CL 137H

COMMENTS BY EURELECTRIC TO IASB

PROPOSED IMPROVEMENTS TO IAS 32 AND 39

Financial Instruments

General remarks

1. Paragraph 7 of amended IAS 39 establishes that

   "...a contract to buy or sell a non-financial item meets the definition of a derivative and is within the scope of this Standard if the entity has a practice of settling such contracts net in cash (either with the counterparty or by entering into offsetting contracts).. ..."

   Eurelectric believes that it is necessary to draw IASB's attention to some issues affecting the application of financial instruments accounting to power market activities:

   1. Defining What Constitues a Financial Instrument for Accounting Purposes

   Some non-financial items, that is, commodities, may have peculiar characteristics that lead to contracts of a similar form of a financial instrument. However, these seeming financial contracts have to adopt this form as a result of the peculiar nature of the commodity purchased or sale in the normal course of business. This kind of arrangements have become quite common, following the expansion of wholesale competition in markets for natural gas in the 1 980s and for electric power in the 1990s

   For instance, electricity has a unique characteristic as a commodity, which is that it cannot be stored in significant quantities. Due to this peculiarity, some of the contracts to buy and sell electricity may permit the buyer some flexibility in determining when to take electricity and in what quantity or may permit entering into offsetting contracts to avoid power imbalances that will endanger the system as a whole. It is worth emphasising that these contracts are derived from the normal course of the electricity business; even sometimes resulting from the market rules set by the public authorities, and they should not be regarded as speculative arrangements.

   Another example of some recurrent contracts that might end up being seen as financial instruments can be found in the gas and electricity industries. One singular feature of these industries is that they required large infrastructure investments. As a result, fixed costs represent a very high percentage of the total cost of producing or transporting electricity or gas. In order to recover such fixed costs, contracts typically include a specified fixed charge, plus a variable charge to recover variable costs. These fixed charges or capacity payments have been initially considered by FAS 133 as the premium payment that is comprised in an option contract, being the variable element the other part of the contract, which is paid only if the option is exercised. The FASB finally accepted the case that these agreements are unique and issued some guidance (DIG Issue C15) to allow these agreements to be excluded from financial instrument accounting, albeit with some requirements to get this relief.

These contracts are entered into as a consequence of the normal course of business and not as a result of speculative practices. The buyer of the electricity under the contract may be contractually or even legally obliged to maintain sufficient capacity to meet electricity needs of its retail or wholesale customer base.

Therefore, it would be advisable to exclude these contracts from the scope of the amended version of IAS 39.

2. Interaction Between Energy Trading and Financial Instrument Accounting

It is also worth considering whether the IAS should seek to establish separate accounting guidance for energy trading activity (as distinct from financial instruments: the one being the activity, the other being the form of the contract, if you will) and, if so, how such energy trading guidance should interact with guidance on financial instruments (a company might be engaged in trading activity that is not in financial instruments which is why the additional guidance came to be issued). Under US GAAP, there are some tensions between the requirements of FAS 133 on financial instruments and EITF 98-10 on energy trading activities. One occasionally needs to consider which set of GAAP should have precedence. There are many definitional issues in defining what should be energy trading (the broad intention of which is speculation from taking positions) and what should be hedging activity within energy markets (the broad intention of which should be to reduce risk through eliminating positions), since the nature of the businesses and the markets mean that there may not be a clear line between these two activities.

2. Eurelectric expresses its general agreement with regard to EFRAG's objections to the current hedge accounting rules and EFRAG'S proposal that in all cases the accounting for a hedging instrument should follow the accounting for the hedged item during the life of the hedge.

   Eurelectric share EFRAG's views against the current opposite procedure (that the accounting treatment for the hedged item has to follow that of the hedging instrument).

   Consequently, as a response to question 8 raised by IASB in the draft standard, Eurelectric also disagrees with the proposed amendment to account a hedge of an unrecognised firm commitment as a fair value hedge instead of a cash flow hedge (par. 140)