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The Leases Project – An update for the energy and resources industry

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In August 2010, the IASB and FASB (the "Boards") took a major step towards overhauling the existing lease accounting rules by issuing a set of proposals in the form of an exposure draft (ED). The proposals would significantly affect the accounting for lease contracts for both lessees and lessors across all industries. Since issuing the ED, the Boards have conducted extensive outreach. The comment period, which ended on 15 December 2010, garnered over 750 responses, and resulted in roundtable sessions that included participants from all constituencies, including preparers, users and auditors from a wide cross section of industries. Respondents from the energy and resources industry expressed concern over a number of proposals in the ED, including the definition of a lease, contracts containing both lease and service components, variable lease payments and lease term. The Boards recently discussed these topics and made some tentative decisions which differ from the proposals in the ED.

Definition of a lease

The ED defines a lease as "a contract in which the right to use a specified asset or assets is conveyed, for a period of time, in exchange for consideration." The ED includes the following two principles, based on the existing guidance in IFRIC 4 *Determining Whether an Arrangement Contains a Lease*, relating to that definition:

- the fulfilment of the contract depends on providing a specified asset or assets; and
- the contract conveys the right to control the use of a specified asset for an agreed period of time.

The right to control the use of a specified asset would be conveyed if any one of the following conditions is met:

a) The entity has the ability or right to operate the asset or direct others to operate the asset in a manner that it determines while obtaining or controlling more than an insignificant amount of the output or other utility of the asset.

b) The entity has the ability or right to control physical access to the underlying asset while obtaining or controlling more than an insignificant amount of the output or other utility of the asset.

c) The entity will obtain all but an insignificant amount of the output or other utility of the asset during the lease term and the price that the entity will pay for the output is neither contractually fixed per unit of output nor equal to the current market price per unit of output as of the time of output delivery.

Several respondents from the energy and resources industry requested that the Boards revise the proposed definition in the ED because of concerns relating to determining whether power purchase arrangements (PPAs) and other types of agreements to purchase power are leases or service arrangements. Some respondents noted that the proposed definition, which is consistent with IFRIC 4, would not eliminate the current diversity in practice resulting from differing interpretations of the terms "output" and "contractually fixed per unit of output". For example, questions currently arise as to whether an "output" should include both physical and intangible outputs (e.g., capacity and renewable energy credit (REC) rights for environmental benefits) and whether "contractually fixed per unit of output" encompasses certain escalator clauses (e.g., specified escalation percentages or escalation based on an inflation index) or separate fixed pricing for different times of the day.

Pricing of the output would not be relevant in determining whether a purchaser has right to control the use of the underlying asset.

Some energy and resources respondents also commented that a PPA should not qualify as a lease when the purchaser does not have decision-making ability over the power plant (e.g., the owner of the plant makes the day-to-day decisions over the plant's operations). Respondents felt that the obligation to purchase power, in and of itself, should not constitute control for purposes of determining whether a PPA is a lease. Rather, the determination of control should be more consistent with other accounting standards such as the forthcoming revenue recognition and consolidation standards.

In April 2011, the Boards tentatively decided that a contract would be considered a lease if fulfilment of the contract depends on the use of a specified asset and the contract conveys the right to control the use of a specified asset. A "specified asset" would be an identifiable asset that is explicitly or implicitly identified in the contract. An asset would be implicitly identified if it would not be practical and economically feasible for the owner to substitute alternative assets in place of the underlying asset during the lease term. Conversely, a contract would not contain a lease if it would be practical and economically feasible for the owner of the asset to substitute the underlying asset and substitution could occur at any time without the customer's consent. In reaching this tentative decision, the Boards rejected the view of defining a specified asset more broadly as an asset of a particular specification rather than as an asset that is uniquely identified.

The Boards also tentatively decided that a contract would convey the right to control the use of the underlying asset if the customer has the ability to direct the use, and receive the benefit from use, of a specified asset throughout the lease term. The ability to direct the use of a specified asset may include having the ability to make decisions about using the specified asset that significantly affect the benefit received by the customer from that use throughout the lease term. Examples of decisions that would significantly affect the benefit received by the customer include determining how, when, and in what manner the specified asset is used or determining how the specified asset is used in conjunction with other assets or resources to deliver the benefit from its use to the customer. If a customer can specify the output or benefit from use of the asset, but is unable to make decisions about the input or process that results in that output, the ability to specify the output would not, in and of itself, be determinative that the customer has the ability to direct the use of the asset.

A customer's ability to receive the benefit from use of a specified asset refers to its present right to obtain substantially all of the potential economic benefits from use of that asset throughout the lease term. Pricing of the output would not be relevant in determining whether a purchaser has the right to control the use of the underlying asset.

In circumstances in which the supplier directs the use of the asset used to perform services requested by the customer, the Boards tentatively decided that customers and suppliers would be required to assess whether the use of the asset is an inseparable part of the services requested by the customer (if inseparable, the entire contract would be accounted for as a service contract because the customer has not obtained the right to control the use of the asset) or a separable part of the services provided. The Boards directed the staffs to clarify the wording and perform outreach activities to understand any potential problems with this tentative decision. It is therefore uncertain at this time how the separable versus inseparable guidance would affect the conclusion as to whether a PPA is a lease or a service.

The Boards' tentative decisions provide some clarity as to whether PPAs would meet the definition of lease in the final standard. Specifically, if the purchaser of power is unable to make decisions about the input or process that results in the output (the power), it appears that the purchaser would lack the ability to direct the use of the asset. That is, purchasing substantially all of the power from a specified power plant would not, in and of itself, result in a PPA meeting the definition of a lease regardless of the arrangement's pricing terms. The purchaser would need to have the ability to make decisions about using the specified asset that significantly affect the benefits received from that use throughout the contract term. For example, the purchaser may need to determine (1) how, when, and in what manner the power plant is used or (2) how the power plant is used in conjunction with other assets or resources to deliver the benefit from its use to the purchaser, in order for the purchaser to conclude that it has the right to control the underlying asset.

The economic benefits arising from the use of a power plant under a PPA would include economic benefits arising from the use of the underlying power plant, whether physical or intangible.

In contrast, under paragraph 9(c) of IFRIC 4, a purchaser considers whether the possibility that one or more parties other than the purchaser will take more than an insignificant amount of the output or other utility that will be produced or generated by the asset during the term of the arrangement is remote, and the price that the purchaser will pay for the output is neither contractually fixed per unit of output nor equal to the current market price per unit of output as of the time of delivery of the output. Both the amount of output purchased and the pricing terms are considered in determining whether a contract would convey the right to control the use of the underlying asset. However, the tentative decisions would require the purchaser to have the ability to make some decisions about using the specified asset and would eliminate the consideration of pricing of the output. Consequently, "take-or-pay" contracts that require a purchaser to make specified minimum payments regardless of whether it receives the contracted power but does not provide the purchaser with any decision making ability relating to the input or process used to make the power may not be considered a lease under the tentative decisions. On the other hand, tolling arrangements where the purchaser provides the input used in production of the power and is also involved to some extent in the operation of the power plant may be considered a lease under the tentative decisions.

Further, the economic benefits arising from the use of a power plant under a PPA would include economic benefits arising from the use of the underlying power plant, whether physical or intangible, except for income tax benefits. For example, RECs or other secondary physical output such as steam would be considered economic benefits. For PPAs in which the customer does not obtain the right to all of the benefits from the power plant, such as where RECs are sold to another party other than the purchaser of the power, the purchaser may conclude that it has not obtained substantially all of the potential economic benefits from use of that asset throughout the term of the contract. This conclusion will depend on the value of the RECs as compared to the total economic benefits of the power plant.

The following examples, adapted from examples in a staff agenda paper prepared for the Boards, illustrate the staffs' views on the application of these tentative decisions:

Example 1: Power purchase agreement – coal generation facility

An electricity provider (Customer) enters into a contract with the owner of a coal generation facility that produces electricity (Supplier) to purchase all of the power produced by two of the five generating units within the facility for five years. The generating units are specified in the agreement and it is not practical and economically feasible for Supplier to use other generating units to fulfil its obligations under the contract. Customer determines when electricity is produced and pays a price that is made up of a fixed capacity charge, an operations and maintenance charge and a pass-through charge for the cost of coal. Supplier makes all decisions about the input and operation of the generating units in producing the output (e.g., its employees operate the generating unit in a manner that Supplier determines, and carries out any repairs and maintenance or other procedures necessary to ensure that the generating units operate properly).

Staffs' tentative conclusion

The fulfilment of the contract would depend on the use of a specified asset because the generating units are explicitly identified in the contract, and it is not practical for Supplier to perform under the contract using other sources of power.

Customer would likely not have the right to control the use of the generating units because it would not have the ability to direct the use of those units. Supplier decides how and in what manner the generating units are used by making decisions about the input and operation of those units. Although Customer specifies the timing and quantity of electricity to be produced (the output from use of the units), it has no ability to direct the process used to make the electricity. Customer is unlikely to be able to use the generating units on their own or together with other resources readily available to Customer. The use of the units is an inseparable part of the contract to purchase electricity. Therefore, Customer has not obtained the right to use the generating units and the contract does not contain a lease. Note that this conclusion applies despite the fact that Customer is taking all the output of the plant pursuant to pricing that is neither fixed nor market per unit of output.

The Boards tentatively decided that lessees would be required to allocate between lease and non-lease components based on their relative standalone purchase prices.

However, if Customer provides the coal used in the generating units and is also involved to some extent in the operation of those units, Customer would likely have the ability to direct the use of the generating units, and therefore, the contract would likely contain a lease. In that case, Customer is not only involved in specifying the output from use of the units but it also has the ability to make decisions about the input and process used to make that output. Therefore, it would likely control the use of the generating units throughout the term of the contract because it also has the right to obtain substantially all of the potential economic benefits from the use of those units.

Example 2: Power purchase agreement – solar plant

An electricity provider (Customer) enters into a contract with the owner of a solar plant that produces electricity (Supplier) to purchase all of the power produced by the solar plant for a period of 10 years. The solar plant is specified in the contract. Supplier carries out any repairs and maintenance or other procedures necessary to ensure that the solar plant operates properly. Incentives for the production of renewable energy (in the form of RECs) are earned by Supplier as the electricity is produced. The RECs have significant value as compared to the total economic benefits of the solar plant and are purchased by a party other than Customer.

Staffs' tentative conclusion

Fulfilment of the contract depends on the use of a specified asset. The solar plant is explicitly identified in the contract and it is not likely to be practical for Supplier to perform under the contract using other assets.

Customer would likely not have the right to control the use of solar plant because it would not have the ability to direct the use of that plant. The solar plant requires relatively little intervention or operation after it is built – the most significant input, the sun, being outside of the control of either Supplier or Customer. Nonetheless, any decisions about the use of the operation of the solar plant are determined by Supplier (e.g., ongoing maintenance). Customer has no ability to influence or be involved in the use of the solar plant and only has the right to any electricity produced by the plant throughout the contract term.

If Customer had the right to make those decisions about the operation of the solar plant, the PPA would likely still not be considered a lease because Customer does not have the right to obtain substantially all of the potential economic benefits from use of the solar plant because the RECs are purchased by another third party and have significant value compared to the total economic benefits of the solar plant.

Contracts that contain both lease and service components

The ED would generally not apply to the "distinct" service components of a contract that also contains a lease. A service component would be considered "distinct" if the entity or another entity either sells an identical or similar service separately or the entity could sell the service separately because the service has a distinct function and a distinct profit margin. Lessees and lessors would allocate the payments required under the contract between the distinct service and lease components in proportion to the standalone selling price of each component. However, if the lessee or lessor is unable to allocate the payments, the entire contract would be accounted for as a lease. If the service component is not distinct from the lease component, the entire contract would be accounted for as a lease.

In March 2011, the Boards tentatively decided that in contracts that include both lease and non-lease components, lessees and lessors would identify and separately account for the non-lease components in the contract. The distinct versus non-distinct guidance included in the ED would not be carried forward to the final standard. Further, the Boards tentatively decided that lessees would be required to allocate between lease and non-lease components based on their relative standalone purchase prices. If the purchase price of one component in a contract that contains a lease is observable, a lessee would apply the residual method to allocate the price to the component for which there are no observable purchase prices. The Boards tentatively decided that lessees would treat the entire contract as a lease when there are no observable prices for any of the components.

The Boards' tentative decision to limit recognition of variable lease payments to disguised minimum lease payments will alleviate many concerns.

The tentative decision to require separation of lease and non-lease components will require lessees to determine the components of an arrangement based on the revised definition of a lease. The tentative decision to allocate based on observable purchase prices will require lessees to obtain the information relating to the pricing of the components from lessors or other third party sources.

Variable lease payments

The ED would require the use of a probability-weighted expected outcome approach to estimate lease payments including contingent rentals, term option penalties and residual value guarantees. Many respondents to the ED objected to this proposal, noting that the approach would be costly to implement and could result in unreliable estimates for long-term leases. Energy and resources industry respondents expressed concerns that the proposal would result in unreliable estimates because of the uncertainties in energy production under PPAs, including the impact of abnormal weather patterns, unplanned outages, maintenance and the seller's operating policies. Respondents also indicated that the requirement to reassess would result in volatility in earnings.

In April 2011, the Boards tentatively decided that variable lease payments should not be included in the measurement of a lessee's liability to make lease payments and a lessor's lease receivable unless the variable lease payments are "disguised minimum lease payments". Disguised minimum lease payments are variable lease payments structured in such a way that they are in-substance fixed lease payments. The final standard is expected to include guidance to assist in identifying disguised minimum lease payments.

The Boards' tentative decision to limit recognition of variable lease payments to disguised minimum lease payments will alleviate many concerns expressed by energy and resources industry respondents regarding unreliable estimates of variable lease payments.

Lease term

The ED defines the lease term as the "longest possible term that is more likely than not to occur." The comment letters overwhelmingly disagreed with this proposal because many entities thought that a renewal option does not represent a liability until the lessee has actually exercised the option and estimating the lease term would be burdensome and costly to implement and could result in unreliable estimates for leases with multiple renewal options.

In February 2011, the Boards tentatively decided that "lease term" should be defined for the lessee and lessor as the non-cancellable period for which the lessee has contracted with the lessor to lease the underlying asset, together with any options to extend or terminate the lease when there is a "significant economic incentive" for an entity to exercise an option to extend the lease, or for an entity not to exercise an option to terminate the lease. Factors such as the existence of a bargain renewal option and a penalty for not renewing the lease would be considered in determining the lease term but past practice and management intent would not. The lease term would be reassessed only when there is a significant change in facts and circumstances.

The tentative decision to include renewal options in the lease term when there is a "significant economic incentive" to exercise the option represents a change from the ED because it raises the threshold for when renewal options would be included in the lease term. Judgement will be required, but the tentative decision is more closely aligned with IAS 17 *Leases* that uses a "reasonably certain" threshold. The Board tentatively decided to require reassessment of the lease term which would represent a change from the current guidance.

Looking ahead

The Boards still have a number of issues to discuss and will need to determine whether re-exposure of the proposals is necessary. The final standard is expected to be issued by the end of 2011. We will provide you periodic updates as significant decisions are reached by the Boards.

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