



Solution 130.4

Component	Financial instruments for energy & utilities
Index	Embedded derivatives
Short title	“Pass-through” pricing clause (2)

Attention: This guidance is based on the revised standards and interpretations that are mandatory for accounting periods commencing 1 January 2005. A company may early adopt an individual revised standard, but only in its entirety. Guidance based on the previous version of the standards is included in the “Applying IFRS 2004” guidance.

Issue

An embedded derivative is a derivative instrument that is combined with a non-derivative host contract to form a single hybrid (combined) instrument [IAS39R.10]. Such embedded derivatives are required to be separated from the host contract if their economic characteristics and risks are not closely related to those of the host contract [IAS39R.11].

After the development of an active market for electricity in its country of operations, a railway entity enters into contracts to buy electricity in which the purchase price is indexed to the price of coal. Is the coal price indexation an embedded derivative that is required to be separated from the host contracts?

Background

A railway entity enters into electricity supply contracts whose prices include indexation to the commodity (e.g. coal) used to generate the electricity. There is an active market for electricity in its country of operations. The specific power plants that generate the electricity are identified in the contracts. However, the contracts do not qualify as leases under IFRIC 4.

Evidence shows that the price of electricity in the active market is not linked to the price of coal.

Solution

Yes. The coal-pricing clause is an embedded derivative. The indexation in the contract is not closely related to the economic risks and characteristics of the host contract since the price of electricity in the market is not directly influenced by the price of coal and the contract was entered into after the development of the active market. The entity therefore has to separate the embedded derivatives from the host contract.