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Do you have a lease of green technology?

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What's the issue?

Climate change may cause companies to exit leases of polluting assets early. However, it also provides companies with an opportunity to access government incentives by investing in emerging greener technologies such as solar farms, wind farms and electric vehicles. Using leasing as a financing tool to access these technologies can provide flexibility.

When considering how to finance any investment in green technology, a company needs to consider whether the arrangements result in on-balance sheet lease obligations under IFRS 16 *Leases*, and how the availability of green energy certificates might affect its assessment. Further, if a company enters into a contract to purchase 'green' electricity that is delivered via a grid or pooling arrangement, then additional complexities may arise when assessing whether the arrangement contains a lease or a financial instrument.

Getting into more detail

Is there an on-balance sheet lease liability?

Companies may enter into arrangements to purchase electricity generated by solar or wind plants to certify themselves as carbon neutral. These arrangements may contain leases.

Assessing whether these arrangements contain a lease can be complex, largely because of the relative simplicity of the underlying generating assets. Only if a company directs the right to use the assets will it have a lease arrangement. Often, once the plant is up and running there are few significant decisions to be made – i.e. some or all of the decisions may be predetermined. Therefore, when assessing who directs the right to use the plant, a company may need to determine who designed and operates the plant. *[IFRS 16.B24, B28–B29]*

Leases can be an attractive way of financing investments in green technology due to the flexibility they provide – but care is needed when identifying and measuring on-balance sheet lease obligations.

If there is a lease, then whether there is an on-balance sheet lease liability will depend on the payment structure. If the company is paying for electricity generated per unit, then all lease payments will be variable. In this case, the company will have a liability only if it has committed to a fixed minimum purchase. *[IFRS 16.27, 38, B42]*

Green energy certificates

Government incentives relating to green technology may be in the form of tax credits and renewable energy credits (RECs). Understanding the nature of these incentives – and which party receives them – can be crucial to determining whether there is a lease.

If the incentives associated with the technology would be considered 'economic benefits' from using the underlying asset, then they are included in the assessment of whether there is a lease. For example, if one party receives the electricity but another receives RECs for using the underlying asset, then the parties share the economic benefits from using the asset. This may mean that there is no lease. *[IFRS 16.B21]*

Conversely, income tax credits are benefits derived from owning the asset and are excluded from the assessment. *[IFRS 16.IE2.Ex9]*

Pooling arrangements

In some cases, there is no direct physical delivery of electricity from the supplier to the customer. Instead, the supplier delivers the 'green' electricity to a public grid and the customer receives electricity from that grid.

In these cases, the supplier and the customer may manage their exposure to the risk of fluctuations in the electricity spot prices by entering into an agreement to exchange in cash the difference between the contractually agreed fixed price and the variable spot price.

The customer will need to assess carefully whether it has a lease in place for the generating plant and whether the agreement creates a derivative financial instrument to be measured at fair value. *[IFRS 16.9, Insights 7.1.120.110–180]*

The IFRS Interpretations Committee discussed a similar scenario in June 2021.

Disclosures

Companies need to provide clear and meaningful disclosures about the nature of their leasing activities and the significant judgements made in determining whether a lease exists.

Actions for management to take now

- Consider whether the arrangements for access to green technology contain a lease.
- Assess whether green energy certificates are economic benefits from using the underlying asset that will impact the lease evaluation.
- Consider involving accounting professionals in reviewing potential leasing arrangements to identify unintended financial reporting consequences.
- Provide clear and meaningful disclosures about significant judgements and estimates made.

References to 'Insights' mean our publication **Insights into IFRS**

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