



MAJOR ELECTRICITY USERS' GROUP

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Technical Director – Accounting Standards
New Zealand Institute of Chartered Accountants
PO Box 11 342
WELLINGTON

By email to ASD@nzica.com

Attention: Joanna Yeoh, Project Manager – Accounting Standards

Dear Joanna

Submission on International Accounting Standards Board Discussion Paper on Fair Value Measurements in relation to electricity financial derivatives

1. This is a submission by the Major Electricity Users' Group (MEUG) on the International Accounting Standards Board (IASB) Discussion Paper titled, *Fair Value Measurements* (the "DP") issued by the Financial Reporting Standards Board (FRSB) of the New Zealand Institute of Chartered Accountants.
2. MEUG is a trade association representing large electricity consumers'. Member companies of MEUG are listed in the appendix to this submission. Several MEUG members were consulted in the preparation of this submission. Some MEUG members may make submissions also.
3. In relation to electricity financial derivatives (EFDs), this submission comments on:
 - a) Generic changes for defining and applying fair value measurement per the DP, ie:
 - i) The proposed fair value hierarchy;
 - ii) Whether an exit (selling) value is appropriate for EFDs; and
 - iii) Blockage factors.
 - b) Improving market and regulatory information in New Zealand to improve measurement of fair value for EFDs; and
 - c) Problems encountered with the application of the existing New Zealand International Accounting Standard number 39 (NZ IAS39) for EFDs and a suggestion for improving those practices.
4. The opening section of this submission provides background on how large end users' manage their risks with EFDs.

Background

5. Purchasing EFDs is one strategy large electricity consumers use to manage electricity purchase cost risks. Valuing EFDs for financial reporting purposes to comply NZ IAS 39 has been problematic because:
- a) There is no transparent market for EFDs and hence valuations based on a number of other input factors are needed¹. The most important of these input factors is the forward spot price.
 - b) Forward spot prices are observable in the “energyhedge” forward market developed by the five largest electricity suppliers for small quarterly trades (refer www.energyhedge.co.nz).
 - c) The relationship between the observable forward prices on energyhedge and fair valuations of EFDs is complicated by factors such as:
 - i) Energyhedge trading and prices are for small base load increments (0.25 MW) for at most three years and only at the Haywards Grid Exit Point (GXP). By comparison EFDs can be in excess of 10 MW, frequently are for 5 years and in some cases for 10 years, and can apply to different GXP (there are over 240 GXP) and therefore have significant locational price differentials relative to Haywards GXP prices.
 - ii) Prudential levels differing between transactions between energyhedge counterparties and the parties to EFDs.
 - iii) Possible exercise of market power by electricity suppliers. This is currently the subject of a Commerce Commission investigation into possible breaches of Part II of the Commerce Act.

Resolving possible issues of fair prices in relation to fair competition is of course outside the scope of the FRSB.
6. A practical example of the wide variation between energyhedge forward prices and the complexity to then value EFDs follows. Some MEUG members in offering to sell excess EFDs to suppliers have been quoted prices almost half that of equivalent term prices on energyhedge. The same MEUG members when seeking a price to buy from energyhedge were offered prices significantly in excess of energyhedge prices. In the latter case the margin appears to have been well in excess of margins required to cover prudential differences between the end consumer and that of suppliers.

Generic changes to accounting standards

7. MEUG has four comments on the DP:
- a) MEUG agrees with the proposed fair value hierarchy prioritising prices in active markets (Level 1 inputs) as better reflections of fair value than values based on unobservable inputs for the asset or liability (Level 3).
 - b) MEUG has concerns with applying an exit (selling) price rule for measuring fair value in relation to EFDs in New Zealand. A consumer or generator deciding to exit from owning EFDs may not find that possible because there are no buyers even at distress prices. “Selling” to another party through assignment may not be considered a complete exit because liabilities remain with the original counterparty. Using a novation to exit a position is dependent on the agreement of the EFD vendor to

¹ There is a fixed price contracts index published by M-co (refer www.COMITfree.co.nz) however it is widely recognized that this is not a fair measure. For example it is not clear if the index aggregates EFDs only or might also include large physical contracts. The methodology to standardize “contracts” (scaling to a common volume across trading periods and location) is not transparent. And the date contracts are reported in the index may reflect the date the contract was signed rather than the date the contract takes effect.

accept the novation and this can also be a barrier to exiting. Assignment and novation are common practice for parties adjusting their EFDs portfolio but often there is no active market to actually assign or novate. Therefore a strictly exit price rule for EFDs may not be practical.

- c) MEUG has concerns that blockage factors might be precluded if prices for EFDs become more transparent. Again our concern is that in thin relatively slow growing markets, especially ones which have no prospect of cross-border competition such as the New Zealand electricity market, then buyers and sellers can and do achieve significant scale economies.
- d) It is essential that parties valuing EFDs do not also audit those valuations. The confidence of parties relying on auditor opinions would be undermined if the same parties, even under the guise of "Chinese walls," were allowed to also value EFDs.

Improving market and regulatory information to improve fair value measures of EFDs

- 8. MEUG suggest the following actions to improve availability and quality of market and regulatory information and thereby improve, amongst other things, the measurement of fair value for EFDs:
 - a) Electricity suppliers further improving energyhedge. For example extending the years that energyhedge trades and reducing the spread between must offer and must bid prices. The FRSB can't influence this.
 - b) The FRSB could though support regulatory initiatives to improve greater transparency of EFDs. For example the Electricity Commission is considering mandatory publication of aggregated information on all EFDs subject to a de minimus level and protecting information that is commercially sensitive. The FRSB could assist in that process by ensuring regulations drafted by the Electricity Commission were consistent with NZ IAS39, consistent with the likely direction that the IASB will evolve IAS39 and to keep transaction costs as low as possible.

Improving the application of NZ IAS 39

- 9. Accounting for EFDs can result in very large changes in values month by month and year by year. For example for the quarter just ended New Zealand had relatively healthy lake levels whereas this time last year there had been a prolonged drought. Actual and forward spot electricity prices have therefore been highly volatile and this has been reflected in fair value measures of EFDs. There appears to be some confusion by parties about how NZ IAS39 is applied, and this is heightened by the volatile valuations.
- 10. For example there are anecdotal reports of parties applying percentage caps on EFDs relative to physical exposures each month to define "normal" risk hedging versus speculative hedging. The basis for using such a threshold is unclear. Even if such a threshold were appropriate, it should be applied consistently by all valuers and auditors. The application of such rules to parties using hedge accounting and those that don't also appears to be a point of confusion.
- 11. MEUG suggest the FRSB could facilitate a dialogue between EFD suppliers, buyers and auditors to discuss some of the more technical aspects of the electricity market to ensure valuation techniques in the absence of active market prices are "fair." There may even be a case for a New Zealand EDFs standard or similar.

Concluding comments

12. It will be several years before specific amendments or new standards are proposed by the IASB on measuring fair value after the likely consultation on an Exposure Draft for standards next year. We shouldn't wait for that process while there is some confusion in applying NZ IAS39 in relation to EFDs that could be fixed. New Zealand can and should also be proactive about developing active markets or mandatory disclosure requirements to allow "fair values" for EFDs to be directly observed well in advance of the IASB prescribing various rules to be used in valuations.
13. Copies of this submission have been referred to the Electricity Commission and electricity suppliers for their information.

Yours sincerely



Ralph Matthes
Executive Director

cc Electricity Commission, Mr Tim Street
cc Contact Energy, Peter Macintyre
Genesis Energy, Malcolm Alexander and John Carnegie
Meridian Energy, MaryAnn Mitchell and Mike Roan
Mighty River Power, James Moulder, Neil Williams and Robert Allen
Todd Energy, Charles Teichert
Trustpower, Keith Tempest

Appendix: MEUG members electricity consumption and own generation					
MEUG member ²	Load GWh/y	Gen. GWh/y	Net GWh/y	Peak	
Auckland International Airport Ltd	23	-	23	13 MVA	www.auckland-airport.co.nz
Business NZ	n.a.	n.a.	n.a.		www.businessnz.org.nz
Canterbury Meat Packers Ltd.	41	-	41		www.cmp.co.nz
Carter Holt Harvey Limited	1,105	260	845	130 MW	www.chh.co.nz
Rio Tinto Aluminium NZ Ltd	5,000	-	5,000	580 MW	www.riotintoaluminium.com
Dongwha Patinna NZ Ltd	58	-	58	9 MW	www.patinna.com
Fletcher Building Limited	454	-	454		www.fletcherbuilding.com
Heinz Wattie's Ltd	56	-	56		www.watties.co.nz
Holcim (New Zealand) Ltd	70	-	70		www.holcim.com/nz
Lion Breweries	23	-	23	6.5 MW	www.lion-nathan.co.nz
Methanex New Zealand Ltd	18	-	18		www.methanex.com
New Zealand Steel Ltd	1,045	600	445	106 MW	www.nzsteel.co.nz
Norske Skog	1,300	230	1,070	170 MW	www.norske-skog.com
Oceana Gold Ltd	152	-	152	16.5 MW	www.oceanagold.com
Pan Pac Forest Products Ltd	550	66	550	78 MW	www.panpac.co.nz
Ravensdown Fertiliser Co-op	28	22	6		www.ravensdown.co.nz
Solid Energy New Zealand Ltd	29	-	29		www.coalnz.com
Tegel Foods Ltd	56	-	56		www.tegel.co.nz
Telecom New Zealand Ltd	190	-	190		www.telecom.co.nz
The New Zealand Refining Co. Ltd	235	-	235		www.nzrc.co.nz
Winstone Pulp International Ltd	330	-	330	48 MW	www.wpi-international.co.nz
Wood Processors Assoc of NZ	n.a.	n.a.	n.a.		www.wpa.org.nz
	<u>10,763</u>	<u>1,178</u>	<u>9,585</u>		
NZ total demand ³	36,898				
MEUG as percentage of total ⁴	29%				

² Load, generation and peak load data may not be up to date because of changes in operations by individual companies since last surveyed by MEUG.

³ Refer Ministry of Economic Development, Energy Data File, January 2006, p139, demand for year ended 30 March 2005

⁴ Excluding demand by non-MEUG members of Business NZ and Wood Processors Association