



STAFF PAPER

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IFRS® Interpretations Committee meeting

Project	Power Purchase Agreements in a Gross Pool Electricity Market (IFRS 16)		
Paper topic	Initial consideration		
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Introduction

1. The IFRS Interpretations Committee (Committee) received a submission about an electricity retailer (customer)'s accounting for a power purchase agreement (PPA) in a gross pool electricity market. The submitter asks whether, applying paragraph B9(a) of IFRS 16 *Leases*, the customer has the right to obtain substantially all the economic benefits from use of an identified asset.
2. This objective of this paper is to:
 - (a) provide the Committee with a summary of the matter;
 - (b) present our research and analysis; and
 - (c) ask the Committee whether it agrees with our recommendation not to add a standard-setting project to the work plan.

Structure of the paper

3. This paper includes the following:
 - (a) background information (paragraphs 5–11);

- (b) outreach (paragraphs 12–13);
 - (c) staff analysis (paragraphs 14–27); and
 - (d) staff recommendation (paragraph 28).
4. There are three appendices to the paper:
- (a) Appendix A—proposed wording of the tentative agenda decision;
 - (b) Appendix B—Illustrative Example 9 accompanying IFRS 16; and
 - (c) Appendix C—submission.

Background information

5. The submission describes a transaction in a gross pool electricity market.

Characteristics of a gross pool electricity market

6. From the submission, we understand that in a gross pool electricity market:
- (a) registered electricity suppliers supply electricity to a connection point on the power system, and registered customers consume electricity from that power system.
 - (b) a market operator meters each electricity supplier’s supply of electricity into the grid and each customer’s consumption of electricity from the grid in 30-minute intervals.
 - (c) the operator determines the spot price for each 30-minute interval during the trading day; the spot price is the market-determined clearing price that matches supply with demand.
 - (d) the operator calculates for each participant (suppliers and customers) the amount receivable and payable, by applying the relevant spot price to the metered amount for each 30-minute interval.
 - (e) each customer pays the operator for the electricity it has consumed on the settlement date and the operator pays each supplier for the electricity it has supplied on the same date.

7. We understand from the submitter that the gross pool electricity market described in the submission has numerous registered participants—both suppliers and customers.

The transaction

8. A windfarm generator (supplier) enters into a PPA with a customer, both of which are registered participants in a gross pool electricity market as described above.
9. The PPA:
- (a) identifies a windfarm owned by the supplier that will be used to supply electricity to the grid in the gross pool electricity market;
 - (b) covers notionally all the electricity the windfarm will supply to the grid over a 20-year period;
 - (c) swaps the spot price per megawatt of electricity supplied by the windfarm to the grid for a fixed price per megawatt, and is settled net in cash—in effect, the supplier receives a fixed price per megawatt for the electricity it supplies to the grid and the customer settles with the supplier the difference between that fixed price and the spot price per megawatt for that volume of electricity; and
 - (d) transfers to the customer all renewable energy credits related to the production of electricity by the windfarm. The renewable energy credits accrue from use of the windfarm.

The question

10. The submitter asks whether, applying paragraph B9(a) of IFRS 16, the customer has the right to obtain substantially all the economic benefits from use of the windfarm throughout the 20-year term of the PPA. To contain a lease, the contract must convey to the customer that right as well as the right to direct the use of the windfarm throughout the period of use. The submission outlines both:
- (a) View 1—the customer has the right to obtain substantially all the economic benefits from use of the windfarm; and
 - (b) View 2—the customer does not have the right to obtain substantially all the economic benefits from use of the windfarm.

Appendix C to this paper reproduces the submission, which provides further details about each view.

11. The submitter notes that, for the purpose of the submission, it is assumed that the customer designed the windfarm before it was constructed. We do not discuss this factor in our staff analysis in this paper—applying IFRS 16, the customer’s involvement in the design of an asset does not affect whether it has the right to obtain substantially all the economic benefits from use of that asset (paragraph B9(a) of IFRS 16), although it may affect its right to direct the use of the asset (paragraph B9(b) of IFRS 16).

Outreach

12. The purpose of any outreach we perform is to understand:
 - (a) the prevalence of the transaction or fact pattern submitted; and
 - (b) the accounting applied to that transaction or fact pattern.
13. We decided not to perform outreach on this submission—and proceed to analyse the question submitted—for the following reasons:
 - (a) the submitter indicated that PPAs are common in the utility industry and gross pool electricity markets have been identified in a number of jurisdictions. We know from work undertaken in the development of IFRS 16 that, indeed, PPAs are common contracts in the utility industry and such contracts are typically material for entities that enter into them.
 - (b) in March 2019, the Committee published the Agenda Decision [Application of the Highly Probable Requirement when a Specific Derivative is Designated as a Hedging Instrument](#). The question submitted that led to that agenda decision involved a derivative contract referred to as a load following swap, the terms and conditions of which were similar to the PPA described in this submission. Although outreach responses indicated that such load following swaps are not common in many jurisdictions, the Committee analysed the question and provided explanatory material in the agenda decision because comment letters identified a broader question about the application of the hedging requirements

in IFRS 9 *Financial Instruments*. For this submission, we are similarly of the view that there is a broader question about ‘the economic benefits from use’ of an asset (as specified in paragraph B9(a) of IFRS 16) that could be addressed by analysing the question submitted.

Staff analysis

The applicable requirements in IFRS 16

14. Appendix A to IFRS 16 defines a lease as ‘a contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration’. ‘A contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration’ (paragraph 9 of IFRS 16).

15. Paragraphs B9–B31 set out application guidance on the assessment of whether a contract is, or contains, a lease. Paragraph B9 states:

To assess whether a contract conveys the right to control the use of an identified asset (see paragraphs B13–B20) for a period of time, an entity shall assess whether, throughout the period of use, the customer has both of the following:

(a) the right to obtain substantially all of the economic benefits from use of the identified asset (as described in paragraphs B21–B23); and

(b) the right to direct the use of the identified asset (as described in paragraphs B24–B30).

16. Applying IFRS 16, a contract therefore contains a lease only if, throughout the period of use, the customer has *both* the right to obtain substantially all the economic benefits from use of an identified asset and the right to direct the use of that asset.

Right to obtain the economic benefits from use

17. Paragraph B21 states:

To control the use of an identified asset, a customer is required to have the right to obtain substantially all of the economic

benefits from use of the asset throughout the period of use (for example, by having exclusive use of the asset throughout that period). A customer can obtain economic benefits from use of an asset directly or indirectly in many ways, such as by using, holding or sub-leasing the asset. The economic benefits from use of an asset include its primary output and by-products (including potential cash flows derived from these items), and other economic benefits from using the asset that could be realised from a commercial transaction with a third party.

18. Paragraph BC118 states:

...a customer should consider benefits relating to the use of the asset (for example, renewable energy credits received from the use of an asset or by-products resulting from the use of an asset).

19. Illustrative Example 9 accompanying IFRS 16 (reproduced in Appendix B) illustrates the application of the definition of a lease to contracts for energy and power. Although the illustrative example is not intended to provide an answer for any actual fact pattern, it illustrates the application of the requirements to transactions that involve the supply of electricity and power and, in that respect, are similar to the fact pattern in the submission.

Applying the applicable requirements

20. Paragraph B21 of IFRS 16 states that the economic benefits from use of an asset include ‘its primary output and by-products’ and paragraph BC118 identifies renewable energy credits as an example of a benefit relating to the use of an asset. In the fact pattern described in the submission, the economic benefits from use of the windfarm include electricity as its primary output and renewable energy credits as a by-product or other economic benefit from use of the asset that could be realised from a commercial transaction with a third party. Illustrative Example 9 accompanying IFRS 16 concludes similarly—the primary output from use of a solar farm or power plant in those examples is electricity or power respectively and the economic benefits from use of the solar farm also include a by-product—renewable energy credits—that accrue from use of the farm.

21. In the PPA described in the submission, the customer has the right to obtain the renewable energy credits. The customer has no right, however, to obtain the electricity produced by the wind farm. As a consequence, we conclude that the customer does not have the right to obtain substantially all the economic benefits from use of the windfarm throughout the 20-year term of the contract.
22. In reaching this conclusion, we note the following:
- (a) the PPA results in the customer settling with the supplier—net in cash—the difference between a fixed price and the spot price per megawatt of electricity the windfarm supplies to the grid over the 20-year term of the contract. There is no physical delivery of electricity from the supplier to the customer. The customer’s exposure to price risk for all the electricity the windfarm supplies is not an economic benefit from use of the windfarm. That contract—to swap the spot price for a fixed price and settle net in cash—does not convey to the customer the right to use the windfarm for a period of time.
 - (b) the PPA transfers to the customer all renewable energy credits that accrue from use of the windfarm. The renewable energy credits are a by-product from use of the windfarm and are part of the economic benefits from its use. However, alone, the renewable energy credits do not constitute substantially all the economic benefits from use of the windfarm; the electricity produced and supplied to the grid—as the primary output from use of the windfarm—constitutes a substantial proportion of the economic benefits from its use.
 - (c) the customer’s purchases of electricity via its electricity consumption from the grid does not give the customer the right to obtain substantially all the electricity produced and supplied by the windfarm. The customer has no contract that gives it the right (or creates an obligation) to purchase *any* of the electricity produced by the windfarm and supplied to the grid.

Why we disagree with View 1—the customer has the right to obtain the economic benefits from use

23. The rationale for View 1 (ie the customer has the right to obtain substantially all the economic benefits from use of the windfarm) is as follows:
- (a) the customer combines the PPA with the expected purchases of electricity from the grid and considers them together in concluding that the customer will obtain substantially all the economic benefits from use of the windfarm over the 20-year term of the PPA. This is because:
 - (i) the customer expects, over the term of the PPA, to purchase at least the amount of electricity the windfarm supplies to the grid. Because electricity is fungible, it is irrelevant where the purchased electricity is produced; and
 - (ii) the market prevents participants from contracting for the purchase or supply of electricity directly; the operator is, in substance, acting as an agent for registered suppliers and customers.
 - (b) the economic substance of the transactions in a gross pool electricity market is the same as those in a net pool electricity market¹ and, thus, the customer’s accounting should be the same in both markets.
 - (c) the customer has agreed to pay a fixed price per megawatt for the volume of electricity produced and supplied by the windfarm over the term of the PPA and is exposed to the price risk. The customer also expects to purchase at least the volume of electricity the windfarm produces. The customer therefore will obtain all the economic benefits from the eventual sale of that volume of electricity.
 - (d) paragraph B21 of IFRS 16 describes economic benefits from use broadly. To have the right to obtain substantially all the economic benefits from use of an asset, IFRS 16 does not require physical delivery of the output of that asset.

¹ In a net pool electricity market, a customer can enter into a contract directly with the supplier to take physical delivery of electricity. This creates a contractual obligation for the supplier to supply the contracted amount of electricity and a contractual right (and obligation) for the customer to purchase the contracted amount of electricity.

24. We disagree with View 1. The PPA—a contract to swap the spot price for a fixed price per megawatt of electricity produced by the windfarm, which is settled net in cash—does not give the customer the right to obtain substantially all the economic benefits from use of the windfarm. The customer’s expectation that it will purchase at least the volume of electricity the windfarm produces and supplies to the grid is different from having the *right* to obtain the electricity produced by the windfarm.
25. There are numerous registered participants in the gross pool electricity market. Because electricity is fungible, the electricity a registered customer consumes cannot be linked to the electricity any particular registered supplier supplies. Regardless of whether the operator is an agent, the PPA provides the customer with neither the *right* to obtain electricity from the windfarm nor the *obligation* to purchase any particular amount of electricity either from the windfarm or the grid. In this respect, a customer in the gross pool electricity market is contractually in a very different position from a customer in a net pool electricity market that has contracted with a supplier to purchase a specified volume of electricity for a period of time. In that case, the customer in a net pool electricity market has both a contractual right to that volume of electricity and a contractual obligation to purchase it. In contrast, the customer in a gross pool electricity market has no such contractual right or obligation. If it unexpectedly requires a low volume of electricity in any period (and less electricity than is supplied by the windfarm), it adjusts its consumption and purchases only the volume of electricity needed.
26. As explained earlier in the paper, exposure to price risk for all the electricity produced by the windfarm is not, in our view, an economic benefit from use of the windfarm. For a customer to have the ability to obtain all the economic benefits from the eventual sale of the electricity, it first has to purchase the same amount of electricity from the grid—as noted above, the PPA does not create a contractual right (or obligation) for the customer to purchase any amount of electricity.
27. Finally, we note that there is no basis in the requirements of IFRS 16 to combine the PPA and the customer’s expected purchases of electricity via consumption from the grid, and treat them as a single contract for the purpose of assessing whether the contract contains a lease. Paragraph B2 of IFRS 16 specifies when, in applying the Standard, an entity combines two or more contracts. It states: ‘an entity shall combine

two or more contracts entered into at or near the same time with the same counterparty (or related parties of the counterparty), and account for the contracts as a single contract if...'. In the fact pattern described in the submission, the criteria in paragraph B2 of IFRS 16 are not met.

Staff conclusion

28. Based on our analysis above, we conclude that, applying paragraph B9(a) of IFRS 16, the customer does not have the right to obtain substantially all the economic benefits from use of the windfarm. The PPA does not therefore contain a lease.

Question 1 for the Committee

1. Does the Committee agree with our analysis of the application of the requirements in IFRS 16, outlined in paragraphs 14–27 of this paper?

Should the Committee add a standard setting project to the work plan?

Is it necessary to add to or change IFRS Standards to improve financial reporting?²

29. Based on our analysis in paragraphs 14–28 of this paper, we conclude that the principles and requirements in IFRS 16 provide an adequate basis for a customer that enters into a PPA with a supplier as described in the submission to determine whether it has the right to obtain substantially all the economic benefits from use of the windfarm.

Staff recommendation

30. Based on our assessment of the work plan criteria in paragraph 5.16 of the *Due Process Handbook* (as discussed in paragraph 29 of this paper), we recommend that the Committee does not add a standard-setting project to the work plan. Instead, we recommend publishing a tentative agenda decision that explains how a customer

² Paragraph 5.16(b) of the *Due Process Handbook*.

applies IFRS 16 in determining whether it has the right to obtain the economic benefits from use of an identified asset.

31. Appendix A to this paper sets out the proposed wording of the tentative agenda decision. In our view, the proposed tentative agenda decision (including the explanatory material contained within it) would not add or change requirements in IFRS Standards.³

Questions 2 and 3 for the Committee

2. Does the Committee agree with our recommendation not to add a standard-setting project to the work plan?
3. Does the Committee have any comments on the proposed wording of the tentative agenda decision set out in Appendix A to this paper?

³ Paragraph 8.4 of the *Due Process Handbook* states: ‘Agenda decisions (including any explanatory material contained within them) cannot add or change requirements in IFRS Standards. Instead, explanatory material explains how the applicable principles and requirements in IFRS Standards apply to the transaction or fact pattern described in the agenda decision.’

Appendix A—proposed wording of the tentative agenda decision**Power Purchase Agreements in a Gross Pool Electricity Market (IFRS 16 *Leases*)**

The Committee received a request about an electricity retailer (customer)'s accounting for a power purchase agreement in a gross pool electricity market. In such a market, customers and suppliers are unable to enter into contracts directly for the purchase and sale of electricity—instead, registered customers and suppliers make such purchases and sales via the market's electricity grid, the spot price for which is set by the market operator.

A windfarm generator (supplier) enters into a power purchase agreement with a customer. Both the supplier and customer are registered participants in a gross pool electricity market. The power purchase agreement:

- (a) swaps the spot price per megawatt of electricity the windfarm will supply to the grid—for the 20-year term of the contract—for a fixed price per megawatt, and is settled net in cash. In effect, the supplier receives a fixed price per megawatt for the electricity it supplies to the grid over the 20-year term of the contract and the customer settles with the supplier the difference between that fixed price and the spot price per megawatt for that volume of electricity; and
- (b) transfers to the customer all renewable energy credits that accrue from use of the windfarm.

The request asked whether, applying paragraph B9(a) of IFRS 16, the customer has the right to obtain substantially all the economic benefits from use of the windfarm throughout the 20-year term of the power purchase agreement.

Paragraph 9 of IFRS 16 states that 'a contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration'. To control the use of an identified asset for a period of time, the customer—throughout the period of use—must have both the right to obtain substantially all the economic benefits from use of the identified asset and the right to direct the use of that asset (paragraph B9 of IFRS 16).

Paragraph B21 of IFRS 16 specifies that 'a customer can obtain economic benefits from use of an asset directly or indirectly in many ways, such as by using, holding or sub-leasing the asset. The economic benefits from use of an asset include its primary output and by-

products (including potential cash flows derived from these items), and other economic benefits from using the asset that could be realised from a commercial transaction with a third party’.

The Committee observed that, in the fact pattern described in the request, the economic benefits from use of the windfarm include the electricity it produces (as its primary output) and the renewable energy credits (as a by-product or other economic benefit from use of the windfarm that could be realised from a commercial transaction with a third party).

The power purchase agreement results in the customer settling with the supplier the difference between the fixed price and the spot prices per megawatt of electricity the windfarm supplies to the grid throughout the 20-year term of the contract. That contract, however, does not give the customer the right to obtain any of the electricity the windfarm produces and supplies to the grid. Although the customer has the right to obtain the renewable energy credits (which represent a portion of the economic benefits from use of the windfarm), the customer does not have the right to obtain substantially all the economic benefits from use of the windfarm without having the right to obtain any of the electricity the windfarm produces during the 20-year term of the contract.

The Committee therefore concluded that, in the fact pattern described in the request, the customer does not have the right to obtain substantially all the economic benefits from use of the windfarm. Consequently, the contract does not convey to the customer the right to use the windfarm for a period of time and, thus, does not contain a lease.

The Committee concluded that the principles and requirements in IFRS Standards provide an adequate basis for a customer that enters into a power purchase agreement as described in the request to determine whether it has the right to obtain substantially all the economic benefits from use of an identified asset. Consequently, the Committee [decided] not to add a standard-setting project to the work plan.

Appendix B—Illustrative Example 9 accompanying IFRS 16

Illustrative Example 9 accompanying IFRS 16 is reproduced below. However, this appendix includes only the analysis of the customer’s right to obtain substantially all the economic benefits from use of the identified asset—we have not reproduced the analysis of whether the customer has the right to direct the use of that asset.

Example 9—Contract for energy/power

Example 9A: a utility company (Customer) enters into a contract with a power company (Supplier) to purchase all of the electricity produced by a new solar farm for 20 years. The solar farm is explicitly specified in the contract and Supplier has no substitution rights. The solar farm is owned by Supplier and the energy cannot be provided to Customer from another asset. Customer designed the solar farm before it was constructed—Customer hired experts in solar energy to assist in determining the location of the farm and the engineering of the equipment to be used. Supplier is responsible for building the solar farm to Customer’s specifications, and then operating and maintaining it. There are no decisions to be made about whether, when or how much electricity will be produced because the design of the asset has predetermined those decisions. Supplier will receive tax credits relating to the construction and ownership of the solar farm, while Customer receives renewable energy credits that accrue from use of the solar farm.

The contract contains a lease. Customer has the right to use the solar farm for 20 years.

There is an identified asset because the solar farm is explicitly specified in the contract, and Supplier does not have the right to substitute the specified solar farm.

Customer has the right to control the use of the solar farm throughout the 20-year period of use because:

- (a) Customer has the right to obtain substantially all of the economic benefits from use of the solar farm over the 20-year period of use. Customer has exclusive use of the solar farm; it takes all of the electricity produced by the farm over the 20-year period of use as well as the renewable energy credits that are a by-product from use of the solar farm. Although Supplier will receive economic benefits from the solar farm in the form of tax credits, those economic benefits

relate to the ownership of the solar farm rather than the use of the solar farm and, thus, are not considered in this assessment.

...

Example 9B: Customer enters into a contract with Supplier to purchase all of the power produced by an explicitly specified power plant for three years. The power plant is owned and operated by Supplier. Supplier is unable to provide power to Customer from another plant. The contract sets out the quantity and timing of power that the power plant will produce throughout the period of use, which cannot be changed in the absence of extraordinary circumstances (for example, emergency situations). Supplier operates and maintains the plant on a daily basis in accordance with industry-approved operating practices. Supplier designed the power plant when it was constructed some years before entering into the contract with Customer—Customer had no involvement in that design.

The contract does not contain a lease.

There is an identified asset because the power plant is explicitly specified in the contract, and Supplier does not have the right to substitute the specified plant.

Customer has the right to obtain substantially all of the economic benefits from use of the identified power plant over the three-year period of use. Customer will take all of the power produced by the power plant over the three-year period of use.

...

Example 9C: Customer enters into a contract with Supplier to purchase all of the power produced by an explicitly specified power plant for 10 years. The contract states that Customer has rights to all of the power produced by the plant (ie Supplier cannot use the plant to fulfil other contracts).

Customer issues instructions to Supplier about the quantity and timing of the delivery of power. If the plant is not producing power for Customer, it does not operate.

Supplier operates and maintains the plant on a daily basis in accordance with industry-approved operating practices.

The contract contains a lease. Customer has the right to use the power plant for 10 years.

There is an identified asset. The power plant is explicitly specified in the contract and Supplier does not have the right to substitute the specified plant.

Customer has the right to control the use of the power plant throughout the 10-year period of use because:

- (a) Customer has the right to obtain substantially all of the economic benefits from use of the power plant over the 10-year period of use. Customer has exclusive use of the power plant; it has rights to all of the power produced by the power plant throughout the 10-year period of use.

...

Appendix C—submission

C1. We have reproduced the submission below and in doing so deleted details that would identify the submitter of this request.

Suggested agenda item: Identifying a lease – power purchase agreements (PPAs) in gross pool electricity markets.

It has come to our attention that there are diverse views on identifying whether power purchase agreements (PPA) in a gross pool electricity market are, or contain, a lease as defined in IFRS 16 *Leases*.

We are seeking clarification by the Committee of the issue detailed below.

Background

Gross pool electricity markets have been the subject of IFRIC agenda decisions in the past.

In its August 2005 IFRIC update, the IFRS Interpretations Committee concluded that a synthetic arrangement that results from the linking of a non deliverable contract entered into with a customer to fix the price of a commodity with a transaction to buy or sell the commodity through an intermediary would not satisfy the normal purchase and sale scope exclusion (the “own use” exemption) in IAS 39:5.

With the adoption of IFRS 16, a similar question has come to light in the context of assessing whether PPAs in a gross pool electricity market are, or contain, a lease.

Gross pool vs net pool electricity markets

Gross pool electricity markets have been identified in the USA, Korea, Singapore, Canada, Australia, New Zealand and parts of the EU. Some jurisdictions use gross pool markets exclusively and others use a combination of gross pool and net pool electricity markets.

In a gross pool electricity market, all purchases and sales of electricity are cleared through a market operator on a gross basis, without the market operator taking delivery or on-selling electricity. There is no bilateral contractual arrangement between an actual seller (generator) and an actual buyer (retailer). Instead, all transactions are settled at spot prices via a market operator that acts as a clearing house for energy transactions. This means that

- Electricity is supplied by the generator to a connection point on the power system through transmission lines.

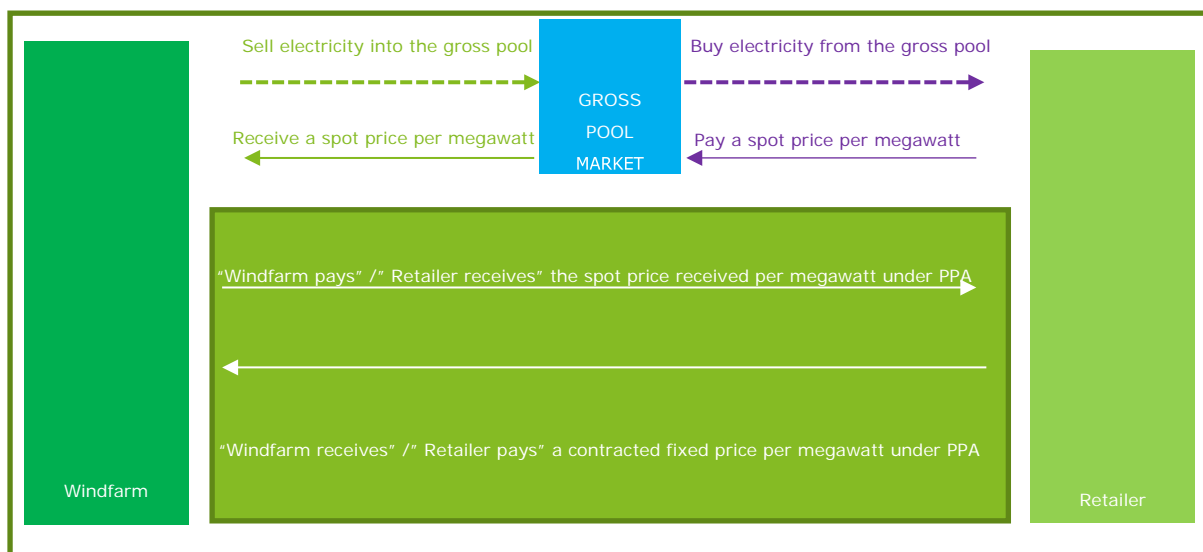
- The market operator meters the generator’s delivery of electricity into the grid and the retailer’s consumption of electricity from the grid for each 30-minute trading period.
- The market operator determines the spot price for each 30-minute interval during the trading day. The spot price is the market determined clearing price that matches supply with demand.
- The market operator then calculates for each participant (retailers and generators) the amount due, or payable, by applying the relevant spot price to the metered amount for each trading period, and issues notices for payments and receipts to each participant.
- The retailers pay amounts due to the market operator on the settlement date and the market operator pays the amounts owed to generators on the same date.

In contrast, in a net pool electricity market, the contracts between generator and retailers are “physically deliverable”. In other words, a generator delivers electricity into the electricity grid in accordance with contracts it has entered directly with retailers.

PPAs in a gross pool electricity market

In a gross pool electricity market, generators and retailers that elect to manage their exposure to spot price risk do so by entering into arrangements which are settled outside the spot market (e.g. swaps, caps, contracts for differences or PPAs).

This submission considers a windfarm (generator) which is a registered participant in a gross pool electricity market that enters a PPA with an electricity retailer which is also a registered participant in the gross pool electricity market.



This submission refers to a PPA that

- Identifies explicitly a windfarm owned by the generator that will be used to sell electricity in the gross market (physical delivery). The windfarm cannot be substituted.
- Covers *notionally* all the electricity generated from the specified windfarm for the next 20 years. Because the rules of the gross pool electricity market prevent the generator and the retailer from transacting directly for the supply of electricity, the PPA is a contract that settles net based on the referenced notional amount.
- Swaps the windfarm's spot selling price per megawatt into the gross market electricity pool for a fixed price per megawatt. The swap of the spot prices for fixed prices follows the underlying volume of electricity that the windfarm has produced (hence the name "load following swaps" for some of these types of arrangements).
- Is always settled net in cash between the contracting parties.
- Includes an agreement that the retailer will obtain all renewable energy credits. These credits are physically delivered, and title passes directly to the customer. The fixed leg of the PPA is priced to include the renewable energy credits.

For the purpose of this submission, it is further assumed that the retailer designed the windfarm before it was constructed. The retailer hired experts in wind energy to assist in determining the location of the farm and the engineering of the equipment to be used. The generator is responsible for building the windfarm to the retailer's specifications, and then operating and maintaining it. There are no decisions to be made about whether, when or how much electricity will be produced because the design of the asset has predetermined those decisions.

In effect,

- The **generator** sells all the volume of electricity produced by the windfarm at spot market prices. Under the terms of the PPA, the spot price is swapped to a fixed price for the volume of electricity produced and sold by the windfarm. Economically, the generator is in the same position as if it had sold all its electricity at a fixed price per megawatt.
- The **retailer** buys the volume of electricity it requires at the spot market price in 30-minute intervals. Under the legislation, the retailer is required to make spot market

purchases. In particular, the retailer is not permitted to enter in contractual arrangements to purchase electricity beyond a specific 30-minute trading period. Under the terms of the PPA, the spot market price is swapped for a fixed price for the volume that the windfarm produces. Economically, the retailer is in the same position as if it had bought its electricity at a fixed price per megawatt (provided that the volume it buys from the pool over the term of the PPA matches the volume that the windfarm produced).

Identifying a lease under IFRS 16

IFRS 16:9 indicates that a contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration. IFRS 16:B9 explains that to determine whether a contract conveys the right to control the use of an identified asset for a period of time, an entity shall assess whether, throughout the period of use, the customer has both of the following:

- a) the right to obtain substantially all economic benefits from the use of the identified asset; and
- b) the right to direct the use of the identified asset.

We are seeking the views of the IFRS Interpretations Committee solely on the application of the criterion in IFRS 16:B9(a) (i.e. whether the retailer has obtained substantially all economic benefits from the use of an identified asset) to the transaction described above. The assessment of the criterion in IFRS 16:B9(b) is not affected by the gross pool market structure and is not subject to this submission.

Question – As a result of the PPA, has the retailer obtained substantially all the economic benefits from the use of an identified windfarm?

View 1A – Yes. The PPA, when considered on a combined basis with the gross pool electricity market transactions, provides the retailer substantially all the economic benefits of an identified windfarm.

In the context of a gross pool electricity market, a retailer that enters the PPA described in the submission is in a similar position to the customer in Illustrative Example 9A that accompanies IFRS 16 and illustrates the assessment of whether a contract between a solar farm and a customer contains a lease.

Proponents of View 1A consider that, in substance, the gross pool electricity market operator is a clearinghouse acting as an agent. They consider that the substance of transaction must be analysed in light of the market structure in which it takes place. The gross pool electricity market prevents participants from contracting directly with each other. They necessarily must go through the gross pool electricity market operator, which in substance acts as their agent. In a net pool electricity market, the same economic transactions are taking place with the only difference being that entities can contract directly with each other. Proponents of View 1A believe that there should not be a difference in the accounting purely because of the market structure.

The PPA references a notional volume that corresponds to all the output from the windfarm. Electricity is fungible, thus the electricity produced by the identified windfarm and the electricity purchased from the gross pool electricity market are indistinguishable. Typically, retailers enter PPAs for a base load of electricity they know they will require. In theory, it is possible that the retailer could purchase less electricity from the gross pool electricity market than the electricity produced by the windfarm identified in the PPA. However, in practice, because the PPA covers the base load expected to be required, the total volume purchased by the retailer from the gross pool electricity market is always more than the volume produced by the identified windfarm. Only in extreme circumstances would the volume purchased be less than that produced by the windfarm. Therefore, the generator sells the volume produced into the gross pool electricity market and the retailer in turn buys the same volume or more from the gross pool electricity market, which is in substance similar to a transaction in the net pool electricity market.

Proponents of this view also argue that the gross pool electricity market is a legal structure which forces generators and retailers to transact in a specific manner. They believe that substance should prevail over legal form. They believe that the economic substance of the transactions that take place in a gross pool electricity market are identical to that in a net pool electricity market and that market participants view electricity purchase contracts as fixed price purchase contracts irrespective of whether they occur in a gross pool or the net pool electricity market. Given that entities behave and transact on the same economic basis in gross and pool electricity markets, the accounting should not differ.

Finally, proponents of this view believe that the conclusion in the August 2005 IFRIC agenda decision is only relevant in interpreting the meaning of ‘delivery’ for the purpose of applying

the own use exemption and that it is not relevant in assessing whether a contract is, or contains, a lease. This is because they believe that the criterion in IFRS 16:B9(b) does not require physical delivery of the output of the identified asset.

View 1B – Yes. The PPA, even when considered on its own, provides the retailer substantially all the economic benefits of an identified windfarm.

Proponents of this view believe that the PPA in itself provides the retailer with substantially all the economic benefits of the identified windfarm.

They note that IFRS 16:B21 describes economic benefits very broadly:

“A customer can obtain economic benefits from use of an asset directly or indirectly in many ways, such as by using, holding or sub-leasing the asset. The economic benefits from use of an asset include its primary output and by-products (including potential cash flows derived from these items), and other economic benefits from using the asset that could be realised from a commercial transaction with a third party.”

As a result of the PPA, considered on its own, the retailer obtains the renewable energy credits as well as taking the economic price exposure on electricity. Indeed, as a result of the PPA, the retailer is exposed to the price risk of all the electricity produced from the specified windfarm for the next 20 years.

Focusing on price exposure piece, the PPA locks the generator into a fixed price per unit of electricity. Typically, the capacity of a windfarm can be determined with 95 per cent certainty. Consequently, having locked the price under the PPA, the generator’s returns from the specified windfarm is essentially fixed for the term of the PPA. In effect, the retailer has obtained the substantially all of the economic benefits from the specified windfarm. This is because:

- The retailer has obtained a fixed cost per unit of electricity volume that matches the volume produced by the windfarm. As a result, it has the ability to obtain all of the economic benefits from the sale of that volume of electricity to its clients.
- Windfarms are typically only built in locations where a feasibility study demonstrates high certainty over the availability of wind to generate the required electricity. Consequently, typically, there is little variability on wind risk and only as a result of a catastrophic event would a major variance occur.

- Electricity is fungible and as such it is irrelevant where the electricity purchased is produced.

Proponents of this view also argue that the criterion in IFRS 16:B9(b) does not require physical delivery of the output of the identified asset.

View 2 – No. In a gross pool electricity market, the PPA does not provide the retailer substantially all the economic benefits of an identified asset.

In a gross pool electricity market, two series of transactions take place:

- The spot transactions in the gross pool electricity market (the retailer and the generator cannot contract with each other directly)
- The separate PPA agreement between the generator and the retailer.

IFRS 16:B2 requires that two or more contracts should be combined and accounted for as a single contract when certain criteria are met. The prerequisites to the combination of contracts are that all contracts must be entered into at or near the same time with the same counterparty (or related parties of the counterparty).

In the fact pattern presented in this submission, these prerequisites are not fulfilled. In particular,

- The spot transactions and the PPA do not have the same counterparty. In fact, in a gross pool electricity market structure, there are no contractual counterparties for purchases and sales of electricity. Rather, transactions operate on a spot basis via a clearing house. Each spot transaction can be seen as a separate contract to buy electricity as and when a purchase is made.
- The spot transactions are a series of individual transactions as and when they occur. Consequently, even if a spot transaction is seen as giving rise to a separate contract to buy electricity at the time the electricity is delivered to the grid, the series of contracts that take place over the term of the PPA are not entered into at the same time of the PPA itself.

As a result, the PPA cannot be combined with the spot transactions for the purposes of applying IFRS 16. IFRS 16:B21 describes the economic benefits from the use of an asset as including its primary output and by-products (including potential cash flows derived from

these items). Considered on its own, the PPA does not entitle the retailer to the primary output from the windfarm.

Further, the fact that the PPA and the spot transactions do not have the same counterparties affects the economic substance of the transaction. For example:

- The retailer has no contractual obligation to buy electricity at spot prices from the gross pool electricity market to match the net settlement under the PPA. Further, if the retailer is unable to purchase electricity at spot due to, for example, liquidity problems, it remains obliged under the PPA. In other words, if the retailer's demand for electricity drops by half, its spot electricity purchases will be reduced accordingly. However, it will still have a financial exposure for the price differential based on all of the electricity produced by the windfarm through the PPA. This reflects the fact that indeed the spot purchases are independent from the volumes committed under the PPA linked to the windfarm production.

In contrast, in a net pool electricity market scenario, the physical electricity purchases and pricing are contractually linked and specified between the same two counterparties. If a customer's demand for electricity is reduced, it would still be contractually obliged to buy all the electricity. It should be noted that electricity supply contracts in the net pool electricity market generally include clauses permitting net settlements in case of mismatches between supply and demand. However, these are typically infrequent. It is important to point out that contracts in net pool electricity markets remain contracts for physical delivery. In a gross pool electricity market structure, the only upfront contract is a PPA that always settles net.

- If the retailer defaults under the PPA, the windfarm will continue to produce electricity and the generator will continue to receive spot market prices from the gross pool electricity market. However, the net cash settlements under the PPA will stop as the counterparty to the contract has defaulted.

As a result, proponents of View 2 do not believe it is appropriate to draw a conclusion based on an "in substance" analysis which ignores the market structure and consequential contractual rights and obligations. Instead, they believe that the market structure gives rise to an important commercial difference. If linked, the contracts can be viewed as representing a normal executory type transaction. When the contracts are not linked, the economic reality is that the spot purchases behave independently from the PPA underlying volume. There is no

requirement to execute purchases from the gross pool electricity market at spot. The financial exposure (contract for cash settlements) is independent of the spot purchases. It is through matching volumes that a synthetically similar result can be achieved. However, in the present case, the criteria for combining contracts into a “synthetic” transaction, which are consistent in IFRS 15⁴, IFRS 16⁵ and IFRS 9⁶, are not met.

In this case, as explained earlier, there are different counterparties which cannot be ignored for the purposes of the accounting.

Proponents of view 2 believe that the August 2005 IFRIC agenda decision is equally relevant to IFRS 16 analysis as it was for the IAS 39 analysis. This is because the basic issue is the same: can a non deliverable contract entered into with a customer to fix the price of a commodity (the PPA) be linked with a transaction to buy or sell the commodity through an intermediary (spot transactions in the gross pool electricity market) and accounted for as a single contract? Proponents of view 2 believe that because the principles used to combine contracts in IAS 39/IFRS 9 and IFRS 16 are the same, the same conclusion should be reached.

Proponents of view 2 also believe that the conclusion reached in View 1B is based on a faulty analysis. This is because, even if the exposure to the variability in the electricity price is transferred to the retailer, the retailer must purchase the electricity at spot market prices from the gross pool electricity market to realise these benefits. The net settlement under the PPA together with the market purchase results in a fixed price for the electricity. The retailer can then sell the electricity which it purchased at a fixed price to retail customers and make a profit. Consequently, the only way that the retailer is able to satisfy the requirement that it has contractually obtained substantially all the economic benefits from the electricity produced by the windfarm is if the PPA and the spot price purchases from the gross pool electricity market are analysed together. However, as explained above, the criteria in IFRS 16:B2 to account for the contracts as one are not met. Furthermore, IFRS 16 is a contract-based standard. The definition of a lease specifically refers to contracts that convey rights. The PPA

⁴ IFRS 15:17

⁵ IFRS 16:B2

⁶ IFRS 9 Guidance on Implementation B.6

is a contract that references all the volume of the windfarm for the purposes of net settlement. It is not a contract for actual electricity.

Reasons for the Committee to address the issue

PPAs are common in the utility industry and especially in the renewable energy sector. We have also noticed an increase in the use of PPAs outside of the utility industry given the need to obtain renewable energy credits as part of corporate entities' sustainability strategies.

Given the tenure of PPA contracts and the volumes of electricity produced, these contracts are highly material. Gross pool electricity markets are seen throughout the globe.

We are concerned that the different views observed in practice produce drastically different accounting result. For example, if it is concluded that the retailer obtains substantially all the economic benefits from an identified windfarm and that it has had the ability to direct the use of that windfarm, the PPA is be accounted for as a lease. Because the payments under the PPA are dependent on the volume of electricity produced, the lease payments would be variable payments not based on an index or rate. As a result, the variable lease payments would not be included in the calculation of the lease liability and PPA would effectively remain off balance sheet.

On the other hand, if it is concluded that the retailer does not obtain substantially all the economic benefits from an identified windfarm, the PPA is not in the scope of IFRS 16. It is instead accounted for as a derivative liability applying IFRS 9 (taking into consideration the fact that, as concluded in the August 2005 IFRIC agenda, the requirements for the "own use" exemption would not be met). These derivative liabilities are typically large and highly material balances.

For these reasons, we believe that this issue is urgent and meets the criteria for acceptance into the Committee's agenda.