of forecasted sales or purchases that are expected (but not necessarily highly probable) to the extent that such volume is expected to be mirrored by the vPPA. Such designation would only relate to the volume and not the other terms of the vPPA. In other words, the hedged item will not simply replicate the terms of the vPPA.
- For the purpose of assessing the economic relationship, differences in assumptions between the hedged item and hedging instrument with regards to the expected vs highly probable volume do not cause a break in the economic relationship. However, for all other assumptions such as pricing assumptions the assessment continues to consider the possible behaviour over the hedged term.
- As IFRS 7 already include comprehensive disclosure requirements for all hedging relationships. Considering the information those investors that we have consulted so far told us will be useful for long-term PPAs (slide 16), we do not think additional disclosure requirements are needed.

# What could be the implications of making amendments to hedge accounting requirements?

It goes without saying that any amendments to the hedge accounting requirements carry a risk of unintended consequences, especially if the amendments are not properly ringfenced. It is also possible that even with proper ringfencing of the amendments, entities might want to extend the application of the amendments to other hedging relationships.

The application of hedge accounting is voluntary and typically involve additional costs and efforts. However, we note that even in the absence of applying hedge accounting, the valuation of derivatives such as vPPAs involve costs and effort. We are also conscious that even with applying hedge accounting, the resulting outcome in the financial statements might still differ between physical PPAs and virtual PPAs because of the underlying differences in the contractual terms of the instruments.

There is also a risk that some of the potential amendments discussed on slide 26 could be deemed to lack the appropriate level of discipline normally required for hedge accounting and therefore could be open to manipulation. However, we think this concern is mitigated to the large extent by the requirement for the hedging relationship to be consistent with the entity's risk management objective, which includes the purpose and design of the vPPAs.

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# Appendix A—Resources

# Weblinks to relevant resources

- Project page: IFRS - Power Purchase Agreements
- IASB meeting in July 2023: Agenda Paper 12A
- ASAF meeting in September 2023: Agenda Paper 3 and meeting summary
- Committee meeting in November 2023: Agenda Paper 7
- IASB meeting in December 2023: Agenda Paper 3