Need to know

IASB proposes amendments for contracts to buy or sell renewable electricity that have specified characteristics

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This *Need to know* outlines the proposed amendments to IFRS 9 *Financial Instruments* and IFRS 7 *Financial Instruments: Disclosures* set out in exposure draft (ED) *Contracts for Renewable Energy,* published by the International Accounting Standards Board (IASB) on 8 May 2024.

- The IASB proposes to amend:
  - the own-use requirements in IFRS 9 to include the factors an entity is required to consider when applying IFRS 9:2.4 to contracts to buy and take delivery of renewable electricity:
    - for which the source of production of the electricity is nature-dependent
    - that exposes the purchaser to substantially all of the volume risk
  - the hedge accounting requirements in IFRS 9 to permit an entity using a contract for renewable electricity with specified characteristics as a hedging instrument:
    - to designate a variable nominal volume of forecast electricity transactions as the hedged item if specified criteria are met
    - to measure the hedged item using the same volume assumptions as those used for the hedging instrument
  - IFRS 7 and IFRS 19 *Subsidiaries without Public Accountability: Disclosures* to introduce disclosure requirements about contracts for renewable electricity with specified characteristics
- The ED does not specify an effective date for the amendments but asks respondents whether an effective date for annual reporting periods beginning on or after 1 January 2025 would be appropriate
- Early application of the proposed amendments would be permitted from the date the amendments are issued
- Entities would be required to apply:
  - the amendments to the own-use requirements in IFRS 9 using a modified retrospective approach
  - the amendments to the hedge accounting requirements prospectively
- The comment period for the ED ends on 7 August 2024.

For more information please see the following websites:

www.ukaccountingplus.co.uk

www.deloitte.co.uk

Background

In June 2023, the IFRS Interpretations Committee (IFRS IC) considered a request it received about how an entity would apply IFRS 9:2.4 to contracts to buy and take delivery of electricity produced from nature-dependent sources. The request noted that entities experience application challenges when applying the requirements in IFRS 9 to these contracts because of:

- the characteristics of the sources of renewable electricity production and the design and operation of the market in which the electricity is sold
- the 'pay-as-produced' features, which oblige the purchaser to buy electricity produced from a reference production facility when the electricity is produced (commonly referred to as physical power purchase agreements (PPAs))—these features expose the purchaser to substantially all of the risk that the volume of electricity produced does not align with the purchaser's demand for electricity at the time of production.

The IFRS IC referred the matter to the IASB. During the IASB's research, stakeholders said that the IASB should also consider how an entity accounts for 'virtual PPAs', i.e. PPAs that 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.

The IASB decided to publish an ED to propose amendments to IFRS 9 and IFRS 7 to address these issues.

The proposed requirements

Scope

The amendments apply specifically to contracts for renewal electricity that have both of the following characteristics:

- the source of production of the renewable electricity is nature-dependent so that supply cannot be guaranteed at specified times or for specified volumes
- the contract exposes the purchaser to substantially all the volume risk under the contract through pay-as-produced features.

An entity would be prohibited from applying the amendments by analogy to other contracts, items or transactions.

> **Observation**
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> The IASB considered whether to include other contracts for electricity in the proposed amendments. In developing the proposals, the IASB did not receive feedback that other contracts result in the same concerns as contracts that have the characteristics described above. For example, the IASB did not include contracts for biomass energy and some contracts for hydroelectricity in the scope of the proposed requirements because those contracts might only have one of the characteristics described above. This is why application of the amendments by analogy to contracts that do not meet the specified characteristics is not permitted.
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> The IASB acknowledges that contracts for renewable electricity are typically accompanied by renewable energy certificates (RECs). The ED does not propose how to account for RECs as the IASB considered that it would be best to address this issue as part of a potential project on pollutant pricing mechanisms.

'Own-use' requirements in IFRS 9

For the purpose of applying the requirements in IFRS 9:2.4 to contracts to buy and take delivery of renewable electricity that have the characteristics set out above under **Scope**, an entity (a purchaser) would be required to consider at inception of the contract and at each subsequent reporting date:

- the purpose, design and structure of the contract including the volumes of electricity expected to be delivered over the remaining duration of the contract. In assessing how the volumes expected to be delivered under the contract continue to be in accordance with the entity's expected purchase or usage requirements, the entity would:
  - be required to consider reasonable and supportable information available at the reporting date about expected changes in the entity's purchase or usage requirements for a period not shorter than 12 months after the reporting date (or the entity's normal operating cycle)
  - be permitted to extrapolate projections from reasonable and supportable information available at the reporting date for periods that are far in the future (i.e. for such periods, the entity would not be required to make a detailed estimate).
- whether past and expected sales of unused renewable electricity within a short period after delivery 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 following criteria are met:
  - the sale arises from the entity's exposure to the 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
- the entity expects to purchase at least an equivalent volume of electricity within a reasonable time (for example, one month) after the sale.

Hedge accounting requirements in IFRS 9

For the purpose of applying the requirements for hedged items in IFRS 9 to a cash flow hedging relationship in which a contract for renewable electricity that has the characteristics set out above under **Scope** is designated as the hedging instrument, an entity would be permitted to designate a variable nominal volume of forecast electricity transactions (either sales or purchases) as the hedged item, if, and only if:

a. the hedged item is specified as the variable volume of electricity to which the hedging instrument relates and
b. the variable volume of forecast electricity transactions designated in accordance with (a) does not exceed the volume of future electricity transactions that are highly probable.

If an entity designates renewable electricity sales in accordance with (a), the forecasted sales would not need to meet the highly probable requirement if the hedging instrument relates to a proportion of the total future renewable electricity sales from the production facility, as specified in the contract for renewable electricity.

If a qualifying cash flow hedging relationship is established, an entity would be required to measure the hedged item using the same volume assumptions as those used for measuring the hedging instrument. However, when measuring the hedged item, all other assumptions and inputs, such as pricing assumptions, would reflect the nature and characteristics of the hedged item (i.e. an entity would not be allowed to incorporate the features of the hedging instrument).

Observation

The ED proposes changes to the way in which the hedged item can be identified. For hedge accounting of purchase or sales of electricity, without the amendments, an entity would be required to designate a specified volume, i.e. an absolute volume, of forecast electricity that is highly probable which cannot be changed throughout the hedge relationship duration. This leads to hedge ineffectiveness when the volume differs from that specified volume. For purchasers of electricity where the volume under the contract is less than their highly probable electricity purchases, and for sellers where the volume of electricity sold is linked to the contract, the IASB does not believe hedge ineffectiveness arising from volume uncertainty faithfully represents the economic effects of the hedge relationship in the financial statements. Consequently, the ED proposes that for contracts in the **Scope** of the amendments hedge ineffectiveness caused by volumetric uncertainty should not arise (i.e. hedge ineffectiveness should only arise from other sources, such as pricing differences).

Disclosure requirements in IFRS 7 and IFRS 19

The IASB proposes amendments to IFRS 7 that would require an entity to disclose information that would enable users of financial statements to understand the effects of contracts for renewable electricity that have specified characteristics on the entity's financial performance, and the amount, timing and uncertainty of the entity's future cash flows.

In particular, an entity would be required to disclose:

- the terms and conditions of the contracts
- for contracts for renewable electricity that are not measured at fair value through profit or loss, either
  - the fair value at the reporting date (along with the applicable IFRS 13 disclosures) or
  - the volume of renewable electricity a seller under the contracts expects to sell or a purchaser expects to purchase over the remaining duration of the contracts. This information, which may be disclosed as a range for specified time bands, would need to be accompanied by an explanation of the methods and assumptions used in preparing the information, and the reasons for changes in the methods or assumptions, if applicable.

In addition, entities with contracts for renewable electricity in the **Scope** of the amendments, would be required to disclose the following information:

- sellers: the proportion of renewable electricity covered by the contracts to the total electricity sold for the reporting period
- purchasers: for the reporting period:

a. the proportion of renewable electricity covered by the contracts to total net volume of electricity purchased
b. the total net volume of electricity purchased, irrespective of the source of production
c. the average market price per unit of electricity in the markets in which the entity purchased electricity
d. if (b) multiplied by (c) differs substantially from the total cost incurred to purchase the volume of electricity in (b), a qualitative explanation of the reasons for the difference.

The IASB is also proposing amendments to IFRS 19 that would introduce similar disclosure requirements for a subsidiary without public accountability that applies that standard.

Observation

Two IASB members voted against the publication of the exposure draft. In particular, these IASB members are of the opinion that:

- fair value accounting is appropriate (i.e. no exception should be introduced) if the purchaser of renewable electricity knows with reasonable certainty that for some periods during the contract the electricity delivered under the contract will not be used, but instead will be sold
- the proposed amendments raise questions for the accounting for other electricity contracts and contracts for other non-financial items, and appears more lenient towards contracts for renewable electricity
- if the IASB believes that the recognition of changes in fair value of contracts for renewable electricity with particular characteristics in profit or loss does not provide useful information, this should have been addressed through presentation.

One of these IASB members also disagreed with the scope of the amendments to hedge accounting. In this member's opinion, there is no principle-based reason as to why an entity should be allowed to designate the variable nominal amount of a contract for renewable electricity in a hedging relationship, whilst being prevented to do so for other contracts with similar economics.

Effective date, transition and comment period

The ED does not propose an effective date. The effective date will be decided when the IASB redeliberates the proposals. However, in the invitation to comment, the IASB asks whether an effective date for annual reporting periods beginning on or after 1 January 2025 would be appropriate and would provide enough time to prepare to apply the proposed amendments. Early application of the proposed amendments would be permitted from the date the amendments are issued.

The IASB proposes to require an entity to apply:

- the amendments to the own-use requirements in IFRS 9 using a modified retrospective approach
- the amendments to the hedge accounting requirements prospectively.

The comment period for the ED ends on 7 August 2024.

Further information

If you have any questions about the proposed amendments, please speak to your usual Deloitte contact.

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