

JOHNSON WINTER & SLATTERY
LAWYERS

Memorandum

Date: 2 September 2009
To: AFMA Environmental Products Committee
From: Fiona Melville

Explanatory Note

AFMA standard form Contract for Sale of Environmental Products

“Derivatives” and treatment under AASB 139/IAS 39

This note is based on the September 2009 edition of the of the Contract for Spot Purchase/Sale of Environmental Products (“Spot Contract”) published by the Australian Financial Markets Association Inc (AFMA) on its web site in the Environmental Products and Contract Documentation section.

The Spot Contract documents a transaction for the forward sale of ESCs/GACs/GECs/RECs/VEECs/VRECs and Green Power Rights. A “GAC” is a greenhouse abatement certificate created under Part 8A of the Electricity Supply Act 1995 of New South Wales or the Electricity (Greenhouse Gas Emissions) Act 2004 of the Australian Capital Territory, a “GEC” is a gas electricity certificate created under the Electricity Act 1994 of Queensland, a “REC” is a renewable energy certificate created under the Renewable Energy (Electricity) Act 2000 of the Commonwealth, a “VEEC” is an energy efficiency certificate created under the Victorian Energy Efficiency Target Act 2007 (Vic), a “VREC” is a renewable energy certificate created under the Victorian Renewable Energy Act 2006 (Vic), an “ESC” is an energy saving certificate created under Part 9 of the Electricity Supply Act 1995 of New South Wales and Green Power Rights are rights to claim eligible Green Power generation recognised under the National Green Power Accreditation Program.

This note contains general advice only and is not intended to constitute a legal opinion on which users may rely in implementing actual transactions. It is strongly recommended that intending users seek specific legal advice in relation to their own particular circumstances.

Q1. Is AFMA’s Spot Contract a “derivative” under the Corporations Act?

Under the Corporations Act 2000 (“Act”) in Australia, a number of important financial services regulations apply if a transaction is determined to be a “derivative”. Will AFMA’s Spot Contract constitute a “derivative” as defined in section 761D(1) of the Corporations Act?

The law

Section 761D(1) of the Act states that:

“For the purposes of this Chapter, subject to subsections (2), (3) and (4) a derivative is an arrangement in relation to which each of the following conditions are satisfied:

- (a) under the arrangement, a party to the arrangement must, or may be required to, provide at some future time consideration of a particular kind or kinds to someone; and*
- (b) that future time is not less than the number of days, prescribed by regulations made for the purposes of this paragraph [being one business day or less for derivatives which are not foreign exchange contracts], after the day on which the arrangement is entered into; and*
- (c) the amount of the consideration, or value of the arrangement is ultimately determined, derived from or varies by reference to (wholly or in part) the value or amount of something else (of any nature whatsoever and whether or not deliverable), including, for example, one or more of the following:*
 - (i) an asset;*
 - (ii) a rate (including an interest rate or exchange rate);*
 - (iii) an index;*
 - (iv) a commodity.”*

Analysis

In our opinion, the better view is that the Spot Contract for Sale of Environmental Products does not fall within the definition of section 761D(1) if, as is anticipated, the Unit Price (being the amount of consideration payable for the Commodity) is specified to be a fixed price. Subclause 761D(1)(c) is not satisfied, as the amount of the consideration is not derived from or varied by reference to the value of something else. The Spot Contract is simply a contract to sell ESCs/GACs/GECs/RECs/VEECs/VRECs or Green Power Rights for a fixed price at a future time.

There is a contrary argument to say that, as the Spot Contract contains a GST gross-up clause as part of the consideration for the arrangement, and the amount payable under the GST gross-up clause will be determined by the applicable rate of GST chargeable under the GST legislation, then arguably the amount of the consideration is ultimately derived from or varies by reference in part to the value of the GST rate, which is a rate within the meaning of section 761D(1)(c)(ii).

However, for reasons more fully explored in our Explanatory Note in relation the Forward Contract for ESCs/GACs/GECs/RECs/VEECs/VRECs and Green Power Rights (see section 3.11.3.40 of the AFMA Guide to Australian OTC Transactions), we believe that the better view is that the inclusion of the GST gross-up clause does not cause the Spot Contract to be a derivative when it otherwise would not be.

A party for whom this issue could cause concern and that wished to put this issue beyond doubt could, as an alternative, express the Fixed Price as a fixed price on a GST-inclusive basis and then delete the GST gross-up clause.

Q2 If the Spot Contract was a derivative would it fall within the “tangible property” exemption in section 761D(3)(a) of the Corporations Act?

If, instead of inserting a fixed price in the Spot Contract, the parties inserted a floating price, for example referable to the market price at the Settlement Date, then the Contract would fall within the definition of a derivative in section 761D(1) unless subsection (3) or (4) applies.

Section 761D(3) excludes certain arrangements, contracts or things from the definition of derivative in subsection (1) for the purposes of Chapter 7. Pertinent here is subclause 761D(3)(a) which excludes sales of *tangible property* (other than currency) at a future date if those sales must be settled by delivery of the property, rather than being cash settled or subject to set-off, and where neither usual market practice nor the rules of licensed market or licensed CS facility permit the seller's obligation to be closed out by matching with an offsetting arrangement.

The Spot Contract requires the Seller to transfer [deliver] the Commodity. If the Commodity were to be classified as tangible property the exemption would be available for the Spot Contract.

Are ESCs/GACs/GECs/RECs/VEECs/VRECs or Green Power Rights “tangible property” for the purposes of section 761D(3)(a) of the Corporations Act?

“Tangible property” is not defined in the Corporations Act.

The common or dictionary meaning of “tangible” is probably best described as “capable of being touched”. Its legal meaning may be defined slightly differently.

Historically, common law has distinguished between real property (realty) and personal property (personalty). Real property consists of land and fixtures. Personal property can be classified as either:

- a *chose in possession* (also sometimes described as tangible property); or
- a *chose in action* (also sometimes described as intangible property).

Choses in possession, or tangible property, are items capable of being the subject of actual physical possession. These would include plant and equipment (which are not fixtures), chattels, stock and unfixed machinery.

The term “chose in action” is usually used to refer to those property rights of which it is impossible to take physical possession, including those which are claimable or enforceable by action, such as debts, interests in partnerships, shares in companies and other incorporeal property.

Each of ESCs/GACs, GECs, RECs, VEECs and VRECs are created pursuant to legislation and are registered on a specifically created database. Whilst they are each called “certificates”, in fact the name “certificate” is inappropriate as a certificate of ownership is not created. Both are uncertificated entitlements made up of various rights and obligations contained in the legislation pursuant to which they are created. Green Power Rights are also uncertificated entitlements created and recognised by the Scheme pursuant to which they are created. An ESC (or a GAC/GEC/VEEC/VREC) is not a tangible thing but rather an entitlement to the benefits that accrue to the registered holder of the GAC (or GEC) under the scheme legislation, being primarily that the Scheme Administrator will accept the surrender of the ESC (or

GAC/GEC/VEEC/VREC) as a credit against the liability otherwise imposed to pay the penalty.

Similarly, a REC represents an entitlement to the benefits that accrue to the registered holder of the REC under the REC legislation, being primarily that the Scheme Administrator will accept the surrender of the REC as a credit against the liability otherwise imposed to pay the shortfall charge.

A Green Power Right represents an entitlement to the benefits that accrue to the holder of the Right under the Scheme rules, being primarily that the retailer holding the Rights can sell Green Power products to customers.

These rights are enforceable by suit by the registered holder of the ESC/GAC/GEC/REC/VEEC/VREC or Green Power Right. The right of enforcement is a chose in action, a form of intangible property.

Therefore, in our view ESCs, GACs, GECs, RECs, VEECs and VRECs are statutory choses in action, a form of intangible property, and not “tangible property” for the purposes of the Corporations Act. Accordingly, the exemption in section 761D(3)(a) does not apply to ESCs, GACs, GECs, RECs VEECs or VRECs.

Q3. Is the Spot Contract subject to AASB139/IAS39 as adopted in Australia?

AASB 132 and AASB 139 implement IAS39 for Australian entities for reporting periods beginning on or after 1 January 2005. AASB 132 contains the requirements for presenting and disclosing information about “financial instruments” and other contracts subject to the Standard and AASB 139 establishes principles for recognising and measuring financial assets, financial liabilities and certain contracts to buy or sell non-financial items.

AASB139 applies to all types of “financial instruments” except certain instruments which have been excluded (such as interests in subsidiaries, associates, and joint ventures accounted for under AASB127 or financial instruments issued by the entity that meet the definition of an equity instrument in AASB 132 (including options and warrants)).

AASB 132 (paragraph 11) defines the term “financial instrument” as:

“any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.”

The term “financial asset” is defined in AASB 132 (paragraph 11) as:

“any asset that is:

- (a) cash;*
- (b) an equity instrument of another entity;*
- (c) a contractual right:*
 - (i) to receive cash or another financial asset from another entity; or*

- (ii) *to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or*
- (d) *a contract that will or may be settled in the entity's own equity instrument and is:*
 - (i) *a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or*
 - (ii) *a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments."*

The term "financial liability" is defined in AASB 132 (paragraph 11) as:

- (a) *a contractual obligation:*
 - (i) *to deliver cash or another financial asset to another entity; or*
 - (ii) *to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or*
- (b) *a contract that will or may be settled in the entity's own equity instrument and is:*
 - (i) *a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or*
 - (ii) *a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments*

Is the Spot Contract a "financial instrument" ?

As indicated above, a financial instrument is a contract which gives rise to a financial asset of one entity. The first question to ask is therefore whether or not the underlying asset being sold under the Spot Contract is a "financial asset".

Is the underlying asset (ESC/GAC/GEC/REC/VEEC/VREC) a "financial asset"?

The definition of "financial asset" includes any asset that is a contractual right to receive cash or another financial asset from another entity or to exchange financial assets with another entity under conditions which are potentially favourable to the

entity. The Application Guidance notes indicate that the entire chain of contractual rights and obligations need to be considered (note AG7) and that, for example, a note payable in government bonds is a financial instrument as the bonds are financial assets because they represent obligations of the issuing government to pay cash. The note is therefore a financial asset of the note holder and a financial liability of the note issuer.

It could be argued that a ESC/GAC/GEC/REC/VEEC/VREC is analogous to a government bond in that its surrender to the scheme administrator relieves the entity from a financial liability which it is to otherwise pay the shortfall charge or penalty. However, whereas a bond is a contractual right to receive cash, a ESC/GAC/GEC/REC/VEEC/VREC is a statutory entitlement to be relieved of an obligation to pay cash. Application Guidance Note 12 specifies that:

“Liabilities or assets that are not contractual (such as income taxes that are created as a result of statutory requirements imposed by governments) are not financial liabilities or financial assets.”

Our opinion therefore is that the underlying commodity, the ESC/GAC/GEC/REC/VEEC/VREC or Green Power Right is not a “financial asset” as defined in AASB 132.

Is the Spot Contract a financial instrument if it can be cash settled?

If the underlying asset is not a “financial asset”, is the Spot Contract nevertheless a financial instrument if it can be settled net in cash?

AASB 132 paragraph 2 states that the presentation requirements apply to the classification of financial instruments from the perspective of the issuer. On the face of it each party could be the issuer of a Spot Contract and from the perspective of the Seller the Seller is receiving a cash and the Buyer has an obligation to pay cash. However, the Application Guidance note 20 states that:

“Contracts to buy or sell non-financial items do not meet the definition of a financial instrument because the contractual right of one party to receive a non-financial asset or service and the corresponding obligation of the other do not establish a present right or obligation of either party to receive, deliver or exchange a financial asset. For example, contracts that provide for settlement only by receipt or delivery of a non-financial item (eg an option or forward contract on silver) are not financial instruments. Many commodity contracts are of this type. Some are standardised in form and traded on organised markets in much the same fashion as some derivative financial instruments. For example, a commodity futures contract may be bought and sold readily for cash because it is listed for trading on an exchange and may change hands many times. However, the parties buying and selling the contract are, in effect, trading the underlying commodity. The ability to buy or sell a commodity contract for cash, the ease with which it may be bought or sold and the possibility of negotiating a cash settlement of the obligation to receive or deliver the commodity do not alter the fundamental character of the contract in a way that creates a financial instrument. Nevertheless, some contracts to buy or sell non-financial items that can be settled net or by exchanging financial instruments, or in which the non-financial item is readily convertible to cash, are within the scope of the Standard as if they were financial instruments (see paragraph 8).”

In other words, applying Application Guidance Note 20, the Spot Contract is a contract to buy and sell non-financial items (ESCs, GACs, GECs, RECs, VEECs and

VRECs), because the fundamental character of the Spot Contract is the sale of the underlying non-financial commodity for a cash consideration, and it will be outside the scope of AASB 132 unless paragraph 8 applies.

Paragraph 8 of AASB 132 states that:

“This Standard shall be applied to those contracts to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, as if the contracts were financial instruments, with the exception of contracts that were entered into and continue to be held for the purposes of the receipt or delivery of a non-financial item in accordance with the entity’s expected purchase, sale, or usage requirements.”

This paragraph does not apply to Spot Contracts as there is no cash settlement option, nor do we understand that there is a custom or market acceptance for them to be settled in cash or by exchange for financial instruments. The Spot Contract is therefore not subject to the Standard AASB 132 or AASB 139.

Our opinion would be different if the market developed such that, either expressly or impliedly, there arose an arrangement or understanding by which the Spot Contract could be settled net in cash rather than by delivery.

Q4. Is the AFMA spot contract for ESCs/GACs/GECs/RECs/VEECs/VRECs a “derivative” for the purposes of IAS39 as adopted in Australia?

Certain “financial instruments” or other contracts within the scope of AASB 139 (paragraph 2-7) are defined as “derivatives” if all three of the following characteristics:

- (a) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the ‘underlying’);*
- (b) it requires 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*
- (c) it is settled at a future date.”*

The consequence of a contract being a derivative is that the contract will be categorised as “financial assets at fair value through profit and loss” and will be recognised and valued according to the rules applicable to this type of categorisation.

In our opinion, the Spot Contract does not fall within the definition of “financial instruments” or other contracts within the scope of AASB 139 (paragraph 2-7), nor does it fall within the definition of “derivative”, as paragraph (a) is not satisfied. The Spot Contract is not therefore not a “derivative” under the Standard.