

Spreading method to be used for some electricity price contracts for difference

Issued: 23 May 2024

S64

This determination relates to the financial arrangement spreading method to be used by a company (Company A) to return income and expenditure in relation to certain off-market contracts for difference (CFDs) in respect of the wholesale price of electricity.

Determination

This determination may be cited as *Special Determination S64: Spreading method to be used for some electricity price contracts for difference*.

1 Explanation (which does not form part of the determination)

1. This determination relates to the financial arrangement spreading method to be used by a company (Company A) to return income and expenditure in relation to certain off-market contracts for difference (CFDs) in respect of the wholesale price of electricity.
2. Company A entered into an off-market CFD (CFD 1) to manage its electricity pricing risk as a result of the sale of its retail electricity business. The intention behind CFD 1 was to give Company A a level of price certainty over its future electricity generation (ie, a hedge against future fluctuations in the spot price of electricity) as a result of becoming a generator without a customer base.
3. Under CFD 1 (which has a 10-year term), Company A pays the counterparty (Company B) a floating price for electricity (based on 30-minute intervals) and Company B pays Company A a fixed price for electricity (all electricity is submitted to the wholesale market and receives spot prices, which are set half-hourly).
4. This determination also applies to other CFDs that Company A enters into in future that are off-market and have a term that exceeds the electricity price path data that is sourced from the Australian Securities Exchange (ASX) New Zealand Electricity Futures market, or that are off-market and have a non-zero day 1 fair market value and an absolute value greater than NZ\$10 million. It is not possible to use the expected value spreading method in s EW 15F for CFD 1 and other CFDs that are in scope of this determination due to the long terms of the instruments, the lack of pricing data and non-zero day 1 values.
5. Company A has adopted International Financial Reporting Standards (IFRS) to prepare its financial statements and to report for financial arrangements.
6. CFD 1 is the subject of private ruling BR Prv 24/32 issued on 23 May 2024 and is fully described in that ruling.

2 Reference

This determination is made under s 90AC(1)(bb) of the Tax Administration Act 1994.

3 Scope of determination

1. This determination applies to Company A in respect of some of the off-market CFDs it enters into in relation to electricity pricing. Specifically, it applies to Company A in relation to CFD 1, entered into on 1 May 2022. It is not possible to use the expected value spreading method for CFD 1, and for other future CFDs described below as being in scope of this determination, due to the long terms of the instruments, the lack of pricing data and non-zero day 1 values.
2. CFD 1 was entered into at the time Company A sold its retail electricity business. It was entered into “off-market” – that is, on day 1, the fair value of CFD 1 to Company A was less than zero. To calculate the initial fair value of CFD 1, Company A compared the agreed electricity price with the electricity forward price path. This data was sourced from the ASX New Zealand Electricity Futures Contracts. The ASX data generally only extends for 3 years. After this point, data was sourced from Energy Link, an electricity consulting firm.
3. There are 960 transactions in total between the parties under CFD 1, with 24 transactions for each of the 40 calendar quarters set out in the terms. The transactions are to be cash settled in accordance with the Master Agreement between Company A and Company B. The prices are fixed for the first 12 months. Following that, prices increase in line with the Consumer Price Index.
4. For the first 5 years, the fixed rate paid by Company B will be set against a historical baseload price (which can be adjusted for location / profile). This fixed rate was set at an off-market rate (ie, set for the first 5 years at a lower average baseload price than the market price of electricity in the spot or forward market at the time CFD 1 was entered into). At the end of the first 5-year period, the rate will be reset closer to the market rate, using an average settlement price (adjusted for location / profile factors) and therefore it is expected that the future fixed rates will not impact the initial day 1 value.
5. This determination also applies to Company A in relation to off-market CFDs with terms that are the same as or similar to CFD 1 and:
 - a) have a term that exceeds the electricity forward price path data that is sourced from the ASX New Zealand Electricity Futures market; or

- b) have a non-zero day 1 fair market value, and the absolute value is greater than \$10 million.
6. Under IFRS 9, eligible CFDs are designated as hedging instruments. This means the fair value is measured at each balance date and recorded in the balance sheet, with the movement in fair value recorded through the cashflow hedge reserve in equity (for the effective portion of the hedge) and the balance recorded through the income statement (for the ineffective portion). The total fair value movement for CFDs ineligible for hedge accounting is recorded in the income statement.
7. For both CFD 1 and other CFDs entered into by the Company "off-market", the non-zero day 1 fair value is calculated by reference to the expected cashflows over the term of the CFD with regard to the electricity forward price path and applying a cost of funds discount factor. Where there is a difference between the contract price and day 1 fair value, IFRS 9 requires the deferral of the difference. This is achieved by calculating a "calibrated CFD" with a zero day 1 value by using an adjustment factor to adjust the agreed prices uniformly.
8. This determination does not apply to the counterparty to any of the above CFDs.
9. This determination is made subject to the continued application of private ruling BR Prv 24/32 (including any ruling issued to replace that ruling, provided that any changes to that ruling do not affect the application of this determination).
10. This determination is also made subject to the following conditions:
 - The IFRS accounting treatment of Company A's off-market CFDs does not materially alter.
 - Company A will continue to treat its on-market CFDs as subject to the modified fair value method.

4 Principle

1. The CFD is a financial arrangement under s EW 3 and is not an excepted financial arrangement under s EW 5.
2. Under s EW 15C(1), a person who uses IFRS to prepare financial statements and to report for financial arrangements must use one of four methods for the financial arrangement, including a determination alternative under s EW 15E. Under s EW 15E(2)(d), the Commissioner may determine the spreading method to be applied.
3. Under s EW 29, Company A is required to calculate a base price adjustment (BPA) in the income year that the CFD matures or is terminated. The BPA will take into account

all consideration received by Company A and all amounts paid by Company A under the CFD.

4. This determination specifies the spreading method that must be applied by Company A to allocate income and expenditure in respect of CFDs that are within scope of this determination.

5 Interpretation

In this determination, all legislative references are to the Income Tax Act 2007, unless otherwise stated.

6 Method

1. Income or expenditure for an income year from the CFD is the total of:
 - a) the amount calculated in accordance with [2] below; and
 - b) the amount described at [3] below.
2. The day 1 fair value calculated by reference to the expected cashflows over the term of the CFD or other term (pursuant to IFRS 9) is adjusted by comparing the payments expected under the CFD with the payments that would be expected under the calibrated CFD and discounting to present value to spread the day 1 fair value over either the term of the CFD or the term to which the day 1 fair value amount relates.
3. At the end of each income year, any amounts that arise due to differences between the calibrated CFD prices and actual electricity prices in the income year as actual payments are made between Company A and the CFD counterparty.
4. IFRS 9 also requires remeasurement of the calibrated CFD at each balance date based on the latest forward electricity prices. Any gains or losses resulting from remeasurement of the calibrated CFD at each balance date based on the latest forward electricity prices under IFRS 9 are not allocated as income or expenditure in the relevant income year.

7 Example

This example illustrates the application of the method set out in this determination.

The figures and values used in this example are indicative only and cannot be relied on as an indication of the expected cashflows under a CFD.

Example

Company A and Customer have agreed to enter into a CFD on the following terms:

- term of CFD: 5 years;
- annual quantum of electricity to be supplied: 100 kWh (20 kWh per year);
- fixed price per kWh of electricity: \$1; and
- agreed price to enter into the CFD: \$0.

To calculate the initial fair value of this CFD, the agreed electricity price (of \$1 per kWh) is compared with an electricity forward price path.

The calculated day 1 fair value of the CFD is a loss of \$45 (because the electricity price path expects the average price of electricity to exceed \$1 per kWh). Pursuant to IFRS 9, a calibrated CFD with prices increased by an adjustment factor of 1.7 results in a zero day 1 value. By the end of year 5, the CFD has matured and has a fair value of 0.

The expected cashflows under the “calibrated CFD” are compared with the expected cashflows under the CFD and then discounted to present value.

These amounts are then allocated to accounting periods to achieve the expected spread of the day 1 negative fair value of \$45 as in row 3 of the table below.

From the beginning of year 1 (when the CFD was entered into) until the end of year 1, Company A was required to pay Customer \$25 based on the electricity spot price over that period (ie, \$1.25 per kWh). Over the same period, Customer was required to pay Company A \$20 based on the agreed fixed price – a net loss of \$5 (refer year 1, rows 1 and 2 of the table).

This effectively comprises the deferred expected loss for year 1 of \$15 as calculated on day 1, offset by favourable unexpected differences in the electricity spot price, which reduced this loss by \$10 for the year (refer year 1, rows 4 and 5 of the table).

At the end of year 1, IFRS 9 also requires remeasurement of the fair value of the “calibrated CFD” based on the forward electricity prices at balance date. This resulted in a positive fair value of \$8 (refer year 1, row 6 of the table). This gain was split between the income statement and the cashflow hedge reserve based on the hedge effectiveness as follows:

- income statement: \$4 gain; and
- cashflow hedge reserve: \$4 gain.

None of the gain is included as income under the spreading method.

The table below illustrates how the spreading method applies for the remaining term of the CFD and the amounts Company A will have to allocate as income or expenditure over the term of the CFD:

		Year 1	Year 2	Year 3	Year 4	Year 5
1.	Payment by Company A under CFD	\$25	\$18	\$15	\$30	\$25
2.	Payment by counterparty under CFD	\$20	\$20	\$20	\$20	\$20
3.	<i>Net amount</i>	<i>(\$5)</i>	<i>\$2</i>	<i>\$5</i>	<i>(\$10)</i>	<i>(\$5)</i>
4.	Day 1 fair value amount spread	(\$15)	(\$12)	(\$8)	(\$6)	(\$4)
5.	Difference between calibrated CFD price and actual electricity price	\$10	\$14	\$13	(\$4)	(\$1)
6.	Gain or loss from remeasurement at balance date	\$8	(\$6)	\$2	\$4	\$0
	Income/(expenditure)	(\$5)	\$2	\$5	(\$10)	(\$5)

This Determination is signed by me on the 23rd day of May 2024.

Howard Davis
 Group Leader

About this document

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