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Power Purchase Agreements

Issues Paper

Objective

1 This issues paper provides a summary of the IASB' tentative decisions to be included in the Exposure Draft proposing amendments to the IFRS 9 Financial Instruments in relation to the hedge accounting and related EFRAG Secretariat analysis. This agenda paper includes references to the IASB Staff Agenda paper 3B 'Proposed amendments to the hedge-accounting requirements' for the 18 March 2024 IASB meeting (Paper 3B).

2 This paper is structured as follows:

A. IASB's tentative decisions

B. EFRAG Secretariat analysis

C. Summary of the IASB discussion (session of 18 March 2024)

D. Questions to the EFRAG FR TEG

IASB's tentative decisions

3 The IASB tentatively decided for cash flow hedging relationship in which a contract for renewable electricity within the scope of the proposed amendments is designated as a hedging instrument, to propose that an entity is permitted to designate as the hedged item a variable nominal volume (or quantity) of forecasted sales or purchases of renewable electricity only if:

(a) the volume of the hedged item is specified as a proportion of the hedging instrument's variable volume.

(b) the hedged item is measured using the same volume assumptions used for the hedging instrument. (All other assumptions used for measuring the hedged item reflect the nature of the hedged item and do not impute the features of the hedging instrument, such as the pricing structure.)

(c) the designated forecasted sales or purchases of electricity are:

(i) for a purchaser, highly probable if the entity has sufficient highly probable forecasted purchases that exceed the estimated variable volume (or quantity) to be designated by the entity as the hedged item.

(ii) for a seller, not required to be highly probable because the designated quantity of sales is certain to be hedged if it occurs.

EFRAG Secretariat analysis

4 The EFRAG Secretariat welcomes the IASB's tentative decision to avoid defining specific unique characteristics of a non-financial item relevant to (v)PPAs and to call the underlying item "electricity".

5 Further, the EFRAG Secretariat welcomes the IASB thorough approach splitting the considerations for sellers and purchasers in (v)PPAs.

6 Regarding the tentative decisions made by the IASB on the scope of the proposed amendments, which also apply to the hedge accounting considerations specifically, the EFRAG Secretariat refers to the comments included in the agenda paper 06-02 – PPA Issues Paper Own-Use Exception paragraphs 8 to 14.

7 Overall, it would be helpful to further elaborate on the periodicity of the assessments. As noted in the IFRIC's June 2023 paper, the delivery of the electricity happens at very granular time intervals, down to 15 minutes or even less in some markets. When considered at these intervals, the mismatches between the production and consumption of electricity can be significant, however in many cases such mismatches decrease or even disappear if the time interval considered is longer.

8 From a practical point of view, both preparers and their auditors would need to understand at what level of time granularity the assessment of the economic relationship is expected to take place. IASB's Staff Agenda Paper 3A provides examples based on the assessment of the production / consumption over a day. Paper 3B provides example of discrete period being a month (paragraph 38 of the Paper 3B: *"However, although a specified volume can be sufficiently predicted over a period, for example a year, the actual power production, and therefore spot sales to the market, in discrete periods (e.g. monthly) is expected to be highly variable based on the nature-based conditions".*

9 The IASB's tentative decisions as outlined above seems to reverse the sequence of the hedging logic which is that an entity has an exposure (the to become hedged item), the entity risk manages this exposure (the to be identified hedging instrument) and then sets up a hedging relationship. Thus, the hedged item exists, and the hedging instruments is identified and adapted to the hedged item. In the IASB's tentative decision the hedged item becomes defined by the hedging instrument: "the volume of the hedged item designated is specified as a proportion of the variable volume of the hedging instrument".

10 If the (v)PPA is load following for the seller, then there is a logic link between the volume of the hedged item and the volume in the (v)PPA as seen for the seller. Unless the (v)PPA is load following to the consumption of the purchaser there is no logic link between the hedged item and the volume in the (v)PPA as seen for the purchaser.

11 In paragraph 3(c)(i) above, the word "capacity" seems to be a printing error to be replaced by "usage".

12 It is not clear, from the current proposal, what happens if there is cap and / or floor on the volume of the hedging instrument.

13 It would be helpful to specify why the logic outlined in 3(c)(ii) above cannot be applied to all load-following swaps from a seller perspective and is only limited to (v)PPAs?

14 The EFRAG Secretariat suggests adding "designated" in paragraph 20 of Paper 3B: "However, as a result of the challenges described in paragraphs 16–19, such <u>designated</u> hedging relationships might not faithfully reflect the actual economic outcome that is achieved through the use of the PPA".

15 Paragraph 20 of Paper 3B further adds: "As a result, the variable volumes under the contract can only fully align to one counterparty's forecasted transactions". This feature is not (v)PPA specific but applies to a large number of (/most) contracts.

16 The statement in paragraph 27 of Paper 3B "the windfarm will achieve 100% offset even if the volume of output varies from period-to-period" is only true if the windfarm is able to estimate its production with 100% accuracy. That is highly unlikely.

17 In paragraph 35 Paper 3B seems to refer to IFRS 9 BC6.76(c) which is one of the objectives of hedge accounting, not the justification of highly probable requirement for the hedged item. Further, the IASB Staff concern on the delay of recognition in profit or loss of the fair value gains or losses on the hedging instrument would be alleviated by the lower of test requirements in IFRS 9.

18 The EFRAG Secretariat is in agreement with the conclusion reached in paragraph 46 of Paper 3B however notes that the issues outlined are not limited to (v)PPAs.

19 Paragraph 50 of Paper 3B would benefit of the clarification related to the definition of the renewable energy. As outlined in paragraph 12 of the agenda paper 06-02 – PPA Issues Paper Own-Use Exception, assuming the economic meaning of the “renewable energy” and considering that the RECs are separately traded, a seller might enter into a virtual PPA for any volume of electricity (not limited by his production) as long as the seller can provide the RECs for the contracted volume.

20 As outlined in paragraph 12 above, it is not clear which patterns identified by the IFRIC are considered here, as paragraph 54 of Paper 3B seems to focus on the overall volumes sold vs designated over a period. However, as noted by the IFRIC’s June 2023 paper, the inefficiencies are also arising from the profile mismatch, albeit same volumes if considered on a longer period.

21 Suggestion of the wording of paragraph 57 in Paper 3B: currently the proposal is written " ... because there is no direct link between the volume of forecasted spot purchases and the volume of electricity produced on which net settlement is required". Suggested wording would be "... because there is no ~~direct~~ link between the (<u>variability in the</u>) volume of forecasted spot purchases and <u>the variability in</u> the volume of ~~electricity produced on which net settlement is required~~ the hedging instrument".

22 In EFRAG Secretariat’s view, there is no link on the variability in volumes neither direct nor indirect, therefore we would suggest refraining from the use of these terms (ex. indirect link).

23 To avoid misinterpretations of the considerations outlined in paragraph 70 of Paper 3B, the EFRAG Secretariat suggests emphasising that the ineffectiveness will occur as a result of dissimilar profile (timing) of purchases and volumes in (v)PPA even if the volumes, overall, concur.

24 It is not clear how the indirect link (or absence thereof, as noted in the paragraph 27 above) of the variability of the volume between hedged item and hedging instrument justifies why the hedged item must be highly probable (and the link of that probability with the suggested indirect link on volumes).

25 Suggested wording in paragraph 77 of Paper 3B would be "therefore, it cannot be used to include features in the ~~value of the~~ (<u>valuation of the</u>) hedged item that only exist in the hedging instrument but not the hedged item".

Summary of the IASB discussion (session of 18 March 2024)

26 The IASB members welcomed the Paper 3B and praised the Staff for thorough analysis.

27 One member disagreed with the scope of the proposed amendments be limited to (v)PPAs and suggested the matter to be re-considered as part of the PIR on IFRS 9 Hedge Accounting.

28 To conclude, majority of the members voted for the IASB's staff proposals included in Paper 3B.

Questions for EFRAG FR TEG

29 Please provide your comments and considerations in regard to the IASB's tentative decisions included in paragraph 3 above.

30 What application challenges do you foresee with the proposed amendments?