Dear Sir / Madam

Response to Exposure Draft 2010/9 Leases

We welcome the opportunity to respond to the above exposure draft (‘ED’).

Solid Energy New Zealand ("Solid Energy") is one of New Zealand’s largest primary energy producers, a major exporter and a significant New Zealand player in the global natural resources and commodity markets. Solid Energy is a State Owned Enterprise and therefore our financial results are consolidated by the New Zealand Government.

Solid Energy is a significant lessee of plant and machinery, property and office equipment.

Our responses to the specific questions raised in the ED are attached below in Appendix 1. Before addressing these, we wish to make some observations of a more general nature on the overall direction of the International Accounting Standards Board's (the "IASB's" or "Board's") leases project.

We do not support the proposals in the ED which requires lessees to recognise a right-of-use asset and corresponding liability for lease arrangement that are not financing arrangements in nature. Our view is based on the following points which are elaborated in Appendix 1:

- The ED, whilst addressing the subjectivity of lease classification applied under NZ IAS 17, creates significant subjectivity in the application of judgement to the determination of lease terms and lease payments.

- This application of judgement is likely to result in volatility in assets and liabilities which will impact on non-accounting issues such as bank covenants.

- The standard itself will cause volatility in assets and liabilities as changes to lease agreements will cause significant changes to the balance sheet. Organisations are likely to change their behaviour in order to manage their balance sheet disclosures.

- We note that the proposed accounting treatment for leases will be inconsistent with the current accounting for non-lease executory contracts. There is no obvious reason as to why this disparity occurs.
The ED does not provide an appropriate outcome where the substance of the lease arrangements are simple short term leases of equipment where the risk and rewards of ownership are not transferred to the lessee.

Both the profit and loss impact, where the total expense is skewed towards the earlier stages of the lease, and the balance sheet impact, where there will be an asset and a liability will create difficulty for users to conceptualise the rationale behind these balances.

We believe that the costs involved with application of the ED for financial reporting purposes, including the costs associated with taxation and consolidation adjustments will outweigh the benefits to users.

We propose the current distinction between an operating lease and financing lease is maintained and:

- that entities recognise an asset and liability only where the substance of the transaction is a financing arrangement.

- that where the substance of the transaction is a financing arrangement, the lease asset and liability are measured at the value that reflects an unconditional obligation to make payments.

- that if necessary and practical disclosures be expanded to make ownership, lease and contractor arrangements more comparable for readers. We support full and clear disclosure.

Our proposed treatment would address many of our concerns and would also assist in aligning lessee and lessor accounting treatments.

We would be happy to discuss our concerns with you. Please contact me if you require any further information.

Yours faithfully

[Signature]

Warren Maslin
Chief Financial Officer
Solid Energy New Zealand Limited
Appendix 1 – IASB - Solid Energy Responses to Invitation to Comment
QUESTIONS TO WHICH WE HAVE SPECIFIC COMMENTS

1850-100
Comment Letter No. 105

Question 1 – Lessees

(a) Do you agree that a lessee should recognise a right-of-use asset and a liability to make lease payments? Why or why not? If not, what alternative model would you propose and why?

(b) Do you agree that a lessee should recognise amortisation of the right-of-use asset and interest on the liability to make lease payments? Why or why not? If not, what alternative model would you propose and why?

(a) We do not agree with the proposed treatment to recognise a right-of-use asset and liability for the following reasons:

- This proposed treatment will significantly alter the face of the statement of financial position, but will not reflect the substance of these types of transactions, where the risks and rewards are not transferred to the lessees. In many instances, the nature of the payment is not a financing arrangement; rather, it is a payment to use an asset for a specified period of time.

- We understand that one of the major reasons behind the introduction of the ED to replace NZ IAS 17 Leases was due to the subjectivity that NZ IAS 17 created on the determining whether the classification of a lease was an operating or finance lease. Whilst the ED resolves the subjectivity surrounding classification, by treating all leases in an identical way, significant subjectivity is introduced in the measurement of the asset and liability, in particular in respect of the determination of the lease term.

- This proposed treatment to recognise additional liabilities will impact borrowing covenants (e.g. equity ratios, gearing ratios etc). Small subjective changes in the measurement of the financial liabilities (e.g. in determining lease terms of incremental borrowing rates) can have a significant impact on balance sheet liabilities and can potentially cause breaches in banking covenants. Under the proposals there is a risk that a decision to increase the probability of a lease extension being adopted will cause a breach of banking covenants. This is a perverse and unacceptable position. We do not believe that the users of our financial statements will appreciate that the volatility in the measurement assets and liabilities are due to subjective decisions such as the “determination of the longest lease term that is more likely that not to occur”.

- The recognition of a right-of-use asset and a liability to make lease payments for lease arrangements will be significantly different to the accounting for non-lease executory arrangements. A non-lease executory contract would occur when a contract is signed to perform a transaction in the future, usually for the provision of goods or services. A common example in our industry is the difference between using a long term contractor to operate a site or leasing equipment directly and operating the site ourselves. The contractor will need to make their own arrangements to provide the relevant plant to operate the site and this will form a significant part of the cost we incur for the provision of their service. Under the existing guidance where Solid Energy leases the plant, the leasing arrangement would typically be classified as an operating lease and the accounting treatment and disclosures would be similar for both the operating lease and long term contractor arrangements. Under the exposure draft there is a significant
difference in accounting which we believe does not reflect the substance of the actual difference between the arrangements. We do not understand why there should be such a difference in the accounting treatment between a lease arrangement and non-lease executory arrangements.

- Our financial statement readers will observe a right-of-use asset and an obligation measured at different values. It is very difficult for users of the financial statements to understand what the net asset or liability represents. In our view the net position does not represent movements in the value of the business, particularly when the nature of the lease arrangements are not in substance financing arrangements.

We believe that where there is a financing arrangement, the lessee’s liability should be measured in accordance with the conceptual framework and the asset measured on a consistent basis. That is, a liability should only be recognised to the extent that there is an unconditional obligation to make lease payments. Thus all non-cancellable and unavoidable payments owed by the lessee should be included in the recognised obligation.

We propose:

- that entities recognise an asset and liability only where the substance of the transaction is a financing arrangement.

- that where the substance of the transaction is a financing arrangement that the lease asset and liability are measured at the value whereby there is an unconditional obligation to make payments.

- that if necessary and practical disclosures be expanded to make ownership, lease and contractor arrangements more comparable for readers.

Our proposed treatment would address many of our concerns and would also assist in aligning lessee and lessor accounting treatments.

(a) We agree that a lessee should recognise amortisation of the right-of-use asset and interest on the liability to make lease payments, but only when the lease arrangement is determined to be a financial arrangement.

We do not agree that the proposed treatment when the nature of the arrangement is not a financing arrangement for the following reasons:

- This recognition of the expense will not reflect the actual pattern of economic benefits that are received from leased assets, if the periods of the leases are not significant. Therefore the substance of the transactions will not be reflected in their form. The expense charged to the statement of comprehensive income will not be consistent throughout the period of the lease, as the earlier years of the lease will have a greater expense than the later years.

- The reclassification of the current lease expense payments as amortisation will result in a significant uplift in the measurement earnings before interest and tax (‘EBIT’) and earnings before interest, tax, depreciation and amortisation (‘EBITDA’). This will mean any agreements based on EBIT or EBITDA must be re-evaluated. The change will also be confusing for users of the financial statements, who regard lease payments as an operating expense that should be included in EBIT and EBITDA.
Question 8: Lease term

Do you agree that a lessee or a lessor should determine the lease term as the longest possible term that is more likely than not to occur taking into account the effect of any options to extend or terminate the lease? Why or why not? If not, how do you propose that a lessee or a lessor should determine the lease term and why?

- We have significant concern regarding whether entities would be able to appropriately estimate lease terms, particularly for renewals in the distant future. The definition of the lease term is likely to give rise to significant areas of subjectivity that could have significant impact on the balance sheet.
- Where it has been determined that the lease arrangement is a financing arrangement we believe that the lease term should be the period in which the lease is non-cancellable by the lessee.

Question 17 – Benefits and costs

Paragraphs BC200-BC205 set out the boards’ assessment of the costs and benefits of the proposed requirements. Do you agree with the boards’ assessment that the benefits of the proposals would outweigh the costs? Why or why not?

The above points will require a significant level of attention and time to implement. This is not considered an efficient use of resource where only simple short-term leasing arrangements exist, which do not require such complex accounting.

Similarly, under the changes proposed by the ED, the presentation in the financial statements will be more complex than under the existing guidance. This will require the users of the financial statements to take extra time and attention to interpret the information; which is not considered an efficient use of resource where only simple leasing arrangements exist.

Solid Energy have significant leasing arrangements with other state owned enterprises. We note that under the proposals the lessee accounting and lessor accounting are likely to provide different measurement base and profit or loss impacts that will need to be eliminated on Crown consolidation.

The differences between lessee and lessor accounting give rise to the likelihood that consolidation adjustment will be required and the cost of performing this exercise should not be underestimated.

Further we note that the divergence between accounting and taxation rules on lease accounting will add additional costs to the preparation of income tax computations and deferred tax computations.

Question 18 – Other comments

Do you have any other comments on the proposals?

It is our opinion that a degree of judgement is required in calculating the incremental borrowing rate to be used in the initial measurement of the right-of-use asset and the liability to make lease payments. This element of judgement means that the resulting asset and liability and the expense charged to the statement of comprehensive income may not accurately reflect the substance of the transaction.