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IFRS Developments

Proposed amendments to IFRS 9 and IFRS 7 - Renewable Energy Contracts

What you need to know

- The proposed amendments to IFRS 9 *Financial Instruments* (IFRS 9) are to the own-use requirements and hedge accounting requirements. There are also proposed amendments to IFRS *7 Financial Instruments: Disclosures* (IFRS 7).
- Under the proposed amendments, the sale of unused renewable electricity will be in accordance with an entity's expected purchase or usage requirements only if specified criteria are met.
- Similarly, the proposed amendments will allow an entity to designate a variable nominal volume of forecast electricity transactions as a hedged item, only if the specified criteria are met.
- The comment period closes on 7 August 2024.

Introduction

On 8 May 2024, the International Accounting Standards Board (the IASB) published the Exposure Draft (ED), Contracts for Renewable Electricity, Proposed amendments to IFRS 9 and IFRS 7[1] . The ED contains proposed amendments to:

- Address how the 'own-use' requirements apply
- Permit hedge accounting if these contracts are used as hedging instruments; and
- Add disclosure requirements to enable investors to understand the effects of these contracts on a company's financial performance and future cash flows

The scope of contracts to which the amendments apply is limited to purchase contracts for renewable electricity that meet specified criteria.

The comment period closes on 7 August 2024. The IASB aims to finalise any changes by the end of 2024, with the proposal that the new requirements will be available for companies to apply as soon as possible after they are finalised. The ED is the culmination of work to date which began with a submission to the IFRS Interpretations Committee (IFRS IC) in 2023 dealing with specific questions relating to power purchase agreements (PPAs)[2]. As a result of the submission, the IASB added a maintenance project to the work plan to explore narrow-scope amendments to IFRS 9 to better reflect how financial statements are affected by PPAs[3].

How we see it

The narrow-scope proposed amendments cover both physical and virtual PPAs (which require net settlement of the difference between the prevailing market price, and the contractually agreed price for the volume of electricity produced from a referenced production facility). This is in response to stakeholders highlighting that the objective of both physical PPAs and virtual PPAs is to ensure access to renewable electricity, and to fix the price per unit of electricity purchased or sold. The economic outcomes are the same, but, in many cases, the design and operation of the electricity market determines the types of contracts entities can enter into.

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[1] IASB proposes amendments for renewable electricity contracts. Available on the IFRS Foundation's website.
[2] Application of the 'Own-Use' Exception in the Light of Current Market and Geopolitical Questions (IFRS 9 Financial Instruments); IFRIC update June 2023; agenda paper 2
[3] Application of the Own-use Exception to Some Physical Power Purchase Agreements—Exploring possible narrow-scope amendments to IFRS 9; IASB update July 2023; Agenda Paper 12A

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Scope of the proposed amendments

The proposed amendments only apply to a contract for renewable electricity with both of the following characteristics:

- The source of production of the renewable electricity is nature-dependent so that the supply cannot be guaranteed at specified times or for specified volumes. Examples of such sources of production include wind, sun and water.
- The contract exposes the purchaser to substantially all the volume risk under the contract through 'pay-as-produced' features. Volume risk is the risk that the volume of electricity produced does not align with the purchaser's demand for electricity at the time of production.

The IASB emphasised that the proposed amendments cannot be applied by analogy to other contracts, items or transactions.

How we see it

The IASB intended the scope of the proposed amendments to be narrow enough to minimise the risk of unintended consequences. Also, the proposed amendments do not cover the accounting for renewables energy certificates (RECs).

Proposed amendments to the own-use exception

IFRS 9 must be applied to 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. This is known as the own-use exception from the scope of IFRS 9.

The proposed amendments provide guidance for the application of the own-use exception to contracts that meet the scoping characteristics outlined above. Where the scoping characteristics are met, when assessing if the own-use exception is applicable, an entity considers at inception of the contract, and at each subsequent reporting date:

- The purpose, design and structure of the contract, including the expected delivery of electricity over the remaining duration of the contract.
- The reasons for past and expected sales of unused renewable electricity within a short period after delivery, and whether such sales are in accordance with the entity's expected purchase or usage requirements.

A sale of unused renewable electricity is in accordance with the entity's expected purchase or usage requirements only if all the criteria below are met:

- The sale arises from the entity's exposure to volume risk, giving rise to mismatches between the renewable electricity delivered, and the entity's electricity demand at the time of delivery.
- The design and operation of the market in which the electricity is sold results in the entity not having the practical ability to determine the timing, or price, of the sale of unused electricity.
- The entity expects to purchase at least an equivalent volume of electricity, within a reasonable time (for example, one month) after the sale, i.e. the entity remains a net-purchaser over a reasonable amount of time.

When assessing if the volumes expected to be delivered are in accordance with the entity's expected purchase or usage requirements, an entity doesn't need to make detailed estimates for extended periods in the future. Rather, an entity may extrapolate projections from reasonable and supportable information available at the reporting date. However, an entity must consider reasonable and supportable information available at the reporting date about expected changes in its purchase or usage requirements for a period not shorter than 12 months after the reporting date (or its normal operating cycle as per paragraph B95 of IFRS 18).

The IASB's objective here is to align the proposals with the underlying principle in IFRS 9 that the distinction when assessing the own-use exception is management's intention (evidenced by facts and circumstances) when entering into a contract.

Importantly, the IASB notes that if an entity enters into a contract that is expected to continuously deliver more electricity than the entity needs, such an 'oversized' contract would not be in accordance with the entity's expected usage requirements.

How we see it

The proposed amendments balance the need to ensure that the new requirements uphold the underlying principles behind the own-use exception while reflecting management's intention in entering into the contract. Ongoing assessment based on reasonable and supportable information available at the reporting date about changes in the entity's purchase or usage requirements will ensure that contracts are reclassified as derivatives in a timely manner when the own-use exception requirements are no longer met.

The net-purchaser criteria could allow application of the own-use exemption when an entity has frequent and substantial sales during the contract, but only on condition that it remains a net-purchaser over a reasonable amount of time. The latter may preclude contracts for renewable electricity set-up for sites on a ramp-up phase where structural excesses are expected over a time horizon which is longer than a reasonable amount of time. In such cases, applying hedge accounting to a wider scope of forecasted purchases (involving other sites) may be an option to reduce the volatility arising from fair valuing the contract.

Hedge accounting requirements

Entities are increasingly using contracts for renewable electricity to fix the price at which renewable electricity will be sold or purchased. However, IFRS 9 generally requires the hedged item to be designated as a specified nominal amount or volume. Any changes to the nominal amount or volume of the hedged item would result in the discontinuation of the hedging relationship.

To overcome this, the ED proposes amendments allowing the hedged item in a cash flow hedging relationship to be specified as a variable volume of electricity aligned with the renewable electricity from the production facility as referenced in the contract for the renewable energy designated as a hedging instrument. Where a hedging contract meets the scoping characteristics, an entity can designate a variable nominal volume of forecast electricity transactions (either sales or purchases) as the hedged item, if, and only if:

- The hedged item is specified as the variable volume of renewable electricity to which the hedging instrument relates; and
- The variable volume of forecast electricity transactions (either sales or purchases) designated above does not exceed the volume of future electricity transactions that are highly probable. Forecasted *sales* are not required to be highly probable if the hedging instrument relates to a proportion of the total future renewable electricity sales from the production facility.

To account for a qualifying cash flow hedging relationship as required by IFRS 9, an entity must measure the hedged item using the same volume assumptions as those used for measuring the hedging instrument. The hedging relationship would, therefore, not be affected by any hedge ineffectiveness caused by a comparison of a fixed nominal volume with a variable nominal volume. However, all other assumptions and inputs used for measuring the hedged item, including pricing assumptions, must reflect the nature and characteristics of the hedged item, and must not impute the features of the hedging instrument.

How we see it

Although the proposed amendments provide a practical solution for in scope contracts, entities must be aware that there may still be other sources of ineffectiveness in the hedging relationship. For example, differences between the timing of purchases and electricity production; the volume of spot purchases and electricity production; or the basis component of the spot price (if the purchases and production relate to different jurisdictions.

Proposed amendments to IFRS 7 Financial Instruments: Disclosures

An entity that is a party to contracts for renewable electricity that meet the scoping characteristics must disclose information about how these contracts affect the amount, timing and uncertainty of the entity's future cash flows (whether or not the own-use or hedging amendments are applied). Specifically, an entity must disclose:

- The terms and conditions of the contracts. Examples of terms and conditions include the remaining contract duration and the type of pricing
- For contracts for renewable electricity that are not measured at fair value through profit or loss, either:
- The fair value of the contracts at the reporting date; or
- The volume of renewable electricity a seller expects to sell, or a purchaser expects to purchase, over the remaining duration of the contracts. An entity is permitted to provide this information as a range for each of the periods: not later than one year; later than one year and not later than five years; and later than five years.

There are also specific disclosure requirements for sellers and purchasers that show how the contracts affected their financial performance for the reporting period. Specifically, sellers and purchasers should disclose the proportion of renewable electricity covered by the contracts to the total electricity sold or purchased during the period.

The IASB has clarified that it is not the intention that an entity will disclose information for each contract separately.

The IASB expects that the benefits of the proposed disclosure requirements will outweigh the costs of applying the requirements. The volume expected to be sold or purchased over the remaining duration would enable investors to understand the size of the future commitments without having to calculate the fair value of the contracts. Information on the price agreed in the contract is not required considering the information could be commercially sensitive.

How we see it

Entities will need to determine the appropriate level of aggregation to ensure that the disclosures are understandable and meaningful for users.

Transition

The IFRS 7 disclosure amendments must be applied when the IFRS 9 amendments are applied.

With regard to the proposed amendments relating to the own-use exception, an entity is not required to restate prior periods and it is only permitted to do so if it can be done without using hindsight. If an entity does not restate prior periods, it must recognise any difference between the previous carrying amount, and the carrying amount at the beginning of the reporting period in which the amendments are first applied, in opening retained earnings of that reporting period.

The proposed hedge accounting amendments must be applied prospectively to new hedging relationships designated on or after the date the amendments are first applied. In addition, an entity is permitted to change the designation of the hedged item in a cash flow hedging relationship that was designated before the date the amendments are first applied without discontinuing the hedging relationship. However, entities are not permitted to reinstate hedging relationships already discontinued at the date the amendments are applied.

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