# *IT 2602 - Income tax : privately owned power stations : control by state electricity authorities*

# TAXATION RULING NO. IT 2602

INCOME TAX : PRIVATELY OWNED POWER STATIONS : CONTROL BY STATE ELECTRICITY AUTHORITIES

F.O.I. EMBARGO: May be released

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PREAMBLE This Office has been asked to provide advice on when a privately owned power station financed by non-recourse debt may be said to be controlled by an end-user other than the owner in circumstances where it is located on, and operated as part of, the power grid of a State power authority. This Ruling sets out guidelines on matters which will be relevant in determining, for the purposes of subparagraph 51AD(4)(b)(ii) of the Income Tax Assessment Act 1936, whether or not a State electricity authority controls directly or indirectly the use of a power station in such circumstances.

2. Section 51AD applies to property acquired by a taxpayer under a contract entered into after 1 pm on 24 June 1982, or constructed by a taxpayer where construction commenced after that time. By the operation of subsection 51AD(8), section 51AD will not apply unless the cost of the acquisition or construction of the property by the taxpayer is wholly or predominantly financed by non-recourse debt, i.e., where the rights of the creditor in the event of default by the taxpayer are predominantly limited to rights against the property itself, or against the income, goods or services generated by the property, or to rights in respect of a security over the property. A debt is also a non-recourse debt if the creditor would not have access to all the unsecured assets of the taxpayer in a recovery action.

3. Where the conditions relating to time of acquisition and non-recourse debt are satisfied, section 51AD will apply to property in either of 2 broad sets of circumstances. The first is where the property is leased and:

- the lessee (or sub-lessee) is not a resident of Australia and the property is, or is to be, used wholly or principally outside Australia;

- the property is, or is to be, used otherwise than solely for producing assessable income; or

- the property was owned and used, or held for use, by the lessee or sub-lessee before the taxpayer acquired it.

The second circumstance in which section 51AD can apply concerns property that is owned by a taxpayer but the use of which in the production, supply, carriage, transmission or delivery of goods or the provision of services is effectively controlled by another person. Section 51AD will apply if that other person (called the "end-user"):

- is not a resident of Australia and the property is, or is to be, used wholly or principally outside Australia;

- uses the goods or services produced by means of the property otherwise than solely for the purpose of producing assessable income;

- derives no income, or derives income that is wholly or partially exempt, in providing those goods or services; or

- owned and used the property, or held it for use, before the taxpayer acquired it.

Where the specified conditions apply, subsection 51AD(10) operates to treat the owner of the property as not having used it for the purpose of producing assessable income or in carrying on a business for that purpose. The effect is that the owner is denied deductions attributable to the ownership of the property, including depreciation, repairs, interest on borrowings etc.

RULING

4. The point needs to be made at the outset that the question of who controls the use of a power station will ultimately turn on the facts of each particular case. The following remarks ought to be treated as principles or guidelines to assist in determining whether or not, on the facts presented, there is effective control of a power station by a State power authority.

5. It is evident, in a context where section 51AD contemplates legal ownership by the taxpayer but effective control in the hands of someone else, that it is not enough simply to look at the strict legal rights attaching to agreements or arrangements that may be entered into by a taxpayer in relation to the management and control of a power station. Nor would such agreements or arrangements be the only matters to come under scrutiny. Insofar as subparagraph 51AD(4)(b)(ii) contains the words "controls, will control, or is or will be able to control directly or indirectly" in relation to the use of a taxpayer's property, it looks to defacto rather than legal control. Accordingly, not only must formal power station management documents be examined to determine who has control, but also any other arrangements - including financial relationships - which could affect the question who controls the operation of the power station. Financial arrangements existing between the legal owner of a power station and others (generally, though, the relevant State power authority) may point to a position of economic dependency such that the legal owner may not in reality be capable of operating the station otherwise than in accordance

with the wishes or directions of those other persons or bodies.

6. Subsection 51AD(1) defines "control" as meaning effectively control. The relevant Explanatory Memorandum points out that to control effectively is to control in a practical sense, whether or not, in a more formal sense, there would be control. So far as is relevant, a number of dictionaries and texts of judicially defined words and phrases indicate that "effectively" means productive of or capable of producing a result, having effect, operative, actual rather than theoretical; "control" means to command, direct, check, limit, curb, regulate, restrain, operate or the power to direct or determine. Those definitions and certain judicial pronouncements suggest that "effectively" means that which actually causes something to happen, and "control" is the power to decide what is to be done, how it will be done, when it will be done and where.

Day-to-Day Operations

7. It is accepted that where a taxpayer's power station is to supply power as part of the State grid, the State authority will need to coordinate the activities of the private station with other stations on the grid. In particular, the State authority may need to vary outputs or institute shutdowns. Where the State authority has such a coordinating or supervisory role which is limited only to such matters as are necessary to ensure a reliable and continuous supply of electricity on the grid, economy of operation of the grid, or public health and safety in emergency conditions, the State authority will not, on that basis alone, be regarded as controlling the use of the power station.

8. In the context of the day-to-day operation of a power station, this Office sees effective control as meaning that a person, organisation or authority either operates the station on a day-to-day basis through its employees or agents or has such an immediate supervisory role (not in the sense explained in the previous paragraph) that enables it to direct others in that day-to-day operation. The staffing arrangements will be important in this regard, particularly where the legal owner has no previous experience or expertise in the management and operation of a power station.

9. If staff operating the station are employees of the State authority, it would be difficult to escape the conclusion that the authority had effective control of its operation, despite the existence, perhaps, of a management agreement under which the authority purports to act as service provider or agent for the owner. A similar conclusion might be drawn if, for example, the employees are employees of the State authority but have been seconded to the staff of the power station owner. The existence of a station management agreement under which key management or technical staff are employees of the State authority or State authority employees seconded to the power station owner, or where the composition of the management board is such that present or seconded employees of the State authority dominate station management, would also suggest effective control of the

power station is with the State authority. Arrangements like those are suggestive of the power station owner having only a passive role in station management, being content to let the State authority take charge on a day-to-day basis.

10. That is not to say that a private owner of a power station located on a State power grid could not effectively control the operation of the station in the production of power for transmission through the grid. Where as a matter of fact a station is managed and operated by the taxpayer through its own staff accountable only to the taxpayer or to a management team in turn accountable to the taxpayer, there may be effective control by the taxpayer. Previous experience by the taxpayer, its directors or its staff in power station management and operation may support a view that it is capable, through its own staff, of operating a power station. Management and operation of the power station without the need to call in aid staff or seconded staff of the relevant State authority would also point to an independent use of the power station by its owner.

11. On this latter point, the mere fact of a taxpayer having employed persons who were formerly employees of a State power authority does not necessarily determine that the State authority has effective control of the use of the power station. If, as a matter of fact, those persons as employees are answerable to the taxpayer in carrying out duties relating to the day-to-day operation of the power station, there may be no element of control by the State authority. A taxpayer whose expertise in power station management derived from overseas experience may seek to ensure the efficiency of its Australian power station operations by "poaching" key staff of the relevant State authority. Employment arrangements of that kind ought not be seen to diminish the taxpayer's control in the management of the power station.

12. A taxpayer may employ an independent contractor to manage and operate its power station on the State grid. If so, the question whether the contractor (on behalf of the taxpayer) or the relevant State authority effectively controlled the operation of the station would need to be determined by reference to the same criteria as explained in relation to cases where the taxpayer purports to operate the station through its own employees.

Financial Arrangements

13. As intimated in paragraph 5, it may also be necessary to examine the financial arrangements relating to the acquisition of the power station, the supply of electricity generated by the station and the purchase of fuel needed to operate it. While economic relationships will not generally be determinative of the question of control of a power station, examination of the whole commercial arrangement surrounding the ownership and operation of the station may point to a situation where the taxpayer's interest is largely of a financing kind, with the result that there is little incentive or purpose (apart from being seen to comply with the "control" test in section 51AD) in

taking part in the management and operation of the station. From another point of view, it may be difficult in some circumstances to escape a conclusion that the power authority would be unwilling to allow a power station on the State grid to be operated otherwise than under its own management and control. That would be the case particularly if, by reason say of guarantees or power supply contracts, the State authority rather than the taxpayer was exposed to commercial risks flowing from inefficient power station operation or, conversely, would be the principal beneficiary of a well-managed station. The following sorts of arrangements may be encountered.

Fixed Return Charges

14. A State authority may agree to buy the output of a taxpayer's power station on a "fixed return" basis. That is, the taxpayer would receive fees equalling its actual costs of providing the power station and producing the electricity, plus a fixed amount which is independent of the amount of power supplied. In reality, the fees represent a return on the taxpayer's investment by compensation for actual costs plus an agreed margin. Under such a scenario, the State power authority rather than the taxpayer will have the much greater interest in power station operating performance as, except where there is some form of contractual default, the taxpayer's management of the station could not affect its return on investment. Under arrangements of those kinds, the State power authority would be strongly motivated to retain effective control rather than the taxpayer, the more so where the authority is the sole or major purchaser of power from the station.

15. The fact that mechanisms were in place to vary the price paid for power would not necessarily point to a "fixed return" basis of power production. Building and operating a power station is a long-term activity, and most taxpayers would want a long-term arrangement to sell the electricity their station produces. Such an arrangement would commonly have a mechanism for adjusting the price paid for electricity from time to time, to reflect changes in the economic environment. Non-recourse lenders would usually require such an arrangement before agreeing to finance a power station.

16. While a price adjustment mechanism which compensates the taxpayer for changes in actual costs might be seen as a "fixed return" arrangement, one based on objective general indicators such as movements in relevant industry costs e.g., labour, building, interest rates, etc., generally would not. It is considered that a taxpayer could more credibly claim to have an incentive to retain control of a power station where it can improve profitability by achieving better performance than that measured by specified objective indicators.

Fixed Fee Arrangements

17. It is recognised that a State authority cannot predict precisely how much electricity it will need to take at any time from a privately owned station connected to the State grid.

This may be partly because consumer demand varies and partly because breakdowns in the State owned stations may require the State authority to seek back up supplies from the taxpayer.

18. It may therefore be appropriate for the authority and the taxpayer to enter into a fixed minimum fee arrangement whereby the authority agrees to pay a minimum regular fixed amount to the taxpayer regardless of the amount of electricity actually supplied. The payment of a fixed minimum fee in such circumstances may not of itself be suggestive of a situation in which the State authority would wish to impose control, unless perhaps the fee was excessive in terms of the minimum notional amount of power being paid for.

19. An arrangement for the payment of a fixed maximum fee, however, would effectively limit the commercial benefits which can flow from the operation of the power station by the taxpayer. Whilst there may be scope for marginal gains through cost cutting, the existence of a fixed maximum fee arrangement might suggest the power authority rather than the taxpayer would seek to control the day-to-day operation of the station.

Reversion of the Property to the State Authority

20. An agreement (written or otherwise) to transfer ownership of the station to the State authority after a specified number of years, or an option (written or otherwise) for the authority to acquire the station at a future time might suggest that its acquisition by the taxpayer under leveraged finance arrangements was seen at the outset as a means whereby the State authority could add a new power station to the State grid with the dual benefits of not having to raise finance directly and the partial underwriting of the project cost through taxation deductions available to the taxpayer. Such a conclusion would be all the easier to make if in all the circumstances power station revenues plus the buy-out price could be seen as having been formulated to ensure a predetermined return on investment to the power station owners.

21. Some agreements might contain conditions that permit a State authority to "step in" and operate a power station (or even acquire the station for a predetermined price) in specified circumstances of default. Exception would not be taken to such conditions provided the authority's "step-in" or acquisition rights could be triggered only in circumstances of gross default in the owner's operation of the station which threatened the overall supply of power from the State grid, and then only where default continued after the owner had been given reasonable notice and opportunity to take remedial action.

Fuel Supply

22. Both the financiers and the State authority may require the taxpayer to have a demonstrated or guaranteed supply of fuel to operate the station in order to ensure a regular supply of power. In some cases the State authority may have access to its own fuel supplies which may be made available to the taxpayer.

On the basis that an appropriate supply of fuel is crucial to the ongoing, efficient operation of a power station, contracts for fuel supply by the State authority to the taxpayer that do not reflect arm's length prices and a relatively long term supply period would call into question the issue of control. That would be the case, for example, where the supply contract enabled the State authority to withhold fuel on the basis of its judgment of the overall needs of the State grid. A short-term coal contract reflecting prices well below market might suggest a degree of economic dependency on the State authority - both through the low price factor and the need to renegotiate the supply contract in the future - whereby the taxpayer is effectively answerable to the State authority in relation to its operation of the station.

SUMMARY

23. All or any of these factors may be present in any particular arrangement and no one factor will necessarily be decisive of the question. As mentioned in paragraph 13, economic relationships will not generally be determinative of the question of control. The point is, though, that the existence of certain financial arrangements might be an indicator that the State authority would be unwilling to relinquish control of a privately owned power station. In summary, a State authority will be regarded as controlling the use of the station if it effectively controls its day to day operations by reference to the criteria explained in paragraphs 6-12 above. The State authority would generally have a positive interest in retaining control - and, conversely, the taxpayer generally would not - if the financial relationship between them is such that the taxpayer bears little risk and receives commercial benefits unrelated to the manner in which the station is operated. In that case, all the arrangements relating to the power station would need to be very carefully scrutinised in order to determine - by reference to both day-to-day operations and financial relationships - who has real control.

COMMISSIONER OF TAXATION
28 June 1990