FEDERAL COURT OF AUSTRALIA

Origin Energy Limited v Commissioner of Taxation (No 2) [2020] FCA 409

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| File numbers: | NSD 198 of 2018NSD 199 of 2018NSD 200 of 2018 |
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| Judge: | **THAWLEY J** |
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| Date of judgment: | 31 March 2020 |
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| Catchwords: | **TAXATION** – appeals under s 14ZZ of the *Taxation Administration Act 1953* (Cth) – whether “capacity charges” payable under an agreement were outgoings of capital or of a capital nature within the meaning of s 8-1(2) of the *Income Tax Assessment Act 1997* (Cth) – where “capacity charges” were paid for the exclusive supply of electricity – where outgoings were a substantial extension the profit-making structure of the applicant – where applicant had substantial control of when and how electricity was generated – where “capacity charges” were, in substance, paid up-front in a lump sum – appeal dismissed**TAXATION** – appeals under s 14ZZ of the *Taxation Administration Act 1953* (Cth) – whether expenditure was in relation to a lease or other legal or equitable right within the meaning of s 40-880(5)(d) of the *Income Tax Assessment Act 1997* (Cth) – where expenditure gave applicant a bundle of rights amounting to a right to use the power stations to generate and trade electricity – appeal dismissed**TAXATION** – appeals under s 14ZZ of the *Taxation Administration Act 1953* (Cth) – whether expenditure could be taken into account in working out the amount of a capital gain or a capital loss from a Capital Gains Tax (CGT) event within the meaning of s 40-880(5)(f) of the *Income Tax Assessment Act 1997* (Cth) – where expenditure gave applicant a number of contractual rights, including the right to trade the electricity generated from the relevant power stations – appeal dismissed |
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| Legislation: | *Electricity Supply Act 1995* (NSW) pt 4 div 6*Income Tax Assessment Act 1936* (Cth) s 51*Income Tax Assessment Act 1997* (Cth) ss 8-1, 40-880, 110-25*National Electricity (South Australia) Act 1996* (SA)*New Business Tax System (Capital Allowances) Act 2001* (Cth)*Taxation Administration Act 1953* (Cth) s 14ZZ*Electricity Industry Restructuring Bill 2008* (NSW) s 4*Electricity Industry Restructuring Bill 2008 (No 2)* (NSW)*Electricity Industry Restructuring (Response to Auditor-General Report) Bill 2008* (NSW)*Tax Laws Amendment (2006 Measures No 1) Bill 2006* (Cth)*Taxation Laws Amendment Bill (No 5) 2002* (Cth)  |
|  |  |
| Cases cited: | *AusNet**Transmission Group Pty Ltd v Commissioner of Taxation* (2015) 255 CLR 439*Cliffs International Inc v Commissioner of Taxation* (1979) 142 CLR 140*Colonial Mutual Life Assurance Society Ltd v Federal Commissioner of Taxation* (1953) 89 CLR 428*Commissioner of Taxation v Citylink Melbourne* (2006) 228 CLR 1*Commissioner of Taxation v Raymor (NSW) Pty Ltd* (1990) 24 FCR 90*Commissioner of Taxation v Sharpcan Pty Ltd* (2019) 373 ALR 414*Commissioner of Taxation v South Australian Battery Makers Pty Ltd* (1978) 140 CLR 645*GP International Pipecoaters Pty Ltd v Commissioner of Taxation* (1990) 170 CLR 124*Hallstroms Pty Ltd v Federal Commissioner of Taxation* (1946) 72 CLR 634*Origin Energy Limited v Commissioner of Taxation* [2019] FCA 2219*Radaich v Smith* (1959) 101 CLR 209*Sun Newspapers Ltd v Commissioner of Taxation (Cth)* (1938) 61 CLR 337  |
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| Date of hearing: | 4 and 5 September 2019 |
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| Solicitor for the Respondent: | MinterEllison |
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ORDERS

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|  | NSD 198 of 2018NSD 199 of 2018NSD 200 of 2018 |
|   |
| BETWEEN: | ORIGIN ENERGY LIMITED (ACN 000 051 696)Applicant |
| AND: | THE COMMISSIONER OF TAXATION OF THE COMMONWEALTH OF AUSTRALIARespondent |

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| JUDGE: | THAWLEY J |
| DATE OF ORDER: | 31 MARCH 2020 |

THE COURT ORDERS THAT:

1. The appeals be dismissed.
2. Unless either party applies within 7 days for a different order with respect to costs, the applicant pay the respondent’s costs.

Note: Entry of orders is dealt with in Rule 39.32 of the *Federal Court Rules 2011*.

REASONS FOR JUDGMENT

THAWLEY J:

|  |  |
| --- | --- |
| A OVERVIEW | [1] |
| B FACTUAL BACKGROUND | [10] |
| B.1 The applicant | [10] |
| B.2 Eraring Energy | [15] |
| B.3 Sale of electricity into the NEM | [18] |
| B.4 Energy industry reforms against which GenTrader Agreements were entered into | [32] |
| B.5 The GenTrader Implementation Deed | [44] |
| B.6 Events between the Implementation Deed and entry into the Transaction Documents | [50] |
| B.7 The Deposit Deeds | [55] |
| B.8 The Mortgage Deeds | [60] |
| B.9 The GenTrader Agreements | [61] |
| B.9.1 Supply of electricity and charges payable by OEEL | [64] |
| B.9.2 OEEL provided at its cost or was liable for the cost of coal and fuel oil | [71] |
| B.9.3 Ownership and operation of the power stations | [73] |
| C SUMMARY OF THE PARTIES’ MAIN CONTENTIONS | [77] |
| C.1 Summary of the applicant’s contentions | [77] |
| C.2 Summary of the respondent’s contentions | [80] |
| D DEDUCTIBILITY UNDER SECTION 8-1 | [82] |
| D.1 Section 8-1 | [82] |
| D.2 Principles | [84] |
| D.3 Consideration | [87] |
| D.3.1 Eraring Energy’s trading business was handed over to OEEL | [89] |
| D.3.2 Substantial control of when and how electricity was generated | [96] |
| D.3.3 Involvement in operation of power stations | [109] |
| D.3.4 Business risks and opportunities acquired by OEEL | [120] |
| D.3.4.1 Coal and fuel oil | [123] |
| D.3.4.2 Capital improvements | [129] |
| D.3.4.3 The structure of the fixed and variable charges | [135] |
| D.3.4.4 Risks in relation to failure of supply | [144] |
| D.3.4.5 Insurance | [147] |
| D.3.5 Structure of payments | [148] |
| D.3.6 Term of the GenTrader Agreements and extension and termination | [154] |
| D.4 Conclusion with respect to s 8-1 | [159] |
| E DEDUCTIBILITY UNDER SECTION 40-880 | [182] |
| E.1 Section 40-880 | [182] |
| E.2 Legislative history of s 40-880 | [185] |
| E.3 Does s 40-880(5)(d) apply to deny a deduction? | [190] |
| E.4 Does s 40-880(5)(f) apply? | [197] |
| E.5 Conclusion with respect of s 40-880 | [203] |
| F CONCLUSION | [204] |

# A OVERVIEW

1. In May 2008, the New South Wales Government announced its intention to implement recommendations made by Professor Owen in respect of the electricity industry in NSW, including that the State divest itself of the generation businesses of each of the three State owned generators, including Eraring Energy (a statutory State owned corporation), and the retail arms of its three electricity businesses.
2. In November 2008, the NSW Government adopted a revised strategy, which would see the State withdrawing from electricity retailing and transferring to the private sector the right to trade the output of publicly owned generators. Under this strategy, the State announced that it would continue to own and operate its power stations as well as the transmission and distribution lines, but would “exchange the risk and volatility of earnings from [the State’s] wholesale electricity trading for secure, predictable payments by the private sector (in return for the right to buy and sell wholesale electricity)”: 2009-10 NSW Budget Paper No 2, Budget Statement at 8-4. The NSW Government stated it would recover revenue, for the trading rights, sufficient to cover the costs of electricity production and delivery over the term of the trading rights contract, and that the relevant agreement might include an upfront component.
3. Against this context, on 1 March 2011, Origin Energy Electricity Ltd (**OEEL**) and Eraring Energy entered into two agreements, called “GenTrader Agreements”. One agreement related to the Eraring Power Station, a large coal-fired power station located 30 km south-west of Newcastle. The other related to the “Shoalhaven Scheme”. The Shoalhaven Scheme is a “pumped storage hydro scheme” involving the Kangaroo Valley and Bendeela Pumping and Power Stations. These pump water up to the Fitzroy Falls Reservoir, usually when electricity prices are low. The water is stored at that reservoir and can be released to fall downstream to generate electricity, usually when electricity prices are high. In addition to electricity generation, water from the Fitzroy Falls Reservoir may be pumped for off-take to supply water to Sydney and Wollongong, particularly during periods of drought.
4. Under the GenTrader Agreements, OEEL agreed to pay a number of charges to Eraring Energy, including substantial “capacity charges”. Under “Deposit Deeds”, OEEL placed interest bearing deposits of $856,000,000 (Eraring) and $11,080,000 (Shoalhaven) with the NSW Treasury. These represented the net present value of all of the annual capacity charges payable under the GenTrader Agreements for the term of those agreements, being 22 and 28 years.
5. In the case of Eraring Energy, the capacity charges were $145,385,320 in the first full year. They reduced each year, at a rate of approximately 85% of the prior year’s charge, such that the capacity charges in the last year were $7,222,996 – see: Annexure A to these reasons. Shoalhaven’s payments were similarly “front-loaded”. OEEL authorised and directed NSW Treasury to pay each year, out of the security deposit, the relevant capacity charge to Eraring Energy.
6. Origin Energy Ltd (**Origin**), the head company of the consolidated group of which OEEL was a member, contended that the capacity charges were deductible in each of the years of income in which those charges were incurred. It contended that the charges were deductible in full under s 8-1 of the *Income Tax Assessment Act 1997* (Cth) (**ITAA 1997**). Origin also contended that, if the amounts were not deductible because they represented capital expenditure, the charges were deductible as “black hole” expenditure over 5 years under s 40-880 of the ITAA 1997. Origin contended that the capacity charges were paid for the acquisition of electricity from Eraring Energy under the GenTrader Agreements, which it referred to as long term “supply contracts”.
7. The respondent contended that the capacity charges were capital in nature and therefore not deductible under s 8-1(1): s 8-1(2)(a). The respondent contended that the expenditure was an affair of capital because the advantage sought by incurring the expenditure was an extension of OEEL’s profit making structure, not simply the annual supply of electricity to OEEL for on-sale. As to Origin’s alternative case, the respondent contended that the amounts were not deductible under s 40-880 because that provision denied a deduction if the expenditure was made in relation to a “legal or equitable right” or “could … be taken into account in working out the amount of a capital gain or capital loss”, both of which applied – see: s 40-880(5)(d) and (f).
8. The proceedings related only to the income tax years ended 30 June 2011, 2012 and 2013. The proceedings are “appeals” under s 14ZZ of the *Taxation Administration Act 1953* (Cth) against objection decisions made by the respondent.
9. For the reasons given below, the capacity charges were an outgoing of capital or of a capital nature, engaging the exclusion from deductibility found in s 8-1(2)(a). Nor did s 40-880 apply by reason of both s 40-880(5)(d) and (f). The capacity charges are properly taken into account under the capital gains tax regime. It follows that the appeals must be dismissed.

# B FACTUAL BACKGROUND

## B.1 The applicant

1. The applicant was the head company of a consolidated group for the purposes of Part 3-90 of of the ITAA 1997. Members of the consolidated group included OEEL and Eraring GenTrader Depositor Pty Ltd (**Origin Depositor**).
2. Origin conducts an integrated energy business. This includes: the exploration for and production of oil and natural gas; the generation of electricity; the sale of electricity into the National Electricity Market (**NEM**) (which comprises the Australian market other than Western Australia and the Northern Territory); the sale of electricity in Western Australia; the entry into long and short term derivative contracts; and the purchase from the NEM of electricity for sale to Origin’s retail and industrial customers.
3. As at 1 January 2010, a little over a year before OEEL entered into the GenTrader Agreements, Origin owned and operated a number of electricity generating units. None of these were coal-fired power stations. They were each peaking power stations, none of them providing baseload power. They included power stations using open-cycle gas turbines, closed-cycle gas turbines and wind. Origin also purchased and sold electricity into the NEM.
4. Origin built a power station at Darling Downs which became operational on about 1 July 2010. The construction of the power station took approximately three years. It was a closed-cycle gas turbine power station, providing baseload power. Its capacity was about 630MW.
5. In Origin’s 2011 Annual Report at [8.2] it was stated that, during the year ended 30 June 2011, “Origin increased its portfolio of owned and contracted generation from 1,710 MW to 5,310 MW”. It then stated:

This followed the commencement of commercial operations at the 630 MW Darling Downs Power Station and entry into the GenTrader arrangements with the Eraring and Shoalhaven power stations (+2,970 MW).

## B.2 Eraring Energy

1. Before entering into the GenTrader Agreements, Eraring Energy was engaged in the business of generating electricity and trading that electricity by selling it into the NEM.
2. Eraring power station is the largest coal-fired baseload power station in Australia. At the time the GenTrader Agreements were entered into, it was in the process of having its four 680MW generating units upgraded to 720MW units, a total capacity of 2880MW.
3. The “Shoalhaven Scheme” comprised the Bendeela power station (2 x 40MW generating units) and the Kangaroo power station (2 x 80MW generating units). These two power stations are referred to in these reasons collectively as the “Shoalhaven power station”.

## B.3 Sale of electricity into the NEM

1. The sale by Origin of generated electricity into the NEM was conducted predominantly through **OEEL**. This activity is regulated by the National Electricity Law (**NEL**), contained in the schedule to the *National Electricity (South Australia) Act 1996* (SA) and the subject of various state and territory application legislation, and the National Electricity Rules (**NER**). The Australian Energy Market Operator (**AEMO**) operates and administers the NEM which is defined as the wholesale exchange and national electricity system: s 2 of the NEL. AEMO’s statutory functions are set out in s 49 of the NEL.
2. All electricity generated within the NEM is produced for supply to the wholesale exchange. A person cannot participate in the generation, transmission or distribution of electricity, or the purchasing of electricity, through a wholesale exchange in the NEM unless the person is registered with AEMO as a “Registered Participant” in relation to a particular activity: s 11 of the NEL. AEMO can register a person into one of ten categories of Registered Participant determined by the particular activity: ch 2 of NER.
3. The electricity supplied to the wholesale exchange is sold by AEMO to appropriately registered participants which sell electricity in the retail market to end consumers. OEEL is, and at all of the relevant times was, registered with AEMO to sell electricity into the wholesale exchange.
4. Origin is registered with AEMO to purchase electricity from AEMO as a “Market Customer”, permitting Origin to on-sell electricity to end consumers.
5. One category of Registered Participant is a “Generator”. A person who owns, controls, or operates a generating system which is connected to a transmission system in the NEM must be registered with AEMO as a Generator, unless exempted from that requirement by AEMO: cl 2.2.1(a) of the NER.
6. A Generator is a “Market Generator” only in so far as its activities relate to any “market generating units”: cl 2.2.4(b) of the NER. A “market generating unit” is defined in the Glossary to the NER in the following way:

A *generating unit* whose *sent out generation* is not purchased in its entirety by the *Local retailer* or by a *Customer* located at the same *connection point* and which has been classified as such in accordance with Chapter 2.

1. A Market Generator is obliged to sell all sent out generation and market ancillary services in relation to the particular generating system through the spot market administered by AEMO: cl 2.2.4(c) and 2.2.6(h) of the NER.
2. The Generator is paid by AEMO in accordance with the price setting mechanism determined in chapter 3 of the NER, resulting from the bidding process, also described in chapter 3.
3. A person cannot sell generated electricity into the NEM unless appropriately registered by AEMO.
4. A Generator’s many obligations under the NER include the mandatory notification to AEMO of forecast available capacity of each generating unit for and over different periods (cll 3.7.3(a), (d), (e), 3.8.4 NER); mandatory notifications of changes to previously notified available capacity (cl 3.8.22 NER); submitting generation dispatch offers for each trading day containing specified information to allow AEMO to operate the spot market (cl 3.8.2 NER); and prompt financial settlements with AEMO (cl 3.15 NER).
5. A person required to be registered as a Generator in relation to a particular generating system may apply for exemption from registration as a Generator if that applicant notifies AEMO of another person who consents to act as “Intermediary**”** in relation to the generating system and AEMO, being satisfied that the Intermediary can be treated as the applicant for the purposes of the NER with respect to the relevant generating system, approves of that person to be registered as the Generator in relation to the generating system – see: cl 2.9 NER.
6. A person who is registered as an Intermediary can bid the sent out generation for the generating system. Subject to various exceptions (including that the applicant is jointly and severally liable for the acts, omissions, statements, representations and notices of the Intermediary as Registered Participant: cl 2.9.3(d)(5)), the Intermediary is treated as the applicant in relation to the generating units owned by the applicant – see: cl 2.9.3(d)(2) of the NER. It is sufficient to note for the purposes of the present matter that the Intermediary has, as a practical matter, the rights and obligations of the Generator applicant so far as concerns the operation of the NEM.
7. Origin, primarily by OEEL, was registered as an Intermediary in relation to generating units owned by the Origin group in Queensland, New South Wales, Victoria and South Australia.
8. OEEL also came to be registered as Intermediary in relation to the generating units which produced the supply of electricity from the Eraring and Shoalhaven power stations as a consequence of entering into the transactions described in more detail below. As the registered intermediary OEEL was entitled to the price paid by AEMO for the sent out generation supplied by Eraring Energy to OEEL at the connection point between the Eraring and Shoalhavenpower stations and the transmission system. The amount paid to OEEL depended on the accepted bids made by OEEL into the market for sale of the electricity.

## B.4 Energy industry reforms against which GenTrader Agreements were entered into

1. The facts in this section are predominantly drawn from specific passages admitted into evidence in these proceedings of the “Final Report of the Special Commission of Inquiry into the Electricity Transactions” provided on 31 October 2011 by the Honourable Brian Tamberlin QC (**Tamberlin Report**). The applicant did not dispute that the facts contained in those parts of the Tamberlin Report which the respondent relied on were correct, but submitted that they were irrelevant to the issues which needed to be determined. The objections to evidence were dealt with at trial – see: *Origin Energy Limited v Commissioner of Taxation* [2019] FCA 2219.
2. On 9 May 2007, the Premier of the State of New South Wales announced the establishment of an inquiry into electricity supply in New South Wales to be undertaken by Professor Anthony Owen, then the Professor of Energy Economics at Curtin University of Technology (**Owen Inquiry**).
3. Professor Owen was asked to:
4. review the need and timing for new baseload generation that maintains both security and competitively priced electricity;
5. examine the baseload options available to meet efficiently any emerging generation needs;
6. review the timing and feasibility of technologies and/or measures available both nationally and internationally that reduced greenhouse gas emissions; and
7. determine the conditions needed to ensure investment in emerging generation, consistent with maintaining the State’s AAA credit rating.
8. At the time of the Owen Inquiry, NSW’s baseload energy was almost exclusively supplied by State owned generators: Macquarie Generation, Delta and Eraring. The State of NSW also operated three electricity businesses and had retail assets.
9. Professor Owen’s report was publicly released in September 2007. The key recommendation was “that the Government of New South Wales divests itself of all State ownership in both retail and generation”. The Owen Report included:

…I have determined that there is a need to be prepared for additional investment in baseload from 2013-14. Further, the most efficient means of providing for baseload is to improve the commercial and policy signals used by the private sector when investing in generation capacity in New South Wales. My key recommendation, therefore, is that the Government of New South Wales divests itself of all State ownership in both retail and generation.

1. Professor Owen specifically recommended that the government divest itself of the “generation businesses” of each of the three State owned generators, including Eraring Energy and the retail arms of its three electricity businesses. Eraring Energy’s “generation business” was a business of generating and selling or trading electricity.
2. On 15 May 2008, the government announced its intention to introduce legislation to implement the recommendations of the Owen Report. The bill that followed was the *Electricity Industry* ***Restructuring Bill*** *2008* (NSW). Section 4 provided:

**4 Authority for transfer of State electricity assets to the private sector**

This Act authorises the transfer to the private sector of State electricity assets in any of the following ways (and in no other way):

(a) the lease of the power stations of an electricity generator and the transfer of the rest of its business,

(b) the transfer of the retail business of an electricity distributor,

(c) the transfer by initial public offer of the business of an electricity generator (including its power stations).

**Note.** This is the ***authorised restructuring*** for transfers of State electricity assets to the private sector. No other transfer of State electricity assets to the private sector is authorised by this Act.

1. Eraring Energy was an “electricity generator” for the purposes of s 4(c), because it was a State owned corporation constituted as an electricity generator: s 3(1) of the Restructuring Bill.
2. After a report by the Auditor-General, the government introduced the *Electricity Industry Restructuring Bill 2008 (No 2)* (NSW) and the *Electricity Industry Restructuring (Response to Auditor-General Report) Bill 2008* (NSW). These were relevantly similar to the Restructuring Bill. These were ultimately opposed and did not progress further.
3. The government adopted a revised strategy. On 1 November 2008, the Premier announced an Energy Reform Strategy. The 2009-10 New South Wales Budget Paper No 2, Budget Statement included at 8-4:

**ENERGY REFORM STRATEGY**

The Premier announced a new reform package on 1 November 2008, which aims to enable private investment in new baseload generation capacity in New South Wales. The measures will see the Government withdrawing from electricity retailing along with transferring to the private sector power station development sites and the right to trade the output of publicly owned generators.

Under the Energy Reform Strategy, the private sector will assume the task and the associated risk and reward of trading wholesale electricity for the generators.

The NSW Government will continue to own and operate its power stations as well as the transmission and distribution lines, which represent the vast majority of electricity assets in New South Wales.

Taxpayers will exchange the risk and volatility of earnings from wholesale electricity trading for secure, predictable payments by the private sector (in return for the right to buy and sell wholesale electricity). The NSW Government will recover revenue for the trading rights, which is sufficient to cover the costs of electricity production and delivery over the term of the trading rights contract and may include an upfront component. In addition, taxpayers would receive an upfront payment for the retailers and development sites.

The strategy recognises that competition is the most effective means of ensuring adequate investment in power generation while continuing to deliver competitively priced electricity. The NSW Government has committed to extending price regulation up to 2013.

1. The 2010-11 New South Wales Budget Paper No 2, Budget Statement included:

**ENERGY REFORM STRATEGY**

In November 2008, the Government announced its Energy Reform Strategy. The Government’s objectives are to:

* ensure NSW homes and businesses continue to be supplied with reliable electricity
* delivery a competitive retail and wholesale electricity market in NSW to increase the potential for the sector to respond dynamically and innovatively to market forces and opportunities
* create an industry and commercial framework to encourage private investment into the NSW electricity sector reducing the need for future public sector investment in retail and generation and
* place NSW in a stronger financial position by optimising the sale value of public assets, reducing the Government’s exposure to electricity market risk, and reducing the State’s public sector debt.

In September 2009, the Government issued a call for expressions of interest from interested parties to participate in the Government’s energy reform transactions. In December 2009, in response to strong expressions of interest, the Government invited qualified parties to proceed to the transaction phase of the reform process. The data rooms for the sale of the retail businesses and gentrader contracts will be open on 1 July 2010.

These transactions include: the sale of the Government’s electricity retailing businesses EnergyAustralia, Integral Energy and Country Energy, new generation development sites and the contracting out of the trading function of state owned generation businesses (commonly referred to as the gentrader model).

The Government expects to execute the electricity reform transactions in 2010.

1. By a letter dated 22 September 2010, Origin was invited to “submit an unconditional, legally binding bid … for the Assets being offered as part of the NSW Energy Industry Reforms”. This letter was sent by Credit Suisse (Australia) Ltd and Lazard & Co Pty Ltd, who were the “joint lead financial advisers” in relation to the sale process. The letter included:

The NSW Government (the “Government”) is pleased to invite you (the “Bidder”) to submit an unconditional, legally binding bid (“Binding Bid” or “Bid”) for the Assets being offered as part of the NSW Energy Industry Reforms (the “Reforms”).

…

**1. Overview of Binding Bid Process**

The deadline for submission of Binding Bids is **1pm (Australian Eastern Daylight Time) on 1 November 2010** (the “Bid Deadline”).

…

**2. Evaluation Criteria**

The Government, in evaluating the Binding Bids, will assess the ability of the Bidders to meet the Government’s Reform objectives, through an assessment of their performance against the Evaluation Criteria set out below. All Binding Bids will be evaluated using these Evaluation Criteria, which feature both quantitative and qualitative aspects.

Importantly, in preparing Bids, Bidders should ensure that they provide the Government with all the information it needs to determine that the Bidder has satisfied the three Mandatory Threshold Criteria, namely:

* Experience and Capability;
* Compliance with the Bid Rules; and
* Compliance with the Employee Protocols.

Binding Bids that do not meet each of these criteria (detailed below) will not be further assessed.

**2.1 Mandatory Threshold Criteria**

[The Mandatory Threshold Criteria were explained]

…

**2.2 Further Evaluative Criteria**

Each Bid that the Government determines meet the Mandatory Evaluation Criteria will then be assessed against the following Further Evaluation Criteria:

*Further Criterion 1 – Bid Price and Payment Structure*

The Government’s requirement is for the Bid price to be payable in cash on completion of the relevant Transaction.

The Bidder’s submitted Bid price for each Asset will be evaluated against this requirement and adjusted for any conditions or other factors that have a direct value impact, for example:

* proposals to make GenTrader Capacity Charges or Purchase Price payments over time or other deferred consideration proposals;
* contingent or alternative consideration proposals;
* stamp duty arrangements (the Bid price should be expressed to be inclusive of NSW stamp duty);
* the costs to the State of accepting the consideration structure proposed by the Bidder; and
* unacceptably long completion periods that are tantamount to payment deferral structures.

[A further three criteria were then set out]…

**3 Binding Bid requirements and information to be provided**

**3.1 Form of Binding Bid**

…

**3.2 Bid Submission Document – Information requirements**

…

**D) Principal terms of Bid**

…

***b) Price and payment structure***

Bidders must provide a total purchase price offered for 100% of each Asset subject of the Bid; inclusive of NSW stamp duty estimated to be payable on the transaction, but exclusive of GST, other taxes, charges and duties (the actual· payment of New South Wales stamp duty will be per the arrangements detailed in· the Transaction Documentation for each Asset). In the case of GenTrader Bids, “price” refers to the upfront Capacity Charge*.* Prices should be set out per the Bid Price Table below. Under the Transaction Documents this price will be further apportioned to relevant components of the Asset.

*Payment terms*

… Bidders should state the amount which is to be paid in cash on completion of the transaction.

…

***d) Transaction Documents***

Bidders must confirm the Bid is made on the terms of the Transaction documents, without amendment (or, alternatively, specify in detail the nature of any amendments proposed by the Bidder and the reasons for these).

Any amendment to the Transaction Documents proposed by the Bidder must also be provided by way of marked (but not retyped) copies of the Transaction Documents, submitted as attachments to the Bid Submission Document (hard copy and in editable form on CD/USB device). Any additions must be marked through the use of typed riders. Any deletions must be indicated by a strikeout. Where amendments or additions are common across more than one transaction document, a separate table summarising the changes. One unbound hard, clean copy of the Transaction Documents marked “Original” must also be submitted in a form capable of execution.

Bidders must confirm that the only changes to the Bid versions of the Transaction Documents released by the Government are as marked.

Bidders must confirm that the Transaction Documents submitted with the Bid are all documents necessary to proceed with the execution of the relevant Transaction.

## B.5 The GenTrader Implementation Deed

1. The State of New South Wales, Eraring Energy and OEEL entered into a GenTrader Transaction **Implementation Deed** (Eraring Bundle) dated 14 December 2010. The Recitals to the Implementation Deed recorded:

A The State is implementing the Reforms to ensure there is timely investment in the electricity sector, thereby delivering efficient and reliable power to the businesses and homes of NSW.

B The Owner and the Gentrader are entering into the Transaction Documents in connection with the Reforms.

C This Deed sets out the arrangements for the Completion of the transactions underlying the Transaction Documents.

1. The word “Reforms” in recitals A and B was defined in the following way:

***Reforms*** means the State’s Energy Industry Reform Strategy, comprising:

(a) the proposed sale of the retail businesses (and brands) of Energy Australia, Integral Energy and Country Energy;

(b) the proposed sale of the capacity and electrical energy of the existing State‑owned generators in the following four Gentrader Bundles:

(i) Eraring Bundle, comprising the Eraring and Shoalhaven power stations;

(ii) Delta West Bundle, comprising the Mt Piper and Wallerawang power stations;

(iii) Delta Coastal Bundle, comprising the Vales Point, Colongra and Munmorah power stations; and

(iv) Macquarie Generation Bundle, comprising the Bayswater and Liddell power stations; and

(c) the proposed sale of seven power station development sites currently owned by the State-owned energy businesses (with the Munmorah power station development site being sold as part of the Delta Coastal Gentrader Bundle).

1. Under cl 2.1 of the Implementation Deed the parties agreed to execute and perform the “**Transaction Documents**”. The Transaction Documents included:
2. Two **GenTrader Agreements**:
	1. the Generation Trading Agreement Eraring Power Station; and
	2. the Generation Trading Agreement Shoalhaven Power Station.
3. Two **Deposit Deeds**:
	1. the Deposit Deed (Eraring Power Station); and
	2. the Deposit Deed (Shoalhaven Power Station).
4. two **Mortgage Deeds**:
	1. Mortgage of Deposit Deed (Eraring Power Station)
	2. Mortgage of Deposit Deed (Shoalhaven Power Station)
5. The Implementation Deed described the timing of steps necessary to achieve commencement and performance of the GenTrader Agreements. The Implementation Deed also described the timing of payments to be made and the terms of security to be provided.
6. A consequence of the Implementation Deed providing for the execution of each of the GenTrader Agreements, they being within the definition of “Transaction Documents”, was that both of those agreements was a “Related GenTrader Agreement” and a “Related Agreement” in relation to the other, with the consequence that a default under one GenTrader Agreement could result in a cross default under the other.
7. The Transaction Documents referred to in the Implementation Deed were entered into on 1 March 2011. They are addressed further below.

## B.6 Events between the Implementation Deed and entry into the Transaction Documents

1. In an ASX/Media Release dated 15 December 2010, Origin stated (footnotes omitted):

Origin Energy Limited (“Origin”) today announced it has executed Sale and Purchase Agreements with the NSW Government to acquire the retail businesses of Integral Energy and Country Energy, and enter into GenTrader arrangements with Eraring Energy for a consideration of $3,250 million. In addition, under the GenTrader arrangements, there is a conditional amount of up to $198 million which will be payable if certain payments are ruled to be tax deductible.

1. Origin also stated:

The Eraring GenTrader arrangements will be acquired for $950 million representing $313/kW and provide flexible base load and peaking generation capacity at a significant discount to the ‘new entrant’ cost to build.

1. In the presentation accompanying that release, Origin stated:

Through the NSW Government’s Energy Reform Process, Origin has agreed to acquire the Integral Energy and Country Energy retail businesses, and the Eraring GenTrader arrangements for $3,250 million.

1. Origin referred to an “acquisition price” for the Eraring GenTrader arrangements as “$950 million (excluding a deferred and contingent payment of up to $198 million)”. It stated:

The GenTrader arrangements increase the scale and diversity of Origin’s generation portfolio making Origin the owner of one of the largest portfolios of generation capacity and generation contractual rights in Australia.

1. Origin described the “Annual Capacity Charge” as being “for the supply of the Total Contract Capacity to Origin over the life of the agreement”. It stated that it “has agreed to place funds on security deposit for the term of the GenTrader arrangements to cover the annual capacity charge payment”.

## B.7 The Deposit Deeds

1. As discussed above and in further detail below, the GenTrader Agreements provided for the payment by OEEL to Eraring Energy of substantial annual capacity charges, totalling $1,094,343,883 (Eraring) and $16,171,431 (Shoalhaven).
2. As had been anticipated by the Implementation Deed, Origin Depositor, the **Crown** in right of the State of New South Wales and Eraring Energy entered into Deposit Deeds. The Deposit Deeds acknowledged that Origin Depositor had placed the sums of $856,000,000 and $11,080,000 on interest bearing deposit with the Crown (NSW Treasury): cl 2.1(a). I infer that these amounts reflected the net present value of the total capacity charges payable under the GenTrader Agreements as at the date of payment of the deposits. The deposited amounts earned interest at 5.2% per annum: cl 2.2(a) of the Deposit Deeds. I infer that the payment of interest on the deposits ensured that the balance of the deposits was sufficient to cover each of the annual capacity charges as they fell due.
3. The deposits were provided as limited recourse security for payment of the capacity charges payable under the GenTrader Agreements: cll 2.1(d), 5.
4. Clause 2.3 of the Deposit Deeds irrevocably authorised and directed the Crown to pay from the deposits the annual capacity charges due to Eraring Energy. The Crown agreed and undertook to Eraring Energy to make those payments on the relevant due dates: cl 2.4. The Deposit Deeds also provided for other amounts to be paid from the deposit as the applicant and Eraring Energy jointly directed: cl 2.4(e). The Deposit Deeds also provided for the refund, if necessary, of the balance of the deposit which remained if the GenTrader Agreements were terminated before the expiry of the term of those agreements: cl 2.4(d).
5. Notwithstanding these provisions, the Crown could apply and invest the deposits in whatever way it saw fit: cl 4.

## B.8 The Mortgage Deeds

1. The Mortgage Deeds identified the interest of Origin Depositor in the Deposit Deeds, including any right to repayment of the deposit, as the “Secured Property”. The secured property was assigned by Origin Depositor as mortgagor to Eraring Energy as mortgagee: cl 2.1 of the Mortgage Deeds. Eraring Energy’s recourse to Origin Depositor was limited to the proceeds recovered by Origin Depositor from the deposit and Eraring Energy could not otherwise claim the “Secured Money” (the capacity charges and any early termination amount) from Origin Depositor: cl 2.13. The mortgage was to be discharged when Eraring Energy was satisfied that all of the capacity charges due had been paid and there were no circumstances in which further Secured Money would arise or was likely to occur within a reasonable time: cl 2.6.

## B.9 The GenTrader Agreements

1. The Eraring and Shoalhaven GenTrader Agreements were also dated 1 March 2011. The two GenTrader Agreements were in substantially similar terms. Eraring Energy was described in the agreements as the “Owner”. OEEL was described as the “GenTrader”.
2. It is necessary to refer in detail to various aspects of the GenTrader Agreements. This is done below, when discussing whether the capacity charges were deductible.
3. The operation of the Gentrader Agreements can be summarised in the following way.

### B.9.1 Supply of electricity and charges payable by OEEL

1. Each GenTrader Agreement provided that “[i]n consideration of the Owner [Eraring Energy] providing the Contracted Supply to the GenTrader [OEEL], the GenTrader must pay the charges described in this clause 23 in accordance with clause 25”.
2. Under cll 23.1 to 23.5 of the Eraring GenTrader Agreement, OEEL was required to pay four types of charges to Eraring Energy, namely the “capacity charges”, “fixed charges”, “variable charges” and “pass through charges” (see also the definition of “Charges” in the Glossary to each GenTrader Agreement). Clauses 23.1 to 23.6 provided:

**23.1 Charges**

In consideration of the Owner providing the Contracted Supply to the GenTrader, the GenTrader must pay the charges specified in this clause 23 in accordance with clause 25.

**23.2 Capacity Charges**

The GenTrader must pay to the Owner the charges set out in Section A of the Charges Schedule (**Capacity Charges**). Each Capacity Charge represents consideration payable by the GenTrader to the Owner for the provision of the Contracted Supply to the GenTrader for the period in which the Capacity Charge is payable.

**23.3 Fixed Charges**

The GenTrader must pay to the Owner the charges set out or determined under Section B of the Charges Schedule (**Fixed Charges**).

**23.4 Variable Charges**

The GenTrader must pay to the Owner the charges set out or determined under Section C of the Charges Schedule (**Variable Charges**).

**23.5 Pass Through Charges**

The GenTrader must pay to the Owner the charges set out or determined under Section D of the Charges Schedule (**Pass Through Charges**).

**23.6 Continuing Obligation to Pay Charges**

The GenTrader acknowledges that:

(a) the Capacity Charges, Fixed Charges and Pass Through Charges are payable whether or not, and regardless of the extent to which, the GenTrader requires provision of the Contracted Supply in any period to which those Charges relate; and

(b) except as expressly provided in this agreement, the GenTrader will not be relieved of its obligation to pay Charges in accordance with this agreement in any event or circumstance or for any reason (including any failure by the Owner to provide the Contracted Supply).

1. Clause 23 of the Shoalhaven GenTrader Agreement was in substantially similar terms, except that OEEL was also required to pay “pumping charges”: cl 23.6.
2. The various charges were payable at different times: capacity charges were paid annually in advance: cl 25.1; fixed charges were paid in arrears by monthly invoice in equal instalments of the stipulated fixed charge; variable and pass through charges were paid monthly – see: Schedule 11 (Eraring) and Schedule 9 (Shoalhaven). The pumping charges in relation to the Shoalhaven GenTrader Agreement were payable monthly.
3. There were also various other amounts which might be payable by one party to the other, as contemplated by cl 24. These included: a “Super Peak Availability Bonus” payable by OEEL where Eraring Energy exceeded the contract availability factors during periods of high demand for electricity; and “Availability Liquidated Damages” and “Over Generation Charges” payable by Eraring Energy in certain circumstances.
4. Clause 40 of the GenTrader Agreements provided for an adjustment to payments made under the GenTrader Agreement if a “Change Event” occurred which caused Eraring Energy’s costs to increase or decrease above the “Change Threshold”. The adjustments could result in an increase or decrease in the amount of payments to be made by OEEL.
5. Clause 42 of the GenTrader Agreements provided for payments by OEEL to the former Electricity Tariff Equalisation Fund, with any receipts from that Fund to be paid by Eraring Energy to OEEL. The fund arrangement ceased to have operation on and from 30 June 2011 and was abolished on 14 June 2012.

### B.9.2 OEEL provided at its cost or was liable for the cost of coal and fuel oil

1. Under cl 15 of the Eraring GenTrader Agreement, OEEL assumed the obligation, at its cost, to supply or procure the supply of coal to be burnt in the power station during the term of the agreement (approximately 22 years). As is described in more detail below, this involved OEEL entering into a number of agreements in order for it to take over responsibility for, and risk in relation to, coal supply and its cost.
2. Under cl 16 of the Eraring GenTrader Agreement, OEEL assumed the obligation, at its cost, to supply or procure the supply of “Fuel Oil” to be burnt in the generation units in the power station during the term of the agreement. It also had to supply or procure the supply of any petroleum product used by Eraring Energy in any motor vehicle, engine driven pumps, mobile plant and equipment or the Black Start Gas Turbine: cl 16.1(b).

### B.9.3 Ownership and operation of the power stations

1. Eraring Energy remained the owner of the generating units in each power station. Under cl 49.11 of both GenTrader Agreements, the “Power Station” and “Site” remained the exclusive property of Eraring Energy. Clause 49.11 of the Eraring GenTrader Agreement provided:

**49.11 GenTrader has no interest in the Power Station or the Site**

The Power Station and the Site are and remain the sole and exclusive property of the Owner. Nothing in this agreement will be construed as conferring on the GenTrader any legal, equitable or beneficial interest of any nature in the Power Station or the Site.

1. Clause 49.11 of the Shoalhaven GenTrader Agreement was in substantially similar terms.
2. Eraring Energy remained responsible for the operation of the power stations. In each of the relevant years it had a little over 400 full time employees.
3. Eraring Energy was permitted by cl 48 of the GenTrader Agreements to make rules and policies to “govern access” to the site and power stations by OEEL’s employees or nominees and persons to whom Eraring Energy was obliged to give access under the GenTrader Agreements, such people being collectively defined as “GenTrader Nominees”. These rules and policies were called “Site Access Rules”. Eraring Energy put in place “Site Access Rules”, which set out the “requirements for access” to both the Eraring and Shoalhaven power stations by “Origin Energy staff”.

# C SUMMARY OF THE PARTIES’ MAIN CONTENTIONS

## C.1 Summary of the applicant’s contentions

1. Origin submitted that, from a legal, practical and business perspective the contractual framework between Eraring Energy and Origin was that of a long term agreement for the supply of electricity by Eraring Energy to OEEL pursuant to which OEEL agreed to purchase essentially all of the sent out generation of Eraring Energy’s power plants, at the connection point between those power plants and the transmission system into the NEM.
2. It was submitted that, apart from the payment of liquidated damages by Eraring Energy in the event of default, the GenTrader Agreements operated in a “very similar manner” to the tolling arrangement between OEEL and the Origin group power station owners.
3. Origin submitted that, by paying the agreed charges imposed by the GenTrader Agreements, supplying coal and meeting invoices for coal procured by Eraring Energy, and meeting the cost of all other necessary fuel delivered to the Eraring power station, OEEL was entitled to the delivery, at the connection point, of essentially all of the sent out generation, ancillary services and, in the case of Shoalhaven, pumping (together the “Contracted Supply”) from the Eraring and Shoalhaven power stations.

## C.2 Summary of the respondent’s contentions

1. The respondent submitted that Origin acquired “a variety of contractual rights which permitted it to dictate as to the generation of electricity and to significantly expand its generation portfolio (coupled with related trading and generation rights)”. It was submitted that “this was the business ‘structure’ or ‘organization’ acquired by Origin ‘for the earning of profit’”. It was not expenditure incurred in the *operation* of Origin’s business structure, being regular outlays expended to generate profit. OEEL incurred the capacity charges to extend its profit-making structure.
2. The respondent submitted that OEEL bore risks which were inconsistent with the arrangements being classified as a long term supply contract or analogous to OEEL’s tolling arrangements. Origin acquired, it was submitted, the ability to dictate the timing and extent of electricity generation, and thus acquired a significant *part* of Eraring’s generation business and contracted for the entire remaining expected life of that generation business. It was an oversimplification to treat the capacity charges as merely relating to the acquisition of electricity; the arrangements were closer, it was submitted, to a joint venture, with risks and costs shared. Origin took on substantial benefits and risks, including risks associated with electricity generation.

# D DEDUCTIBILITY UNDER SECTION 8-1

## D.1 Section 8-1

1. Section 8-1 of the ITTA 1997 relevantly provides:

(1) You can ***deduct*** from your assessable income any loss or outgoing to the extent that:

(a) it is incurred in gaining or producing your assessable income; or

(b) it is necessarily incurred in carrying on a \*business for the purpose of gaining or producing your assessable income.

(2) However, you cannot deduct a loss or outgoing under this section to the extent that:

(a) it is a loss or outgoing of capital, or of a capital nature; …

1. It was not disputed that the outgoings incurred by the applicant satisfied the requirements of s 8-1(1). The respondent contended that the capacity charges were not deductible because paragraph (a) of s 8-1(2) applied.

## D.2 Principles

1. The general principles relevant to whether expenditure is on capital or revenue account have been recently considered by the High Court in ***AusNet*** *Transmission Group Pty Ltd v Commissioner of Taxation* (2015) 255 CLR 439 and *Commissioner of Taxation v* ***Sharpcan*** *Pty Ltd* (2019) 373 ALR 414. In *Sharpcan* at [18], the High Court stated (citations omitted):

Authority is clear that the test of whether an outgoing is incurred on revenue account or capital account primarily depends on what the outgoing is calculated to effect from a practical and business point of view. Identification of the advantage sought to be obtained ordinarily involves consideration of the manner in which it is to be used and whether the means of acquisition is a once-and-for-all outgoing for the acquisition of something of enduring advantage or a periodical outlay to cover the use and enjoyment of something for periods commensurate with those payments. Once identified, the advantage is to be characterised by reference to the distinction between the acquisition of the means of production and the use of them; between establishing or extending a business organisation and carrying on the business; between the implements employed in work and the regular performance of the work in which they are employed; and between an enterprise itself and the sustained effort of those engaged in it. Thus, an indicator that an outgoing is incurred on capital account is that what it secures is necessary for the structure of the business.

1. In *AusNet*, the majority emphasised the importance of the “advantage sought by the taxpayer by making the payments”: at [23], quoting Gibbs ACJ in *Commissioner of Taxation v South Australian Battery Makers Pty Ltd* (1978) 140 CLR 645 at 655. Their Honours referred to the decision of Fullagar J in ***Colonial Mutual*** *Life Assurance Society Ltd v Federal Commissioner of Taxation* (1953) 89 CLR 428 at 454 to the effect that payments forming part of the purchase price of an asset, which form part of the fixed capital of a business, are outgoings of capital: at [24]. Fullagar J identified the questions commonly arising as (emphasis in original):

(1) What is the money really paid *for? –* and (2) Is what it is really paid for, in truth and in substance, a capital asset?

1. The answer to the question what the money is really “for” is not necessarily answered solely by reference to a “juristic classification of legal rights”: ***Hallstroms*** *Pty Ltd v Federal Commissioner of Taxation* (1946) 72 CLR 634 at 648. The answer “depends on what the outgoing is calculated to effect from a practical and business point of view”: *Sharpcan* at [18]; *Hallstroms* at 648. The primary question is the character of the advantage sought by the taxpayer in incurring the expenditure: ***GP International Pipecoaters*** *Pty Ltd v Commissioner of Taxation* (1990) 170 CLR 124 at 137.

## D.3 Consideration

1. A number of factors indicate that the expenditure was an affair of capital. The overarching reason for this conclusion is that the advantage sought by the expenditure was an acquisition of a new or extended profit making structure. OEEL acquired the right to trade the entire output of the power stations for an extended period and to profit from that structure having regard to the various risks and opportunities acquired. OEEL’s profit making structure was significantly extended and altered for an extended term, with the ability further to extend the term. The expenditure is not properly characterised as being merely for the yearly acquisition of electricity by OEEL for on-sale at a profit, even if that is a part of what was acquired by the expenditure. That oversimplifies what the expenditure was for. Such a characterisation fails to recognise that what OEEL sought to achieve by incurring the expenditure, as a matter of practical and business reality, was the acquisition of a business structure constituted by the right to trade the entire output of the power stations, the operation of which would be managed by the owner, but over which OEEL had significant elements of control and in respect of which it bore risk and gained opportunities for profit.
2. This overarching conclusion is supported by a consideration of the following matters, each of which is expanded upon below:
3. What had been Eraring Energy’s trading business was handed over to OEEL.
4. OEEL had substantial control over when and how much electricity was to be generated.
5. Whilst the power stations were managed and operated by Eraring Energy, OEEL had some involvement in the management and operation of the power stations.
6. The effect of the contractual arrangements was for OEEL to acquire a number of business risks and opportunities consistent with acquiring a new or extended business structure. These included:
	1. OEEL took over the obligation to supply or procure the supply of coal and fuel to the Eraring power station.
	2. OEEL could request capital improvements and bore the cost of the upgrade to the Eraring power station generating units.
	3. The fixed and variable charges were structured in a way which meant that OEEL bore some of the risk in relation to generation of electricity.
	4. OEEL took on some of the risks associated with a failure to generate electricity.
	5. OEEL took on the obligation to take out substantial levels of insurance, including industrial and special risks insurance to cover loss and damage to the power stations themselves and any consequential losses.
7. Although the capacity charges were recurrent in form, OEEL paid the whole of them up-front, a matter relevant to the weight to be given to the consideration that recurrent expenditure is often an indicator of expenditure on revenue account.
8. The lengthy terms of the GenTrader Agreements (approximately 22 and 28 years) and the provisions for extension and termination of the agreements are consistent with a conclusion that the capacity charges were on capital account.

### D.3.1 Eraring Energy’s trading business was handed over to OEEL

1. In preparation for the entry into the GenTrader Agreements, Eraring Energy and Origin co-operated in accordance with a Transition Services Agreement and a Transition Plan to hand over to OEEL what had previously been Eraring Energy’s business of trading the electricity generated from the Eraring power station.
2. In February 2011, after the Implementation Deed had been entered into and before the GenTrader Agreements were entered into on 1 March 2011, Mr Jarvis became Origin’s General Manager Wholesale Trading. This was a newly created position.
3. It was not disputed that the Transition Services Agreement and Transition Plan in fact entered into were in the form appended to the Implementation Deed as a draft “Transition Services Agreement” and a “Draft Transition Plan”. Mr Jarvis confirmed he was familiar with the Transition Plan.
4. The Draft Transition Plan provided for the transition of key processes and information from Eraring to OEEL in order for OEEL to operate independently in the market trading the output of the power station. It provided:

The Transition Program sets out to plan for, and execute the transition of, requisite processes, job shadowing and knowledge, data and information flows from Eraring to Gentrader in order for them to operate independently in the market and take up their responsibilities under the GTA [GenTrader Agreement].

1. It “addresse[d] the activities necessary to transfer responsibilities from Eraring to GenTrader”. It stated:

The activities are limited to the following:

* Provision for the transition of processes / knowledge / documentation (including job shadowing) from the following functional areas in support of Gentrader’s responsibilities under the GTA:
* Coal
* Fuel oil
* Electricity trading
* Electricity settlement
* Insurance
* IT
* Configuration of the communication link between the Eraring IT environment and Gentrader
* Configuration of the TSA environment to Gentrader
* Provision of transition of service at the wind down of the term of the TSA, including:
* Extraction of base data sets as-is from Eraring’s IT systems and collation of media for transfer to Gentrader
* Configuring information flows to support the wind down of the TSA services
1. It contained the following:

**Key assumptions**

The following assumptions have directed the development of this document:

* Gentrader will take responsibility for all trading of electricity from LD1
* All existing electricity hedge contracts are settled directly by Gentrader from LD1
* All risks and economic obligations of existing coal supply contracts will be passed to Gentrader via a coal on sale agreement (COSA), however, contract management, correspondence and settlement will be the responsibility of Eraring
* All new coal supply contracts will be settled and managed by Gentrader
* Gentrader will take ownership of and responsibility for the boiler fuel oil at LD1
* For planning purposes, the assumed dates for key milestones used in the Draft Transition Plan are:
* Assumed Signing date: 13 December 2010
* Assumed LD1 and TSA kick-off: 1 March 2011
* Assumed TSA termination: 6 months after LD1

…

Baseline transition

Baseline transition activities are required to be performed irrespective of whether a TSA is taken up by Gentrader and will take place during the period between Signing and LD1. These activities are split by operational workstreams and are detailed below.

Key baseline activities include the facilitation of knowledge transfer to Gentrader, hosting power station site visits, job shadowing, and providing an agreed set of documents and winding down existing activities in relation to trading and settlement.

*Job shadowing*

For the purposes of this Draft Transition Plan, “job shadowing” means Eraring allowing up to six nominees of the Gentrader direct, supervised access to approved Eraring personnel and sites to facilitate an understanding of certain of Eraring’s operations, as described further in section 4, including allowing Gentrader to assign these nominees to sit with and observe approved Eraring employees (at both the power stations and Eraring’s offices) and provision of an appropriate work area for Gentrader representatives. Such access is to be granted:

* for a reasonable period agreed to by the Transition Program Steering Committee
* at all reasonable times required by Gentrader during normal business hours during the applicable period;
* upon reasonable notice;
* under the supervision or direction of the Workstream Sponsor or Project Manager; and
* in accordance with interaction protocols to be agreed by the Transition Program Steering Committee.

Gentrader will ensure that its representatives, in undertaking job shadowing, comply with the reasonable confidentiality, access, security and occupational health and safety restrictions of Eraring and do not interfere unreasonably with Eraring’s operations. The representatives will adhere to all instructions given by their supervising Workstream Sponsor or Project Manager while on site. The Project Manager will approve the Eraring personnel for relevant purposes under this Deed.

In addition to Section 4, where reasonably practicable, Eraring will also allow Gentrader access to approved Eraring personnel, on reasonable notice, for ad hoc queries during the term of the TSA.

*Coal workstream*

Coal activities include knowledge transfer, job shadowing during the period from a reasonable time after Signing until LD1 for a time agreed by the Transition Program Steering Committee, documentation handover and coal stocktake.

The coal workstream knowledge transfer will focus on coal delivery, coal contract management, coal inventory management and contract settlement processes. This is proposed to be delivered through a structured training program.

*Fuel Oil workstream*

Fuel oil activities include knowledge transfer, job shadowing during the period from a reasonable time after Signing until LD1 for a time agreed by the Transition Program Steering Committee, documentation handover and fuel oil stocktake.

The fuel oil workstream knowledge transfer will focus on fuel oil procurement and delivery processes.

*Trading workstream*

Trading activities include knowledge transfer, job shadowing during the period from a reasonable time after Signing until LD1 for a time agreed by the Transition Program Steering Committee, documentation handover, contract novation and trading activity wind down.

The trading workstream knowledge transfer will focus on explaining electricity bilateral contracts, how to bid coal-fired baseload electricity, key interactions with the power stations, and trading IT system training. No training will be provided by Eraring in relation to risk management or trading strategy.

In preparation for Gentrader to trade from LD1, Eraring will gradually wind down trading activities for Eraring and Shoal haven power stations and will sign off the handover prior to LD1. The effort that will be put into continuing to negotiate draft bi-lateral contracts covering the period post LD1 will be agreed with Gentrader.

*Settlement workstream*

Settlement activities include knowledge transfer, job shadowing during the period from a reasonable time after Signing until LD1 for a time agreed by the Transition Program Steering Committee, documentation handover, settlement activity wind down and security amount.

Electricity settlement knowledge transfer program will be focused on Australian Energy Market Operator (AEMO), bilateral, derivatives, ancillary services and ETEF settlements. Settlement system training will also be provided.

Eraring will gradually wind down relevant settlement activities for Eraring and Shoalhaven power stations and ensure appropriate cut off of settlement to cover Eraring activities up to LD1 as covered by the Implementation Deed.

Eraring will agree with Gentrader the form, contents and timeframe of the monthly GTA invoice and what supporting information will be reasonably provided for the various charges on the invoice.

*Insurance workstream*

Subject to Eraring’s insurers accepting the addition of Gentrader interests to current insurance policies, upon expiry of that current policy, Gentrader will take responsibility for taking out key insurances. Eraring will provide Gentrader with brief key terms, conditions and insurance requirements.

*IT workstream*

IT activities include secure data connection, knowledge transfer, documentation handover, AEMO NEM data, Gentrader registration and contingency plan.

Gentrader as the registered Generator in the market from LD1 will be responsible for sending to, and receiving data from the NEM (AEMO) under the GTA.

Eraring will also require market data to meet operational requirements. Preferred solution is for Eraring to receive relevant NEM data directly under a “data sharing” arrangement.

1. Mr Jarvis confirmed that, after the GenTrader Agreements were in place, people in his teams undertook the various workstreams identified in the Draft Transition Agreement. These were workstreams which had not previously existed within Origin. The process involved “reskilling” the employees of OEEL who came to carry out the various workstreams.

### D.3.2 Substantial control of when and how electricity was generated

1. As is explained further below, OEEL had control over the amount of electricity which was generated by the Eraring and Shoalhaven power stations and when electricity was generated. That control arose because of OEEL’s trading activities, which necessarily governed the amount of electricity generated.
2. Eraring Energy was required to provide the “Contracted Supply” to OEEL: cl 3.1 of the GenTrader Agreements. The “Contracted Supply” was defined in the Glossary at Schedule 1 to the Eraring GenTrader Agreement as:

the supply of electricity and Ancillary Services from that amount of the Capacity of the Units that is equal to the Total Contract Capacity.

The definition of “Contracted Supply” in the Shoalhaven GenTrader Agreement was in substantially similar terms, except that the Contracted Supply also included the supply of pumping from that Capacity.

1. The “Total Contract Capacity” for the Eraring station was initially 2,690MW. It gradually increased to 2,800MW from after 31 October 2012 (when the upgrades were due to be completed) and was to remain at that level for the remaining contract years. The “Total Contract Capacity” for the Shoalhaven station was 240MW.
2. Eraring Energy had an ongoing obligation to communicate to OEEL the available capacity of each generating unit: cl 11.1 (Eraring); cl 12.1 (Shoalhaven). Eraring Energy was required to provide daily, weekly and long term forecasts of the availability of the generating units: cl 11.2, 11.3 (Eraring); cl 12.2 and 12.3 (Shoalhaven). The information that Eraring Energy provided to OEEL was used by OEEL in formulating its bids, and to allow it to fulfil its obligations to comply with AEMO information requirements – see generally: cl 3.7E NER.
3. The GenTrader Agreements contemplated that Origin would make “Dispatch Offers” to the National Electricity Market Manager, being AEMO – see: cl 12.1 (Eraring) and cl 13.1 (Shoalhaven). These would, if accepted, result in the sale of the sent out generation (electricity) to which the offer related. Eraring Energy was, with presently irrelevant exceptions, required to comply with any “Dispatch Instruction” received – see: cl 12.2(b) (Eraring); cl 13.2(b) (Shoalhaven). OEEL could, and did, offer less than the Total Contract Capacity to the market. By this mechanism, OEEL controlled if and when generation occurred, with the result that the stations did not operate at their full capacity or at “Total Contract Capacity”.
4. Eraring Energy had to notify OEEL of any anticipated changes in available generating capacity as soon as those changes occurred: cl 11.4 (Eraring); cl 12.4 (Shoalhaven). Such changes included a reduction in capacity of a particular generating unit because it was unavailable for a particular period (for example, for maintenance to be carried out): cl 5.2(b) (Eraring); cl 6.2(b) (Shoalhaven).
5. OEEL had an ongoing obligation to notify Eraring Energy of the volume of electricity it would seek to sell into the NEM. OEEL had to notify Eraring Energy within sufficient time to allow Eraring Energy to produce that volume of electricity: cl 11.5 (Eraring); cl 12.5 (Shoalhaven).
6. Although Eraring was required to provide the “Contracted Supply”, the effect of the contractual arrangements was that Eraring was only to generate so much electricity as was necessary to supply that which OEEL traded into the spot market. As a baseload power station, Eraring did not always operate at full capacity. Mr Jarvis said that it typically ran at somewhere between 50 to 75% capacity. Historically, it had demonstrated a minimum continuous operating load of 210MW per unit – around 32% of its rated capacity (then 660MW per unit). This enabled it to respond in periods of peak demand and high prices. The decision about what level to run the power station was driven by how profitable it would be to produce electricity, which necessarily depended on the cost of the input (coal and fuel oil) and the sale price of electricity in the spot market. As discussed further below, OEEL bore risks and responsibility in relation to the cost of the coal and fuel at Eraring power station. It bore the risk in relation to the market sale price of electricity. Eraring Energy operated the power station such that it supplied the amount of electricity which OEEL decided to offer in the spot market having regard to its costs and the profit it might make.
7. The Shoalhaven power station operated differently, it being a peaking station. Mr Jarvis explained in his evidence:

The power station operates by flowing water through two separate generating units at Fitzroy. Each unit is 80MW. From there, water flows down to Bendeela through two generating units, each of 40MW. Water is pumped back up to Fitzroy when the cost of power is low, and is released to drive the generators when spot prices are higher.

1. The water is pumped to the holding reservoir at Fitzroy Falls during periods of low (or indeed negative) electricity prices and then released to produce electricity during times of high prices. The Shoalhaven power station was not able to operate at peak capacity for extended periods, because of the fact that water needed to be pumped back up once it flowed down. The power station had allocated water reserves sufficient to provide 200MW of generation capacity for up to 28 hours with an extra 40MW for up to 6 hours continuously. The power station had a fast start capability, requiring only 10 minutes from start to achieving full load. The Shoalhaven power station was designed to operate at a greater capacity in times of peak demand and at a lower capacity at other times. The ability to control when generation of electricity occurred was central to the profitable trading of electricity generated by that plant. This was controlled by OEEL.
2. The GenTrader Agreements expressly provided that the capacity charges were payable in full by OEEL whether or not the power stations were “required” (by OEEL) to provide the “Contracted Supply”: cl 23.6 (Eraring) and cl 23.7 (Shoalhaven). Clause 23.6 of the Eraring GenTrader Agreement provided:

**23.6 Continuing Obligatioelizan to Pay Charges**

The GenTrader acknowledges that:

* 1. the Capacity Charges, Fixed Charges and Pass Through Charges are payable whether or not, and regardless of the extent to which, the GenTrader requires provision of the Contracted Supply in any period to which those Charges relate; and
	2. except as expressly provided in this agreement, the GenTrader will not be relieved of its obligation to pay Charges in accordance with this agreement in any event or circumstance or for any reason (including any failure by the Owner to provide the Contracted Supply).
1. To the extent Eraring had generating capacity which was not used in supplying electricity to meet OEEL’s trading activities, it could not use that capacity to sell electricity to any other person: cl 3.2. The electricity generated was solely for Origin’s benefit: cl 4 (Eraring); cl 5 (Shoalhaven).
2. In summary, OEEL’s decision about how much contracted supply to require be generated by Eraring Energy was dependent upon OEEL’s trading activities. OEEL bore risks in relation to the cost of the Eraring power station generating electricity. Its decision whether or not to require the supply of electricity depended upon its assessment of the various risks and benefits both in respect of those aspects of the generation side of the equation in respect of which it was commercially interested and the trading side of the equation. Eraring could only supply OEEL, but received the capacity charges in full irrespective of how much electricity OEEL required it to supply.

### D.3.3 Involvement in operation of power stations

1. As noted above, Eraring Energy remained responsible for the operation of the power stations, using its own employees.
2. Eraring Energy remained responsible for the maintenance of the generating units, including the scheduling of planned outages and the unavailability of particular generating units within the Eraring and Shoalhaven power stations due to testing requirements. The availability and reliability of the generating units was a function of the age of the generating units and the maintenance program implemented and performed by Eraring Energy.
3. Eraring Energy remained responsible for the performance of certain contractual obligations it had when each of the GenTrader Agreement was entered into. For example, Eraring Energy was party to contracts with the Sydney Catchment Authority which permitted the interchange of water between different water storages without which it could not generate electricity: cl 4.2 Shoalhaven GenTrader Agreement.
4. However, as a practical matter, the power stations had to be operated in a manner which permitted Eraring Energy to fulfil the Dispatch Notifications received from AEMO, those notifications being generated having regard to, or on acceptance of, bids that OEEL placed in the NEM. Under the GenTrader Agreements, Eraring Energy agreed to operate the generating units comprising the Eraring and Shoalhaven power stations to supply the volume of sent out generation and the ancillary services requested by OEEL at the connection point: cl 5.1 (Eraring) and cl 6.1 (Shoalhaven).
5. As a practical matter, OEEL could only bid into the NEM quantities of electricity which were within the confines, or operating envelope, of what the power stations could produce.
6. Although OEEL did not acquire either power station, and Eraring Energy remained responsible for managing and performing the day to day operations, OEEL did have an involvement in overseeing the operation of the power stations.
7. The GenTrader Agreements required Eraring Energy to provide the “Contracted Supply” in accordance with, amongst other things, all relevant “Laws” and the “Contracted Requirements”: cl 5.1 (Eraring); cl 6.1 (Shoalhaven). The “Contracted Requirements” were provided for in cl 5.3 (Eraring) and cl 6.3 (Shoalhaven), the former of which provided:

**5.3 Contracted Requirements**

(a) Section C of the Contract Parameters Schedule sets out:

(i) certain rights and obligations of the Parties in relation to the Operating Characteristics of each Unit and the Black Start Gas Turbine; and

(ii) certain performance standards to be met by each Unit and the Black Start Gas Turbine,

(collectively, the **Contracted Requirements**).

(b) Each Party must comply with, and the Owner must ensure that each Unit and the Black Start Gas Turbine meets, the Contracted Requirements.

1. Section C of sch 4 to the GenTrader Agreements set out a number of matters which OEEL could and could not “request or require”. This allowed for OEEL to “request or require” Eraring Energy to “Ramp Up” or “Ramp Down” one or more of a power station’s generating units within certain defined limits. Section C also set the “Minimum Continuous Load” and provided that OEEL could not request a Dispatch at a level lower than that load, other than for the purposes of a start or shut down of a unit.
2. Section C prevented Eraring Energy from shutting down a generating unit except in the specific circumstances identified, which included “a GenTrader Initiated Shutdown”. Paragraph C.3(c) provided that OEEL could request a shut down for any reason, being the definition of a “GenTrader Initiated Shutdown”. Eraring Energy had to comply with such a request. If there was a GenTrader Initiated Shutdown, Eraring Energy was not entitled to start the generating unit until requested to do so by OEEL.
3. Clause 19.1 of the GenTrader Agreements provided for the establishment of a “Co-ordination Committee” which was to be comprised of two representatives from Origin and two from Eraring Energy: cl 19.1(a). Each party was required to “have at least one representative experienced in the operation of coal-fired power stations” for the Eraring station: cl 19.1(b), and “at least one representative experienced in the operation of power stations” for the Shoalhaven station: cl 19.1(b). Clause 19.2(d) provided that the committee functions included:

to discuss operation, maintenance and performance of, and potential capital improvements to, the Power Station [or Stations in the case of Shoalhaven]

1. All decisions of the Committee were required to be unanimous. If the Committee was unable to agree on any matter within its authority, either party could refer the matter to an expert for determination in accordance with cl 45: cl 19.5(a).

### D.3.4 Business risks and opportunities acquired by OEEL

1. The consequence of the arrangements entered into by Eraring and the Origin group was that Eraring divested itself of its trading activities and its responsibilities in relation to the acquisition of fuel for Eraring and confined itself to electricity generation activities. As had been the underlying objective revealed by the documents and circumstances known to the parties at the time of entry into the Implementation Deed and, later, the Transaction Documents, in addition to not engaging in trading activities, Eraring Energy reduced very substantially any risk in relation to the trading of electricity. OEEL acquired Eraring’s trading activities, or the right to trade Eraring’s electricity, in return for the payment of fixed capacity charges.
2. The risks assumed by Origin in relation to trading, and avoided by Eraring Energy, included that Origin’s sale price would fluctuate with the spot price, whereas Eraring Energy received the agreed price which was to be deducted from the security deposit. At a practical level, Origin assumed effectively all of the risks associated with compliance with the NEL and NER*.* Origin bore exposure to, and the benefits of, the Electricity Tariff Equalisation Fund. Eraring was required to make payments to the Electricity Tariff Equalisation Fund, which was established under part 4 division 6 of the *Electricity Supply Act 1995* (NSW). Under the GenTrader Agreements, OEEL was required to pay Eraring amounts equal to what the latter was required to pay into the Equalisation Fund: cl 42.2(a). Eraring Energy was required to pass on any repayments it received from the Fund to OEEL: cl 42.3. The fund ceased to exist in 2012. Origin also took on the risks in relation to hedging.
3. Eraring Energy also divested itself of, and Origin assumed, risks in relation to generation:
4. Origin took on the responsibility and risk of providing critical inputs being coal and fuel oil to the Eraring power station. This was relevant to its overall profitability when assessed together with its trading activities.
5. Origin took on the costs associated with capital improvements if they requested such improvements and funded the upgrades to the Eraring power station generation units.
6. The various charges under the GenTrader Agreements had the consequence that OEEL assumed risks which related to the generation of electricity, not merely risks associated with trading.
7. The risks associated with a failure of supply of electricity by Eraring Energy were shared between Eraring and Origin. In particular, OEEL could claim “Availability Liquidated Damages”, but those damages did not necessarily reflect the economic loss of OEEL arising from any failure. Rather, they were “capped” damages.

#### D.3.4.1 Coal and fuel oil

1. OEEL took over responsibility for supply of, and the cost of, the major inputs to the Eraring power station of coal and fuel oil. It also took on the supply risk of those inputs. Coal was used in the Eraring power station to generate electricity. Fuel oil was burnt in generation units. OEEL also had to supply any necessary petroleum products for the operations.
2. OEEL was required by the Eraring GenTrader Agreement, “at its cost”, to “supply or procure the supply of all coal to be burnt in the Power Station during the Term”: cl 15.1. Further, “all risk” in coal “until it is burnt in the Power Station remain[ed] with” OEEL “at all times and does not pass to” Eraring Energy: cl 15.7(b)(ii). OEEL was required by the Eraring GenTrader Agreement, “at its cost”, to “supply or procure the supply of all Fuel Oil to be burnt in the” generation units during the Term: cl 16.1. As with the coal, risk in the fuel oil remained with OEEL until it was burnt: cl 16.3(b).
3. At the time the parties entered into the Transaction Documents, Eraring Energy was party to a number of coal supply agreements under which it acquired coal from suppliers. Eraring Energy and OEEL entered into “Coal On-Sale Agreements” under which OEEL paid to Eraring Energy the amount Eraring Energy was to pay the relevant supplier: cl 6.1, sch 2. Title and risk in the coal was passed to OEEL at the same time it passed to Eraring Energy from the supplier, with the result that OEEL bore related risks: cl 3.2(a). Further, if there were additional charges passed on to Eraring Energy and not otherwise recovered by Eraring, being costs “attributable to compliance with a Greenhouse Law”, those costs could be passed on to OEEL: cll 6.2 and 6.3. Eraring Energy thus became, in substance, an intermediary. Mr Jarvis confirmed, in cross-examination, that the economic obligations of the existing supply contracts were passed on to OEEL. Origin had not previously entered into coal supply contracts before this new arrangement of supplying coal to Eraring.
4. OEEL also agreed to enter into the “Cobbora Coal Supply Novation Deeds”, which were annexed to the “Implementation Deed”. Although the Novation Deeds were not before the Court, I infer from the definitions in the Implementation Deed and the “Coal Sale Agreement” between a “Miner” and Eraring Energy that the intended effect of the Novation Deeds was to novate to OEEL a coal supply agreement under which Eraring Energy had agreed to purchase coal from a State entity which had proposed to develop a mine near Cobbora. In addition to becoming the purchaser of the coal, OEEL also agreed to reimburse reasonably incurred “Carbon Costs” or providing credits to the Miner for fugitive emissions (from supply and delivery of coal) and assumed liability for downstream emissions (from combustion of coal delivered) under any future carbon scheme. Cobbora was to be the major supplier of coal to the Eraring power station from 2015. OEEL was at risk if the development of the Cobbora coal mine was delayed. OEEL took the benefit of the price of coal under this agreement to the extent it was more favourable than the market price.
5. The risks of additional costs in the form of “carbon costs”, under both the novated agreement related to Cobbora and the various existing supply agreements, were real risks at the time the Transaction Documents were entered into in December 2010 and March 2011.
6. To the extent that the existing arrangements were insufficient to supply the coal needs of the Eraring power station, OEEL was responsible for fulfilling that need.

#### D.3.4.2 Capital improvements

1. Eraring Energy was required to incur expenditure to “operate and maintain” the Eraring power station “as currently configured”: cl 22.1 of the GenTrader Agreements. It was not required to improve the power stations.
2. Under cl 22.2 of the GenTrader Agreements, OEEL could “request” Eraring to carry out capital improvements. The terms of any improvement were to be negotiated, including “the respective responsibilities of the Parties in relation to funding” and “any amendments … to the charges payable”: cl 22.2(d). The commercial reality is that Eraring Energy would have been unlikely to agree to fund a request by OEEL for capital improvement unless OEEL funded it. The terms of the GenTrader Agreements had the result that OEEL had an incentive to invest in capital improvements. Eraring Energy did not. Under the GenTrader Agreements, Eraring Energy was entitled to the “Capacity Charges” that had been agreed. It did not matter whether Eraring in fact delivered more or less electricity.
3. A related issue concerned which entity in fact paid for the upgrade of the generation units at the Eraring power station. These were already being upgraded at the time the GenTrader Agreements were entered into. The parties were in dispute about who paid for the upgrades.
4. Eraring Energy’s Annual Report 2012 included (emphasis added):

… Eraring Energy entered into GenTrader Agreements with Origin Energy following completion obligations of Origin Energy and Eraring Energy on 1st March 2011. Under these agreements, Origin Energy purchased the right to trade the output of Eraring and Shoalhaven Power Stations. Eraring Energy has recognised this transaction as a finance lease, derecognising the Power Station plant and equipment, and recognising a finance lease receivable. In return, *Eraring Energy receives capacity charge payments, together with fixed and variable payments for the Eraring Power Station Upgrade to 4x720MW*, normal “stay in business” capital expenditure and the operation and maintenance costs of Eraring and Shoalhaven stations over the respective lives of the GenTrader Agreements of 22 and 28 years.

1. Origin’s 2011 Annual Report stated: “Origin will fund the continued upgrade of capacity of the Eraring Power Station”. Origin’s 2012 Annual Report stated:

Depreciation and amortisation costs will increase in line with the increased asset base, following the completion of … upgrades to Eraring Power Station …

1. It is notable that the annual fixed charges set out in Table B.1 to Schedule 11 of the Eraring GenTrader Agreement are significantly higher in the first two years at $269,938,000 per annum. For the next four years, the fixed charge dropped to $148,579,000. Taking that into account and noting that Eraring’s Annual Report 2012 stated that Eraring Energy (a) received “fixed and variable payments for the Eraring Power Station Upgrade to 4x720MW”; and (b) was in the final stage of the capacity upgrade to 4 x 720MW (3 had been completed), I conclude that OEEL paid for the upgrade through the fixed and, possibly, variable charges. This conclusion is consistent with the contractual arrangements overall which, in simple terms, made OEEL responsible for the costs of the input to, and the operation and management of, the power stations.

#### D.3.4.3 The structure of the fixed and variable charges

1. As noted earlier, OEEL was required to pay four categories of fees: (1) the capacity charges; (2) fixed charges; (3) variable charges; and (4) pass through charges.
2. The “fixed charges” were specified amounts. I infer that they represented the estimated costs of operating and maintaining the power station as Origin explained in its ASX media release to the market on 15 December 2010 and, in relation to the Eraring power station, that they included the costs associated with the final stages of the upgrade to the generation units.
3. Origin described the “variable charges” as “costs per unit of energy produced to reflect the costs of consumables including chemicals, lubricant and hydrogen and [were] payable monthly”. The charge related to, and varied with, the amount of electricity OEEL required Eraring to generate from the power stations.
4. The “pass through charges” were various costs to Eraring which were passed on to OEEL and included “all charges imposed … for or in relation to the connection of the Power Station to the Transmission Network” and, in the Eraring GenTrader Agreement, “all rates, land taxes and other charges imposed upon” Eraring Energy in respect of the site of each power station: sch 11, section D(a) GenTrader Agreements. Origin described these charges as “including water, transmission connection charges, licence fees, land taxes and auxiliary power purchases”.
5. Apart from the “variable charges”, each of the charges were payable irrespective of the amount of electricity which OEEL required, through its trading activities, that Eraring Energy generate.
6. Each of these three charges related to the cost of generation of electricity and, objectively assessed, were intended to cover the cost of use of the power stations or as covering the cost of generating the electricity. Of course, Eraring Energy retained risk: if actual costs were higher than anticipated, variable and fixed costs might be insufficient and Eraring would not be fully compensated. On the other hand, if actual costs were lower than anticipated, OEEL would be over-compensating Eraring Energy for those costs. That is, OEEL also took on market risk associated with generation of electricity.
7. The respondent submitted that, if the charges otherthan the capacity charges can be said to relate to the generation of electricity, there is no incongruity in characterising the capacity charges as also relating to the generation of electricity. The respondent also submitted that, “[c]onsistently with Origin’s contractual ability to dictate the generation of electricity, the capacity charges can be seen as the price of acquiring control over the future generation and trading of electricity at Eraring power station for the expected technical life of that station; the capacity costs were a cost borne in relation to enlarging Origin’s actual profit-making structure – as opposed to the other costs which amounted to the *use* of that profit-making structure to generate and sell the electricity so produced”.
8. This consideration cuts both ways. On one view, the fixed and variable costs can be seen as covering the cost of generation of the electricity (or the use of the power stations) and the capacity charges can be seen as the price paid for the output, namely the electricity. This view weighs in favour of a conclusion that the capacity charges were on revenue account. Another view is that the capacity charges constitute expenditure to acquire the profit making structure, namely the right to take over the trading of the output for a lengthy term, together with all of the other risks and opportunities furnished by the contractual arrangements as a whole.
9. Taken with the other matters referred to in these reasons, in my view the capacity charges reflect expenditure to secure a profit-making structure in the form of the right to trade the entire output of the power stations, at levels controlled by OEEL, for substantial periods of time.

#### D.3.4.4 Risks in relation to failure of supply

1. If Eraring Energy failed to generate sufficient electricity, OEEL only had recourse to a liquidated amount, referred to as the “Availability Liquidated Damages”; OEEL could not otherwise seek damages, such as expectation damages for breach of contract: cll 24, 37 of the GenTrader Agreements. Eraring Energy’s liability was calculated according to a formula which involved pre-determined values. Further, the “Availability Liquidated Damages” to which OEEL was entitled were capped in pre-agreed amounts: cl 24.2; sch 8 s D (Eraring);sch 8 s E (Shoalhaven).
2. No component of the calculation was set by reference to the actual market loss suffered by OEEL. Albeit Eraring and OEEL therefore shared the risk of Eraring Energy’s failure to supply electricity, it was OEEL which bore the *market* risk of Eraring Energy’s failure to supply.
3. The parties’ intention, objectively ascertained from the terms of their agreements, was for Eraring Energy to bear a fixed risk in respect of its failure to supply, being a part of its generation activities. In substance, the State was to receive, upfront to be held on security deposit, the total amount of capacity charges payable. The maximum amount for which Eraring Energy might be liable by reason of its own defaults was fixed. Eraring Energy substituted its fluctuating risk in relation to a failure to supply for a capped risk to pay “Availability Liquidated Damages”. The assumption of this risk by OEEL is consistent with OEEL extending its profit-making structure.

#### D.3.4.5 Insurance

1. Although Eraring Energy remained the owner of the power stations, cl 30 of the GenTrader Agreements required OEEL to “take out and maintain at all times each of the insurances specified in the Insurance Schedule”. The insurance required was set out in schedule 13 (Eraring) and schedule 10 (Shoalhaven) and included Industrial Special Risks insurance of $2.5bn (Eraring) and $500m (Shoalhaven) for material damage and consequential loss. The transfer to OEEL of the obligation to insure the power stations is consistent with a transaction under which OEEL acquired a capital asset.

### D.3.5 Structure of payments

1. As noted earlier, Origin (by Eraring Depositor) placed the sums of $856,000,000 and $11,080,000 on interest bearing deposit with the NSW Treasury as security for payment of future capacity charges. Also as noted earlier, these amounts reflected the value as at the completion date (the then present value) of the total capacity charges payable under the GenTrader Agreements. The payment of interest on the deposits ensured that the balances of the deposits were sufficient to cover each of the annual capacity charges as and when they fell due for payment.
2. The capacity charges payable by OEEL were debited by the Crown each year. OEEL did not transfer amounts to Eraring; the payments were made by the Crown to Eraring Energy in discharge of OEEL’s liability and Eraring acknowledged that this discharged OEEL’s obligation to pay the capacity charges and limited its recourse by agreeing it could not pursue OEEL for unpaid capacity charges: cll 2.3, 2.4 and 5.1(a) of the Deposit Deeds. The ultimate result was that Origin paid up-front for the capacity charges and the Crown took over the making of payments (by accounting entry) to Eraring Energy.
3. This payment structure is consistent with a characterisation of the expenditure as being “for” a capital acquisition, such as an exclusive right to control, and trade, the generated output of a power station. The character of the expenditure is determined from the perspective of the person incurring the expenditure, that is, by reference to the advantage sought by the person incurring the expenditure: *GP International Pipecoaters* at 137; *AusNet* at [23]. From OEEL’s perspective, the total amount of capacity charges were paid up front for the acquisition of rights to control, and trade, the future generated output of two power stations.
4. It is also relevant to note that the annual capacity charges were not structured by reference to the amount of electricity generated in each year. That is, the capacity charges for each year did not bear a direct relationship to the electricity to be generated in that year. Rather, the capacity charges were highest at the beginning and ever decreasing – see Annexure A to these reasons. For the Eraring station, approximately 81% (and for Shoalhaven approximately 70%) of all of the capacity charges were payable in a little under half the term of the agreement.
5. This structure for payment of the capacity charges is consistent with a payment plan for a capital acquisition, albeit it is not inconsistent with a “prepayment” of annual supplies of electricity. However, the structure of the payments in this way is relevant to the weight which should be given to the form of the charges as recurrent in assessing all of the circumstances so as to determine what, from a practical and business point of view, the expenditure was for.
6. Whilst it is the characterisation of the expenditure from the perspective of OEEL which is critical, it might be noted that the Crown was permitted to “apply and invest the Deposit in any manner it determines at its absolute discretion”: cl 4 of the Deposit Deeds. A part of the context known to both parties at the time of their agreement was that the NSW Government wanted to secure substantial funds immediately, which it could use in whatever way it saw fit, in exchange for disposing of the trading rights to the electricity to be generated. The contractual arrangements gave the NSW Government what was in substance an up-front one off payment, albeit the form of the agreements was that OEEL had a recurring annual obligation to pay capacity charges.

### D.3.6 Term of the GenTrader Agreements and extension and termination

1. As mentioned, the “Term” of the Eraring GenTrader Agreement was for an initial period of approximately 22 years, until 30 June 2032, called the “Initial Expiry Date”. The term of the Shoalhaven GenTrader Agreement was approximately 28 years, until 30 June 2038. The “Term” could be extended for a “Subsequent Period” in accordance with cl 2.4 of the GenTrader Agreements.
2. Clause 22.3(b)(ii) of the Eraring GenTrader Agreement implicitly contemplated that the “technical life” of each station might be extended by capital improvements. Clause 2.4 of the GenTrader Agreements contemplated that, in the event that an extension was sought within a prescribed period before the “Initial Expiry Date”, Eraring Energy was required to “negotiate exclusively” with OEEL in relation to an extended “Term”. Objectively ascertained from the terms of the GenTrader Agreements and the surrounding circumstances, the transactions were structured such that OEEL would have, if it sought it, the benefit of the entire lifespan of each power station.
3. OEEL could only terminate the GenTrader Agreements in limited circumstances involving a protracted period of difficulty, for example: (1) force majeure under which Eraring was relieved of some of its obligations for at least 30 months: cl 31.9; (2) a “Total Loss Event”, which effectively required the capacity of a unit or units to fall below 75%: cl 32.3; or (3) an “Availability Default”, which involved the “Contract Availability Factor” being less than a specified percentage for a period of 24 consecutive months cl 33.3.
4. OEEL could terminate the GenTrader Agreements early, but it would be at pain of forfeiting Origin’s deposit: if OEEL terminated early, it was obliged to pay the present value of all future capacity charges, namely the “Early Termination Amount”: cl 33.5(c)(i)(B) (Eraring); cl 34.1(b)(ii) (Shoalhaven). This amount was to be met out of what remained on deposit: cl 2.3(a)(iii) of the Deposit Deeds.
5. The lengthy term of the GenTrader Agreements and the extension and termination arrangements also support the conclusion that the expenditure, viewed in the context of the whole arrangement, was on capital account.

## D.4 Conclusion with respect to s 8-1

1. The “advantage sought” (*GP International Pipecoaters* at 137; *AusNet* at [23]; *Commissioner of Taxation v Citylink Melbourne* (2006) 228 CLR 1 at [148]; *Sharpcan* at [18]) by the expenditure or what the expenditure was “for” (*Colonial Mutual* at 454; *AusNet* at [24]; *Sharpcan* at [22]) was the acquisition of a new or extended profit making structure for Origin, that structure being constituted by a bundle of contractual rights which operated to give OEEL:
2. what had been Eraring Energy’s business of trading electricity, together with a number of other risks and opportunities, including market risks associated with the input to the Eraring power station (coal and fuel oil);
3. rights to the entire output of the Eraring and Shoalhaven power stations and the corresponding inability of those power stations to sell excess electricity to any other person;
4. substantial elements of control over the generation of electricity, including the right to decide how much, and when, electricity was to be generated by the power stations; and
5. so far as concerns the Eraring GenTrader Agreement, a significant expansion to Origin’s existing business structure, in particular an expansion into baseload coal-fired power stations, including the supply of coal and sale of output.
6. Origin submitted that what OEEL acquired was similar to a typical long term supply contract. As has been discussed and as further discussed below, OEEL acquired risks and opportunities beyond those provided by a typical long term supply contract. It also acquired elements of control beyond those typically encountered in a long term supply contract. In any event, the question is the characterisation of the particular acquisition, not how it compares to a different one, even if there is potential benefit in analogy – cf: *AusNet* at [78] (Gageler J); at [143] (Nettle J).
7. As noted at [78] above, Origin also submitted that, apart from the payment of liquidated damages by Eraring Energy in the event of default, the GenTrader Agreements operated in a “very similar manner” to the Tolling Agreement between OEEL and the Origin group power station owners. I reject that submission for the following reasons.
8. The Tolling Agreement was described in these terms by Mr Jarvis:

For·internal management and accounting purposes, Origin’s Generation division and Electricity Operations agreed a tolling arrangement under which Electricity Operations was treated as if it purchased the sent out generation of the generating units owned and operated by Origin’s Generation division in return for a tolling charge. That arrangement was formalised in 2010 in a Tolling Agreement between Generation and Energy Risk Management (of which Electricity Operations forms part).

1. It was submitted that, under that arrangement, OEEL was obliged to pay a tolling charge to the owners as the purchase price for the sent out generation produced by those owners and to source fuel for the operation of the generating units. The Tolling Agreement did no such thing.
2. The “Executive Summary” of the Tolling Agreement included:

The purpose of this document is to formalise the agreed tolling methodology which provides the basis for the monthly tolling payment made by ERM to Generation. This document outlines the commercial principles underlying the elements of the Tolling Charge and the review process for adjustments to the Tolling Charge.

The Tolling Charge for each plant is calculated as the sum of:

1. Return on Capital Invested
2. Major Maintenance Fee
3. Growth Capex and SIB Capex Fee
4. Operations and Maintenance Fee
5. The “Purpose” of the Tolling Agreement was described in cl 1 in the following way:

**1 Purpose**

The purpose of this agreement is to measure and report on the returns that Origin achieves from its merchant generation assets. The intent of the agreement is to provide a commercial basis for the tolling charge, while at the same time providing flexibility to review the allocation of value between Generation and ERM as may be appropriate in response to material changes in the business.

1. The Tolling Agreement is not “very similar” to the GenTrader Agreements.
2. Origin placed particular reliance on the decision of the Full Court of the Federal Court in *Commissioner of Taxation v Raymor (NSW) Pty Ltd* (1990) 24 FCR 90 (Davies, Gummow and Hill JJ). Raymor sold and distributed plumbing goods and accessories, including copper tubing, the majority of which it purchased from Metal Manufacturers Ltd (MML) for resale. Raymor and MML entered into three substantially similar agreements in 1983, 1984 and 1985. Under those agreements, Raymor purchased copper tubing with payment to be made in advance of delivery. Raymor negotiated an 8½% discount off the usual list price achieved in part by reason of it being a large purchaser of copper tubing. The agreements contained a “rise and fall clause” to take account of the fact that the copper price would vary and might be higher or lower at the time of delivery of the copper. For present purposes, the 1984 year can be used as an example. Clauses 7 and 8 of the 1984 agreement provided:

7. As consideration for the goods sold by the Vendor pursuant to the terms of this Agreement and as specified in the Annexure hereto the Purchaser shall pay to the Vendor on the execution of this Agreement the total purchase price as specified in the Annexure hereto of Six hundred thousand, one hundred and thirteen dollars and sixteen cents ($600,113.16) (the receipt whereof is hereby acknowledged by the Purchaser).

8. The parties acknowledge that notwithstanding the payment made pursuant to Clause 7 hereof, the price of each item of goods set out in the Annexure hereto may be subject to variation in accordance with the provisions of this Clause and in the event of any such variation being required to be made hereunder then the parties will make the appropriate financial adjustment in accordance with their normal trading terms. The price of each item of goods set out in the Annexure hereto shall be varied in the event of the Australian Copper Price increasing above or falling below $1,560.00 per tonne at the date of delivery of each item of goods in which event the price for such item shall become the Vendor’s List Price as applicable at that time determined by reference to the Australian Copper Price at the date of such delivery and discounted by 8½%.

1. Raymor paid the amount of $600,113.16 on 29 June 1984. Delivery of stock pursuant to the agreement commenced in early July 1984 and continued over a period of several months.
2. The Commissioner disallowed a deduction with the consequence, as the Full Court noted, that Raymore was not afforded a deduction for its trading stock: *Raymor* at 94. At the time, s 51 of the *Income Tax Assessment Act 1936* (Cth) provided:

(1) All losses and outgoings to the extent to which they are incurred in gaining or producing the assessable income, or are necessarily incurred in carrying on a business for the purpose of gaining or producing such income, shall be allowable deductions except to the extent to which they are losses or outgoings of capital, or of a capital, private or domestic nature, or are incurred in relation to the gaining or production of exempt income.

(2) Expenditure incurred or deemed to have been incurred in the purchase of stock used by the taxpayer as trading stock shall be deemed not to be an outgoing of capital or of a capital nature.

1. At trial, Lockhart J had concluded that the expenditure was deductible under s 51(2). As the Full Court noted at 95, it followed from his Honour’s reasons that, independently of s 51(2), the payments were also deductible under s 51(1) of the Act without reference to s 51(2). The trading stock aspect of the case may be put to one side for present purposes.
2. The principal submission for the Commissioner was that the expenditure was not for trading stock but for the right to acquire trading stock in the future and, therefore, on capital account. It was said that the right to acquire the future stock “matured” at the time of delivery into trading stock, a revenue asset. It was said that it was only at the time of delivery that the expenditure, albeit effected by payment in the preceding year of income, could properly be characterised as being expenditure incurred in the purchase of stock and so meet the test of deductibility. This argument was rejected and the appeal was dismissed.
3. The Full Court referred (at 99) to the “classic test for resolving the distinction between capital and income” as enunciated by Dixon J in ***Sun Newspapers*** *Ltd v Commissioner of Taxation (Cth)* [(1938) 61 CLR 337](https://www.westlaw.com.au/maf/wlau/app/document?&src=rl&docguid=I65265a52172411e2aceaa1779488cc18&hitguid=I6d5c12919c4211e0a619d462427863b2&snippets=true&startChunk=1&endChunk=1) at 363:

There are, I think, three matters to be considered, (a) the character of the advantage sought, and in this its lasting qualities may play a part, (b) the manner in which it is to be used, relied upon or enjoyed, and in this and under the former head recurrence may play its part, and (c) the means adopted to obtain it; that is, by providing a periodical reward or outlay to cover its use or enjoyment for periods commensurate with the payment or by making a final provision or payment so as to secure future use or enjoyment.

1. The Full Court noted (at 99) that, earlier in *Sun Newspapers* (at 362), Dixon J had said:

… the expenditure is to be considered of a revenue nature if its purpose brings it within the very wide class of things which in the aggregate form the constant demand which must be answered out of the returns of a trade or its circulating capital and that actual recurrence of the specific thing need not take place or be expected as likely.

1. The Full Court then stated at 99 (Origin’s emphasis added):

Here the character of the advantage sought was the acquisition of trading stock for delivery within a short time after the date the contract was entered into. As a matter of fact, delivery was completed within several months of the date of the contract. It is a misleading half-truth to say that what the taxpayer acquired was merely a contractual right to obtain delivery of stock in the future. The answer to the first question posed by Dixon J is not to be obtained by a jurisprudential analysis of the process of entering a contract. It can be said of every payment pursuant to a contract that it secures to the payee the contractual rights under the contract. In that sense every payment made under a contract confers upon the payee a chose in action which can be described as an asset and which contractual right is discharged by the performance of the contract. But such an analysis is of no assistance in the resolution of whether a particular outgoing is on capital or revenue account. Rather as Dixon J said in [*Hallstroms Pty Ltd v Commissioner of Taxation (Cth)*](https://www.westlaw.com.au/maf/wlau/app/document?&src=rl&docguid=I115bfde39d5411e0a619d462427863b2&hitguid=I6d430c3d9c4211e0a619d462427863b2&snippets=true&startChunk=1&endChunk=1)(1946) 72 CLR 634 at 648 the answer:

“… depends on what the expenditure is calculated to effect from a practical and business point of view, rather than upon the juristic classification of the legal rights, if any, secured, employed or exhausted in the process.”

1. Origin placed particular emphasis on the underlined part of the passage set out above. That part of the passage must be read in the context of what appears before it and after it and in the context of the facts. Raymor was entering into yearly contracts for the supply of copper tubing for on-sale within its existing business operations and structure. The Full Court was making the point – unremarkable in the light of the facts of the case – that the expenditure was for the copper tubing, not for the contractual right to the copper tubing.
2. Origin submitted that the advantage from incurring the charges for the sent out generation supplied by Eraring Energy was the electricity acquired to on-sell it into the spot market, and not for the use or ownership of the means of production owned and operated by another. It submitted that it was not outlaid as an acquisition of the means of production which generated the supply – cf: *Hallstroms* at 648 (Dixon J); *AusNet* at [73] (Gageler J). Origin submitted that the payments here were, as they were in *Raymor*, to obtain a supply of that which OEEL used to meet the regular demands of its business: *Raymor* at 99. Origin submitted that OEEL “simply purchased electricity under a long term agreement for sale in the course of its business”. It was said that the payment of capacity charges was not the payment of the purchase price of any asset acquired by OEEL or of any rights which comprised a new business.
3. I disagree. The expenditure was incurred to acquire a substantial extension to OEEL’s profit making structure or a new profit making structure. The practical business and legal consequence of the transactions was that OEEL acquired the right to trade the whole of the electricity generated by the power stations for 22 and 28 years. The contractual arrangements giving rise to that right were such that OEEL, through its trading activities, could control when and how much electricity was generated. OEEL also took on risks and opportunity with respect to Eraring’s generation activities. As Origin submitted, the main risks which were transferred by the State to OEEL were: first, the market risk associated with selling electricity into the NEM; and, secondly, but only in respect of the Eraring power station, the risk associated with fluctuations in the fuel price. These were not the only risks and opportunities, as discussed above. The fact that some of those risks were shared is no objection to characterisation of the expenditure as being on capital account. The acquisition of an interest in a joint venture might have that character. The totality of the arrangements gave rise to a new or extended business structure for Origin, which substantially extended its previous operations.
4. The capacity charges were not an expenditure of OEEL incurred in carrying out operations within its *existing* business structure analogous to the so-called “prepayments” in *Raymor* (acknowledging that the word “prepayment” is strictly incorrect – see: *Raymor* at 97). Nor were the capacity charges in the nature of working expenses for the purchase of electricity for on-sale analogous to Origin’s tolling arrangements.
5. The power stations remained in the ownership of, and were managed and operated by, Eraring Energy. However, OEEL acquired the right to the long term capacity of, or the output of, Eraring Energy’s two power stations. At the risk of over-simplification, Eraring Energy became an asset manager, managing the existing capacity, but OEEL acquired the right to trade the output, together with substantial risks and opportunities associated with the generation aspect of Eraring Energy’s business. The capacity charges were paid “for” the acquisition of a profit making structure. The expenditure was not merely “for” the purchase of electricity for on-sale.
6. The expenditure was, as a matter of substance, one-off. It is true that the capacity charges were recurrent in form, usually an indicator that expenditure is on revenue account. In *AusNet* at [15], the majority noted that a “recurrent payment” might tend to indicate the expenditure was of a revenue nature, whilst a “once and for all payment” might tend to indicate that expenditure was a capital outlay, particularly when made with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade. The weight to be given to this factor necessarily depends on the particular facts and, in particular, the precise way in which the expenditure is “recurrent”. The fact is that OEEL paid all of the capacity charges for a period of 22 (Eraring) and 28 (Shoalhaven) years in advance. The up-front payment of the recurrent expenditure was calculated to secure an enduring benefit. The enduring benefit would not have been obtained if the capacity charges had not been paid up-front. Even if one looked past the fact that the capacity charges were all paid in advance, to the recurrent form of them, once “expenditure can be truly characterized as the payment of consideration for a capital … advantage, it will be of a capital nature notwithstanding that the payments are recurrent”: *Cliffs International Inc v Commissioner of Taxation* (1979) 142 CLR 140at 156.
7. Because the capacity charges are an “outgoing of capital, or of a capital nature” within the meaning of s 8-1(2)(a), they are not deductible.

# E DEDUCTIBILITY UNDER SECTION 40-880

## E.1 Section 40-880

1. It was not in dispute that, if the expenditure was capital in nature, the requirements of s 40-880(2) of the ITAA 1997 were met:

***Business related costs***

*…*

*Deduction*

(2) You can deduct, in equal proportions over a period of 5 income years starting in the year in which you incur it, capital expenditure you incur:

(a) in relation to your \*business; or

(b) in relation to a business that used to be carried on; or

(c) in relation to a business proposed to be carried on; or

(d) to liquidate or deregister a company of which you were a \*member, to wind up a partnership of which you were a partner or to wind up a trust of which you were a beneficiary, that carried on a business.

1. The respondent contended, however, that the exclusions in s 40-880(5)(d) or (f) applied such that a deduction under s 40-880(3) was not allowable. Section 40-880(5) and (6) relevantly provide:

*Limitations and exceptions*

…

(5) You cannot deduct anything under this section for an amount of expenditure you incur to the extent that:

(a) it forms part of the \*cost of a \*depreciating asset that you \*hold, used to hold or will hold; or

(b) you can deduct an amount for it under a provision of this Act other than this section; or

(c) it forms part of the cost of land; or

(d) it is in relation to a lease or other legal or equitable right; or

(e) it would, apart from this section, be taken into account in working out:

(i) a profit that is included in your assessable income (for example, under section 6‑5 or 15‑15); or

(ii) a loss that you can deduct (for example, under section 8‑1 or 25‑40); or

(f) it could, apart from this section, be taken into account in working out the amount of a \*capital gain or \*capital loss from a \*CGT event; or

(g) a provision of this Act other than this section would expressly make the expenditure non‑deductible if it were not of a capital nature; or

(h) a provision of this Act other than this section expressly prevents the expenditure being taken into account as described in paragraphs (a) to (f) for a reason other than the expenditure being of a capital nature; or

(i) it is expenditure of a private or domestic nature; or

(j) it is incurred in relation to gaining or producing \*exempt income or \*non‑assessable non‑exempt income.

(6) The exceptions in paragraphs (5)(d) and (f) do not apply to expenditure you incur to preserve (but not enhance) the value of goodwill if the expenditure you incur is in relation to a legal or equitable right and the value to you of the right is solely attributable to the effect that the right has on goodwill.

1. It is relevant to look at the historical legislative context, particularly in understanding the meaning of the phrase “lease or other legal or equitable right”.

## E.2 Legislative history of s 40-880

1. Section 40-880 was inserted by the *New Business Tax System (Capital Allowances) Act 2001* (Cth) and was applicable on or after 1 July 2001. It contemplated a deduction over five years for specific items of expenditure, commonly referred to as “black hole” expenditure because of the likelihood the expenditure would not otherwise have been taken into account. As originally enacted, s 40-880(1) provided:

You can deduct amounts for capital expenditure you incur that is one of these:

(a) expenditure to establish a \*business;

(b) expenditure to convert your business structure to a different business structure;

(c) expenditure to raise equity for your business;

(d) expenditure to defend your business against a takeover;

(e) costs to your business of unsuccessfully attempting a takeover;

(f) costs of liquidating a company that carried on a business and of which you are a shareholder;

(g) costs to stop carrying on a business;

to the extent that the business is or was carried on for a \*taxable purpose.

1. In 2002, the original provision was amended so as to add exclusions from the operation of the section, including those which are now reflected in s 40-880(5)(d) and (f) above.
2. The explanatory memorandum for the *Taxation Laws Amendment Bill (No 5) 2002* (Cth) stated (emphasis added):

**Amendments to subsection 40-880(3)**

3.63 Section 40-880 is intended to be a provision of last resort. It does not, and is not intended to, encompass all ‘blackhole’ expenditure. Item 49 amends subsection 40-880(3) to add further exclusions from deductibility to ensure that the section operates as intended.

3.64 As a provision of last resort, expenditure should only be deductible under section 40-880 if it is not already recognised elsewhere in the income tax law. In seeking to give effect to this intention, section 40-880, as currently enacted, states that expenditure is only deductible under section 40-880 to the extent that it is not:

* included in the cost of a depreciating asset held by the taxpayer;
* included in the cost of land; or
* deductible under another provision of the income tax law apart from section 40-880.

3.65 However, these exclusions were not sufficient to give effect to the policy intention of section 40-880. This is because they do not exclude expenditure that is already recognised in some other manner, for example, through the cost base of an asset under the capital gains and losses provisions, or that, for other policy reasons, is intended to be excluded from deduction.

3.66 Item 49 amends subsection 40-880(3) to provide that expenditure will only be deductible under section 40-880 to the extent that it is also not:

* incurred in relation to leases or other legal or equitable rights **[Schedule 3, item 49, paragraph 40-880(3)(d)]**;
* taken into account in working out an assessable profit or a deductible loss **[Schedule 3, item 49, paragraph 40-880(3)(e)]**;
* taken into account in working out a capital gain or capital loss under the capital gains and losses provisions **[Schedule 3, item 49, paragraph 40-880(3)(f)]**; or
* specifically made non-deductible under a provision of the income tax law **[Schedule 3, item 49, paragraph 40-880(3)(g)]**.

3.67 The Government is reviewing the treatment of expenditure incurred in relation to leases or other legal or equitable rights as part of the consideration of the recommendations of the Review of Business Taxation. The appropriate income tax treatment of capital expenditure incurred in relation to these leases and rights will be determined as part of that review. Consequently, capital expenditure on leases or other legal or equitable rights will be excluded from deduction under section 40-880. For example, expenditure representing lease surrender payments incurred in closing down your business will not be deductible under section 40‑880.

…

3.70 As item 49 excludes expenditure that is taken into account in working out a capital gain or capital loss under the capital gains tax provisions from deductibility under section 40-880, the words ‘apart from this section’ that appear in paragraph 40-880(3)(f) ensure that this exclusion interacts in the correct manner with the cost base rules in the capital gains and losses provisions.

1. Section 40-880 was repealed and substituted in 2006. The provision was said to provide a “systematic solution to business black hole expenditures”: explanatory memorandum to the *Tax Laws Amendment (2006 Measures No 1) Bill 2006* (Cth).
2. In relation to the phrase “lease or other legal or equitable right” and “expenditure that could be taken into account in working out a capital gain or loss”, the explanatory memorandum stated:

**Expenditure in relation to a lease or other legal or equitable right**

2.68 This exclusion replicates that found in the repealed section 40‑880, having been added in 2002 in the context of the Government’s review of the treatment of expenditure incurred on leases or other legal or equitable rights. The 2005-06 Budget announced that the Government would take a case-by-case approach in relation to the taxation of rights. ***[Schedule 2, item 30, paragraph 40‑880(5)(d)]***

**Example 2.12**

In January 2006, AORT Pty Ltd was seeking to obtain a prospecting right over a particular tract of land. It undertakes an investigation to determine if there are any other rights held over that land.  The investigation finds that a farmer holds a right of access over the land, and AORT Pty Ltd agrees to pay the farmer compensation to access the land. As the taxpayer’s expenditure is in relation to a right (being compensation for the right to access the land) it is not deductible under the business-related costs provision.

However, the expenses would be included in the expanded first element of cost of a depreciating asset the taxpayer starts to hold as being in relation to starting to hold that asset, being the exploration right.

…

2.70 Expenditure is deductible where it is incurred in relation to a lease or other legal or equitable right, and the value of the expenditure to the taxpayer arises solely from the effect that the right has in preserving, but not enhancing, the value of goodwill.  For example, capital expenditure may be incurred in relation to a right that is both unlimited in duration, and which merely prevents goodwill from being damaged.  Such a right has no distinct value in itself.  Its value lies in the effect its existence has upon the value of the goodwill. Such expenditure represents in substance a blackhole expense even though it is in relation to an asset. ***[Schedule 2, item 30, subsection 40-880(6)]***

2.71 Where a taxpayer incurs an expense in relation to a right and that right enhances the value of the goodwill, or has an inherent value in itself then it would not be appropriate to allow a deduction as a business related cost as the expenditure does not represent a loss to the taxpayer.

…

**Expenditure that could be taken into account in working out a capital gain or loss**

2.73 Where an amount can be taken into account in working out a capital gain or loss from a CGT event, it is not deductible. A capital gain or loss that has not yet been realised or where the capital gain or loss is disregarded (eg, because it is a pre-CGT asset) or reduced is excluded from deduction under section 40-880 by paragraph 40-880(5)(f). An amount is not taken into account in working out a capital gain or loss if the expenditure cannot be included in the cost base or reduced cost base of the asset (eg, expenses related to the sale of a CGT asset that falls through). In relation to non-residents, this provision excludes a capital gain or loss from an asset that does not have the necessary connection with Australia or any other kind of capital gain or loss that an Australian resident can make but a non-resident cannot. This exclusion has been transferred from the repealed section 40-880 with minor modification to reflect the broader application of the law. ***[Schedule 2, item 30, paragraph 40‑880(5)(f)]***

**Example 2.13**

On 1 May 2006, Chooks Pty Ltd, a restaurateur, enters into a franchise agreement under which it pays $100,000 for the right to use the franchisee’s name.  Therefore, Chooks has acquired a CGT asset, that is, the right, with a cost base of $100,000. The cost will ultimately be recognised at the time of a subsequent CGT event, for example, were Chooks to dispose of the right.

## E.3 Does s 40-880(5)(d) apply to deny a deduction?

1. The legislative history and extrinsic material confirms what is otherwise apparent from the terms of s 40-880(5)(d), read in the context of the statutory scheme as a whole, that it was not intended that s 40-880(2) always provide a deduction simply because the particular expenditure could not otherwise be taken into account.
2. As noted above, the repeal and substitution of s 40-880 in 2006 adopted the language of the predecessor to s 40-880(5)(d) and the explanatory memorandum records that “[t]his exclusion replicates that found in the repealed section 40-880”: at [2.68].
3. The term “lease” is not defined for s 40-880. At common law, a “lease” involves the grantee having a “*legal right of exclusive possession* of the land”: *Radaich v Smith* (1959) 101 CLR 209 at 222 (Windeyer J) (emphasis in original).
4. The respondent submitted, and I accept, that the phrase “other legal or equitable right” is apt to cover:
5. various rights to use, or access, or exploit land, including a *profit-à-prendre*, a *profit-à-rendre* and easements;
6. comparable rights in relation to tangible chattels, such as chattel leases, bailments and licences; and
7. comparable rights in relation to choses in action, an example of which might be a licence to use intellectual property within a particular geographical area.

Whether or not s 40-880(5)(d) does cover such a right depends on the particular facts.

1. In my view, s 40-880(5)(d) might also apply in relation to a right where there is no particular underlying asset to which the right relates, such as a restrictive covenant or a franchise.
2. The respondent submitted that the words “other legal or equitable right” were apt to capture that in relation to which the capacity charges were incurred. The respondent submitted:

The capacity charges were payable to secure, and for the benefit of using, the “Total Contract Capacity” of each power station and to dictate the relevant capacity for the expected useful life of each power station. In other words, Origin could call for the provision of some or all of the “Contracted Supply” of that capacity, at its discretion … This constituted one or more legal rights, being choses in action, in relation to which Origin incurred the capacity charges. As such, the charges were each “in relation to a … legal … right” for the purposes of s 40-880(5)(d).

1. The GenTrader Agreements gave the taxpayer a bundle of contractual rights, amounting to a chose or choses in action, including what amounted in summary to the right on the part of OEEL to trade the entire output of the power stations for substantial terms of 22 and 28 years. The rights included a right for OEEL to demand the supply of electricity in the amounts it required, and for Eraring Energy to comply with those demands, albeit OEEL’s requirements had to be set by reference to the contractual framework and generating capacity of the power stations. The bundle of rights OEEL acquired amounted, in substance, to a right to use the power stations – albeit paying for them to be managed and operated by the owners of them – to generate electricity to permit OEEL to trade that electricity on the spot market. The rights acquired under the agreements, fall within the concept of “other legal or equitable right”.

## E.4 Does s 40-880(5)(f) apply?

1. The respondent also submitted that the expenditure fell within s 40-880(5)(f) because “it could, apart from this section, be taken into account in working out the amount of a \*capital gain or \*capital loss from a \*CGT event”.
2. The respondent submitted that Origin acquired a number of CGT assets under the Transaction Documents, including a “right to receive the ‘Contracted Supply’ in accordance with the ‘Dispatch Instructions’ it chose to give to Eraring Energy from time to time”. It was submitted that the “capacity charges related to, and were payable for, that and associated rights”.
3. The respondent submitted that, on the happening of a CGT event in relation to that right, Origin may have a capital gain or a capital loss. The cost base in relation to each CGT asset must be determined in accordance with divisions 110 and 112 of the ITAA 1997. The first element of cost base is “the money you paid, or are required to pay, in respect of \*acquiring” the asset: s 110-25(2)(a). The respondent submitted that the capacity charges were paid “in respect of \*acquiring” Origin’s rights in relation to directing the provision of the “Contracted Supply”, and therefore will be “taken into account in working out the amount of” a capital gain or capital loss for the purposes of parts 3-1 and 3-3 of the ITAA 1997.
4. Origin characterised the capacity charges as being “in return for … performance by Eraring Energy” and “not for the acquisition of specific rights under the contract”.
5. In my view, the capacity charges were “money you paid, or are required to pay, in respect of \*acquiring” a CGT asset within the meaning of s 110-25(2) and form a part of the first element of the cost base of the acquired asset.
6. The contractual rights, including specifically the right to trade, for the contractual term, the generated output of the power stations, produced at the levels directed by OEEL, were CGT assets. It follows that the capacity charges are not deductible under s 40-880(2), because of s 40-880(5)(f). The capacity charges are taken into account under the capital gains tax regime.

## E.5 Conclusion with respect of s 40-880

1. Section 40-880 does not operate to allow a deduction for the expenditure because such a deduction is denied by paragraphs (d) and (f) of s 40-880(5).

# F CONCLUSION

1. The appeals must be dismissed.

|  |
| --- |
| I certify that the preceding two hundred and four (204) numbered paragraphs are a true copy of the Reasons for Judgment herein of the Honourable Justice Thawley. |

Associate:

Dated: 31 March 2020

**ANNEXURE A**

|  |  |  |
| --- | --- | --- |
| **Contract Year** | **Total Capacity Charges for Eraring Power Station** | **Total Capacity Charges for Shoalhaven Power Station** |
| 1 (~4 months) | $56,019,126 | $494,909 |
| 2 | $145,385,320 | $1,365,956 |
| 3 | $126,098,880 | $1,259,953 |
| 4 | $109,370,930 | $1,162,177 |
| 5 | $94,862,065 | $1,071,988 |
| 6 | $82,277,910 | $988,799 |
| 7 | $71,363,135 | $912,065 |
| 8 | $61,896,287 | $841,286 |
| 9 | $53,685,286 | $775,999 |
| 10 | $46,563,535 | $715,779 |
| 11 | $43,162,758 | $631,917 |
| 12 | $36,688,344 | $587,683 |
| 13 | $31,185,093 | $546,545 |
| 14 | $26,507,329 | $508,287 |
| 15 | $22,531,229 | $472,707 |
| 16 | $19,151,545 | $439,617 |
| 17 | $16,278,813 | $408,844 |
| 18 | $13,836,991 | $380,225 |
| 19 | $11,761,443 | $353,609 |
| 20 | $9,997,226 | $328,857 |
| 21 | $8,497,642 | $305,837 |
| 22 | $7,222,996 | $284,428 |
| 23 | ­ | $264,518 |
| 24 | ­ | $246,002 |
| 25 | ­ | $228,782 |
| 26 | ­ | $212,767 |
| 27 | ­ | $197,873 |
| 28 | ­ | $184,022 |
| Total | $1,094,343,883 | $16,171,431 |