

Power Purchase Agreements — Navigating the Complex Accounting Landscape

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As renewable energy technology continues to improve, it has become less expensive to purchase and increasingly popular. Renewable energy — primarily solar and wind — is generally procured through a power purchase agreement, or PPA.

PPAs can be quite complicated and present some unique and interesting accounting challenges. This e-newsletter considers some relevant factors for reader awareness.

Characteristics of PPAs

PPAs may be physical or virtual (also called financial or synthetic).

With a physical PPA, or “PPPA,” the buyer (often referred to as the “off-taker”) purchases power from a producer or project owner, either for their own use or for sale to others. The power production facility (or “project”) may be built on the off-taker’s property, behind the electric meter, or somewhere off premises but on the same power grid.

Under a virtual PPA, or “VPPA,” the project is generally located on a different grid, often in a different state, and the off-taker never takes physical delivery of the power. Rather, the electricity produced by the project is sent to the grid, where it is indistinguishable from electricity generated from other sources (including non-renewable sources) and sold to others at the current market price. The off-taker is entitled to a share of the profit or loss on the sale of the power and typically obtains the rights to the renewable energy certificates (or RECs) associated with the VPPA giving the off-taker credit for the use of the renewable energy.

Off-takers may contract to purchase all the electricity generated by a project (as would be the case with a behind-the-meter installation), a fixed amount of electricity, or a percent of a project’s output. The PPA may require a fixed monthly payment, or a fixed, escalating or variable (indexed) price per kWh. Variable prices might also be limited by collars that set minimum and maximum prices. Larger projects, which can include multiple off-takers, might be set up as joint ventures or syndications. PPA incentives such as RECs and tax credits may pass to the off-takers or be retained by the project developer/owner.

The type of PPA, its structure and the pricing depend on the goals of the off-taker, the specific market (and whether the market is regulated or unregulated) and the financial needs and goals of the project developer/owner, among other things. All the variables in these arrangements raise a number of accounting questions that must be explored. Following is a discussion of some of the accounting issues that may arise from an off-taker’s perspective.

Is the PPA a Lease?

Under ASC 840-10, Leases (the current lease standard), a lease exists if any of the following conditions are met:

- The off-taker has the ability or right to operate the power generation project while obtaining or controlling more than a minor amount of the output;

- The off-taker controls physical access to the power generation project while obtaining or controlling more than a minor portion of the output; **or**
- It is remote that another party will take more than a minor amount of the output and the price paid by the off-taker is neither contractually fixed per unit of output nor equal to the current market price at the time of delivery.

Under the new leasing standard, ASC 842, which becomes effective for fiscal years beginning after December 15, 2019 (non-public entities), a lease is defined as a contract that conveys the right to control the use of an identified asset for a period of time and the customer has both a) the right to obtain substantially all the economic benefits from the identified asset, and b) the right to direct the use of the identified asset.

Given the criteria under either standard, it would seem that many PPAs would qualify as leases, particularly behind-the-meter installations. However, this is not necessarily the case. For example, where a project owner has been granted an easement allowing the owner unfettered access to a project installed on the rooftop of a building [for example, a school (the off-taker)], does the school control access to the project? Or, when the project owner retains all the credits and incentives of a project, has the off-taker obtained all the economic benefits? And, if the off-taker cannot control the output of the project or cannot change the system maintenance provider, do they have the right to direct the use of the project? These are difficult but important questions to answer in addressing the off-taker's accounting for the arrangement.

Is the PPA a Derivative?

Under ASC 815-10, Derivatives and Hedging, a derivative is defined as a financial instrument or other contract with all the following characteristics:

- There are one or more underlyings. (In the case of a PPA, this is the price of electricity.)
- There are one or more notional amounts. (In the case of a PPA, the notional amount is the specified volume, which may or may not be defined.)
- There is no initial net investment in the contract, which is often the case upon execution of a PPA.
- The contract allows for net settlement. (This is generally not the case with a physical PPA, but often is the case with a virtual PPA.)

VPPAs are more likely to meet the definition of a derivative, but even with PPPAs you might have a lease with an imbedded derivative, depending on the structure of the agreement.

If it is concluded that an imbedded derivative exists, such derivative would typically have to be adjusted to fair value at the end of each reporting period.

Is the PPA an Equity Investment or Variable Interest Entity?

While this question is less likely to arise in connection with a behind-the-meter PPA, it is an important consideration when structuring an off-promises PPPA or a VPPA. The financing structure of a project, volume or credit guarantees, and control of a project through voting or contractual rights are all elements that may cause a PPA to be classified as a variable interest entity, or a consolidated or non-consolidated equity investment. These issues should be thoroughly explored and vetted prior to finalizing the structure of a PPA.

End Note

There are many great reasons to enter into a PPA to cover some or all of your electricity needs: financial, environmental, social, regulatory and enhancement of your public profile, to name some. However, PPAs are long-term commitments and generally complex. Before signing on the dotted line, be sure to take the time to understand just how the PPA works and how the various provisions in a PPA can affect the

accounting. This will not only help avoid surprises, but can help in negotiating the PPA to achieve the financial reporting results you desire (or at least to avoid those that are undesirable).

Contact Us

If we can provide accounting assistance with a PPA or if you have any questions on this topic or any matter related to accounting and auditing, please contact the partner in charge of your engagement or the following:

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