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Suggested agenda item: identifying a lease - battery offtake arrangements in gross pool electricity markets.

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

We are seeking clarification by the IFRS Interpretations Committee (the Committee) of the issue detailed below.

Background

With the increased investment in the energy industry towards battery storage globally, a question has been raised as to whether the economic benefits of a BOA are fundamentally different to a virtual power purchase agreement (PPA) with a windfarm generator in a gross electricity market and therefore are, or contain, a lease. Many of the factors and analysis for a BOA are consistent with those presented as part of the 2021 IFRIC windfarm decision. As such, the assessment of the accounting treatment of a BOA cannot occur in isolation of the 2021 IFRIC windfarm decision.

In the November 2021 IFRIC update, the Committee concluded that an electricity retailer does not have the right to obtain substantially all the economic benefits from use of a windfarm throughout the term of an agreement with a windfarm generator. The Committee noted that the primary outputs of a windfarm is the electricity produced and the renewable energy credits, however, the economic benefits from the electricity produced from the windfarm could not be obtained by the electricity retailer due to the gross market construct. Emphasis was placed on the delivery of the economic benefits of the windfarm in the assessment of whether the windfarm was as a lease, with the fact pattern conceding control to the retailer via its pre-determined design.

The concept of delivery of economic benefits in the context of the normal purchase and sale scope exclusion (the 'own use' exemption) was also considered in recent Committee meetings and is an ongoing subject of discussion with the International Accounting Standards Board. While this discussion is part of the International Accounting Standard Board's recent project on Nature Dependent Electricity contracts, battery offtake arrangements are not in scope of those amendments. The principles in the June 2023 Staff papers presented to the Committee[1] denote that physical delivery of electricity can only occur in a net pool market. Therefore PPAs entered in gross pool markets are considered 'virtual PPAs' as the economic benefits can never be received by the electricity retailer, and as such, are considered derivatives.

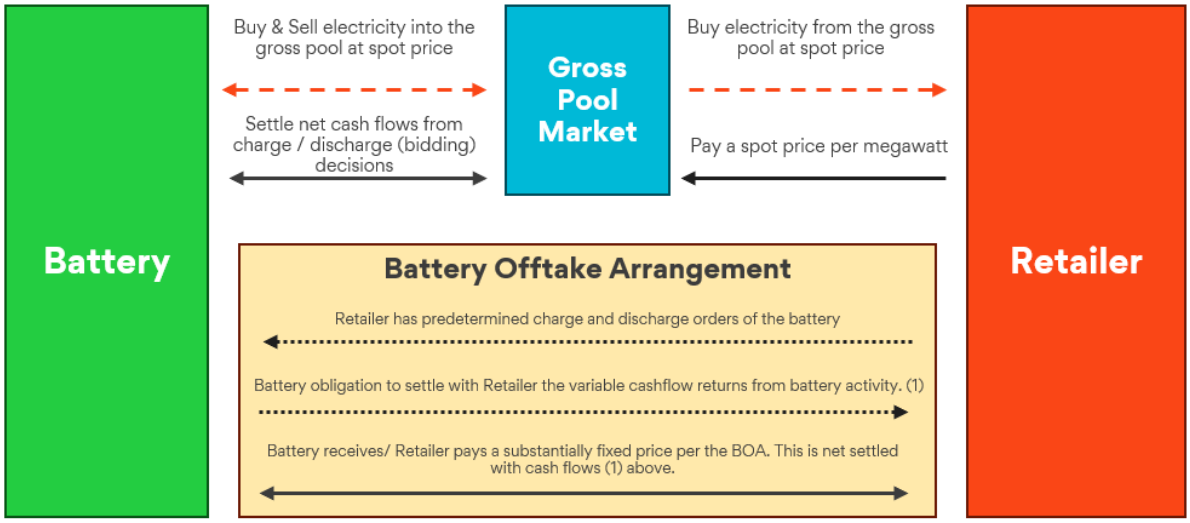
This submission leverages the 2021 IFRIC windfarm decision and identifies key differences and similarities that arise due to the difference in the nature of the asset being analysed.

Battery offtake arrangement in a gross pool market

[1] IFRS Staff Paper, Application of the 'own use' exception in the light of current market and geopolitical questions (IFRS 9), https://www.ifrs.org/content/dam/ifrs/meetings/2023/june/ifric/ap02-application-of-the-own-use-exception.pdf

The mechanics of a gross pool market have been documented in recent IFRIC agenda decisions[2]. Therefore, only pertinent, incremental operational aspects of a BOA are considered below.

Similar to virtual PPAs in a gross pool market, BOAs in a gross pool market are entered into between battery owners and retailers that elect to manage their exposure to spot price risk by entering into arrangements which are settled outside the spot market. The battery owner is a registered participant in the gross pool electricity market, entering into a BOA with an electricity retailer that is also a registered participant in the gross pool electricity market.



BOAs typically have the following features:

- The arrangement explicitly refers to a large-scale commercial battery owned by the battery owner that will be used to sell electricity in the gross market (physical delivery).
- The battery cannot be substituted.
- The battery owner is the registered participant for the battery operations and is financially responsible for the battery activity to the electricity market operator. Battery activity includes revenue earned from the battery discharged into the grid and the expense for the electricity required to charge the battery from the grid, both at the relevant spot price.
- The electricity market operator will cash settle the variable battery activity with the battery owner weekly, in line with contractual obligation as financially responsible market participant with the gross market.
- Per the terms of the offtake arrangement, the variable cash flow from battery operations and the substantially fixed charge are net settled monthly with the electricity retailer outside of the electricity market operation mechanics.
- The battery owner as the registered participant for the battery, receipts physical benefit of the electrons as they pass to and from the grid.

[2] IFRS Staff Paper, Application of the 'own use' exception in the light of current market and geopolitical questions (IFRS 9), https://www.ifrs.org/content/dam/ifrs/meetings/2023/june/ifric/ap02-application-of-the-own-use-exception.pdf
IFRS Tentative Agenda Decision and comment letters: Economic Benefits from Use of a Windfarm (IFRS 16), https://www.ifrs.org/projects/completed-projects/2021/economic-benefits-from-use-of-a-windfarm-ifrs-16/tentative-agenda-decision-and-comment-letters/

- The electricity retailer pays to the battery owner a fixed charge per annum over a 10-year period. The economic useful life of the battery is approximately 20 years.
- In exchange for the substantially fixed charge, the electricity retailer receives or pays the variable cash flows to the battery owner.
- The battery operation activity is predetermined by the retailer in the offtake agreement and is required to charge daily in the middle of the day and discharge daily at the beginning of the evening peak.
- All activities required to physically enable the battery to charge/ discharge the battery in accordance with the offtake remains the responsibility of the battery owner.

In summary, the electricity retailer swaps a fixed amount in exchange for the variable cash flows associated with battery operations, which is used to hedge their retail pool market purchases. The difference between variable cashflow returns through operations and the fixed amount due from the electricity retailer are net settled between the two counterparties.

Identifying a lease under IFRS 16

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

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

We are seeking the views of the IFRS Interpretations Committee solely on the application of the criterion in IFRS 16:B9(a) (i.e. whether the retailer has obtained substantially all economic benefits from the use of an identified asset) to the transaction described above. The assessment of the criterion in IFRS 16:B9(b) has been met as the electricity retailer is deemed to have control as they have set the predetermined operations of the battery per the scenario outlined above and is not subject to this submission.

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

View 1 – Yes. The primary benefits of a battery are that of storage, not generation. Despite not receiving the battery's physical output of electricity, the electricity retailer retains the economic benefits associated with the battery's operation.

Proponents of this view believe that the primary benefit of a battery is storage rather than electricity generation. Inherent in the nature of a storage product, it does not have a product of itself to produce or generate, rather it 'houses' assets (in this case electricity as predetermined by the nature of the asset) for future consumption. Similarities can be drawn to gas pipelines or warehouses, where the economic benefit is the ability to transport or store assets. The entity that owns the pipeline or warehouse does not have rights to the items stored in these assets, nor can it control when or how the battery owners gain access.

In comparison to the 2021 IFRIC windfarm decision, the nature of the battery is fundamentally different to a windfarm. A windfarm is designed to passively generate electricity and therefore the economic benefits are the green certificates and electricity created in that generation. For

batteries, the benefit is their ability to store and discharge that electricity as required. A commercial battery cannot generate electricity in its own right. As such the operating decision is the primary economic benefit associated with a battery. IFRS 16:B21 describes the economic benefits from the use of an asset as including its primary output and by-products including potential cash flows derived from these items, and as this decision is predetermined and entitlement to net proceeds remains with the electricity retailer, so too do the economic benefits.

Proponents of this view also believe that the battery owner is in substance, a settlement agent of the electricity retailer. This aligns with principal versus agent considerations of IFRS 15:B35. In this fact pattern, the battery owner does have legal title to the electricity, however, does not have bidding control to realise the economic benefits through sale to the gross pool market. The battery owner only takes physical delivery of the electricity momentarily before it is sold into the gross electricity market, with the entitlement to economic benefits being passed through to the retailer.

View 2 – No. The economic benefits of the battery is the *storage of electrons*. As such, the BOA does not provide the retailer with substantially all the economic benefits due to the structure of the gross pool electricity market.

Similar to the principles of the 2021 IFRIC windfarm decision, two series of transactions are taking place:

- Spot transactions in the gross pool electricity market (the retailer and the battery owner cannot contract with each other directly)
- The separate BOA agreement between the battery owner and the retailer

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

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

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

As a result, the BOA cannot be combined with the spot transactions for the purposes of applying IFRS 16.

IFRS 16:B21 describes the economic benefits from the use of an asset as including its primary output and by-products (including potential cash flows derived from these items). While a battery does allow for storage, this has no value without the physical output into the gross pool

market and as such, the economic benefits are tied to the electrons flowing from the battery. As the registered participant for the battery, the battery owner has the ultimate responsibility to the market operator and legal title to the electricity stored and discharged from the battery. As the contracts cannot be combined as noted above, the entitlement to the economic benefits ultimately resides with the battery owner.

Further, important economic parallels of the BOA transaction can be drawn to the 2021 IFRIC windfarm decision. In both instances, the electricity retailer will pay a fixed amount, which will be netted against proceeds from sales and purchases to and from the grid and is settled as one net payment between the electricity retailer and battery owner. Therefore when considering economic benefits, the electricity retailer will be exposed to the financial return from bidding in the market, however it will be the battery owner who as the registered participant for the battery, will be the party that receives and sells the *benefit of electron storage* to the market.

Proponents of view 2 do not believe it is appropriate to draw a conclusion based on an 'in substance' analysis which ignores the market structure and consequential contractual rights and obligations which was reinforced by the 2021 IFRIC windfarm decision. The market structure gives rise to an important commercial difference. If linked, the contracts can be viewed as representing a normal executory transaction. There is no requirement of the retailer to execute purchases from the gross pool electricity market at spot that matches the profile of the battery operations. The financial exposure (contract for cash settlements) of the battery is independent of the spot purchases of the electricity retailer. It is through matching volumes that a synthetically similar result can be achieved. However, in the present case, the criteria for combining contracts into a "synthetic" transaction, which are consistent in IFRS 15, IFRS 16 and IFRS 9, are not met. In this case, as explained earlier, there are different counterparties which cannot be ignored for the purposes of the accounting.

Proponents of view 2 also argue that accepting view 1 overlooks the economic benefits analysis outlined in the 2021 IFRIC windfarm decision. Like the 2021 windfarm decision, the BOA concedes control to the retailer and focuses on the primary economic output of the windfarm, being the generation of electrons. Similarly, view 2 considers the economic output of a battery to be the storage of electrons. The determining factor of whether a BOA is a lease is therefore the ability to gain access to those electrons, which cannot be achieved as a retailer in a gross pool market. To support view 1 and thereby determine that a BOA in a gross pool market is a lease because the economic benefit is primarily storage would be akin to determining that the economic benefit of a windfarm is primarily generation. Proponents of view 2 believe this would mean the beneficiary of the electron is ultimately ignored and thus would contradict the outcome of the 2021 IFRIC windfarm decision.

Reasons for the Committee to address the issue

BOAs are common in the utility industry and are expected to increase significantly in the near future. We have also noticed an increase in the use of BOAs outside of the utility industry as batteries form a critical part for climate conscious consumers wanting to transition to renewable generation and reduce greenhouse gas emissions. Given the tenure of BOA contracts and the volumes of electricity produced, these contracts are often highly material. Gross pool electricity markets are also commonly seen throughout the globe.

We are concerned that the different views observed in practice produce considerably different accounting results. For example, if it is concluded that the retailer obtains substantially all the

economic benefits from an identified battery and that it has the ability to direct the use of that battery, the BOA is be accounted for as a lease. The fixed payments made by the retailer would result in a lease liability being recognised, however, as the battery owner would effectively be seen as an agent of the retailer, the variable proceeds would likely be considered an executory contract and remain off balance sheet until realised.

On the other hand, if it is concluded that the retailer does not obtain substantially all the economic benefits from an identified battery, the BOA is not in the scope of IFRS 16. It is instead accounted for as a derivative applying IFRS 9 consistent with the 2021 IFRIC windfarm decision. These derivatives are typically large and highly material balances.

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

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