# Staff paper

Agenda reference: 2

**IFRS® Interpretations Committee meeting**

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| Date | **June 2023** |
| Project | **Application of the 'own use' exception in the light of current market and geopolitical questions (IFRS 9)** |
| Topic | **Initial consideration** |
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## Introduction

1. The IFRS Interpretations Committee (Committee) received a submission about the application of paragraph 2.4 of IFRS 9 to contracts for the procurement of renewable energy (referred to as power purchase agreements or PPAs) as part of an entity's commitment to reduce the effects of climate change and to decarbonise their production and products. According to the submission, although the 'own use' requirements in IFRS 9 work well in markets with stable supply conditions, the changing electricity market conditions give rise to application challenges and could result in accounting outcomes that do not faithfully represent the economic substance of such contracts.

2. The submission, which we have summarised in paragraphs 6–15, described three fact patterns. We have attached the submission in Appendix A, which provides further information about the questions and the alternative views the submitter has identified.

3. The objective of this paper is:

   (a) to provide the Committee with a summary of the matter;

   (b) to present our analysis; and

(c) to ask the Committee whether it agrees with our recommendation to refer the matter to the IASB to develop a narrow-scope amendment that addresses the application of paragraph 2.4 of IFRS 9 particularly to contracts for the purchase of a non-financial item that cannot be stored and has to be consumed within in a short time interval in accordance with the market structure in which the item is traded.

## Structure of the paper

4. This paper includes a:

   (a) summary of the submission;

   (b) summary of findings from the information request;

   (c) staff analysis;

   (d) staff conclusion and questions for the Committee; and

   (e) staff recommendation.

5. There are two appendices to the paper:

   (a) Appendix A—Submission

   (b) Appendix B—Relevant extracts from the Due Process Handbook

## Summary of the submission

6. The submission notes that in light of many jurisdictions taking action to reduce the effects of climate change, entities are increasingly entering into long-term renewable energy contracts. This has led to entities experiencing application challenges and questions when applying the requirements in IFRS 9 regarding contracts to buy non-financial items in accordance with the entity's expected purchase, sale or usage requirements (expected usage requirements).

7. The submission describes three common fact patterns related to the application of the requirements of paragraphs 2.4 and 2.6 of IFRS 9. The submitter offers a number of views and discusses the possibility of applying the own use exception for each of the fact patterns. Please refer to the extracts in Appendix A for the detailed fact patterns and alternative views.

### *Fact pattern one: Purchased-as-produced contracts*

8. 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.[1] 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.

9. 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).

10. 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

[1] In a physical PPA both the producer and the entity are connected to the same power grid.

purpose of this is to enable the entity's operations. There is no explicit net settlement option within the contract.

11. 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*

12. 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.

13. 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.

14. 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.

15. 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*

16. 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).

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

- 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.
- 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.
- 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.

18. 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.

19. 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.

## Findings from the information request

20. We sent an information request to members of the International Forum of Accounting Standard-Setters, securities regulators and large accounting firms. We also made the submission available on our website.

21. The information request asked:

    (a) Are fact patterns such as the ones described the submission common and/or widespread? If fact patterns are common and/or widespread:

        (i) are they common or widespread across all jurisdictions and industries, or are they common only in particular jurisdictions or industries (please identify and describe those jurisdictions or industries)?

        (ii) if they are common does the accounting for those fact patterns have a material effect on entities' financial statements?

    (b) Are there any other facts patterns which are in substance similar to the ones described in the submission?

    (c) If the fact patterns described in the submission are common and/or widespread, have you observed material diversity in how entities are applying the relevant IFRS Accounting Standards? If so, please describe the accounting observed with reference to the IFRS requirements applied (if known)?

    (d) If you have observed material diversity, is the diversity present and similar across all jurisdictions and industries, or is the diversity only in evidence in particular jurisdictions or industries (please identify and describe those jurisdictions or industries)?

22. We received 19 responses—nine from national standard setters, six from large accounting firms, two from groups representing a group of securities regulators and two from other respondents. The views received represent informal opinions and do not reflect the official views of those respondents or their organisations.

### *Are fact patterns common and widespread?*

23. With specific reference to the energy market, the majority of large accounting firms said that fact pattern one is common in many jurisdictions (particularly in Europe) while fact pattern two is common in some jurisdictions and is becoming increasingly common in a few other jurisdictions.

24. In response to fact pattern three, the large accounting firms said that it is common in some jurisdictions while less common in other jurisdictions. Two large accounting firms said that although this fact pattern is currently not yet common, it may become more common in the future.

25. With regards to the impacted jurisdictions, the large accounting firms said that these fact patterns are common across all or many industries, but they are particularly prevalent in fuel and power consuming industries.

26. The feedback from standard setters was mixed. Standard setters from Europe observed all three fact patterns to be common in their jurisdictions. On the other hand, standard setters from Hong Kong and Japan said these fact patterns are not common in their jurisdictions while some other standard setters from the Asia Pacific region said that these fact patters are commonly found in certain industries such as energy, gas and oil consuming industries.

27. The two organisations representing securities regulators also reported that some of their members commonly observe these fact pattern in practice. One organisation representing a securities regulator stated that from the nine national enforcers responding to the information request, four considered these fact patterns common and widespread in their jurisdictions. Similarly, the second organisation representing a

securities regulator observed these fact patterns especially in energy intensive industries based on examples provided from Belgium, Canada and Israel.

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

28. All respondents 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 energy and fuel 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. In addition, some respondents commented on the reliability of the fair values obtained as the valuation methodology would typically need to be based on unobservable (ie level 3) inputs. These respondents questioned the usefulness of the information such fair value measurements would provide to users of financial statements.

29. One standard setter consulted with a user advisory group in their jurisdiction and said that that most of the participants 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. Some of these users 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. 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.

***Has material diversity been observed in practice?***

30. 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, including different interpretations of:

(a) the meaning of 'practice of settling similar contracts' net as described in paragraph 2.6(b) of IFRS 9;

(b) the meaning of 'selling it within a short period after delivery' as described in paragraph 2.6(c) of IFRS 9, with current interpretations ranging from a matter of hours or days to 12 months after delivery;

(c) the term 'expected purchase, sale or usage requirements' as required in paragraph 2.4 of IFRS 9. Current practice ranges from some applying thresholds based on significance or reasonableness to assess the frequency and materiality of any mismatches in deliveries and consumption while others interpret the requirements to mean any sales of delivered energy to fail the requirements for the own use exception; and

(d) whether the requirements are applied to a contract in its entirety or to a proportion of a contract, for example 80 per cent of the contract is accounted for as an executory contract and 20 per cent as a derivative.

### *Are there any other similar fact patterns?*

31. 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 which are widespread across jurisdictions.

32. A number of respondents provided details of other PPA contracts or features they have observed in practice with regards to fact patterns one and three, for example:

(a) agreements on the time intervals at which the entity has an option to sell the energy to the grid or balancing agent;

(b) PPAs where the balancing agent is trading electricity at the direction of the entity or its own account;

(c) PPAs where the contractual output is specified for the whole production capacity of the energy provider; and

(d) PPAs where the contractual output is agreed as base load:

(i) with some flexibility for maintenance; or

(ii) up front agreed significant sell back amounts.

33. In relation to fact pattern two while some respondents considered this to be a one-off situation one respondent commented that there could be many situations why an entity might be forced to net settle a contract early. Not all of the respondents considered early net settlement in specified situations to fail the own use exception.

34. Respondents also noted that similar questions arise regarding the accounting for virtual PPAs (VPPAs). VPPAs often consist of both delivery of energy and Renewable Energy Certificates (RECs) (or similar attributes). Often the buyer takes delivery of the RECs, but not the electricity, which cause further accounting complexity in light of the embedded derivatives, which exist in such arrangements.

35. One respondent also said that the Committee's analysis should not only consider the accounting from the purchaser's perspective, but also from the perspective of the seller.

36. Overall, respondents were concerned that if the guidance of the Committee were only to cover the fact patterns described in the submission, such an approach would leave many unanswered questions regarding the application of the own use exception to other fact patterns.

## Staff analysis

37. Although the submission only asks about the application of the own use requirements in IFRS 9, the staff note that there are other relevant accounting requirements to consider. An entity first needs to consider whether a 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.*

38. However, for the purpose of the analysis in this paper, we only consider the requirements in IFRS 9 on the assumption that no other Accounting Standards apply. In addition, the analysis does not consider the accounting for any potential embedded derivatives which could arise if renewable energy certificates (REC) or similar items are sold together with energy as part of the same PPA.

### *Relevant requirements of IFRS 9*

39. 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.

40. 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.

41. In addition, we note that over the years 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.

42. When analysing the submission that led to the Agenda Decision referred to in paragraph 41(b) of this paper, a key element of the Committee's analysis was understanding the way in which the electricity market on which that submission was based, is structured.

43. We think a similar understanding is needed for this submission (as summarised in paragraphs 6–19 of this paper). Paragraphs 44–55 below provides background information on the ways in which electricity markets are structured.

### *Background on structure of electricity markets*

44. All electricity markets must continuously be balanced between supply and demand to ensure system security and stability. The system moves out of balance when demand or production levels change unexpectedly. The independent system operator (ISO) in each system is responsible for ensuring that the system balances and remains within its operational parameters. However, any imbalances represent real power flows which are converted into financial payments.

45. Given that there will always be a compulsory financial settlement system for imbalances in the power grid, the wholesale electricity market design can be broadly put into two major categories– ‘gross pool’ and ‘net pool’ electricity markets.

*Gross pool electricity markets*

46. In a gross pool electricity market, all purchases and sales of electricity are cleared through a market operator on a gross basis, without the market operator taking delivery or on-selling electricity. There is no bilateral contract fulfilment between an actual seller (generator) and an actual buyer (customer). Instead, all transactions are settled at spot prices via the market operator that acts as a clearing house for energy transactions. Gross pool electricity markets are prevalent in for example the USA, Australia, Korea, Singapore and Canada.

47. Therefore, a gross pool market ignores bilateral agreements between electricity generators and customers. All electricity production and consumption are transacted as if it were an imbalance, to be settled at market spot prices. Any bilateral fixed price contracts between energy generators and electricity customers are settling the difference between spot price and contract price separately. Such settlement takes the form of financial contracts for examples swaps, caps, contracts for differences or virtual PPAs (VPPAs).

48. The Agenda Decision *Benefits from Use of a Windfarm* (IFRS 16 Leases) was based on a gross pool electricity market.

*Net pool electricity markets*

49. In a net pool electricity market, the energy sellers (generators) contract directly with electricity buyers (customers) for the volume of electricity to be delivered and the contracts are physically deliverable. When electricity is produced, the electricity generator transfers the electricity via the grid and credits the customer’s account with the volume delivered. When notified of the delivery, the customer has a specified time interval to clear the account by consuming the electricity (typically 15–30

minutes) to avoid an imbalance in the grid. A net pool market measures imbalances, on which penalties are charged, as the difference between the electricity customer's contract position with a generator and its physical consumption.

50. If the customer is not able to clear its account by consuming the electricity within that time interval, the surplus is transacted through a voluntary pool mechanism at the spot prices. Typically, the electricity customers engage third parties to sell surplus energy delivered to them to avoid any penalty charges. They may also use the same third party to procure additional power in times where no electricity is delivered by a contracted generator for example a windfarm.

51. India, the UK and most of Europe has adopted this design and all these entities operating the pool are known as Power Exchanges (PX).

*Accounting implications of gross pool and net pool electricity markets*

52. In a net pool market, the customer has contracted with a supplier to purchase a specified volume of electricity for a period of time. In that case, the customer has both a contractual right to that volume of electricity and a contractual obligation to purchase it.

53. In contrast, in a gross pool electricity market, a PPA provides the customer with neither the right to obtain electricity nor the obligation to purchase or consume any particular amount of electricity either from the PPA contract partner or the grid. The customer in a gross pool electricity market is contractually in a very different position from a customer in a net pool electricity market and has no contractual right or obligation to purchase an agreed quantity of energy. If the customer in a gross pool electricity market unexpectedly requires a lower volume of electricity in any period than expected, it would purchase only the volume of electricity needed.[2]

[2] Refer to paragraph 25 of agenda paper 5 of the June 2021 IFRIC meeting.

54. Therefore, the key difference between a gross pool and a net pool electricity market is that in a gross pool electricity market the electricity contracted under a PPA is never (even in solely contractual terms) considered to be *physically* delivered to the electricity customer. This is because the difference between the fixed price and the spot price determined in a gross pool is always settled net between the electricity generator and the customer, whereas in a net pool electricity market the settlement mechanism allows for what is contractually considered *physical* delivery of electricity to the electricity customer.

55. As a result, physical PPAs, as described in the submission, can only be contracted where market operators run a net pool electricity regime. For that reason, the remainder of our analysis only focuses on such a market.

### *Applying the own use exception in IFRS 9*

56. 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, the IASB concluded that 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).

57. Applying the requirements in paragraph 2.4 of IFRS 9 to the fact patterns described in the submission requires, in the staff's view, an assessment of:

    (a) the meaning of delivery of electricity;

(b) the meaning of net settlement, including the meaning of 'past practice' and 'similar contracts' in paragraph 2.6 (b) of IFRS 9; and

(c) an entity's expected electricity usage.

*Meaning of delivery of electricity*

58. In 2005, the Committee considered a submission about the meaning of delivery (see paragraph 41(a)) for the purposes of what is now paragraph 2.4 of IFRS 9. That submission described situations in which the market design or process imposes a structure or intermediary (eg a gold refiner or an electricity market operator) that prevents the producer from physically delivering its production to the counterparty.

59. The staff analysis at the time considered that in such circumstances, a market mechanism or an intermediary in the sales and delivery process may physically receive the product from the producer and verify the quantity and quality of the product. At this time, the producer would cease to control the physical product and instead may control a right or claim to sell or apply a specified quantity (and quality) of that product through the market mechanism.

60. The Committee 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.

61. Consistent with the 2005 Agenda Decision, the staff believe that delivery of electricity into the grid by the generator in a net pool electricity market (as explained in paragraphs to 49–51 of this paper) constitutes 'delivery' for the purpose of paragraph 2.4 and 2.6 (c) of IFRS 9 because:

(a) at the time the electricity is delivered into the grid, the electricity customer is able to instantaneously access that electricity; and

(b) the delivery of electricity by the generator to the user satisfies both the customer's contractual right to that volume of electricity and its contractual

obligation to purchase electricity at the fixed price. This constitutes the fulfilment of the power purchase arranged in that contract.

*Meaning of net settlement*

62. Paragraph 2.6 of IFRS 9 states that 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 and describes four ways in which this would be the case.

63. That same paragraph states that contracts to which paragraph 2.6(b) or (c) of IFRS 9 applies are not 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 usage requirements and are accounted for as derivatives. However, other contracts to which paragraph 2.4 of IFRS 9 applies are assessed to determine whether they were entered into and continue to be held for the purpose of the entity's expected usage requirements.

64. The staff consider that the circumstances described in paragraph 2.6(b) of IFRS 9 might be relevant to fact pattern two described in the submission. IFRS 9 does not include requirements for how to assess whether an entity has a practice of settling similar contracts net in cash or another financial instrument or by exchanging financial instruments' (neither do the requirements in paragraphs 8–10 of IAS 32). However, we considered that the phrases 'similar contracts' and 'past practice' are not unique to IFRS 9 and are used in other IFRS Accounting Standards. For example, IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and IFRS 15 *Revenue from Contracts with Customers* both include requirements based on the entity's accounting for similar contracts. Similarly, IAS 37 and IFRS 2 *Share-based Payment* are among the Accounting Standards that requires an assessment of an entity's past practice when applying particular requirements.

65. We acknowledge the information provided by respondents to the information request that said there is diversity in practice with regards to the frequency of net settling that

would establish a past practice or what constitute similar contracts. However, we are of the view that an entity needs to apply judgement depending on facts and circumstances to determine whether it has established a past practice of net settlement and whether contracts in a group of contracts are similar for the purpose of applying paragraph 2.6(b).

66. On the other hand, the circumstances described in paragraph 2.6(c) of IFRS 9 might be relevant to fact patterns one and three described in the submission. 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.

67. In our view, for paragraph 2.6(c) to apply, 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. For most contracts to buy or sell a non-financial item that can be settled net in cash, this assessment is quite straightforward and does not require extensive analysis as the entity's purpose for selling the underlying is a matter of fact—the entity has either entered into the contract to buy the non-financial items for its expected usage requirements (in which case paragraph 2.6(c) does not apply) or it has entered into the contract to use the non-financial items in short-term profit-generating activities.

68. However, we acknowledge that in the context of electricity markets, where an entity is required to sell any unused electricity within a short period after taking delivery at the current spot price, determining whether an entity sells an item for the purpose to profit from short-term price fluctuations might require more extensive consideration. This is because the entity might have to sell electricity more often (ie over most weekends) and at times the current spot price could be higher than the fixed price the entity paid, resulting in a profit.

69. In such circumstances, we are of the opinion that the primary consideration is whether the selling activities are profit-orientated or whether it is a result of the electricity market structure and therefore do not preclude the own use exception from being

applied. We therefore think the evaluation of whether a contract is entered into and continues to be held in accordance with an entity's expected electricity usage requirements is the key consideration in these circumstances.

*Evaluation of an entity's expected electricity usage requirements*

70. Paragraph BCZ2.18 of the Basis for Conclusions on IFRS 9 explains that the objective of the own use exception in paragraph 2.4 of IFRS 9 is to determine the circumstances in which a commodity-based contract meets the definition of a financial instruments and is therefore accounted for as a derivative. In other words, the own use exception result in a contract that would otherwise have been accounted for as a derivative to be scoped out of IFRS 9 if the contract was entered into, and continue to be held, for the entity's expected usage requirements. The requirement for a contract to be for the purpose of the entity's expected usage requirements applies not only at inception, but also over the life of the contract.

71. IFRS 9 does not provide any requirements or application guidance on determining whether a contract is for an entity's expected usage requirements. However, for most commodity contracts, this assessment is relatively straight-forward, if they are easily storable. 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. This seems to be supported by the fact that neither the IASB not the Committee has been made aware that the lack of requirements in this regard has given rise to application questions or diversity in practice.

72. However, this does not necessarily apply when determining whether PPA contracts are entered into and held in accordance with an entity's expected usage requirements. 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 until needed and mostly have to be consumed shortly after delivery.

(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.

73. Responses provided in response to the information request indicated that in evaluating fact patterns similar to those described in the submission, some stakeholders are of the view that the selling of excess electricity at spot prices within one or more delivery intervals means that some electricity is not consumed for own use at that particular delivery time and therefore the own use exception cannot be applied.

74. Some other stakeholders argue that if an entity cannot consume the electricity when delivered but repurchases at least same amount of electricity at times when consumption is ensured the own use criterion can be met. These stakeholders are of the opinion that the entity uses the spot market as a storage mechanism and does not intend to generate profits from those transactions although it cannot rule out that some transactions will lead to profit or losses.

75. Finally, some other stakeholders are of the opinion that as long as the entity takes delivery of the contracted amount of electricity, the entity's expected usage must be assessed over a longer time interval or the term of the contract. These respondents say that the own use exception applies to the contract as a whole and not individual delivery times, therefore expected usage cannot be determined at every time interval the electricity is delivered. Such an approach would also involve selling and buying from the spot market to match short term usage requirements.

76. The staff believe that the reference to an entity's *expected* purchase, sale or usage requirements in paragraph 2.4 of IFRS 9 implies the use of an estimate of the entity's electricity needs (for example an expected value approach) and that the actual usage might be different. Therefore, we think that IFRS 9 already allows some deviation from the expectation to still be consistent with the principles of the own use exception.

77. However, we are of the view that there is not adequate application guidance in IFRS 9 to determine whether a PPA 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 we think it is not clear:

(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.

(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 is 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?

## Staff conclusion and questions for the Committee

78. Our findings from our information request suggest that the fact patterns and questions described in the submission are common in many jurisdictions, especially those that

operate net pool electricity markets, there is observed diversity in practice and the resulting effects on entities' financial statements are expected to be material. Our outreach also indicates that the fact patterns described in the submission are a subset of a range of broader, but similar, questions which are widespread across jurisdictions.

79. As noted in paragraph 77, we are of the view that the principles and requirements in IFRS 9 do not provide an adequate basis for an entity to determine the appropriate accounting for PPAs in the circumstances described in the submission. We therefore believe that it would be necessary to add or change the requirements for the own use exception in IFRS 9 to improve financial reporting.

| Questions for the Committee |
| --- |
| 1. Does the Committee agree with our analysis in paragraphs 37–79 of this paper regarding the application of paragraphs 2.4 and 2.6 of IFRS 9 to the fact patterns described in the submission? |

### *Should the Committee add a standard-setting project to the work plan?*

80. To assess whether narrow-scope standard setting is required in light of our conclusion that it would be necessary to add or change the requirements for the own use exception in IFRS 9 to provide an adequate basis for an entity to apply the own use exception to PPAs, we have carried out an assessment of the fact patterns in the submission and the additional questions raised during outreach against the criteria in paragraph 5.16 of the *Due Process Handbook*.

81. Our findings from information request (see paragraphs 20–36) confirm that the submitted fact patterns are prevalent and are expected to have a material effect on those affected (paragraph 5.16(a) of the Due Process Handbook). Additionally, the diversity in practice reduces the ability of users of financial statements to compare reporting entities from period to period. As the preliminary views from users of financial statements indicate, there also seems to be mixed views about whether accounting for PPAs as derivatives provide useful information.

82. As explained in paragraph 77, we think it would be necessary to add or amend the requirements in IFRS 9 (paragraph 5.16(b) of the Due Process Handbook) to clarify:

    (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;

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

83. The staff believes that these questions could be resolved efficiently within the confines of existing IFRS Accounting Standards (paragraph 5.16(c) of the *Due Process Handbook*). Considering the findings from the information request, we think the scope of a potential standard setting project could be limited to contracts for the purchase of a non-financial item where the market structure has the characteristics described in paragraph 72 of this paper.

84. Paragraph 5.16(d) of the Due Process Handbook requires that the matter in a standard-setting project is not so narrow that it is not cost-effective for the IASB and stakeholders to undertake the due process required to change an IFRS Accounting Standard. We are of the view that a narrow-scope standard-setting project to address only the scope of transactions and the questions described in paragraph 82 and 83 of this paper would be sufficiently narrow in scope for the IASB to complete the project efficiently, but also not too narrow to not be cost-effective.

## Staff recommendation

85. Based on our assessment of the Committee's agenda criteria in paragraph 5.16 of the *Due Process Handbook* (paragraphs 80–84 of this paper), we recommend that the Committee refers the matter to the IASB by recommending that the IASB develop a narrow-scope amendment that addresses the application of paragraph 2.4 of IFRS 9 particularly to contracts for the purchase of a non-financial item that cannot be stored

and has to be consumed within in a short time interval in accordance with the market structure in which the item is traded.

| Questions for the Committee |
| --- |
| 2. Does the Committee agree with our recommendation as set out in paragraph 85? |

## Appendix A—Submission

A1. We have reproduced the submission below and doing so deleted details that would identify the submitted of this request.

**Issue 1: Purchase-as-Produced Contracts**

The Matter

The company is an industrial entity that is transitioning its business in line with the Paris Climate Agreement. In addition, the market and the company's customers demand products that are produced with green energy. To secure the company's own demand of energy from renewable sources, the company enters into a (physical[3]) power purchase agreement with an operator of wind energy facilities. The contract obliges the company to acquire a fixed share (e.g. 50%) of the wind energy produced by a wind park of the operator. The price per unit for the energy is fixed in advance and remains stable throughout the contract duration of 25 years. The operator does not guarantee a specific amount of output (energy) but estimates with certain probabilities (e.g. 50%, 75%) an expected amount. The energy provider feeds in the energy produced to the grid and transfers the "energy credits" to the account of the company in exchange for the fixed consideration per unit.

The total energy demand of the company 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 company does not operate its production facilities 24/7 but pauses production during the night times, on weekends and holiday season. There is thus a mismatch between the demand profile of the company and the supply profile of the wind park.

Since the company is obliged to acquire the energy of the wind park in the amount (e.g. 50% of the current production volume) and at the time it is produced and the company has no feasible option to store the energy, the company sells energy that cannot be consumed immediately (e.g. on weekends or overnight) to the spot market and repurchases (at least) the same amount from that market at times when the production facilities are operated. In other words, the energy provider continues to transfer the amounts of energy fed into the grid to the account of the company and the

[3] Meaning that both, the producer and the entity are connected to the same power grid.

company has to sell unused amounts from its account to third parties. The process of selling and repurchasing is designed to be an autopilot that acts without the intention of trading to realize profits and has the sole (and documented) intention to enable the entity's operations. The process of selling and repurchasing is usually delegated to a service provider for a fixed or formula based fee. Transportation fees for the use of the grid is not considered for purposes of this example.

The company views the difference in prices (lower prices during night times, on weekends and during holiday season when production is paused vs. higher prices when repurchased on spot markets during peak times) as costs of storage, i.e. it uses the energy spot market as a storage facility. The company does not operate as a trading party in the market, the production schedule and the consumption profile dictate spot price transactions.

Accounting for the contract

On the date of inception of the contract, the company regards the sole purpose of this power purchase agreement as a contract 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. The company does not designate the contract as measured at fair value through profit or loss in accordance with IFRS 9.2.5.

The company further analyses whether the contract can be settled net in cash in accordance with IFRS 9.2.6.

Note: for the purpose of this discussion, it is assumed that the conditions do not change throughout subsequent periods and that some market transactions become necessary for unused amounts of energy. The company is always in a net purchaser position, i.e. it buys more energy from the spot market than it has sold to it based on a monthly view (meaning that for every calendar month, the company has purchased more energy on spot markets than it has sold). The average purchase price exceeds the average sale's price, so that the company incurs expenses for "storing" the energy on sport markets which is part of the fee paid to a service provider involved to sell unused amounts of energy to and repurchase additional demands from the grid/spot markets.

*View A*

The company assess at inception of the contract that

(a) the terms of the contract do not provide for an option to settle net in cash or by exchanging financial instruments.

(b) the company has no practice of settling similar contracts net in cash or another financial instrument or by exchanging financial instruments.

(c) the company intends to sell unneeded energy out of the contract to the spot market and also intends to purchase at least the same amount of energy at times when it is needed. The company uses the spot market as a storage mechanism and does not intend to generate profits from those transactions although it cannot rule out that some transactions will lead to profits or losses. Transactions on the spot market are solely used to store the energy.

(d) the company assesses the non-financial item to be readily convertible to cash as there is an active market where unused energy can be sold and purchased at any time.

The company concludes that the own-use-exemption applies to its contract because it is entered into and continues to be held for the purpose of taking delivery of the non-financial asset (energy) in accordance with the entity's expected (energy) consumption.

*View B*

The company expects transactions on the spot market already at inception of the contract for the amount of energy it cannot use when it is produced. Under View B this would disqualify the contract from the application of the own-use-exemption because the contract was not – in its entirety – being held to the purpose of the receipt of the energy at the specific time of production (IFRS 9.2.4) but with some anticipated sales transactions.

*View C*

As the company intends to sell unused energy to the spot market, the company creates a practice of settling similar contracts on the spot market and therefore the contract is not entered into for the purpose of the receipt of the energy (IFRS 9.2.6(b)).

*View D*

Under this View D, the transactions on the spot market may lead to a breach of the requirement set out in IFRS 9.2.6(c) (generating profit from short term fluctuations in price or dealer's margin) because the company cannot rule out that profit arises from some sales transactions, even though this is not intended.

Views B-D would all result in recognizing the contract as a derivative financial instrument.

Discussion

As laid out above, there are several ways to interpret the requirements of IFRS 9.2.4-9.2.6 which gives rise to diversity in practice. Failure to meet the requirements of the own-use-exemption results in a mandatory recognition as a financial derivative at fair value. Given contract durations of 25 years and above, the fair value of such contracts is both difficult to measure and subject to enormous volatility and likely leads to massive effects in the company's statement of financial performance when changes in the fair value are recognized in profit or loss. It would also decouple the effects of the company's efforts to secure its supply of energy from the operating results as the fair value changes will occur and be presented before the consumption of the energy, the production phase and the sale of the output manufactured using this energy. We observe an increasing number of such transactions and thus believe that the issue is increasingly widespread and will have significant effects on those entities affected.

We therefore think that clarification is needed on how IFRS 9 is to be applied. In addition, we believe that the economic phenomenon and the intention of the company when entering the contract is not adequately reflected by a treatment of such contracts as derivative financial instruments, solely because there is no feasible way to store the quantities of energy involved and the company has to use the spot market as a storage mechanism. We also question whether accounting for such contracts as derivative financial instruments would adequately depict the operating performance of the company, since energy costs would affect the operating profit at their spot prices and the effect of the Power Purchase Agreement (PPA) containing fixed prices would occur as a measurement adjustment in periods different from the period of consumption.

**Issue 2: Settlement of power purchase contracts**

The Matter

Company B has contracts to purchase natural gas for use in its own production facilities. The company used its planning to derive its estimated gas demand for the next 12 months. The company contracted 80% of its forecasted demand in forward contracts to fix the price and secure physical supply in advance. The remaining 20% of the forecasted demand are procured on spot

markets on a short-term basis. The company uses this mechanism already for quite some time and has never settled any contracts net in the past but has taken all amounts as contractually agreed upon. The contracts themselves did not provide a net settlement option. Therefore, it has classified all existing contracts in own-use-contracts in accordance with IFRS 9.2.4.

In the light of the current economical and geo-political environment, local governmental authorities called for voluntary energy saving efforts to ensure sufficient supplies. It also stated, that a lack of supplies would force the government to restrict the use of energy for certain industries, to which Company B belongs. To prevent any restriction and maintain its operations, Company B invested in alternative energy resources and improvements to save energy and reduced its demand. It achieved significant energy savings, reducing its demand by 30%. Since not all of the forward contract volume that the company already had in place (and which were classified as own-use-contracts) was needed any longer, the company settled some of its contracts with the supplier by agreeing to compensate the supplier for any loss the supplier would suffer and receiving compensation from the supplier if the supplier makes a profit when selling the unused volumes of natural gas on the spot market compared to selling it to Company B. The settlements were structured as a net payment for all unneeded amounts at the point in time where the supplier and the company have reached a settlement agreement calculated as the product of the amounts to be settled and the difference between the fixed price of the contracts and the then current market price.

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.

Accounting for the contract

Before the settlement, Company B made use of the own-use exemption and did not recognize the forward contract in accordance with IFRS 9.2.4. As the company has settled some of its contracts in cash, the company assesses whether it has created a past practice of settling similar contracts net in cash in accordance with IFRS 9.2.6(b). The entity concludes that, if such a practice was created, similar contracts would be tainted and there was a need to reclassify these contracts and recognize them as financial derivatives.

*View A*

Company B has no history of net settlement for similar contracts. It assesses that the current economical and geo-political environment were unforeseeable at the inception of the contracts. Even though the governmental call for energy saving efforts was voluntary, the company needed to act in order to safeguard its operations and production.

Company B therefore concludes that is has not created a practice of settling such contracts net in cash because the circumstances are extraordinary and would not be expected at inception of the contract nor to recur regularly in the future. Therefore, it does not reclassify similar contracts as derivatives.

*View B*

Even though the company has not had any settlements in the past, nor does it expect to do so again in the future, the company considers that it has created a practice of settling such contracts net in cash since the governmental call for energy saving issues was voluntary. It was not entirely clear whether restrictions would have applied in case the company had kept its operations unchanged. Thus, all similar contracts entered into in the future are reclassified as derivative financial instruments (i.e. they are "tainted") in accordance with IFRS 9.2.6(b).

Discussion

IFRS 9 does not describe or provide guidance on the term "practice (of settling net in cash)". It seems unclear how an entity would treat unforeseeable events that are not expected to reoccur in the future. Accounting literature concludes that the criterion should be read "very narrowly", i.e. that voluntary actions always lead to creating a practice of settling net in cash. It is also not clear at what point in time such contracts would become "untainted" as a "practice" would no longer be assumed.

In our view, judgement should be applied to examine whether a practice is established. We think that a practice should also involve an expectation of similar transactions in the future or clear evidence of past settlements. Companies' reaction to unforeseeable events or developments (e.g. pandemics and wars that lead to unexpected disruptions, and government policy decisions which could potentially lead to financial or other penalties) with regard to contracts they have entered into before such an event, should not create a practice. Consequently, such settlements should not "taint" similar contracts that continue to be held for the purpose of taking delivery. Given the wide

reaching effects a tainting could have, we see the issue as pervasive. Since such settlements increased in the light of the current geo-political situation and are likely to occur in the future if the market pressure forces entities to change their energy sourcing, we believe that the issue is widespread.

**Issue 3: Oversized Contracts**

The Matter

Company C 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 company 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 Company C only an expected output of its facilities (e.g. 50% of the output of its solar farm) which it cannot guarantee but only estimate with certain probabilities (e.g. a 50% or 75% confidence level).

Company C assesses (based on information provided by the energy provider) that,

- with a probability of 10% the solar farm produces its peak output, and the company would receive 130% of its energy demand.
- with a probability of 75% the solar farm operates under most probable conditions, and the company would receive 95% of its energy demand.
- with a probability of 15% the solar farm operates under most unfavorable conditions, and the company would receive 50% of its energy demand.

The company plans accordingly to receive 95% of its energy demand from the provider and to procure any additional demand on the spot market. The same applies if the actual output of the energy provider is lower that the most probable amount. In the case of an output in excess of the Company C's demand, the company would sell the excess amount on the spot market and repurchase it there to compensate any future shortfall if necessary (although it is not certain that the shortfall would match the sales). The contract does not permit net settlement and the company has no history of net settlements or profit taking of contracts that were classified as own-use in accordance with IFRS 9.2.4.

Accounting for the contract

At contract inception, Company C assess the contract for its eligibility to be treated as an own-use-contract in accordance with IFRS 9.2.4. The company's intention is to take delivery of the energy and so is entered into for the purpose of the receipt of the energy in accordance with the company's expected usage requirements. It is ***probable*** (but not certain) that the output of the contract will be less than the forecasted energy usage.

However, IFRS 9.2.4 uses the term "expected" only in connection with the "entity's expected usage, purchase, sale or usage requirements". It is therefore unclear, whether the company should refer to the expected amount of energy to be received by the energy provider.

View A

Since the output of the energy provider is variable by nature, the only way to assess the amount of output is by the use of probabilities. The fact that the amount of energy may exceed the demand of Company C is not most probable but possible. Company C therefore assumes that it assesses the contract based on the expected (most probable) amount of output to assess whether the contract is in line with its expected usage requirements. Therefore, it applies the own-use-exemption.

View B

Since Company C is exposed to the possibility of amounts of output that exceed its demand, Company C assumes that such contracts do not fall under the scope of the own-use-exemption, because there is a possibility of taking delivery of the energy and selling it within a short period and so the contractual amounts may not wholly be for the purpose of the company's own consumption. Thus, the contracts will have to be recognized as derivative financial instruments.

Discussion

The inherent volatility in output is a central characteristic of renewable energies and unlike the conventional production of energy. Consequentially, expectations about amounts that will be received become necessary to plan consumption and secure supply of renewable energy. Given the increased and further increasing importance of renewable energies, we think that View A is most suitable as it would not disincentive companies that use renewable energies and allow them to better present their operating performance (as explained in the discussion of Issue 1, we do not believe that accounting for such contracts as derivative financial instruments presents faithfully

the transaction as the primary objective is securing the supply of energy to enable a company's operations).

## Appendix B—Relevant extracts from the Due Process Handbook

5.13 The [IASB] and the Interpretations Committee work together in supporting the consistent application of IFRS Standards. They do so by, among other things, issuing narrow-scope amendments to the Standards, issuing IFRIC Interpretations and publishing agenda decisions to address application questions. The [IASB] and Interpretations Committee seek to achieve a balance between maintaining the principle-based nature of the Standards and adding or changing requirements in response to emerging application questions.

…

5.16 The Interpretations Committee decides a standard-setting project should be added to the work plan, either by recommending that the [IASB] develop a narrow-scope amendment or by deciding to develop an IFRIC Interpretation, when all of the following criteria are met:

(a) the matter has widespread effect and has, or is expected to have, a material effect on those affected;

(b) it is necessary to add or change requirements in IFRS Standards to improve financial reporting—that is, the principles and requirements in the Standards do not provide an adequate basis for an entity to determine the required accounting;

(c) the matter can be resolved efficiently within the confines of the existing Standards and the *Conceptual Framework*[4]; and

(d) the matter is sufficiently narrow in scope that the [IASB] or the Interpretations Committee can address it in an efficient manner, but not so narrow that it is not cost-effective for the [IASB] or the

[4] In the Due Process Handbook, 'Conceptual Framework' refers to the *Conceptual Framework for Financial Reporting*.

Interpretations Committee and stakeholders to undertake the due process required to change a Standard.

…

5.18 If the Interpretations Committee recommends that the Board should develop a narrow-scope amendment, it refers the matter to the Board…