MARSTEL
TERMINALS
LIMITED

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12 November, 2010

Mr Kevin Stevenson
The Chairman
Australian Accounting Standards Board
PO Box 204
Collins Street West
Victoria 8007 AUSTRALIA

Email: standard@aasb.gov.au

Dear Mr Stevenson,

ED 202R: Leases

Our comments and recommendations regarding ED 202R are provided in this submission. Our comments are given under item 4 General comments rather than items 1-3 of the AASB Specific Matters for Comment.

Marstel Holdings Pty Ltd and its subsidiary companies is a private company group which operates bulk liquid storage tank farms in Australia and New Zealand. It operates predominantly on leased land and its accounts would be materially impacted by introduction of the proposed lease standard.

In summary, Marstel generally concurs with the proposals of the Standard for shorter term leases of assets that are generally available for purchase by a lessee.
However, Marstel recommends that the Standard setters consider including additional "scope exclusions" under clause 5 for leases greater than a certain period (including all renewal rights) and/or for leases of certain types of assets (e.g. infrastructure land and other like assets which are not available for purchase by a lessee) due to uncertainties in selecting a discount rate and future lease payments.

Please do not hesitate to contact me if you wish to discuss further any matters arising from this submission.

Yours sincerely,

MARSTEL HOLDINGS PTY LTD
Anne Catley CFO

EXPOSURE DRAFT LEASES
ED/2010/9

Comments by

Anne Catley, CA
Chief Finance Officer, Alternate Director,
Marstel Holdings Pty Ltd and subsidiaries

Background of Marstel Group

Marstel Holdings Pty Ltd and its subsidiary companies (the Marstel Group) operate bulk liquid storage tank farms in Australia and New Zealand. The industry usually operates within a Port precinct on Port owned land, with exceptions only in minor regional port locations. It is highly unlikely that Port owned land will be available for a terminal operator to purchase. This business model is used by Ports throughout the world and applies to stevedoring and other Port users in addition to terminal companies.

Often the terms of the Port leases include options to extend the term. The Marstel Group makes a significant investment in tanks, piping, site works etc on terminal sites. Under normal business conditions the company expects to extend its leases, by exercising all renewal rights, to optimize the return from the capital investment, and to maintain the "going concern" business.

Background of Marstel Group Leases

The Marstel Group accounts show rental expense on operating leases in the year ended 30 June 2010 of AUD999,422.

Lease commitments disclosed in the Group accounts are AUD20,455,472 at 30 June 2010. The commitment is calculated until the first lease expiry option in current day dollars. Based on the maximum lease term available under the leases the contingent liability using current rental rates is approx AUD29M.

Both the expense and lease commitment relate almost solely to leases of land owned by Port authorities as described above ("infrastructure" land).

Implementation of the lease standard will have a material impact on the statement of financial position for the Group.

General Comments relating to Long Term Leases of Infrastructure Land

The first line of the Introduction section of the Standard states "Leasing is an important source of finance". The land that Marstel leases from "infrastructure" bodies is typically never available for purchase in the first instance. Further, such leases do not have, and probably never will have, a lessee purchase option. Therefore, Marstel's leases do not represent a source of purchase finance. Hence, a significant distinguishment to the circumstances of a lessee of a computer, a motor vehicle, or an aircraft.

Case Study

A case example is presented to demonstrate the implications of adoption of the proposed lease standard. The information is from a lease agreement signed by a Marstel subsidiary with a Port Authority. Marstel has a further lease with an expiry date of 2057, thus the lease described below is not an isolated case.

Inception of the lease: 1 August 1973
Initial Term: 21 years
Initial Rental NZD5,760 per annum from 1 August 1973
Rental Review: After 10 years in each lease renewal, adjusted to current market rent
Options: 3 further terms of 21 years each
Maximum lease period: 84 years (4 periods of 21 years)
Lease expiry: 31 July 2057

Rental history:
1 August 1973 NZD5,760
1 August 1983 NZD48,000
1 August 1994 NZD58,450
1 August 2004 NZD177,050 (8.7% of July 2003 valuation)

Valuation of Land- July 2003 NZD2,030,000
(No valuations completed since 2003)
Alternative calculations of the net present value of the lease payments based on a number of assumptions are attached as Appendix 1.

Liability Concepts and Criteria

1. What is a liability? The Accounting Framework defines liability as "a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefit".(para 49(b))
2. "Some liabilities can be measured only by using a substantial degree of estimation". A liability which uses a substantial degree of estimation is called a provision.(para 64)
3. "A provision shall be recognized when....(c) a reliable estimate can be made of the amount of the obligation". (AASB137 para 14)
4. AASB 137 clause 25 states that "Except in extremely rare cases, an entity will be able to determine a range of possible outcomes and can therefore make an estimate of the obligation that is sufficiently reliable to use in recognizing a provision"
5. AASB 137 clause 26 states "in an extremely rare case where no reliable estimate can be made, a liability exists that cannot be recognized. That liability is disclosed as a contingent liability".
6. Para 33 of ***FRAMEWORK FOR THE PREPARATION AND PRESENTATION OF FINANCIAL STATEMENTS*** states
   "To be reliable, information must represent faithfully the transactions and other events it either purports to represent or could reasonably be expected to represent.
   In certain cases, the measurement of the financial effects of items could be so uncertain that entities generally would not recognize them in the financial statements."

A. Significant Estimates Required in Determining Future Lease Payments

In applying the above criteria to the lease in question:

- The historical rental review percentage increases were 740% in 1983, 21% in 1994, and 200% in 2004. What estimate would be made of the lease payment post 1 August 2015, the date of the next rent review? What estimate would be made of the lease payment at subsequent rent reviews in 2025, 2036 and 2046?
- Can the estimates, however made, be "sufficiently reliable" given the historical variations and long future time frame (i.e. 36 years from current date)?
- We also concur with the view of Mr Stephen Cooper under AV7 of the Basis for Conclusions as to "whether lease payments which an entity has no contractual or constructive obligation to pay meet the definition of a liability." We also agree with his view in AV8 that structuring opportunities in relation to the proposed standard should be avoided by "establishing principles for identifying where optional lease periods and contingent rental arrangements lack economic substance" and using "appropriate disclosure" rather than enforcing a standard that is misleading in its implementation.

B. Significant Estimates required in determining lease term

Clause 13 of the proposed lease standard requires that "a lessee shall determine the lease term by estimating the probability of occurrence for each possible term, taking into account the effect of any options to extend or terminate the lease". Under B16 "the lease term is defined as the longest possible term that is more likely than not to occur."

Assessing probabilities in periods up to 10 years may be acceptable; however can a reasonable probability assessment be made for 10+ year periods? Further, conservatism may influence the decision of lessees to assign a low probability to renewal to minimize the impact on a company's accounts. i.e. how will the Standard cover the prospect that lessees may arbitrarily or "unfaithfully" estimate that there will be no or limited lease renewals?

Thus we support the alternative view of Mr Stephen Cooper when he states that "if the exercise of the options to extend merely depends on future business conditions it is inappropriate to reflect this in the measurement, even if extension or renewal of the lease is likely".

C. Significant Estimates required in determining Discount Rate

For long term leases of land, it is unusual for the lessor to disclose to the lessee the lessor's "borrowing" rate charged to the lessee or the lessor's yield on the property. Hence, in this circumstance, clause 12(a) requires the use of the "lessees incremental borrowing rate" to calculate the present value of the lease payments. Clause 19 states "a lessee shall not change the rate used to discount the lease payments except to reflect changes in reference interest rates when contingent rentals are based on those reference interest rates".

Can the estimates of the discount rate, however made, be "sufficiently reliable" given the complicating factors which apply to Marstel as follows:

- Infrastructure type land is not normally available for purchase and a "long term" market related borrowing rate may not be available i.e. referring to the Appendix A definition of "borrowing rate", there are fundamental difficulties for

Marstel to determine the rate of interest that, at the date of inception of the lease (e.g. 1973), it would have to pay to borrow over a similar term (e.g. over 84 years), and with a similar security (e.g. "rare" port located land), the funds necessary to purchase a similar underlying asset (e.g. port land which is not available for purchase).

- The requirement to select a rate "not to be changed" to be applicable for a long period (e.g. 84 years) presents fundamental uncertainties. Further, a small percentage point difference in the rate will have a fundamental impact on the discounted value of long term cash flows (Refer Appendix 1).

D. <u>Financial Leverage Overstatement</u>

The alternative views of Mr Cooper express concerns relating to "... would overstate financial leverage and would not provide useful information" and "... the resulting liability and related measures of financial leverage are overstated".

The longer the period of the lease the greater the potential financial leverage overstatement. For example, consider the implications at the inception of Marstel's 84 year lease. The right of use asset recognized may exceed by many times the market value of the land at the inception of the lease.

The question arising is whether such recognition is providing useful or faithful financial information. There is also the critical issue of the lessee's compliance with banking covenants, particularly equity ratios.

E. <u>Scope Exclusions</u>

We note the comment in BC38(b), under the heading of "Long Term Leases of Land", that "there is no conceptual basis for differentiating long term leases of land from other leases". Marstel is of the view that the fact that infrastructure land is never or seldom available for purchase, and hence the lease does not represent a source of purchase finance, does provide a conceptual basis for differentiation. That point aside, there are fundamental "measurement uncertainty" issues the longer the period of a lease.

<u>Summary Comments</u>

Marstel generally concurs with the proposals of the Standard for shorter term leases of assets that are generally available for purchase by a lessee (e.g. computer, vehicle, or aircraft).

Marstel's concern, having regarding to its various infrastructure land leases, is that the longer the period of a lease:

- the greater the uncertainty of the quantum of future lease payments;
- the greater the challenge in selecting a reliable "lessee incremental borrowing rate", which is to remain unchanged, for the purpose of discounting the lease payments; and hence the greater the uncertainty of the resulting discounted value;

- the greater the financial leverage overstatement effect of applying the proposals within the Standard.

Hence, we **recommend** that the Standard setters consider including additional "scope exclusions" for leases greater than a certain period (including all renewal rights) and/or for leases of certain types of assets (e.g. infrastructure land and other like assets which are not available for purchase by a lessee).

APPENDIX 1. Proposed Lease Standard ED2010/9

Assessment of NPV of Lease Liability

As from 2010 to end of lease term in 2057

(Demonstrating differences from varying assumptions on "longest possible term"

AT 5.00% DISCOUNT RATE (10 Yr Govt Bond Rate) 5.00%

No of Yrs to Expiry	47	26	5	84
	(End of all options)	(2nd Renewal)	(1st Renewal)	(If lease written today)
NPV	3,183,539	2,545,127	766,534	3,485,020
Year				
2011	177,050	177,050	177,050	177,050
2012	177,050	177,050	177,050	177,050
2013	177,050	177,050	177,050	177,050
2014	177,050	177,050	177,050	177,050
2015	177,050	177,050	177,050	177,050
2016	177,050	177,050		177,050
2017	177,050	177,050		177,050
2018	177,050	177,050		177,050
2019	177,050	177,050		177,050
2020	177,050	177,050		177,050
2021	177,050	177,050		177,050
2022	177,050	177,050		177,050
2023	177,050	177,050		177,050
2024	177,050	177,050		177,050
2025	177,050	177,050		177,050
2026	177,050	177,050		177,050
2027	177,050	177,050		177,050
2028	177,050	177,050		177,050
2029	177,050	177,050		177,050
2030	177,050	177,050		177,050
2031	177,050	177,050		177,050
2032	177,050	177,050		177,050
2033	177,050	177,050		177,050
2034	177,050	177,050		177,050
2035	177,050	177,050		177,050
2036	177,050	177,050		177,050
2037	177,050			177,050
2038	177,050			177,050
2039	177,050			177,050
2040	177,050			177,050
2041	177,050			177,050
2042	177,050			177,050
2043	177,050			177,050
2044	177,050			177,050
2045	177,050			177,050
2046	177,050			177,050
2047	177,050			177,050
2048	177,050			177,050
2049	177,050			177,050
2050	177,050			177,050
2051	177,050			177,050
2052	177,050			177,050
2053	177,050			177,050
2054	177,050			177,050
2055	177,050			177,050
2056	177,050			177,050
2057	177,050			177,050
				177,050

APPENDIX 1.

Assessment of NPV of Lease Liability

Proposed Lease Standard ED2010/9

As from 2010 to end of lease term in 2057

(Demonstrating differences from varying assumptions on "discount rate"

FOR MAXIMUM LEASE TERM REMAINING 47 YRS

	Discount Rate	3.00%	4.00%	5.00%	6.00%	8.00%
	NPV	$4,430,625	$3,725,652	$3,183,539	$2,760,037	$2,153,684
Year						
2011		177,050	177,050	177,050	177,050	177,050
2012		177,050	177,050	177,050	177,050	177,050
2013		177,050	177,050	177,050	177,050	177,050
2014		177,050	177,050	177,050	177,050	177,050
2015		177,050	177,050	177,050	177,050	177,050
2016		177,050	177,050	177,050	177,050	177,050
2017		177,050	177,050	177,050	177,050	177,050
2018		177,050	177,050	177,050	177,050	177,050
2019		177,050	177,050	177,050	177,050	177,050
2020		177,050	177,050	177,050	177,050	177,050
2021		177,050	177,050	177,050	177,050	177,050
2022		177,050	177,050	177,050	177,050	177,050
2023		177,050	177,050	177,050	177,050	177,050
2024		177,050	177,050	177,050	177,050	177,050
2025		177,050	177,050	177,050	177,050	177,050
2026		177,050	177,050	177,050	177,050	177,050
2027		177,050	177,050	177,050	177,050	177,050
2028		177,050	177,050	177,050	177,050	177,050
2029		177,050	177,050	177,050	177,050	177,050
2030		177,050	177,050	177,050	177,050	177,050
2031		177,050	177,050	177,050	177,050	177,050
2032		177,050	177,050	177,050	177,050	177,050
2033		177,050	177,050	177,050	177,050	177,050
2034		177,050	177,050	177,050	177,050	177,050
2035		177,050	177,050	177,050	177,050	177,050
2036		177,050	177,050	177,050	177,050	177,050
2037		177,050	177,050	177,050	177,050	177,050
2038		177,050	177,050	177,050	177,050	177,050
2039		177,050	177,050	177,050	177,050	177,050
2040		177,050	177,050	177,050	177,050	177,050
2041		177,050	177,050	177,050	177,050	177,050
2042		177,050	177,050	177,050	177,050	177,050
2043		177,050	177,050	177,050	177,050	177,050
2044		177,050	177,050	177,050	177,050	177,050
2045		177,050	177,050	177,050	177,050	177,050
2046		177,050	177,050	177,050	177,050	177,050
2047		177,050	177,050	177,050	177,050	177,050
2048		177,050	177,050	177,050	177,050	177,050
2049		177,050	177,050	177,050	177,050	177,050
2050		177,050	177,050	177,050	177,050	177,050
2051		177,050	177,050	177,050	177,050	177,050
2052		177,050	177,050	177,050	177,050	177,050
2053		177,050	177,050	177,050	177,050	177,050
2054		177,050	177,050	177,050	177,050	177,050
2055		177,050	177,050	177,050	177,050	177,050
2056		177,050	177,050	177,050	177,050	177,050
2057		177,050	177,050	177,050	177,050	177,050
		8,321,350	8,321,350	8,321,350	8,321,350	8,321,350

APPENDIX 1.
Assessment of NPV of Lease Liability
Proposed Lease Standard ED2010/9
As from 2010 to end of lease term in 2057
(Demonstrating differences from varying assumptions on future increases in rental
FOR MAXIMUM LEASE TERM REMAINING 47 YRS

	Discount rate	3.00%		6.00%		3.00%		6.00%
	NPV	$7,107,730		$3,896,869		$12,865,166		$6,144,750
Year	Rent increase 3%pa	Rental	Rent increase 3%pa		Rent increase 6%pa		Rent increase 6%pa	
2011	100.00%	177,050	100.00%	177,050	100.00%	177,050	100.00%	177,050
2012	103.00%	177,050	103.00%	177,050	106.00%	177,050	106.00%	177,050
2013	106.09%	177,050	106.09%	177,050	112.36%	177,050	112.36%	177,050
2014	109.27%	177,050	109.27%	177,050	119.10%	177,050	119.10%	177,050
2015	112.55%	177,050	112.55%	177,050	126.25%	177,050	126.25%	177,050
2016	115.93%	205,249	115.93%	205,249	133.82%	236,933	133.82%	236,933
2017	119.41%	205,249	119.41%	205,249	141.85%	236,933	141.85%	236,933
2018	122.99%	205,249	122.99%	205,249	150.36%	236,933	150.36%	236,933
2019	126.68%	205,249	126.68%	205,249	159.38%	236,933	159.38%	236,933
2020	130.48%	205,249	130.48%	205,249	168.95%	236,933	168.95%	236,933
2021	134.39%	205,249	134.39%	205,249	179.08%	236,933	179.08%	236,933
2022	138.42%	205,249	138.42%	205,249	189.83%	236,933	189.83%	236,933
2023	142.58%	205,249	142.58%	205,249	201.22%	236,933	201.22%	236,933
2024	146.85%	205,249	146.85%	205,249	213.29%	236,933	213.29%	236,933
2025	151.26%	205,249	151.26%	205,249	226.09%	236,933	226.09%	236,933
2026	155.80%	275,838	155.80%	275,838	239.66%	424,311	239.66%	424,311
2027	160.47%	275,838	160.47%	275,838	254.04%	424,311	254.04%	424,311
2028	165.28%	275,838	165.28%	275,838	269.28%	424,311	269.28%	424,311
2029	170.24%	275,838	170.24%	275,838	285.43%	424,311	285.43%	424,311
2030	175.35%	275,838	175.35%	275,838	302.56%	424,311	302.56%	424,311
2031	180.61%	275,838	180.61%	275,838	320.71%	424,311	320.71%	424,311
2032	186.03%	275,838	186.03%	275,838	339.96%	424,311	339.96%	424,311
2033	191.61%	275,838	191.61%	275,838	360.35%	424,311	360.35%	424,311
2034	197.36%	275,838	197.36%	275,838	381.97%	424,311	381.97%	424,311
2035	203.28%	275,838	203.28%	275,838	404.89%	424,311	404.89%	424,311
2036	209.38%	275,838	209.38%	275,838	429.19%	424,311	429.19%	424,311
2037	215.66%	381,824	215.66%	381,824	454.94%	805,468	454.94%	805,468
2038	222.13%	381,824	222.13%	381,824	482.23%	805,468	482.23%	805,468
2039	228.79%	381,824	228.79%	381,824	511.17%	805,468	511.17%	805,468
2040	235.66%	381,824	235.66%	381,824	541.84%	805,468	541.84%	805,468
2041	242.73%	381,824	242.73%	381,824	574.35%	805,468	574.35%	805,468
2042	250.01%	381,824	250.01%	381,824	608.81%	805,468	608.81%	805,468
2043	257.51%	381,824	257.51%	381,824	645.34%	805,468	645.34%	805,468
2044	265.23%	381,824	265.23%	381,824	684.06%	805,468	684.06%	805,468
2045	273.19%	381,824	273.19%	381,824	725.10%	805,468	725.10%	805,468
2046	281.39%	381,824	281.39%	381,824	768.61%	805,468	768.61%	805,468
2047	289.83%	513,140	289.83%	513,140	814.73%	1,442,471	814.73%	1,442,471
2048	298.52%	513,140	298.52%	513,140	863.61%	1,442,471	863.61%	1,442,471
2049	307.48%	513,140	307.48%	513,140	915.43%	1,442,471	915.43%	1,442,471
2050		513,140		513,140		1,442,471		1,442,471
2051		513,140		513,140		1,442,471		1,442,471
2052		513,140		513,140		1,442,471		1,442,471
2053		513,140		513,140		1,442,471		1,442,471
2054		513,140		513,140		1,442,471		1,442,471
2055		513,140		513,140		1,442,471		1,442,471
2056		513,140		513,140		1,442,471		1,442,471
2057		513,140		513,140		1,442,471		1,442,471
		15,434,739		15,434,739		31,843,862		31,843,862