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**Memorandum**

**Date:** 12 July 2013  
**To:** Australian Financial Markets Association  
**From:** Amanda Seaton

**Explanatory Note**

**AFMA standard form Spot Contract for Sale of Environmental Products**

**“Derivatives” under the Corporations Act 2001**

This note is based on the July 2013 edition of the Contract for Spot Purchase/Sale of Environmental Products (“Spot Contract”) published by the Australian Financial Markets Association Ltd (AFMA) on its website in the Environmental Products and Contract Documentation section.

The Spot Contract documents a transaction for the forward sale of Environmental Products, being ESCs, GACs, GECs, LGCs, STCs, GRECs, VEECs, Eligible ACCUs and Voluntary NKACCUs. 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, an “LGC” is a large-scale generation certificate created under the *Renewable Energy (Electricity) Act 2000* of the Commonwealth (“REC Act”), an “STC” is a small-scale technology certificate created under the REC Act, a “GREC” is an LGC created by a generator accredited under the National GreenPower Accreditation Program, a “VEEC” is an energy efficiency certificate created under the *Victorian Energy Efficiency Target Act 2007* (Vic) and an “ESC” is an energy saving certificate created under Part 9 of the *Electricity Supply Act 1995* of New South Wales. An “Eligible ACCU” is an Australian carbon credit unit issued under the *Carbon Credits (Carbon Farming Initiative) Act 2011* (Cth) (“CFI Act”) that is also an eligible Australian carbon credit unit under the *Clean Energy Act 2011* (Cth) and a “Voluntary NKACCU” is a non-Kyoto Australian carbon credit unit (as defined in the CFI Act) that is not also an Eligible ACCU.

**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 and accounting advice in relation to their own particular circumstances.**

This note does not apply to transactions for Eligible ACCUs or Voluntary NKACCUs. This is because the products are regulated as financial products under the *Corporations Act 2001 (Cth)*.<sup>1</sup>

*Q1. Is AFMA's Spot Contract a "derivative" under the Corporations Act?*

Under the Corporations Act ("Act") a transaction that is a "derivative" under section 761D(1) is also a "financial product" under section 764A(1)(c) and so, a number of important financial services regulations apply. The purpose of this note is to consider whether AFMA's Spot Contract constitutes a derivative as defined in section 761D(1) of the Act.<sup>2</sup>

### ***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 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<sup>3</sup>] 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 order to be a derivative for the purposes of section 761D(1) of the Act, a contract must satisfy each of paragraphs (a), (b) and (c) of section 761D(1).

The Spot Contract satisfies paragraph (a) and we assume for present purposes that it also satisfies paragraph (b).

Does the Spot Contract satisfy paragraph (c) of section 761D(1)? First, section 761D(1)(c) refers to the "*amount of the consideration, or value of the arrangement*". Secondly, section 761D(1)(c) applies where the consideration or value "*is ultimately determined, derived from or varies by reference to (wholly or in*

<sup>1</sup> Refer to section 764A(1) of the Corporations Act and the related regulations in the *Corporations Regulations 2001 (Cth)*.

<sup>2</sup> There are other categories of financial product under the Corporations Act. This note considers only the derivatives definition.

<sup>3</sup> Regulation 7.1.04(1), but refer also to section 761(D)(2) and regulation 7.1.04(2).

*part) the value or amount of something else (of any nature whatsoever and whether or not deliverable), including, for example ...”*

It is convenient first to consider the amount of the consideration in the Spot Contract.

The amount of the consideration is (for one party) the future delivery of the commodity and (for the other party) the future payment of the Unit Price multiplied by the Sold Commodity, grossed up for GST.

Is the GST rate a “something else” within the meaning of section 761D(1)(c) of the Act? It is possible to adopt a very broad interpretation of the words “something else”, as illustrated by the decision of the Court of Appeal of New South Wales in *International Litigation Partners Pte Ltd v Chameleon Mining NL* [2011] NSWCA 50. We consider that there is a real prospect that the broad interpretation of section 761D(1)(c) will be adopted in future cases such that the GST rate is capable of being a “something else” for the purposes of section 761D(1)(c).<sup>4</sup>

Even if the GST rate is a “something else”, can it be said that in the case of the Spot Contract, the amount of the consideration “is ultimately determined by, or derived from, or varies by reference to (wholly or in part) the value or amount of” the GST rate? We think it is unlikely that a court would find that the GST gross up in the Spot Contract satisfies that part of the definition.

It is also necessary under section 761D(1)(c) to consider the “*value of the arrangement*” and whether that value “*is ultimately determined, derived from or varies by reference to (wholly or in part) the value or amount of something else*”.

A similar point arose in the Federal Court in the matter of *Keynes v Rural Directions*<sup>5</sup>. That matter concerned forward contracts for the sale of grain and whether the contracts were derivatives. In the course of their decisions, both Besanko J at first instance and the Full Court on appeal considered whether the value of a forward commodity contract varies by reference to the market price of the underlying commodity for the purposes of section 761D(1). At first instance, Besanko J rejected the argument.<sup>6</sup> The Full Court did not need to decide the point since it agreed that section 761D(3)(a) applied and the contracts in question were not derivatives. The Full Court nonetheless referred to the question whether the value of a forward contract can be said to vary by reference to the market price of the underlying commodity. It cast some doubt on the approach of the primary judge, but declined to determine the question.<sup>7</sup>

Based on the decision of the Besanko J, we consider that the Spot Contract is not a derivative by reason of the value varying by reference to the market price of the underlying commodity. Nonetheless the comments of the Full Court create some legal uncertainty.

### **Conclusions**

We conclude that the Spot Contract is not a derivative under section 761D(1).

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<sup>4</sup> We note for completeness that if the Forward Contract used some market reference price or index reflecting the market price of the Environmental Product commodity as the Cash Settlement Price (as is usual in most cash-settled forward commodity transactions), then it would also satisfy paragraph (c) of section 761(D)(1) of the Act, and hence would be a derivative.

<sup>5</sup> *Keynes v Rural Directions* (2) [2009] FCA 567; decision on appeal at [2010] FCAFC 100.

<sup>6</sup> *Keynes v Rural Directions* (2) [2009] FCA 567 at [87].

<sup>7</sup> At [62].

In relation to the GST gross-up clause, a party who wishes to put this point beyond doubt could, as an alternative, express the Unit Price on a GST-inclusive basis and then delete the GST gross-up clause.

We consider that the comments of the Full Court of the Federal Court in *Keynes v Rural Directions* has created some legal uncertainty about the application of the Act to forward commodity contracts for intangible property, such as the Spot Contract. Users of the Spot Contract should consider whether such legal uncertainty presents any risk to them.

*Q2: Does the Spot Contract fall within the “tangible property” exemption in section 761D(3)(a) of the Corporations Act?*

Section 761D(3) excludes certain arrangements, contracts or things from the definition of derivative in subsection (1) for the purposes of Chapter 7. Under section 761D(3)(a), the section only applies to sales of tangible property (other than currency).

In our view the section does not apply on the basis that Environmental Products are not tangible property within the meaning of the section.

**Johnson Winter & Slattery**