IFRS Accounting

Staff paper

Agenda reference: 12

IASB® meeting

Date	**July 2023**
Project	**Application of the 'own use' exception to some physical power purchase agreements**
Topic	**Exploring possible narrow scope amendments to IFRS 9**
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Purpose of this meeting

1. In June 2023 the IFRS Interpretations Committee (Committee) discussed a request about applying paragraph 2.4 of IFRS 9 to physical delivery contracts to buy renewable energy. The request stated that entities are experiencing application challenges and questions when applying the requirements in IFRS 9 particularly due to the unique characteristics of the renewable energy market and the related features of the long-term physical delivery contracts. The three fact patterns described in the request are summarised in Appendix A of this paper.

2. In analysing the fact patterns, the Committee was of the view that the principles and requirements in IFRS 9 do not provide an adequate basis for an entity to determine the required accounting for some physical power purchase agreements (PPAs) in a consistent way. The Committee specifically considered contracts for the purchase of a non-financial item when the underlying non-financial item cannot be stored and has to either be consumed or sold within a short time in accordance with the market structure in which the item is bought and sold.

3. The Committee therefore recommended the IASB consider undertaking a narrow-scope standard-setting project that addresses the application of the 'own use' exception in IFRS 9 to such PPAs.

4. The purpose of this meeting is to:

   (a) provide the IASB with a summary of the Committee's discussions;

   (b) consider what the scope and priority of a potential standard-setting project could be; and

   (c) ask whether the IASB agree to add adding a narrow-scope standard-setting project to the workplan.

Structure of the paper

5. This paper is structured as follows:

   (a) summary of the Committee's discussions;

   (b) staff analysis of the:

      (i) scope of a potential narrow-scope standard-setting project; and

      (ii) priority of a potential narrow-scope standard-setting project;

   (c) staff recommendation; and

   (d) question for the IASB.

6. There are two appendices to the paper:

   (a) Appendix A–Summary of fact patterns in the submission to the Committee; and

   (b) Appendix B–Relevant requirements of IFRS 9.

Summary of the Committee's discussions

Findings from the information request

7. This section summarises the finding reported in paragraphs 20–36 of Agenda Paper 2 of the June 2023 Committee meeting.

8. The Committee received 19 responses on the information request send to the members of the International Forum of Accounting Standard-Setters, securities regulators and large accounting firms —nine from national standard setters, six from large accounting firms, two from groups representing a group of securities regulators and two from other respondents.

Are fact patterns common and widespread?

9. With specific reference to the energy market, the majority of large accounting firms said that:

   (a) fact pattern one is common in many jurisdictions (particularly in Europe);

   (b) fact pattern two is common in some jurisdictions and is becoming increasingly common in a few other jurisdictions; and

   (c) fact pattern three is common in some jurisdictions while less common in other jurisdictions. Where this fact pattern is currently not yet common, it is expected to become more common in the future.

10. With regards to the impacted jurisdictions, these fact patterns are common across all or many industries, but they are particularly prevalent in fuel and power consuming industries.

11. Organisations representing securities regulators also reported that some of their members commonly observe these fact patterns in practice.

12. The feedback from standard setters and organisations representing securities regulators was mixed. All three fact patterns are commonly observed across Europe

and in particular in industries such as energy, gas and oil consuming industries across the Asia Pacific region. On the other hand, these fact patterns are not currently common in Hong Kong and Japan.

Do these fact patterns have a material effect on financial statements?

13. All respondents to the information request said that, in jurisdictions where these fact patterns already are, or are becoming common, accounting for these fact patterns have a material effect on the financial statements. This is because PPAs are typically long-term contracts (in some cases up to 25 years) which, when combined with price volatility in the renewable energy markets, can result in significant fair value changes from one period to the next if an entity is required to account for such PPAs as a derivative.

Has material diversity been observed in practice?

14. In impacted jurisdictions preparers, auditors and regulators said that they observed diversity in practice with regards to how the own use requirements are applied to PPAs and that this diversity in practice have material effects on entities' financial statements. According to these respondents, IFRS 9 does not provide sufficient guidance on how to assess whether entities satisfy the requirements for own use and this has caused diversity in practice to develop in a number of areas.

Are there any other similar fact patterns?

15. Many respondents said that even though the fact patterns described in the submission are common in the electricity market, similar questions arise in the context of other energy and fuel markets such as oil and gas. One of the large accounting firms specifically noted that the fact patterns in the submission are a subset of a range of broader questions with regards to PPAs and 'own use' accounting under IFRS 9 which are widespread across jurisdictions.

16. Respondents also noted that similar questions arise 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 (ie 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.

17. 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). Stakeholders said that the accounting for RECs is a complex area that also gives rise to many application questions.

18. Overall, respondents were concerned that if the Committee were only to consider the fact patterns described in the request, such an approach would leave many unanswered questions regarding the application of the own use exception to other fact patterns. In particular, these respondents were of the view that VPPAs and physical PPAs are entered into for the same purposes and economically provide the same outcomes. They were concerned that accounting for VPPAs and physical PPAs differently would establish a different accounting treatment for economically similar contracts.

Requirements of IFRS 9 with regard to the 'own use' exception

19. The Committee noted that the application questions described in the request only relate to physical PPAs and therefore only considered the relevant requirements for such contracts. The Committee considered that an entity first needs to consider whether a physical PPA is accounted for applying another IFRS Accounting Standard, for example IFRS 10 *Consolidated Financial Statements,* IFRS 11 *Joint*

Arrangements and/or IFRS 16 *Leases*. However, for the purpose of its analysis it only considered the requirements in IFRS 9 (see Appendix B for relevant requirements) on the assumption that no other Accounting Standards apply.

20. The Committee considered that the requirements for the own use exception in IFRS 9 were carried over unchanged from IAS 39 *Financial Instruments: Recognition and Measurement*. Paragraph BZ2.18 of the Basis for Conclusions on IFRS 9 explain that the IASB amended IAS 39 in 2003 to achieve consistency between IAS 39 and IAS 32 *Financial Instruments: Presentation* with respect to the circumstances in which a commodity-based contract meets the definition of a financial instrument and is accounted for as a derivative. As a result, a contract to buy or sell a non-financial item should be accounted for as a derivative when it:

    (a) can be settled net or by exchanging financial instruments; and

    (b) is not held for the purpose of receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements (a 'normal' purchase or sale).

21. In analysing the application of the requirements in paragraph 2.4 of IFRS 9 to the fact patterns described in the submission, the Committee considered:

    (a) the meaning of delivery of the non-financial item;

    (b) the meaning of net settlement as described in paragraph 2.6 of IFRS 9; and

    (c) an entity's own usage requirements.

Meaning of delivery

22. The Agenda Decision 'Meaning of delivery' published in August 2005 concluded that for the own use exception, 'delivery' is not restricted to the physical delivery of the underlying to a specific customer, but that the allocation of the underlying to a customer's account could be regarded as delivery.

23. The Committee observed that in the impacted jurisdictions (see paragraphs 9–12 of this paper) the electricity markets are predominantly organised as a net pool market which enables delivery of energy, which might explain why the PPAs described in the request are not common in some jurisdictions. However, the Committee also acknowledged that in some circumstances, it could be possible to have contractual arrangements that result in delivery even if the electricity market is structured as a gross pool market.

24. The Committee was therefore of the view that for the purpose of applying the own use exception in IFRS 9 to PPAs, the non-financial item must be considered to be delivered to the customer’s account, regardless of how the electricity market is organised (referred to as physical PPAs).

Meaning of net settlement

25. The Committee considered that paragraph 2.6 of IFRS 9 states that there are various ways in which a contract could be settled net in cash or another financial asset and provides examples of situations in which that is the case. The Committee also considered that unless paragraph 2.6(b) or 2.6(c) applies, other contracts that are capable of being net settled and to which paragraph 2.4 could be applied, are assessed to determine whether they were entered into and continue to be held for the purpose of the entity’s expected purchase, sale or usage requirements.

26. Paragraph 2.6(c) IFRS 9 states that when an entity has a practice of taking delivery of the underlying item with the intent to sell it within a short period to generate a profit from this sale, the entity effectively net settles the contract and the ‘own use’ exception cannot be applied. The Committee considered that both elements need to be present: (1) the practice of selling the underlying shortly after taking delivery; and (2) the fact that an entity does so *for the purpose* of generating profits from short-term price fluctuations.

27. Energy markets are typically highly regulated where any energy delivered to a customer’s account has to be consumed within a specific time interval (typically 15 to

30 minutes) to avoid punitive penalty charges from the market operator (ie grid operator). For that reason, some selling activity is unavoidable in such a regulated market for market participants where the delivered electricity exceeds their demand at the time of delivery. However, market participants have no discretion with regards to the timing or sales price of the electricity; all transactions with the grid are transacted at spot prices. Although an entity might generate a profit on some transactions, it could equally make a loss on others.

28. The Committee was of the view that in the fact patterns described in the request, sales of the unused electricity do not appear to be driven by a profit objective (ie the sales of unused electricity are not made for the purpose of generating profits from short-term price fluctuations). Therefore, determining whether the own use exception can be applied depends on an assessment of an entity's expected usage requirements.

An entity's own usage requirements

29. The Committee observed that IFRS 9 does not provide any requirements or application guidance to determine whether a contract is for an entity's expected usage requirements. However, for most commodity contracts, this assessment is relatively straight-forward. Even if an entity has an excess supply of such a commodity to be used or consumed by the entity as part of its operating activities, these commodities are capable of being stored until needed by the entity and therefore there are no forced sales within a short time interval.

30. However, the structure of the electricity market (as described in paragraph 27 of this paper) is characterised by unique features that are absent in a typical commodity or consumption goods market. Therefore, determining whether PPA contracts are entered into and held in accordance with an entity's expected usage requirements requires more complex analysis.

31. The Committee was of the view that for physical PPAs to buy energy from renewable resources there is not adequate application guidance in IFRS 9 to determine whether a contract is entered into and continues to be held for the delivery of a non-financial

item in accordance with an entity's expected usage requirements. In particular, the Committee agreed with the staff analysis that the following questions could be relevant in such assessment:

(a) to what extent the market structure in which a non-financial item is transacted is relevant to determining an entity's own usage requirements. This is especially the case when the non-financial item cannot be stored and has to be consumed immediately;

(b) over which period an entity's expected usage requirements needs to be evaluated when delivery could occur on a near-constant basis. Assessing an entity's expected usage over different periods could significantly affect to which contracts the own use exception could be applied. For example, if IFRS 9 requires expected usage at each delivery point, very few if any PPAs would qualify for the own use exception; and

(c) to what extent transactions in the spot market subsequent to delivery indicate that a PPA is, or is not for the purpose of an entity's own usage requirements. For example, is there a threshold for 'permissible sales' (ie a proportion of the energy delivered) or do subsequent purchases 'cancel out' the sales as long as an entity is a net purchaser of energy?

32. The Committee therefore recommended that the IASB consider adding a narrow-scope standard setting project that addresses the application of paragraph 2.4 of IFRS 9 for such PPAs.

Staff analysis

Informal outreach with users of financial statements

33. As part of the information request, one standard setter reported that user advisory group in their jurisdiction said that:[1]

    (a) most of members have a general preference to account for PPA contracts as executory contracts, because they consider such contracts to serve a dual purpose; securing the energy supply for the entity at a fixed price and contributing to the entity meeting its green ambitions/requirements.

    (b) some of members specifically noted that if the PPAs are accounted for as derivatives, the volatility in profit or loss would not faithfully reflect the economic substance of these long-term contracts and could show profits or losses that could be misleading.

    (c) however, a few others observed that an entity would have to consider the risk and opportunities arising from such contracts and that some fair value analysis might be needed to fully understand the economic implications of the PPAs from a risk management perspective.

34. Following the Committee's discussion in June, we conducted additional informal outreach with a small number of users to further understand their perspective on long-term physical PPAs and particularly whether accounting for these contracts as derivatives (measured at fair value through profit or loss) would provide information that is useful to understand the way in which companies manage their supply of renewable energy.

35. The feedback from these users of financial statements were consistent with the feedback summarised in paragraph 33 of this paper. In particular, investors told us that:

[1] As reported in paragraph 29 of Agenda Paper 2 for the June 2023 Interpretations Committee meeting.

(a) Recognising the fair value changes for a physical PPA over its contractual life in the financial statements would not provide useful information because the financial statements would not show the effect of the actual cost to the entity, for example the actual cost of the renewable energy purchased during the year.

(b) Recognising volatility in profit or loss that are not aligned with the actual costs on these contracts does not necessarily provide useful information about the purpose of the contract and the effect of entering into a fixed price commitment for some of the entity's energy needs; and

(c) The fair value of physical PPAs is not necessarily a useful indicator of the risk embedded in such long-term contracts, because it does not provide useful information about the changes in the operating costs of the entity for the period and therefore the risks or benefits to the entity's operating profits. This is because the fair value of the contract is based on current expectations of energy costs over the contract term and such expectations could change frequently.

36. These investors said that to understand the risks and benefits associated with these contracts it is more important to understand how the actual costs under the contract (ie the fixed price paid for energy) for the period compares to the price the entity would have paid to purchase an equivalent volume of energy in the spot market (ie effects on the operating cost of the entity). They therefore expressed a preference for disclosure of the critical terms of those arrangements in the financial statements over recognising the fair value of the physical PPAs.

37. In addition, these investors are interested in understanding the effects on the financial statements of any transactions that occur in the market at spot prices (for example the selling and repurchasing of energy to balance demand with supply).

Increasing prevalence of PPAs

38. In addition to the informal outreach with users of financial statements, we have also researched publicly available information regarding PPAs, particularly for renewable

energy to gain an understanding of the increasing prevalence of PPAs. We observed a high number of commitment activity or recently contracted long term PPAs as part of a general shift towards greener energy. This demand is expected to increase further over the coming years in line with a number of companies' commitment to be carbon free within a reasonable timeframe. For example, according to Transparency Market Inc, the global power purchase agreement market was valued at US$ 20.1 bn in 2022. It is estimated to advance at a rate of 39.3% from 2023 to 2031 and reach US$ 399.2 bn by the end of 2031.

39. The number of PPAs entered into is consistently increasing as shown in this chart about the number of PPA deals signed in the EMEA region included in an article by Engie Impact:

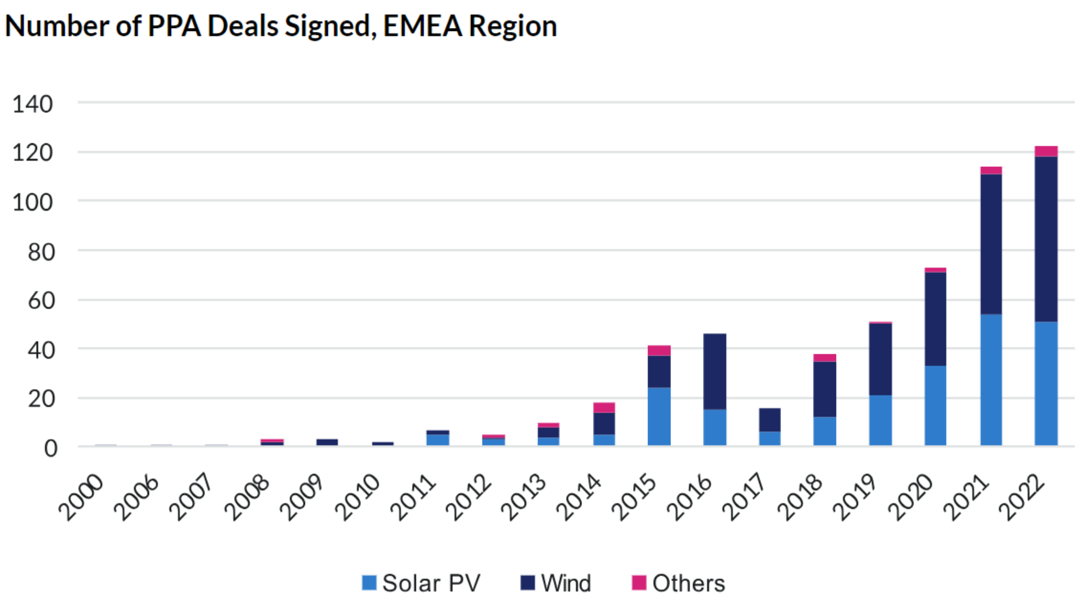

Figure 1: Number of PPA deals in recent years, increasing despite price uncertainty. Source BNEF, April 26, 2023

40. As a result, the total energy mix in the grid is changing and consequently the requirements for connection and transport of electricity as well as the reliability of the supply side are changing too.

41. We are of the view that the effects of these arrangements and any diversity in practice in the application of the own use exception in IFRS 9 will therefore become more prevalent and widespread in the next couple of years.

Possible scope of narrow-scope standard setting project

42. Consistent with our view in paragraphs 71-72 of Agenda Paper 2 of the June 2023 Committee meeting, we are of the opinion that the application questions raised in the context of renewable energy PPAs, are not indicative of fundamental questions about the broader application of paragraphs 2.4 and 2.6 of IFRS 9 to commodities that have physical substance and are economically storable. As a result, we do not think amendments to IFRS 9 are necessary for these 'traditional' contracts to buy or sell non-financial items.

43. However, the structure of the electricity market is characterised by unique features that are absent in a typical commodity or consumption goods market and therefore it differs substantially from other commodity markets, for example:

    (a) *Unpredictability of supply*: the availability of renewable energy resources can vary sharply over time and cannot be 'regulated' to coincide with the times of electricity demands by a customer, for example no supply after business hours;

    (b) *Inability to store electricity:* electricity is by nature not capable of being stored economically until needed and mostly must be consumed shortly after delivery; and

    (c) *Automated sale of unused electricity within short time interval*: any electricity allocated to a customer's account that is not used within the specified time interval (usually 15–30 minutes) are subject to penalty charges. This means the customer must consume or sell the delivered amount within this time interval to avoid imbalance/penalty charges.

44. Feedback from stakeholders is clear that such energy markets give or increasingly will give rise to questions when applying IFRS 9 and we are of the view that the results of

the Committee's initial discussions and the evidence gathered (see paragraphs 7–18) have shown that standard-setting is needed.

45. As discussed in paragraph 16 of this paper, many stakeholders also said that similar application questions arise in the context of VPPAs. Despite the substantial differences in the contractual substance of the physical PPAs and VPPAs, stakeholders said that the economic outcomes are the same. In both cases entities are attempting to secure their long-term supply of renewable energy at a fixed price. In most cases the differences only arise because of the design and structure of the electricity market in their jurisdiction. They are of the view that if the IASB (or the Committee) were to only consider narrow-scope standard-setting for physical PPAs, it would put entities with VPPAs at a significant disadvantage.

46. Although we acknowledge stakeholders' views that there are application guidance questions about the accounting for RECs, we think these questions would potentially be more appropriately dealt with as part of the IASB's pipeline project on pollutant pricing mechanisms. We are therefore not recommending any narrow-scope standard setting in this regard.

47. To address these application questions with regards to PPAs, we think there are two ways in which the IASB could scope a narrow-scope standard-setting project:

(a) clarifying the assessment of an entity's expected usage requirements for physical PPAs in markets with unique features; or

(b) considering the requirements for all PPAs (both physical PPAs and VPPAs).

Clarification of the own use assessment for some physical PPAs

48. As a possible approach the IASB could limit the scope of a narrow-scope standard setting project to clarifying how to assess an entity's own usage requirements for some physical PPAs. Such an approach would be consistent with the questions asked to the Committee and the recommendation that the IASB consider a narrow-scope amendment to IFRS 9. As discussed by the Committee, the scope of narrow-scope

standard setting could focus on physical PPAs for the purchase of renewable energy where:

(a) the underlying non-financial item cannot be stored economically; and

(b) has to either be consumed or sold within a short time in accordance with the market structure in which the item is bought and sold.

49. We acknowledge that similar application questions could arise for other physical electricity PPAs (particularly if they are equally long-term). Therefore, the standard-setting project could be limited either to renewable energy contracts only or focus more broadly on physical electricity PPAs. However, including other PPAs in the standard-setting project might have unintended consequences as they have potentially been in place for quite some time without significant application issues being raised by stakeholders.

50. Consistent with the analysis for the June Committee meeting (as explained in paragraph 31 of this paper), we think any narrow-scope standard setting with regard to physical PPAs could attempt to answer the following questions:

(a) to what extent the market structure in which a non-financial item that cannot be economically stored and has to be consumed immediately is transacted, is relevant to determining an entity's own usage requirements.

(b) over which period an entity's expected usage requirements needs to be evaluated when delivery could occur on a near-constant basis.

(c) to what extent transactions in the spot market subsequent to delivery indicate that a physical PPA is, or is not for the purpose of an entity's own usage requirements.

(d) whether the requirements for the own use exception are applied to a contract in its entirety or could be applied to a portion/proportion of the contract.

51. We think that such a narrow-scope standard-setting project could address the application questions with regard to the own use exception:

(a) efficiently within the confines of the existing Standards and the Conceptual Framework; and

(b) in an effective and timely manner.

52. However, we think that not including the accounting for VPPAs in a narrow-scope standard setting project would only respond to some of the feedback received and concerns raised by stakeholders. It could also lead to significant different accounting outcomes for economically similar contracts. Such an outcome could have substantial consequences for entities operating in a market where it is not possible to enter into physical PPAs and the only option is a VPPA. For this reason, we are not recommending this approach.

Consider the requirements for all PPAs

53. As noted in paragraph 52, considering the accounting effects for physical PPAs in isolation could result in significantly different accounting outcomes for PPAs that are entered into for the same purposes and with economically similar outcomes. Stakeholders have said that this would put entities that can only enter into VPPAs at an accounting disadvantage.

54. A review of the requirements in IFRS 9 including the wider issues identified during the initial outreach request would therefore have the advantage that it could address all the questions with regards to PPAs in one single project.

55. However, if the IASB were to pursue this option further, the scope of the project would be wider than just focussing on physical PPAs. Although the potential clarifications for physical PPAs necessary under this approach are similar to the approach described in paragraphs 48–52, resolving the accounting issues of contracting VPPAs are more complex. This is because VPPAs are derivative contracts under which renewable energy cannot be delivered (refer to paragraph 16). As such, to achieve similar accounting outcomes to applying the own use exception to physical PPAs would require either:

(a) a change to the definition of a derivative contract in IFRS 9; or

(b) changes to the hedge accounting requirements in IFRS 9.

56. We do not consider it feasible to change the definition of a derivative contract in IFRS 9. Such an approach would result in a fundamental change to derivative accounting in IFRS 9 and would affect the accounting for a wide range of instruments beyond VPPAs. We also do not consider it feasible to create an exception for VPPAs specifically; not only would such an exception be difficult to scope (and justify) but it would also carry a significant risk of unintended consequences.

57. The Committee previously considered a question about load following swaps and how the 'highly probable' requirement for hedged items is applied when the notional amount of the hedging instrument (load following swap) varies depending on the outcome of the hedged item (forecast energy sales). The Committee concluded that based on the hedge accounting requirements in IFRS 9, the forecast energy sales lack the required specificity to be designated as a hedged item and therefore do not qualify for hedge accounting.[2]

58. Although stakeholders did not necessarily disagree with the Committee's technical analysis of the current hedge accounting requirements in IFRS 9, they noted that the hedge described in the submission is far more effective than a swap whose notional amount is a fixed volume and that such a hedge designation is not 'abusive'. In their view, in economic terms, the hedging instrument is a near perfect hedge of the entity's exposure to the hedged risk. As a result, they said applying hedge accounting would potentially improve the relevance of financial information.

59. The hedging instrument (the load following swap) described in that agenda decision is similar to a VPPA that is used to 'hedge' an entity's exposure to cash flow variability of future energy purchases at spot prices. We therefore think that hedge accounting might be a potential solution to better reflect the purpose and objectives of VPPAs

[2] Application of the Highly Probable Requirement when a Specific Derivative is Designated as a Hedging Instrument (IFRS 9 Financial Instruments and IAS 39 Financial instruments: Recognition and Measurement)—March 2019

and believe it would be worthwhile exploring whether a potential solution in this regard could be developed.

60. Although we acknowledge that the IASB will decide later this year when to start the post-implementation review of the hedge accounting requirements in IFRS 9, we do not consider this a reason to not explore a potential standard setting solution for matters that are pervasive and could have significant effects on entities' financial statements when such matters arise.

61. We therefore recommend that adding a narrow-scope standard setting project to the workplan (subject to the priority assessment discussed in paragraphs 63–65 below) explores:

(a) the application of the own use exception in IFRS 9 to physical PPAs for the purchase of renewable energy where:

(i) the underlying non-financial item cannot be stored economically; and

(ii) has to either be consumed or sold within a short time in accordance with the market structure in which the item is bought and sold; and

(b) the application of the hedge accounting requirements using VPPAs as the hedging instrument.

62. Although this approach will require more time and resources as the one outlined in paragraphs 48–52, we are still of the opinion that such a narrow-scope standard setting project could address the identified issues:

(a) efficiently within the confines of the existing Standards and the Conceptual Framework; and

(b) is still sufficiently narrow in scope that the IASB can address it in an effective and timely manner.

Priority of a potential narrow-scope standard-setting project

63. Consistent with the IASB's approach to determine the priority of narrow-scope standard setting projects resulting from the post-implementation review process, we analysed the narrow-scope project recommended in paragraph 61 against each of these factors in the table in paragraph 64. We believe these criteria could provide an adequate basis to determine the priority of a narrow-scope standard-setting project to effectively deal with the matters discussed in this paper.

64. Does the evidence gathered during the process indicate that:

	Staff assessment
(a) the matter has substantial consequences?	**Yes** As noted in paragraphs 9–13 and paragraphs 33–41 of this paper (and in Agenda Paper 2 of the June 2023 Committee meeting), PPAs are becoming more prevalent and are expected to have material effects on entities' financial statements. The uncertainty about how to assess whether long-term physical PPAs for renewable energy are held for an entity's own usage requirements resulted in some entities accounting for these contracts as derivatives (measured at fair value through profit or loss) and while others accounted for these contracts as executory purchase contracts. This diversity in practice has substantial consequences not only for preparers, but also for users of financial statements. For preparers, the volatility in profit and loss resulting from the changes in the fair value of the physical PPA do not reflect the economic substance

	Staff assessment
	of these contracts and therefore do not provide a faithful representation of the entity's performance for the year. In addition, users of financial statements told us that changes in fair value over the contractual life of the PPA in profit or loss do not provide useful information about the fixed price commitment that management has entered into and the effect this has on the entity's performance because it would not be possible to translate these fair value changes into actual operating costs for the entity for the reporting period. Entities contracting VPPAs are in a similar position to entities who cannot apply the own use exception. While there might be no diversity in practice when applying the requirements in IFRS 9 to VPPAs, the inability to designate these contracts as hedging instruments in a qualifying hedging relationship, is not necessarily consistent with or provide useful information to users of financial statements about the purpose of the contracts and how entities are using them to hedge its future energy costs. We think that exploring a standard-setting solution for only physical PPAs would have substantial consequences for entities which operate in markets where predominantly VPPAs are contracted.
(b) the matter is pervasive?	**Yes**

	Staff assessment
	As noted in the initial request for information in Agenda Paper 2 and the additional outreach and research performed, physical PPAs and VPPAs for renewable energy are increasingly becoming more prevalent and widespread. As the demand for renewable energy is increasing, more entities are entering into PPAs to secure their supply for the long-term. The effects described in (a) above are in many cases not yet observable in the financial statements because many PPAs were only recently entered into, however the effects are expected to become more observable over the coming years.
(c) the matter arises from a financial reporting issue that can be effectively addressed by the IASB in a timely manner?	**Yes** As discussed in paragraphs 53-62 of this paper, we are of the view that limiting the scope of a narrow-scope project to applying the own use exception to physical PPAs with the characteristics described in paragraph 48 while at the same time exploring changes to the hedge accounting requirements, would enable to the IASB to respond to the questions raised in a timely manner while also limiting the risk for unintended consequences.
(d) the benefits of any action would be expected to outweigh the costs? To determine this, the IASB would consider the extent of	**Yes** The effect of the current lack of requirements and application guidance on how to assess whether a physical PPA is held for an entity's own usage

	Staff assessment
disruption and operational costs from change and the importance of the matter to users of financial statements.	requirements affect not only prepares, but also users of financial statements as described in paragraphs 33–37 of this paper. At the same time the inability to designate VPPAs as hedging instruments in a qualifying hedging relationship, is not necessarily consistent with, or provide useful information to users of financial statements about, the purpose of the contracts and how entities are using them to hedge its future energy costs. Although the application of hedge accounting in itself is complex and costly, we are of the view that if prepares are able to better reflect their risk management activities in their financial statements, users of financial statements will benefit from more useful information being provided about VPPAs. While we agree that any standard-setting activity is disruptive to stakeholders, we are of the view that expected benefits, both to users and preparers of financial statements, to be gained from a narrow-scope project as described in paragraph 53–62 of this paper would exceed the expected cost to stakeholders. The sooner clarity and certainty can be provided to stakeholders, the less risk of disruption to embedded practices there will be.

65. Based on our assessment of the potential narrow-scope amendment to IFRS 9 as described in paragraphs 63-65 of this paper, we consider the priority of standard setting to be high.

Staff recommendation

66. Based on our analysis in paragraphs 33–65 we recommend that the scope of the narrow-scope standard-setting project explores:

    (a) the application of the own use exception in IFRS 9 to physical PPAs for the purchase of renewable energy where:

        (i) the underlying non-financial item cannot be stored economically; and

        (ii) has to either be consumed or sold within a short time in accordance with the market structure in which the item is bought and sold; and

    (b) the application of the hedge accounting requirements using VPPAs as the hedging instrument.

67. We also recommend that the project is classified and added to the workplan as a high priority project.

Question for the IASB

Questions for the IASB
1. Does the IASB agree with our recommendation in paragraph 66–67 to add a narrow-scope standard setting project to the workplan?

Appendix A—Summary of fact patterns in the submission to the Committee

Fact pattern one: Purchased-as-produced contracts

A1. To secure the entity's own demand for energy from renewable sources, the entity enters into a physical power purchase agreement (PPA) with a wind park operator. The contract obliges the entity to acquire a fixed share of the energy produced (for example 50 per cent of the production) at the time it is produced and 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 entity in exchange for the fixed priced per unit.

A2. The total energy demand of the entity by far exceeds both the contracted share of the estimated output and the contracted share of the peak output of the wind park. However, the entity does not operate its production facilities 24/7 but pauses production during the night times, on weekends and holiday season. There is therefore a mismatch between the demand profile of the entity and the supply profile of the wind park and there will be times when the entity is unable to consume the energy when it is delivered (ie over weekends or during the night when facilities are closed).

A3. As there are no feasible option to store the energy, the entity 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 entity's operations. There is no explicit net settlement option within the contract.

A4. The submitter asks whether the entity can apply the own use exception in IFRS 9 at inception of the contract when it is unavoidable that there would be times during the life of the contract that the entity will be unable to consume the energy when delivered and therefore will have to sell the energy on the spot market.

Fact pattern two: Settlement of power purchase agreements

A5. Entity B has contracts to purchase natural gas for use in its own production facilities. Based on the entity's estimated gas demand for the next 12 months, the entity contracted 80 per cent of its forecasted demand in forward contracts to fix the price and secure physical supply in advance. The entity has been using this mechanism for a long time and has taken delivery of all energy contractually agreed upon. The entity has never settled any contracts net.

A6. Due to the current economical and geo-political environment, the government in the jurisdiction in which the entity operates, called for voluntary energy saving efforts to ensure sufficient supplies to all consumers. To prevent any restriction on the availability of energy and to maintain its operations, the entity invested in energy saving efforts and reduced its demand by 30 per cent. Since not all the forward contracts that are already in place were needed anymore, the entity settled some of the contracts by entering into a compensation agreement with the supplier. The net settlements are structured as net payment for all unneeded volumes at that point calculated as the product of the amounts to be settled and the difference between the fixed price of contracts and the current market price.

A7. The company continues to regard the primary purpose of the natural gas purchase agreements as contracts to buy a non-financial item as it is entered for the purpose of the receipt of energy in accordance with the company's expected usage requirements as laid out in IFRS 9.2.4.

A8. The submitter asks whether the net settlement of some of the forward contracts result in the entity having a past practice of net settling similar contracts as described in paragraph 2.6(b) of IFRS 9, leading to IFRS 9 being applied to other such forward contracts.

Fact pattern three: Oversized contracts

A9. The entity intends to secure its energy demand by entering into power purchase agreements with providers of renewable energies (wind and solar) which provide for a fixed price per unit. The entity is able to reliably plan its demand. In contrast, the power purchase agreements do not promise a fixed amount of output. Given the dependence on weather conditions, the energy provider offers to the entity only an expected output of its facilities (e.g. 50 per cent of the output of its solar farm) which it cannot guarantee but only estimate with certain probabilities (e.g. a 50 per cent or 75 per cent confidence level).

A10. The entity assesses (based on information provided by the energy provider) that,

a. with a probability of 10 per cent the solar farm produces its peak output, and the company would receive 130 per cent of its energy demand;

b. with a probability of 75 per cent the solar farm operates under most probable conditions, and the company would receive 95 per cent of its energy demand; and

c. with a probability of 15 per cent the solar farm operates under most unfavourable conditions, and the company would receive 50 per cent of its energy demand.

A11. The entity therefore expects to receive 95 per cent of its energy demand from the energy provider. Any additional demand the entity has would be procured from the spot market. Similarly, any excess energy at the point of delivery would be sold to the spot market. The contract does not permit net settlement and the entity has no history of net settlements or profit taking of contracts that were classified as own use in accordance with paragraph 2.4 of IFRS 9.

A12. The submitter asks whether the entity can apply the own use exception in paragraph 2.4 of IFRS 9 when at inception of the contract, there is probability that each point of delivery the energy delivered might be more than what the entity needs and therefore has to be sold on the spot market.

Appendix B—Relevant requirements of IFRS 9

B1. Paragraph 2.4 of IFRS 9 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.

B2. Paragraph 2.6 of IFRS 9 states:

> There are various ways in which a contract to buy or sell a non-financial item can be settled net in cash or another financial instrument or by exchanging financial instruments. These include:
>
> (a) when the terms of the contract permit either party to settle it net in cash or another financial instrument or by exchanging financial instruments;
>
> (b) when the ability to settle net in cash or another financial instrument, or by exchanging financial instruments, is not explicit in the terms of the contract, but the entity has a practice of settling similar contracts net in cash or another financial instrument or by exchanging financial instruments (whether with the counterparty, by entering into offsetting contracts or by selling the contract before its exercise or lapse);
>
> (c) when, for similar contracts, the entity has a practice of taking delivery of the underlying and selling it within a

short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin; and

(d) when the non-financial item that is the subject of the contract is readily convertible to cash.

A contract to which (b) or (c) applies is not entered into 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 and, accordingly, is within the scope of this Standard. Other contracts to which paragraph 2.4 applies are evaluated to determine whether they were entered into and continue to 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 and, accordingly, whether they are within the scope of this Standard.

B3. In addition, the Committee has published other agenda decisions that might be relevant to the analysis of the fact patterns and questions in the submission, most notably the following:

(a) August 2005—*Meaning of delivery* in paragraph 5 of IAS 39 (now paragraph 2.4 of IFRS 9). The Committee noted that 'delivery' for the purposes of the exception is not necessarily restricted to the physical delivery of the underlying to a specific customer, as physical delivery is not a condition of the exception.

(b) December 2021—*Benefits from Use of a Windfarm* (IFRS 16 *Leases*). The Committee concluded that the agreement between an electricity supplier and electricity retailer as described by the fact pattern of the submission which references a gross pool settlement system for electricity does not contain a lease. This is because the electricity retailer has no right to obtain any of the electricity the windfarm produces throughout the period of the agreement.