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Jean-Paul Gauzès
EFRAG Chairman
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Re: PIR – IFRS 9 Financial Instruments: Classification and Measurement

Dear Mister Gauzès,

I am a solo practitioner and want to share with you my views on an additional item to be included in your response to the IASB on its Request for Information on PIR IFRS 9 *Classification and Measurement*. This response will not deal with any other aspects of your draft comment letter.

Based on my experience in the private sector, I consider that the difference in accounting treatment of Virtual Power Purchase Agreement (VPPA) contracts under IFRS and US GAAP will, in most cases, result in more profit or loss volatility and in an increased administrative burden (for instance, [EMIR](#)¹ reporting) under IFRS. The reason for this is that under IFRS, these contracts are generally treated as derivatives, whilst under US GAAP they are treated executory contracts due to being regarded as contracts without notional.

The concern is that given the intricacies around the accounting and valuation of these derivatives, companies may feel less inclined to use VPPAs as one of the tools to reach their sustainability goals. Thereby working against the sustainability goals defined and pursued by the European Union.

In its Communication regarding energy prices in Europe published on 13 October 2021², the European Commission highlighted the need for “**Stepping up investments in renewable energy and in energy efficiency**”. The members states are encouraged to³:

- **Step up investments in renewable energy, renovations and energy efficiency and speed up renewables auctions and permitting processes**
- **Step up investments in trans-European networks**, including interconnectors, storage and transmission and distribution grids

¹ The European Market Infrastructure Regulation (EMIR) was adopted by the EU in 2012 and it regulates over-the-counter derivatives, central counterparties and trade repositories. EMIR aims to reduce systemic risk, increase transparency in the OTC market and preserve financial stability.

² See full document [here](#)

³ See full document [here](#)

Therefore, I suggest aligning the IFRS accounting treatment with US GAAP by a limited addition to the implementation guidance to remove the disadvantages for the entities reporting under IFRS and hereby making VPPAs a more attractive option for companies in pursuing their sustainability goals. For more details on VPPAs and the accounting under IFRS and US GAAP, please refer to Appendix 1 to this letter.

If you would like to further discuss the views expressed in this letter, please contact me.

Yours sincerely,

A handwritten signature in blue ink, appearing to read 'Ermelindo Varela', is positioned below the text 'Yours sincerely,'.

Ermelindo Varela

Appendix 1: Detailed technical analysis and proposal

1. VPPA contracts:

1.1. What are they?

The case described in this submission pertains to VVPA⁴ contracts directed at the production of solar or wind energy.

VVPA contracts come in different shapes and forms, given their over-the-counter (OTC) nature. However, typically, they will have the following key characteristics:

- The supplier is responsible for the design, operation and maintenance of the energy production facility;
- The customer is entitled to the guarantee of origin certificates;
- On a periodic basis (for instance, monthly) there is a financial settlement between the two parties to the contract, based on an energy index price and the price agreed in the contract (i.e., a contract for difference);
- There is no physical settlement of the contract between the supplier and the customer;
- The aim is to generate clean energy (for instance, wind or solar energy) which the supplier will sell into an organized spot market;
- Typically, solar and wind VPPA contracts do not contain a minimum or maximum quantity of energy to be produced in a given period of time;
- The contract between the customer and supplier will typically have a duration of 10 or more years.

1.2. Why are they used?

VPPA contracts are used for three main reasons:

- 1) To hedge energy costs and potentially generate savings⁵;
- 2) To help achieve sustainability goals through the guarantee of origin certificates;
- 3) Since it is not geographically bound, it increases the flexibility and scalability in achieving sustainability goals.

VPPA are often more flexible and attractive than PPA⁶ for the following reasons:

- 1) Companies can aggregate multiple and smaller energy loads under one single project. In the context of European Union, these projects can be pan-European. For instance, the guarantee of origin certificates generated by one project in Spain can be cancelled on behalf of consumption in multiple countries in the European Union;
- 2) Engineering problems and other operational risks sit with the supplier, since there is no physical delivery of energy.

⁴ According to WindEurope, the volume of PPA contracts in 2021 will surpass 3.5 GW and the forecast is to reach 407 GW by 2030 (see further details [here](#)). We assume these figures include both direct and virtual PPA.

⁵ VPPA contracts will typically involve multiple suppliers taking part in a competitive auction, which will potentially result in better prices for the customer.

⁶ Power Purchase Agreement or Direct PPA, see more details in Annex 1

1.3. European Green Deal

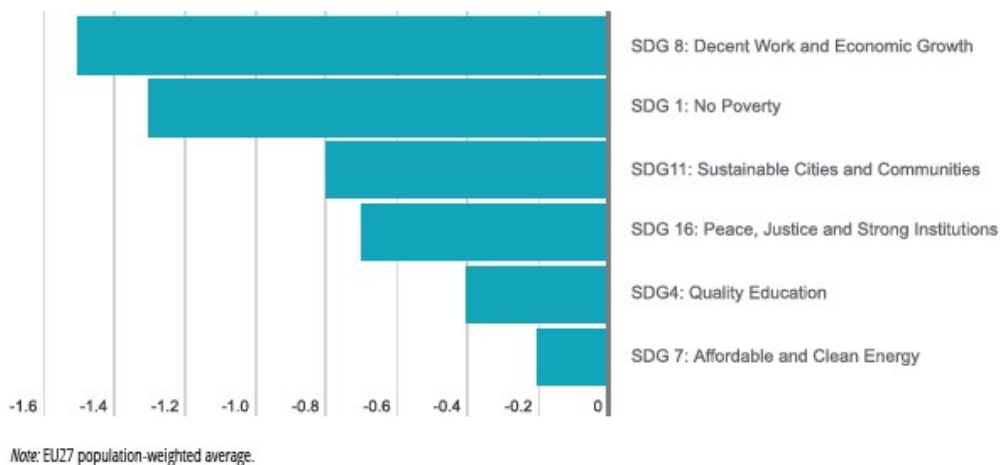
The [European Green Deal](#) (EGD) Communication was issued in 2019 by the European Union (EU), in which the goal of zero net emission by 2050 is set out. As stated in the Communication:

The Green Deal is an integral part of this Commission's strategy to implement the United Nation's 2030 Agenda and the sustainable development goals (...)⁷.

One of the United Nations (UN) sustainable development goals (SDG) as described in the Green deal is **Affordable and Clean Energy** and according to the Europe Sustainable Development Report 2021 (ESDR), the EU is facing challenges in achieving this goal⁸.

Furthermore, the ESDR notes that **Affordable and Clean Energy** is one of the goals with sharpest decline in the period 2019 and 2020⁸.

Figure 1.6 | SDG goals with the sharpest decline between 2019 and 2020, EU27



Against this backdrop, the ESDR⁸ proposes six SDG transformations for Europe and among them is **Sustainable Energy**, which ties back to the following actions under the EGD:

- Increasing the EU's climate ambition for 2030 and 2050⁹; and
- Supplying clean, affordable and secure energy¹⁰.

Typically, companies will use a combination of different strategies in achieving their sustainability goals, including VPPAs. For further information about other strategies, please refer to Annex 1, part A.

⁷ See page 3 of the [European Green Deal](#).

⁸ See Lafortune G, Cortés Puch M, Mosnier A, Fuller G, Diaz M, Riccaboni A, Kloke-Lesch A, Zachariadis T, Carli E, Oger A (2021). Europe Sustainable Development Report 2021: Transforming the European Union to achieve the Sustainable Development Goals. SDSN, SDSN Europe and IEEP, France: Paris.

⁹ Through the 'Climate Law', the EU made the public commitment towards climate neutrality by 2050 and will set policies in place aiming at further reduction of greenhouse gas emissions and the correct pricing of carbon.

¹⁰ The decarbonizing the energy system by developing a power sector largely based on renewable sources is one of the priorities, together with phasing out of coal and decarbonizing gas.

2. Accounting treatment of VPPAs:

2.1. The 3 steps analysis

Generally, when analysing VPPA contracts, the following 3 steps are followed:

2.1.1. Consolidation analysis

Firstly, the contract is examined to determine whether the investor (i.e., customer) has control over the investee (i.e., supplier). The analysis is performed in accordance with IFRS 10 *Consolidated Financial Statements*. For details of such analysis, please refer to Annex 1, part B.

If we reach to the conclusion that consolidation is required under IFRS 10, then the investor should consolidate the investee. No further analysis is needed.

However, if the conclusion is that consolidation is not justified, the second step is to review the contract for leases as defined by IFRS 16 *Leases*.

2.1.2. Lease analysis

As a general note and in accordance with BC169 “The IASB decided to exclude variable lease payments linked to future performance or use of an underlying asset from the measurement of lease liabilities. (...)”. This exemption would be applicable to certain PPA contracts aiming at production of solar or wind energy. For details of the analysis relating to VPPAs, please refer to Annex 1, part C.

If the conclusion is reached that the contract contains one or multiple leases, then no further analysis is performed. If the conclusion is that the contract contains no lease(s), then the last step is to analyse the contract for possible derivatives.

2.1.3. Derivative analysis

The steps described above, are similar both under IFRS and US GAAP and will in most cases lead to the same conclusion. However, when analysing the contract for derivatives¹¹, the probable conclusion under US GAAP is that the contract does not contain or is not a derivative because it does not contain a notional. Consequently, under US GAAP, the contract will be treated as an executory contract. Unfortunately, under IFRS, the same contract will still meet the definition of derivative since the IFRS definition of derivative does not require a notional.

Considering that the conclusions regarding consolidation and leases will likely be similar under US GAAP and IFRS, the remainder of this submission will solely focus on the analysis of the accounting treatment of derivatives.

2.2. Definition of derivatives under US GAAP

According to ASC 815 *Derivatives and Hedging* paragraph 10-15-83, a contract must meet all the three criteria below to qualify as a derivative instrument:

- There is an underlying, and one or more notional amounts and/or payment provisions;
- There is little or no initial net investment;
- Net settlement is permitted or required.

¹¹ These VPPA contracts do not meet the criteria for the “own-use” exemption as they are cash settled and there is no delivery of energy between the parties to the contract.

The rest of the submission focuses solely on the first criterion, since the second and third will in most cases lead to similar conclusions under IFRS.

2.2.1. Underlying, notional amount, payment provision

In accordance with ASC 815-10-15-83(a), to satisfy this requirement, the contract has both of the following terms, which determine the amount of the settlement or settlements, and, in some cases, whether or not a settlement is required:

- One or more underlyings
- One or more notional amounts or payment provisions or both.

The Implementation Guidance (ASC 815-10-55-5) deals with identification of notional amount in commodity contracts.

"Many commodity contracts specify a fixed number of units of a commodity to be bought or sold under the pricing terms of the contract (for example, a fixed price). However, some contracts do not specify a fixed number of units."

It then describes four contracts, of which the first one is relevant to this discussion. Contract 1 is for the supply of *'[a]s many units as required to satisfy its actual needs (that is, to be used or consumed) for the commodity during the period of the contract (a requirements contract). The party is not permitted to buy more than its actual needs (for example, the party cannot buy excess units for resale). (...)'*

ASC 815-10-55-7 (a), further clarifies that with regard to Contract 1 *"(...) If the notional amount is not determinable, making the quantification of such an amount highly subjective and relatively (for example, if a contract does not contain settlement and default provisions that explicitly reference quantities or provide formula based on historical usage), such contracts are considered not to contain a notional amount as the term is used in this Subtopic."*

The paragraph also explains that default provisions often refer to anticipated quantities to be used when calculating penalties in the event of non-performance. Average historical usage quantities may also be specified in the penalty amounts. Where such amounts are determinable, they are considered to be the notional amount of the contract.

As described above, while specific downtime for maintenance is specified in VPPAs, there is no minimum or maximum quantity of energy to be produced in a given period of time. The production is conditional on factors outside the control of any of the parties to the contract (in this case, weather conditions).

2.2.2. Conclusion under US GAAP

Considering the above, most VPPA contracts will not meet the definition of derivatives contracts under US GAAP. Consequently, these contracts will be treated as executory contracts, whereby on a periodic basis (for instance, monthly), the parties will settle the contract for difference and the customer will receive the renewable energy credits¹².

Since the contract is not a derivative, there is no need to mark-to-market every reporting period, which would involve considerable subjectivity in determining the appropriate valuation inputs and

¹² In the European Union these are designated as guarantee of origin certificates

assumptions relating to the expected output as well as long-term energy prices. There are two additional benefits of the classification as an executory contract:

- There is no profit or loss volatility caused by the periodic marking-to-market; and
- There is no requirement to report these contracts under Dodd-Frank.

2.3. Definition of derivatives under IFRS

2.3.1. Relevant IFRS paragraphs

IFRS 9 Appendix A specifies the requirements to be met for a financial instrument to be considered a derivative. Appendix A paragraph BA.1 clarifies that "(...) A derivative *usually* has a notional amount, which is an amount of currency, a number of shares, a number of units of weight or volume or other units specified in the contract. (...)"

The idea that the notional is not essential to the definition of derivative is further illustrated by the Implementation Guidance paragraph B8 which specifies that "IFRS 9 does not exclude from its scope derivatives that are based on sales volume." The example has been reproduced in Annex 1 part D.

2.3.2. Conclusion under IFRS

Considering the above, under IFRS, most of the VPPA contracts will meet the criteria to be classified as derivatives, with the following major consequences:

- It makes the use of this type of contract less attractive for entities reporting under IFRS, since it will cause volatility in their profit or loss performance. This will be particularly true for entities listed in a stock exchange in the European Union;
- Questionable relevance¹³ of amounts calculated based on highly judgmental assumptions (weather conditions, forward energy prices for long dated contracts, etc);
- It increases the burden for entities reporting under IFRS, without clear benefit for investors and users of financial statements, given the highly judgmental nature of the assumptions and valuation inputs;
- Considering the above, it will negatively impact the sustainability goals as set out by the European Union, namely the measures set out in the 'Toolbox'¹⁴; and
- It creates additional EMIR reporting requirements, while entities reporting under US GAAP have no obligation to report this type of contract.

3. Proposed solution

I propose a limited scope exemption to the definition of derivative in the Implementation Guidance, whereby contracts where:

- There is no specified notional and

¹³ According to the Conceptual Framework 2.7, Financial information is relevant when it has predictive value, confirmatory value or both. In this case, fair value of this type of contracts involve a significant number of assumptions, such as i) Amount of energy to be generated, ii) Long-term forward curve of energy prices, iii) Intraday adjustments to the price curve, which is highly dependent of the geographic location of the plant (i.e. a wind energy project in Spain will not be comparable to a wind energy project in Denmark). Under these circumstances, we consider the predictive or confirmatory value to be limited.

¹⁴ See Communication [Tackling rising energy prices: a toolbox for action and support](#), 3.2.3. Stepping up investments in renewable energy and in energy efficiency

- A notional cannot be derived from penalties or non-performance clauses;

And where the **output**:

- Has no minimum or maximum;
- Can be zero and neither of the parties to the contract can influence that outcome; and
- It cannot reliably be estimated and without introducing significant judgmental assumptions (i.e. weather conditions)

Are **not** considered to be derivatives under IFRS 9.

it's important to note that, with the proposed change, the example provided in Implementation Guidance B.8 would still meet the definition of derivative, since the seller can influence the sales volume through, for instance, rebates, price reduction/increase or marketing campaign. Depending on whether the amendment follows the US GAAP example around default and penalty provisions, this could also play a further role in minimising the impact of such a change.

ANNEX 1: Additional information

A. Link between VPPAs and sustainability goals

The strategies mentioned here are not exhaustive. The purpose is to illustrate the link between these strategies and sustainability goals, their advantages, and drawbacks.

Direct Power Purchase

This is also known as Power Purchase Agreement (PPA). Under a PPA contract, there is physical delivery of energy to the customer. These are normally long-term contracts (10 years or more), which can be seen as a disadvantage since it exposes a variety of risks in connection with contract duration. Another main limitation with this strategy is that it is geographically bound. The upside of these contracts is direct contribution to the production of clean energy. In some countries where VPPAs are legally not permitted, PPAs are the preferred alternative when pursuing sustainability goals.

Purchase of Renewable Credits

This strategy main selling point is its simplicity, as it does not entail long negotiations between customer and supplier. However, it is perceived to have a low real contribution to the sustainability goals, since it does not directly contribute to the production of clean energy.

Direct Investment (capex)

This strategy requires initial investment to build the production facilities. It clearly contributes to the generation of clean energy and allows companies to achieve savings. However, it presents some drawbacks:

1. It may require engineering skills that are not present in the companies;
2. The payback period will typically take several years;
3. It is feasible only in limited circumstances due, for instance, to geographic limitations.

B. Application of IFRS 10 to the contract:

Power over the investee

In most cases, the contracts are structured in a way that it's up to the supplier to design, build, operate and maintain the facilities and the customer has no power (either through voting rights or commercial arrangements) to direct the activities of the investee.

Exposure or rights to variable returns

In most cases, there will be variability in connection with the contract for differences (CfD). However, from the perspective of the customer, the main benefit is the guarantee of origin certificates. Therefore, the variability on the CfD is not sufficient to trigger consolidation under IFRS 10.

Ability to use power to affect returns

If the customer has no power over the investee, this criterion will also not be met.

C. Application of IFRS 16 to the contract

Identifiable asset

The first question is whether the contract contains an identifiable asset. Typically, the answer to this question is yes.

Substantially all benefits

Then, the next question is whether the customer has the right to obtain substantially all of the economic benefits from the use of the asset. Generally, this requirement will not be met, since the benefit to be obtained by the customer is the guarantee of origin certificates, which is considered to be a by-product¹⁵ (IFRS IC [Staff Paper](#)).

Right to direct the asset

The next question is regarding who has the right to direct the asset and how it is used throughout the period of use. Here also in most cases the customer will not have the knowledge and expertise to direct the use of the asset.

D. IG B.8 Definition of a derivative: foreign currency contract based on sales volume

Entity XYZ, whose functional currency is the US dollar, sells products in France denominated in euro. XYZ enters into a contract with an investment bank to convert euro to US dollars at a fixed exchange rate. The contract requires XYZ to remit euro based on its sales volume in France in exchange for US dollars at a fixed exchange rate of 6.00. Is that contract a derivative?

Yes. The contract has two underlying variables (the foreign exchange rate and the volume of sales), no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors, and a payment provision. IFRS 9 does not exclude from its scope derivatives that are based on sales volume.

¹⁵ This view is confirmed by IFRIC Staff Paper: Power Purchase Agreements in a Gross Pool Electricity Market (IFRS 16) | Initial Consideration. See paragraph 21