

Query No. 11

Subject: Accounting for Agreement for sale of electricity generated under Ind AS.¹

A. Facts of the Case

1. The querist is a public sector undertaking (hereinafter referred to as ‘the company’), engaged mainly in extraction and sale of manganese ore from its mines in Madhya Pradesh and Maharashtra. It has also diversified into production of electrolytic manganese di-oxide, ferro alloys and generation of wind power. The company having decided to venture into wind energy generation project had entered into agreement on Build, operate, and transfer (BOT) basis, with a developer, who has the expertise in designing, construction, commissioning, operating and maintaining the wind energy generators (WEGs). Incidentally, the developer had already obtained lease for the land required for the project in its favour from the State Government. The developer has agreed to transfer the lease in favour of the company for the consideration alongwith cost of design, construction, installation and commissioning the WEGs. Further, it is agreed to pay to the developer annually the operation and maintenance charges at the agreed rate with 5% escalation p.a. The operation and maintenance charges were applicable from 3rd year to 20th year.

2. Power generated from this WEG is sold to the State’s electricity distribution company (hereinafter referred to as ‘the EDC’) at the rates fixed by Madhya Pradesh Electricity Regulatory Commission (MPERC) for a period of twenty years. As per agreement with the EDC, which is the sole customer for this line of business at present, the consideration is solely dependent on the number of units generated and there is no stipulation for any guaranteed generation or minimum amount payable. The company raises invoices on monthly basis at the MPERC determined rates for total electricity generated from the WEGs. Thus, generation from individual WEG is of no relevance for this purpose and monthly invoice can be (a) Nil if no electricity is generated from the WEGs or (b) for any amount even though, hypothetically, entire quantity is generated from a single WEG, the rest of WEGs generating Nil quantity. The agreement with the EDC contains termination clause, which is operative in case the EDC fails in making timely payments to the company for three consecutive months. In case of termination of the agreement, the company is free to sell power to any other entity. Given the power situation in the country, sale of power to some other entity(ies) by entering into Power Purchase Agreement (PPA) is not at all difficult.

3. The company has entered into a separate agreement with WEG developer for supply, construction, operation and maintenance of WEGs. The agreement specifies minimum guaranteed availability of each of the WEGs and deductions from operation and maintenance charges (OMC) in case of failure in maintaining minimum availability. The company has also made one-time lumpsum payment to the WEG developer for leasehold rights of the land used for the WEGs for twenty-five years. The payment has been made at the beginning of the contract period.

4. In view of the foregoing, the company is accounting for the transactions as under:

(a) Although the revenue generated from the project is not substantial in relation to the total turnover of the company, the investment in the project is more than 10% of its gross block of assets. In view of this and the fact that the risks and rewards of the new venture are different from that of its main business, the company considers WEGs as a separate reportable segment.

¹ Opinion finalised by the Committee on 5.6.2018 and 6.6.2018.

- (b) Lumpsum one-time consideration paid for obtaining leasehold rights over land is treated as leasehold land in accounts and is depreciated over the 20 years.

Cost of WEGs is treated as plant and machinery and is depreciated over its useful life, which is 22 years as specified in Schedule II to the Companies Act, 2013. In addition, the company has also claimed allowable tax benefits under Income-tax Act, 1961, i.e., 80-IA benefits and accelerated depreciation.

- (c) Monthly invoices towards generation of electricity are accounted for and treated as revenue from the sale of electricity.

OMCs are accounted for as expenditure of the WEG division. Besides this, administrative expenses, like rates and taxes, inspection fees, insurance charges, etc., are borne by the company and, hence, are also accounted for likewise.

- (d) The querist has stated that during audit of annual accounts, the Government audit team has contended that the agreement entered into with the EDC is in the nature of finance lease wherein the company is a lessor and the EDC is a lessee and, hence, the assets are to be treated accordingly in accounts. However, the company has given an assurance to the Government auditors that opinion of the Expert Advisory Committee of the Institute of Chartered Accountants of India will be sought on this point and that accounting treatment will be given accordingly in accounts for/from the next financial year, i.e., 2017-18.

5. The querist has also clarified that:

- (a) The WEGs are owned by the company and there is no transfer of risks/rewards to the EDC at any point of time, even after termination of the agreement,
- (b) Maintenance of the WEGs is the responsibility of the company and the EDC is not in any way concerned about operation and maintenance of the assets,
- (c) Payment by the EDC is dependent entirely on total number of electricity units generated and can be Nil, if no electricity is generated,
- (d) The company is at liberty to terminate the contract with EDC and sell the electricity generated from the project to another entity, if the EDC makes default in payment of electricity bills for three consecutive months, and
- (e) In view of the foregoing, the agreement is essentially for sale of electricity and does not fall in the category of any lease arrangement.

Analysis by the company

6. As per the stand taken by the company, accounting treatment accorded with regard to the agreement with EDC does not attract Indian Accounting Standard (Ind AS) 17, 'Leases'. With reference to Ind AS 17, the company's contentions are as under:

- (i) A lease is defined in the Ind AS as an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time. In the instant case, the right to use the WEGs lies with the company and the same are in full control of the company. EDC has not been given in any manner, the right to use of WEGs, whatsoever, relating to the control or custody of the WEG. Hence, it is a normal sale-purchase transaction instead of a lease wherein right to use of assets is involved.

- (ii) The plant was conceived, designed, developed and commissioned well before the contract with EDC. As the plant has started generating electricity units, the same needs to be sold, as it is not a product to be stored. Due to location of the plant being in the State of Madhya Pradesh (MP) the most preferred, efficient and convenient way of sale of the electricity units, is with the EDC in MP State.

The sale of electricity to EDC is not as per any customized rate but the same is as per the rates specified by the Madhya Pradesh Electricity Regulatory Commission (MPERC), an independent regulatory authority. These rates are applicable to all wind energy producers in the State of Madhya Pradesh. These tariffs of MPERC are applicable to all the plants commissioned on or after the order date of 21.11.2007 and intended for sale of electricity to the MP EDC. Thus the tariff arrangement between the company and EDC is not exclusive one and the same is common for all the wind energy producers in MP.

- (iii) A finance lease is defined in the Ind AS as a lease that transfers substantially all the risks and rewards incidental to ownership of an asset; title may or may not eventually be transferred. In the instant case, no risk incidental to the ownership is transferred; this is evident from the fact that (a) in case of Nil generation from any WEG either on account of low wind velocity or machine breakdown, nothing is payable by the EDC to the company, (b) in case of complete damage to the WEGs, the resultant loss is loss of the company (not of the EDC), (c) excessive generation of electricity gets paid fully by the EDC to the company.
- (iv) As per the agreement with EDC, the company will be fully responsible for the design, construction, testing, inspection and maintenance of WEGs in accordance with the standard utility practices, relevant technical standards and specifications. Thus, the EDC has no right to any assets or interferences as far as operation and maintenance is concerned.
- (v) As per the agreement with EDC (clause No.1.c), the licensee (EDC) cannot deny the company to inject additional power at the point of interconnection near to the site in future on any account except on technical ground. This clearly shows that EDC does not have the right to use the assets as it wants and hence, the arrangement does not qualify to be a lease.
- (vi) As per clause 13, the company is required to intimate the number of WEGs connected to common metering point. Any subsequent addition or reduction in the number can be done by giving 30 days notice. Thus, the company has liberty to add/reduce the number of WEGs which clearly gives freedom to the company to exploit the assets in a manner it wishes. Consequently, the EDC has no right to restrict the use of assets in any manner.
- (vii) Examples of situations indicated in paragraph 10 of Appendix C to Indian Accounting Standard (Ind AS) 17, 'Leases' include cases where the lessor transfers the ownership of the asset to the lessee by the end of lease term or the lessee has an option to purchase the asset. In the instant case, there is no stipulation to this effect in the agreement with the EDC. Further, the paragraph also includes cases where leased assets are of such specialised nature that only the lessee can use them without major modifications. This is also not applicable in the instant case; In fact, as pointed out above, EDC is not at all operating or using the assets and the use of assets in case of other entities by terminating the present agreement is very much possible.

The additional indicators given in paragraph 11 of Appendix C like bearing of losses by lessee in case of cancellation of agreement or continuing the operations by the lessee for secondary period are also not present in the agreement with the EDC.

- (viii) The Ind AS also points out to cases where the purchaser has the ability or right to operate the asset in the manner it determines while obtaining or controlling significant output of the asset. There is no clause in the agreement with the EDC, which enables it to operate or control the asset.

From the above, the querist is of the view that it is quite evident that the arrangement between the company and the EDC does not give rise to any doubt regarding right to use of the WEG assets by the company. The right to use of assets rests solely with the company. Further, the PPA does not grant right to receive series of payments from EDC. In case the company fails to generate the wind energy units, there will not be any payment by EDC. The agreement between the company and EDC is purely buy and sell commercial agreement wherein EDC pays only when it receives the supply of electricity units.

7. In nutshell, the arrangement with the Electricity Distribution Company (EDC) is not one of 'finance lease' for the reasons that are nowhere in the realm of the Ind AS 17 whose pre-requisites are:

- (i) Transfer of right to use the assets. The Standard under the caption – 'Scope', specifically states that the same does not apply to agreements that are contracts for services that do not transfer the right to use assets from one contracting party to the other.

In the extant case, the EDC is eligible to the products (units of electricity) emerging out of use and operation of asset owned, possessed and controlled by the other party to the agreement, i.e., the company.

- (ii) In terms of the definition in the Standard, a finance lease is a lease that transfers substantially all the risks and rewards incidental to ownership of an asset.

The arrangement with the EDC falls beyond the primary requisites of the definition which clearly delineates what exactly a finance lease means.

- (iii) Minimum lease payments over the lease term is the crux of any lease arrangement, which is totally absent in the arrangement with the EDC. Their payments to the company are wholly based on the quantum of supply made by the company. If there is no supply, no payment will be made.

- (iv) Under finance lease, payments made by the lessee to the lessor are essentially towards the cost of acquisition of the asset where the lessee has the option to purchase the asset at the end of the lease term. This phenomenon is conspicuously absent in the company's arrangement with the EDC.

- (v) Substance of the arrangement clearly indicates how the same is in harmony with the appendices to the Standard which spell out situations which are obviously not one of leases.

B. Query

8. Whether, the agreement with the EDC, merely for sale of electricity generated by the company, denotes an arrangement, which can be treated as a finance lease or it is a normal transaction of sale and purchase of electricity units supplied by the company to EDC.

C. Points considered by the Committee

9. The Committee notes that the basic issue raised in the query relates to whether the agreement to sell electricity to the EDC can be treated as a finance lease under Ind ASs or it is a normal transaction of sale and purchase of electricity units between the company and EDC. The Committee has, therefore, considered only this issue and not examined any other issue that may arise from the Facts of the Case, such as, accounting for the OMC, accounting for land lease arrangements with the developer, revenue recognition by the company, accounting for WEGs, appropriateness of considering WEGs as a separate reportable segment, amortisation of leasehold rights over land, etc. Also, the Committee has not examined the applicability of Ind AS 114, 'Regulatory Deferral Accounts', to the agreement.

10. Further, the Committee notes that the company has a back-to-back arrangement with the WEG developer for supply, construction, operation and maintenance of WEGs under which the WEG developer has given a minimum guaranteed availability for each WEG. The Committee has not examined the nature of the agreement with the WEG developer.

11. The Committee notes that Appendix C to Ind AS 17, Determining whether an Arrangement contains a Lease, provides the guidance to determine when an arrangement, including sale/purchase arrangement, might contain a lease. Once a determination is reached that an arrangement contains a lease, the lease arrangement should be classified as either financing or operating, according to the principles in Ind AS 17, 'Leases'. A lease that transfers significantly all the risks and rewards incidental to ownership of an asset is a finance lease. A lease other than a finance lease is an operating lease. Accordingly, the Committee is of view that in the extant case, the company should first determine whether the arrangement is, or contains, a lease. In that context, the Committee notes that Appendix C to Ind AS 17 provides as follows:

“6. Determining whether an arrangement is, or contains, a lease shall be based on the substance of the arrangement and requires an assessment of whether:

(a) fulfilment of the arrangement is dependent on the use of a specific asset or assets (the asset); and

(b) the arrangement conveys a right to use the asset.”

“Arrangement conveys a right to use the asset

9 An arrangement conveys the right to use the asset if the arrangement conveys to the purchaser (lessee) the right to control the use of the underlying asset. The right to control the use of the underlying asset is conveyed if any one of the following conditions is met:

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

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

(c) Facts and circumstances indicate that it is remote that one or more parties other than the purchaser will take more than an insignificant amount of the output or other utility that will be produced or generated by the asset during the term of the arrangement, and the price that the purchaser will pay for the

output is neither contractually fixed per unit of output nor equal to the current market price per unit of output as of the time of delivery of the output.”

12. The Committee notes that none of the terms and conditions of the Power Purchase Agreement dated 27th June, 2008 as provided by the querist, give the EDC either the ability or the right to operate the WEG assets. Rather the WEG assets are operated by the company along with developer. Therefore, the criterion laid down in in clause (a) of paragraph 9 of Appendix C of Ind AS 17 is not met.

13. The Committee also notes that the Power Purchase Agreement does not provide the EDC the right to control the physical access to the WEG assets. Therefore, the criterion contained in clause (b) of paragraph 9 of Appendix C of Ind AS 17 is also not met.

14. As regards to the criteria laid down in paragraph 9(c) of Appendix C of Ind AS 17, the Committee notes that in the extant case, it may be considered as remote that any party other than the EDC will take more than an insignificant amount of the output, i.e. electricity generated by the WEG assets during the term of the power purchase agreement. However, the Committee notes that clause 10.1 of Annexure I to the Power Purchase Agreement (MPERC tariffs for wind energy projects commissioned after the order date of 21.11.2007) provides the tariff rates per unit of power generated and supplied during the term of the Power Purchase Agreement, as per which, the tariff per unit is Rs. 4.03, Rs. 3.86, Rs. 3.69 and Rs. 3.52 during years 1, 2, 3 and 4, respectively and thereafter, from year 5 onwards, the tariff per unit is fixed at Rs. 3.36 per unit.

15. The Committee notes that although the tariff per unit may not be equal to the current market price per unit of the electricity at the time of the supply, the tariff per unit has been pre-determined for each year of the agreement. At the inception of the arrangement, the company, i.e. the supplier, and the EDC, i.e., the purchaser, can determine what the exact price will be for every unit of electricity supplied at each point in time during the term of the arrangement. Therefore, the tariff rate per unit is fixed per unit as there is no variability in the tariff per unit depending on the volume of the electricity generated by the asset. Therefore, the criterion contained in clause (c) of paragraph 9 of Appendix C of Ind AS 17 is also not met.

16. Accordingly, the Committee notes that none of the criteria in paragraph 9 of Appendix C to Ind AS 17 are met. Resultantly, the power purchase agreement in the extant case does not contain an element of lease.

17. With regard to the issue as to whether sale of electricity generated by the company is a normal transaction of sale and purchase of electricity, the Committee wishes to state that the company should first examine whether the agreement between the company and the WEG developer is on a principal-to-principal basis or whether the company is acting merely as an agent of WEG developer. Further, the company should also examine whether the arrangement in the extant case is within the scope of Appendix A, Service Concession Arrangements to Ind AS 11, ‘Construction Contracts’.

D. Opinion

18. On the basis of the above, for the reasons mentioned in paragraphs 12-16 above, the Committee is of the opinion that the power purchase agreement with the EDC cannot be classified as a lease (operating or finance) under Ind AS 17. Further, the issue, whether the sale of electricity generated by the company is a normal transaction of sale and purchase or not, should be first examined from the perspective of whether the agreement between the company and the WEG developer is on a principal-to-principal basis and whether the

arrangement in the extant case is within the scope of Appendix A, Service Concession Arrangements to Ind AS 11 'Construction Contracts', as discussed in paragraph 17 above.
