



## **The Victorian Treasury and the Smelter Reduction Amount (A)**

In 1984, the State Electricity Commission of Victoria (SECV) entered into two Electricity Supply Agreements (ESAs) with aluminium producer Alcoa which were tied to the world price of aluminium. The idea of the ESAs was to supply the Loy Yang B power generator with a long term customer and ensure Alcoa's ongoing presence in regional Victoria. Low aluminium prices since that point led to a considerable shortfall that the Government then sought to recover by introducing the Smelter Reduction Amount (SRA) in 1997. This was a levy applied to the wholesale price of electricity which was collected from electricity retailers who ultimately recouped the cost from end-users. The Australian Steel Company (Operations) Pty Ltd (TASCO), a major electricity consumer and one of Alcoa's main competitors, was opposed to the SRA, which it considered to be a government subsidy to Alcoa. In June 2003, the company lodged a writ in the High Court claiming the levy was an excise, and therefore in direct contravention of the Australian Constitution. Realising the significance of the claim, the SECV handed over the case to the Department of Treasury and Finance. On a worst case analysis, the eventual outcome could involve large scale refunds.

### **Victoria's electricity industry**

Up until the early 1990s, Victoria's electricity industry was managed by the State Electricity Commission of Victoria (SECV) – an integrated Government monopoly. In October 1993, the SECV (like a number of public utilities across Australia) was corporatised and its generation, distribution and transmission divisions were

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This case was written by Marinella Padula, Australia and New Zealand School of Government, for Professor John Alford as a basis for class discussion rather than to illustrate either effective or ineffective handling of a managerial situation. The generous assistance and support of the Victorian Department of Treasury and Finance is gratefully acknowledged.

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disaggregated into three separate companies; Generation Victoria, Electricity Services Victoria and National Electricity, respectively.

By October 1994, National Electricity had been split into: the Victorian Power Exchange (VPX), which was responsible for operating the main power system securely and for managing spot trading in the wholesale electricity market (VicPool); and PowerNet Victoria, which owned and maintained the high voltage grid. At the same time, Electricity Services Victoria (ESV) was broken down into three urban and two regionally based distribution businesses; CitiPower Ltd, Solaris Power Ltd, United Energy Ltd, Eastern Energy Ltd and Powercor Australia Ltd. They owned and operated the low voltage distribution network as well as retail trading divisions. Meanwhile, Generation Victoria's power stations and coal mines were divided into five separate generation businesses:

- Loy Yang A – a 2000 MW power station and Loy Yang brown coal mine
- Hazelwood – a 1600 MW power station and Morwell open cut brown coal mine
- Yallourn W – a 1450 MW Power station and Yallourn open cut brown coal mine
- Newport and Jeeralang gas fired power stations (965 MW)
- Victorian hydro-electric (Southern Hydro) consisting of Kiewa, Dartmouth, and Eildon/Rubicon/Cairn Curran systems (469 MW).<sup>1</sup>

The SECV initially retained the Government's interest in Loy Yang B and the Snowy Mountains hydro-electric scheme. However, from 1995 to 1997, the distribution and generation businesses were gradually privatised and sold mainly to international consortiums. Some businesses changed names as a result, for example Solaris became AGL and Eastern Energy became TXU after acquisition by Texas Utilities. In 2003, there were seven main generation businesses in Victoria with over 30 generators. Meanwhile, the five Victorian distribution companies were:

<b>Company</b>	<b>No. of customers<sup>2</sup></b>
AGL Electricity	266,000
CitiPower	265,000
Powercor Australia	598,000
TXU	542,000
United Energy	582,000

These five electricity distributors serviced twelve retailers who then sold electricity to domestic and business customers. This included distribution companies such as AGL and TXU who had their own retail operations (*Exhibit A*). Developments at the Victorian level occurred against a backdrop of changes to the electricity industry nationally. In May 1991, the idea of a national energy market was floated in an Industry Commission report. By 1998, the National Electricity Market Management Company Limited (NEMMCO) was operational with the Queensland, New South

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<sup>1</sup> From Background Paper 21 1997-98 'Electricity Industry Restructuring-A Chronology' Ann Rann Science, Technology, Environment and Resources Group 30 June 1998 Parliament of Australia Parliamentary Library

<sup>2</sup> From Essential Services Commission website ([www.esc.vic.gov.au](http://www.esc.vic.gov.au)), Victorian Electricity Industry Structure at 30 June 2003.

Wales, Australian Capital Territory, Victorian and South Australian governments as members. It operated on a break-even basis, charging fees to participants. NEMMCO's purpose was to administer and manage the national electricity market to ensure consistency and efficiency of supply – especially crucial during periods of heavy usage (for example, on a very hot day) or in the event of disaster. Because extreme temperatures are unlikely to occur across the entire network simultaneously, the supply can be shared between regions via interconnectors that link the states. In Victoria, excessive demand is only problematic for a few hours on a couple of days each year.

### **From coal to current: Electricity production and distribution**

In Victoria, electricity production was primarily powered by coal with most of the state's requirements met by brown coal generators located in the LaTrobe Valley. These generators were supplied by several open cut mines which drew upon rich coal deposits in the Gippsland basin area. Gas, wind and solar-powered generators, along with hydro-electric plants, made up the remaining electricity producers. Where generation from fossil fuels was concerned, the energy released through burning gas or coal heated water which, in turn, produced steam. This steam was then pressurised and forced through a turbine to create electricity (*Exhibit B*). Along with energy, greenhouse gases are a by-product of this means of production.

As electricity cannot be stored, production is virtually an instantaneous response to fluctuating demand. Under the national market system, generation companies bid the price they were prepared to sell electricity for onto the national market at five minute intervals, 24 hours per day. Under most circumstances, NEMMCO ranked the generators by price and scheduled them to produce electricity according to prevailing demand, beginning with the lowest bidder (*Exhibit B*). Each of those five-minute intervals was called a “dispatch” price and they were averaged over a trading period of half hour blocks to produce a “spot” price. This was the price retailers paid for purchasing electricity during the trading period. Retail companies then purchased the electricity by megawatt hour from the market according to the price determined by NEMMCO. That cost could then be passed on to the end consumer, along with the electricity retailer's service, transmission and maintenance charges (*Exhibit C*).<sup>3</sup>

Once the electricity had been generated, a transformer at the power plant converted it into a high-voltage current that could be transmitted rapidly and efficiently. In Victoria, electricity was delivered along a network of 13,000 galvanised steel towers connected by more than 6,500km of cable.<sup>4</sup> This network was now owned and operated by a private company - SPI PowerNet (which later became SP Ausnet). It owned and maintained the transmission towers and high voltage power-lines that were built on long corridors of land (easements) reserved for power transmission, totalling approximately 17,500ha (*Exhibit B*). After travelling along the high-voltage transmission network, the electricity then reached one of 44 terminal stations across the state which serviced the twelve electricity retailers. At this point, the voltage was lowered and relayed to more than 2.2 million homes and businesses via overhead

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<sup>3</sup> An introduction to Australia's National Electricity Market NEMMCO June 2005

<sup>4</sup> Transmission Easements [www.sp-ausnet.com.au](http://www.sp-ausnet.com.au) accessed 4/9/05

powerlines or underground cable.<sup>5</sup> These lower-voltage distribution networks were owned and operated by the distribution companies such as AGL and TXU.

Another party involved in the management of the electricity industry in Victoria was the Victorian Energy Networks Corporation (VenCorp) – a not-for-profit organisation wholly owned by the Victorian Government. Established in 1997, it was the monopoly provider of shared transmission network services in Victoria, acquiring bulk network services from SPI PowerNet and other service providers. Although VenCorp didn't own any transmission assets it was responsible for network planning and investment decision-making. Its work was funded via the Transmission Use of System (TUOS) charges applied to all users of the shared network. TUOS charges were set or approved by the Australian Competition and Consumer Commission (ACCC) and for the most part comprised SPI Powernet's revenue stream. These charges were also passed on to end-use customers via retailers (*Exhibit C*).

### **The Smelter Reduction Amount (SRA)**

Many variables influenced the supply and demand factors surrounding electricity. Consequently, predicting prices was not an easy task, nor was managing risk in industries where electricity represented a significant proportion of operating costs. Thus wholesalers and large customers often entered into hedge contracts in which they agreed to a pre-determined range of prices for the provision of electricity over a designated period of time. If the price of electricity fell below a certain level, customers would pay the difference to suppliers and vice versa. The State Electricity Corporation of Victoria (SECV), like other electricity retailers, also had an electricity hedging agreement in place. The hedge was to protect the SECV's position under two long-term electricity supply agreements with the aluminium producer, Alcoa.

Aluminium smelting is an energy intensive industry where electricity can account for 30-40 percent of costs, or more. Two Electricity Supply Agreements (ESAs) were signed in 1984 by the SECV and Alcoa, the state's largest single electricity consumer. These supplied Alcoa's Point Henry and Portland aluminium smelters with electricity at prices tied to the world price of aluminium. The contracts were due to expire in 2014 and 2016 respectively.

From the government's point of view, the ESAs would provide a long-term customer for the Loy Yang B plant, thereby funding its construction and adding additional generation capacity to Victoria. The agreements also enabled Alcoa to continue at Point Henry as well as establish the Portland smelter, bringing economic benefit to the region, in particular, and the state in general. It was originally envisaged that the state would break even over the lifetime of the contracts with movements in the world price of aluminium; the ESAs were not intended to provide a subsidy. However, low aluminium prices since 1984 saw Alcoa receive electricity at a considerable discount compared to the market price of electricity. Consequently, there was a substantial shortfall between the cost of electricity to the SECV as opposed to what Alcoa paid for it. Up until 1997, the SECV's losses were absorbed by the Consolidated Fund (i.e. State revenue), at which point the Government implemented an alternative.

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<sup>5</sup>Transmission Easements [www.sp-ausnet.com.au](http://www.sp-ausnet.com.au) accessed 4/9/05

The Smelter Reduction Amount (SRA) was introduced on 1 July 1997 under s.158BA of the *Electricity Industry Act 1993*. It was added on to the wholesale price of electricity, initially at \$2.00<sup>6</sup> per megawatt hour (MWh). Linked to the Consumer Price Index, the SRA had risen to \$2.40 p/MWh by 2002-2003 where the average wholesale electricity price was \$27.73 per MWh. The cost of the SRA was paid by retailers, who could then recover this cost from Victorian electricity consumers. However, the charge was not itemised on their bills, except occasionally in the case of large customers. With regard to collecting the SRA, the money was channelled from the retailers and other wholesale customers to NEMMCO who then forwarded the funds to the SECV (*Exhibit C*).

Victoria's SRA was expected to collect in the order of \$500 million (in nominal terms) by the end of 2004. Although the levy was not fully covering ESA losses, it was providing approximately \$80 million towards these losses in 2002-03. (The remainder was met from privatisation proceeds retained by the SECV.) Instead of applying a more general tax to recover the cost of the agreements, the then Kennett Government took the view that funding should come from electricity users as they were the direct beneficiaries of new power infrastructure.

**Table 1: Historical SRA and smelter trading losses (nominal, \$ million)**

Year	Smelter reduction amount (SRA)	Smelter trading losses
1997-98	63	171
1998-99	65	200
1999-00	68	181
2000-01	72	166
2001-02	78	116
2002-03	83	123
2003-04 (est.)	87	120
Total	516	

## **TASCO makes a claim**

The Australian Steel Company (Operations) Pty Ltd (TASCO) was a wholly-owned subsidiary of Smorgon Steel – one of Australia's leading manufacturers, distributors and recyclers of steel, including concrete reinforcing steel, tubing and specialty steel products. Smorgon Steel's net profit after tax in 2002-03 was recorded at \$62 million, on revenue of \$2.6 billion. The company employed 6000 people nationally, some of whom worked at TASCO's Victorian steel mills in Laverton North and Sunshine. TASCO's steel products were in direct competition with Alcoa's aluminium products in the building industry. In June 2003, TASCO lodged a writ against the SECV in the High Court, claiming that the SRA was an excise and therefore illegal under s.90 of the Commonwealth Constitution which states:

<sup>6</sup> All prices in Australian dollars. In 1997, one Australian dollar equalled approx.75cUS.

“On the imposition of uniform duties of customs the power of the Parliament to impose duties of customs and of excise, and to grant bounties on the production or export of goods, shall become exclusive.”

This served to limit the kind of taxes the states could introduce, however terms such as “goods” and “excise” were open to interpretation. Section 90 was initially seen as a means of maintaining the Federal Government’s control over tariff policy, but subsequent rulings by the High Court gradually broadened the definition of an excise to: a tax imposed on any step in the production, manufacture, sale or distribution of goods (whether foreign or domestic in origin). This came out of *Ha v New South Wales* (1997) 189 CLR 465 where the Court ruled that monthly licence fees applied by the New South Wales government to the retail and wholesale sale of tobacco constituted an excise and were therefore invalid. The impact of this ruling was significant in that it prevented the states from levying similar business licensing fees on the sale of alcohol and petrol.<sup>7</sup>

TASCO wanted the High Court to declare the SRA unconstitutional and therefore invalid, and sought reimbursement of all SRA amounts paid by it since its introduction in 1997. As Origin Energy (formerly Citipower and Powercor) was TASCO’s electricity retailer and collected the funds in the first instance, it was also named in the writ as a co-defendant. TASCO’s plans became apparent in a series of newspaper articles in late May 2003, detailing Smorgon’s dissatisfaction with the SRA levy. A Smorgon spokesman was quoted as saying that the company had “been concerned for some time about the equity of the situation” and considered the levy “a tax on all manufacturing industry for the benefit of one entity (Alcoa)”.<sup>8</sup>

VicPower Trading (formerly the SECV and now responsible for managing the ESAs) first learned of the writ a few weeks before it was lodged. Geoff Steer, member of the executive committee at VicPower, saw the threat it posed to VicPower’s revenue source but also appreciated the case’s broader significance, stating that:

“As soon as we received the notice we were in communication with the State, because of course, it was a massive issue for them. Not very long after that, there was a legal arrangement put in place between us where the State would manage the action – our assets and liabilities finish up with the State anyway. And from that point on in time it was largely the State driving the action via the Department of Treasury and Finance and the Solicitor General’s office.”

Publicly at least, it did not appear as though litigation was necessarily an inevitable outcome. A July 2003 article claimed that Smorgon “had hoped to resolve the matter through discussions with the Victorian Government, but had to file the writs after this process stalled.”<sup>9</sup> Yet, a company spokesman was still quoted as saying that: “Our preferred outcome is that we can have some substantial discussions with the Government to resolve this.”<sup>10</sup> Thus far the Victorian Government had made little public comment on the matter, beyond a spokeswoman for Victorian Treasurer John

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<sup>7</sup> Griffith, G. ‘The Future of State Revenue: The High Court Decision in Ha and Hammond’ Briefing Paper 16/97 Parliament of NSW

<sup>8</sup> Myer, R. ‘Business - Smorgon to spearhead legal challenge over Alcoa’s power levy’ *The Age* 30/5/2003

<sup>9</sup> Thomson, J. ‘Power Levy Punch-up’ *Business Review Weekly* 24/7/03

<sup>10</sup> *ibid.*

Brumby who commented that the Government had been advised that the Alcoa levy was “legal and constitutional”.<sup>11</sup>

## State taxation powers

Since federation, taxation powers have gradually drifted from the states (once independent colonies) to the Commonwealth. The Constitution initially laid out Commonwealth versus State powers, including provisions which gave the Commonwealth exclusive power over the imposition of customs, excise and bounties. However, the most significant change occurred in 1942 during World War II when the Federal Government became the sole collector of income tax. Designed to be a temporary measure, the Commonwealth’s right to continue collecting income tax was upheld in 1957. The Commonwealth Government also collected levies and all income tax from enterprises as well as a range of other taxes including GST. Introduced on 1 July 2000, the GST (Goods and Services Tax) was set at a rate of 10 percent and imposed on the majority of products and services sold in Australia. Some of the proceeds from this tax were returned to states in the form of grants, in part compensation for the loss of state licensing fees on the sale of tobacco, alcohol and petrol which came out of the High Court ruling in *Ha v New South Wales* (1997). This decision cost the states a major source of revenue.

Thus Victoria, like the other states, had become increasingly reliant on revenue from the Commonwealth. Since the *Ha* decision and the introduction of the GST, grants from the Commonwealth grew from 35 percent of Victoria’s revenue to an estimated 45 percent in 2002-03 (*Exhibit D*). State Premiers regularly protested against what they saw as a growing centralism which forced them to capitulate to Federal demands in order to receive sufficient funds to provide essential infrastructure and services such as hospitals, schools, roads and police. The responsibility for providing such services and facilities was largely vested with the states. In 2003, Victoria’s taxation revenue was drawn primarily from:

- Payroll tax
- Taxes on immovable property (including land tax)
- Taxes on financial and capital transactions (including duties and debits tax)
- Insurance
- Gambling taxes
- Motor vehicle taxes (including registration fees).<sup>12</sup>

The State Revenue Office (SRO) collected the majority of Victoria’s taxation revenue, more specifically: payroll tax, land tax, debits tax and duties. Payroll tax was charged to all employers and calculated as a percentage of employee wages beyond the designated threshold. Land tax was an annual tax on the total unimproved value of all land owned in Victoria, with some exceptions including a person’s primary residence. Duties were applicable to a range of transactions including: the purchase of land, mortgages, general and life insurance policies; motor vehicle transfers; the

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<sup>11</sup> Myer, R. ‘Business - Smorgon to spearhead legal challenge over Alcoa's power levy’ *The Age* 30/5/2003

<sup>12</sup> ‘Budget Paper No 4 – Statement of Finances 2004-2005’ Department of Treasury & Finance Victoria p. 217

hiring of goods; and the sale of livestock (cattle/sheep/goats). Debits Tax was a tax on debit transactions to accounts with cheque drawing facilities and included direct debits, over-the-counter withdrawals, cheque, EFTPOS and automatic teller machine withdrawals.

By contrast, the Department of Treasury and Finance did not collect revenue, but existed to provide the Victorian Government with support and advice with regard to the state's financial management (*Exhibit E*).

### **Treasury and Finance takes the lead**

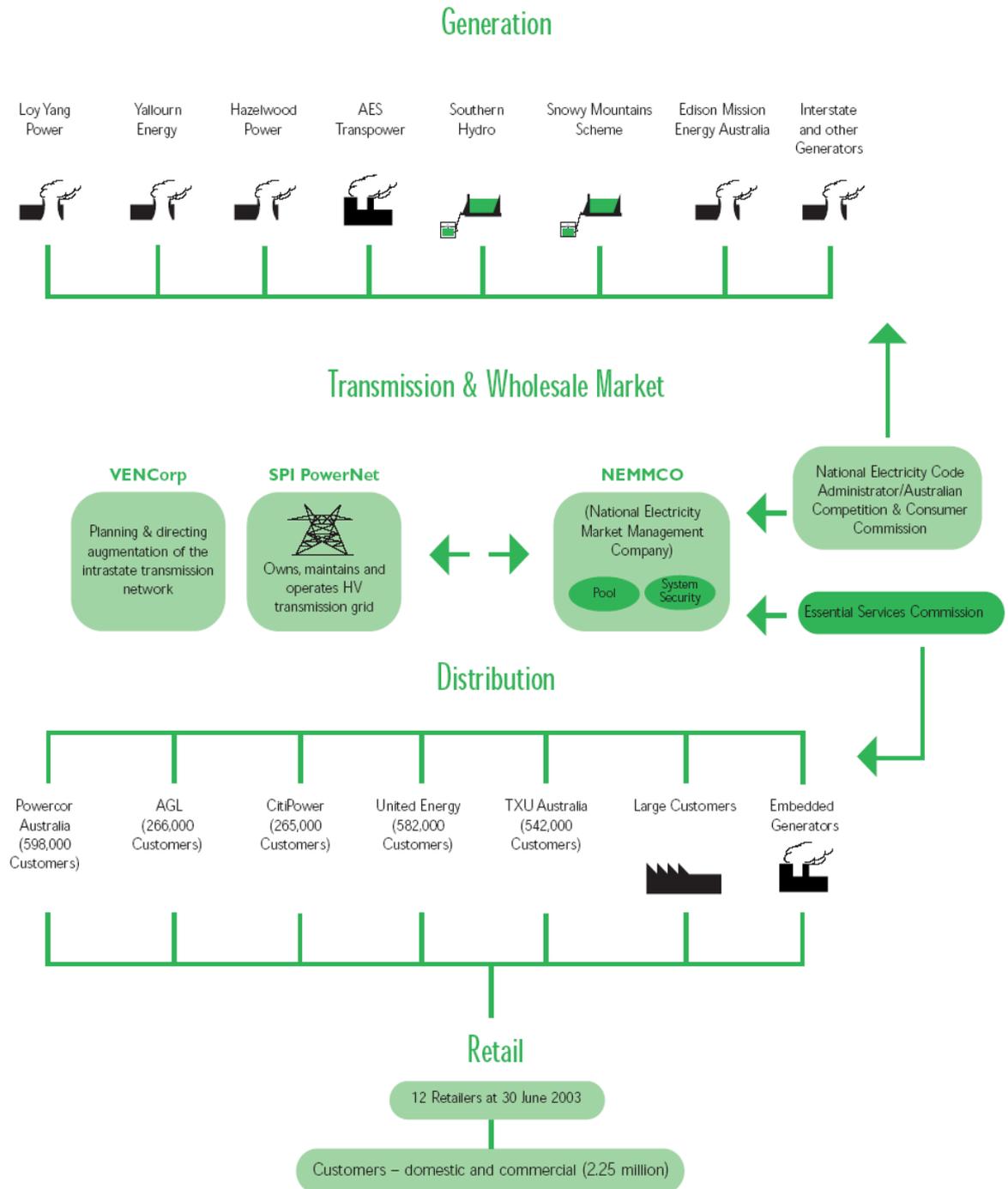
Sandra Denis, Assistant Director of Revenue Policy at the Department of Treasury and Finance (DTF), was a relatively recent appointment. She came to the Department with a great deal of technical and policy expertise and experience in the Victorian Government's energy group as Manager, Legal and Legislation. It was not unusual for DTF or the SRO to deal with constitutional cases each year and at first, the TASCO case appeared no different. Recalled Denis: "Initially, I didn't think it was any more significant than other projects that were assigned to me – after all, I had a legal background and had worked in the energy area, so it seemed to be a natural fit. As things developed, it became more apparent that this was a very significant project."

Both at the time of the introduction of the SRA and again following the decision in *Ha* the State had received authoritative legal advice which concluded that the levy was constitutional. However, this case presented several unique complicating factors, not least the difficulty of quantifying exactly how much was at stake. But what was known was the fact that the DTF was dealing with an extremely complex legal environment where it would be difficult to predict outcomes with certainty.

The Department immediately set about putting senior and experienced resources on the matter. One of the first tasks involved appointing a project manager. Sandra Denis, who had originally been assigned the case, had a legal background and considerable public sector experience but had not previously managed a project of this magnitude. Yet, it was recognised that few in DTF had experience in handling an issue like this. As Department Secretary Ian Little remarked, "...this had turned from the kind of constitutional case that comes along once a year into something that comes along once a decade."

**Exhibit A: Victorian electricity industry structure (at 30 June 2003)**

Source: Essential Services Commission website ([www.esc.vic.gov.au](http://www.esc.vic.gov.au)). accessed 10/9/05



## Exhibit B: Production and Transmission of Electricity

Fig 1: From PowerWorks [www.powerworks.com.au](http://www.powerworks.com.au)

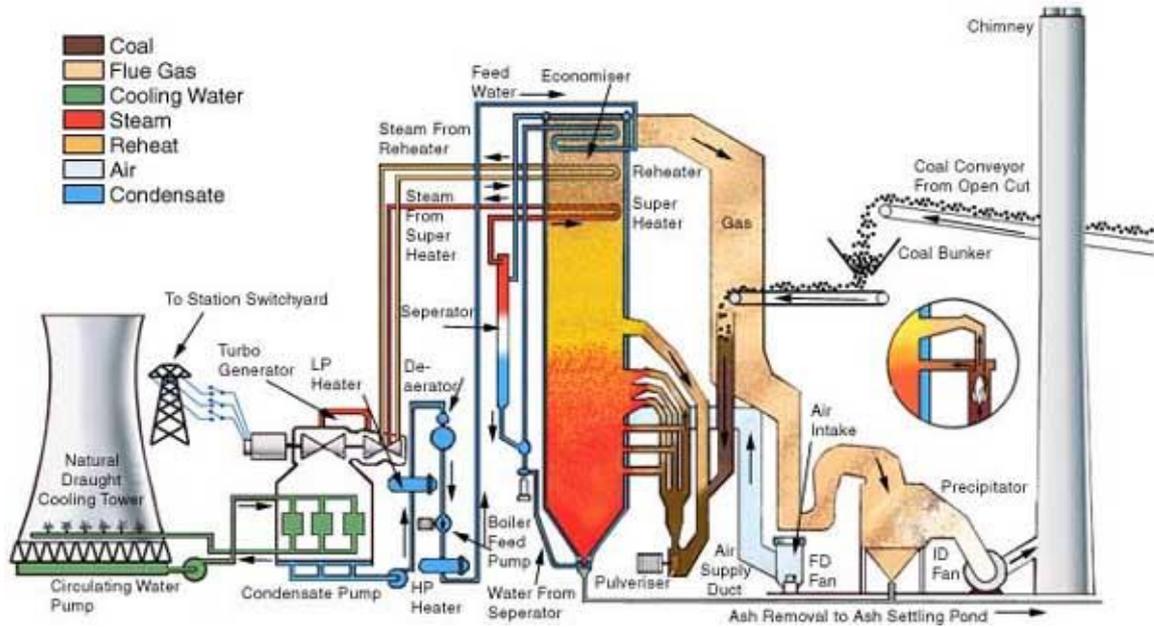


Fig 2: From *An introduction to Australia's National Electricity Market* NEMMCO June 2005 p.5

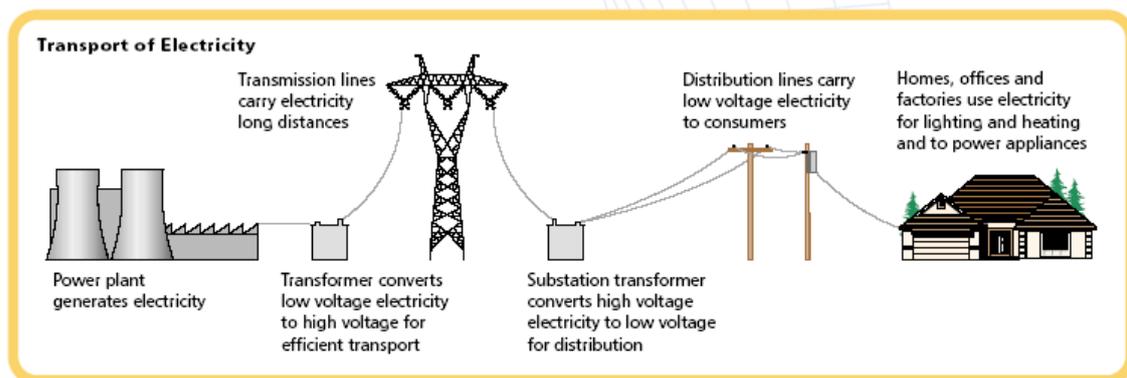


Fig 3: From SPI PowerNet ([www.spipowernet.com.au](http://www.spipowernet.com.au))

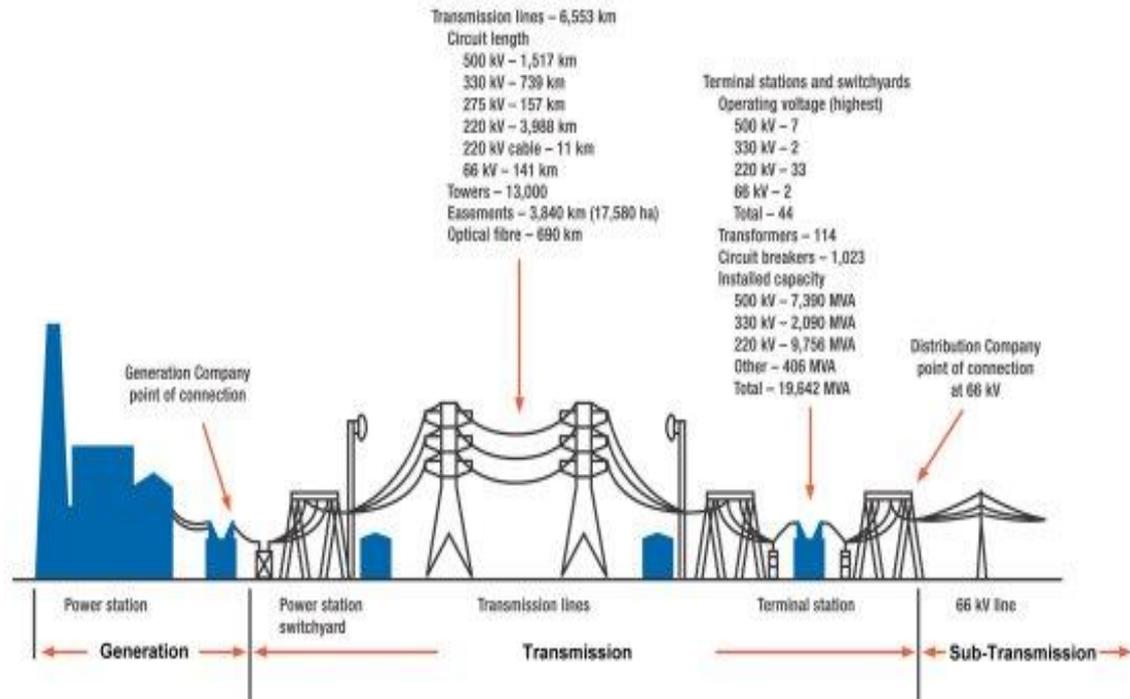
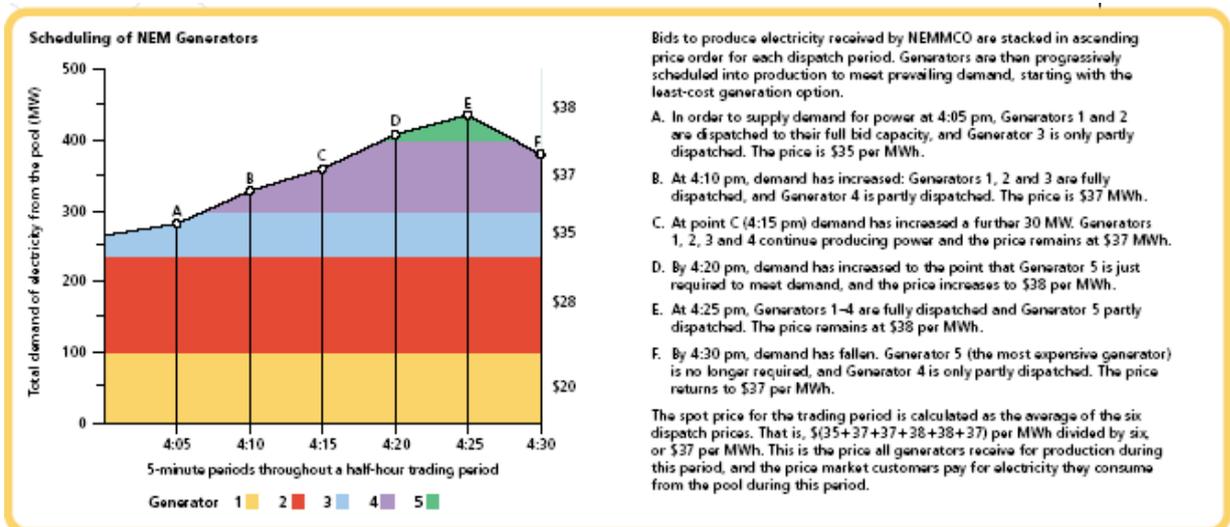
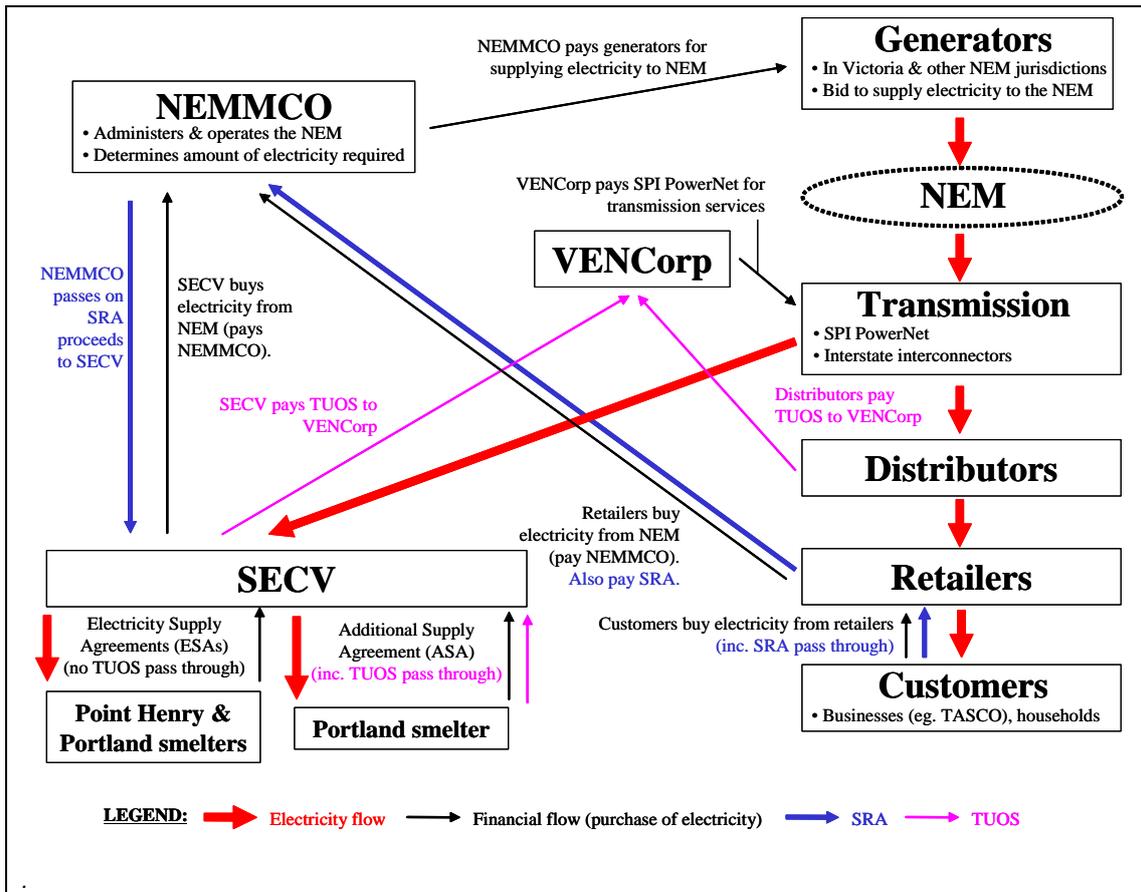


Fig 4: From *An introduction to Australia's National Electricity Market NEMMCO* June 2005 p.15

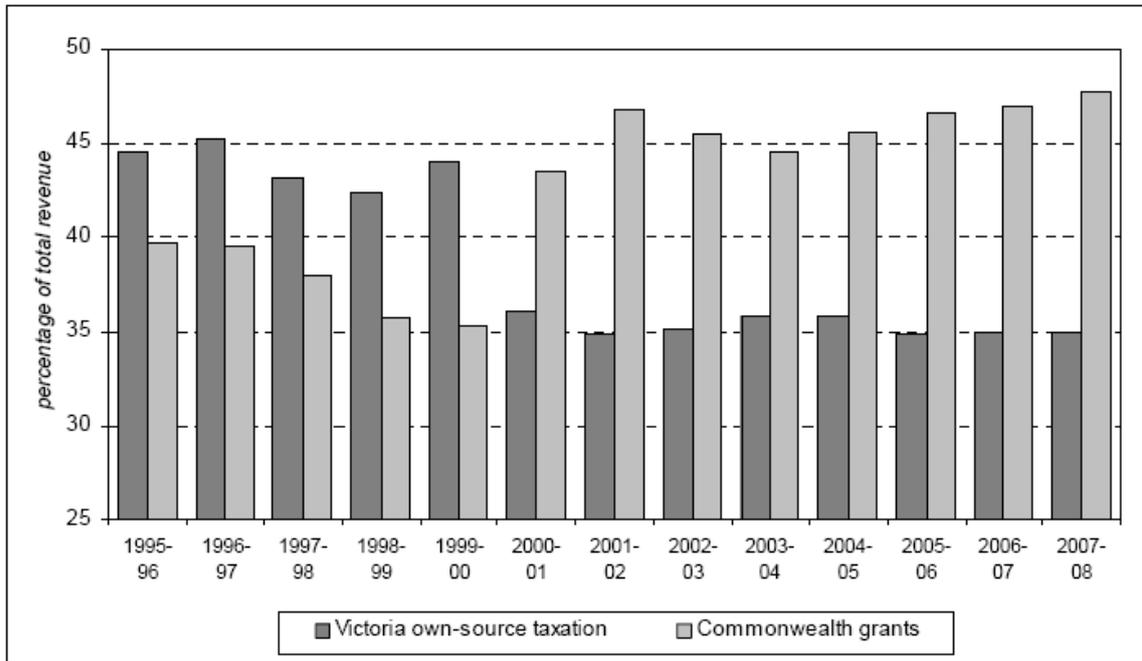


## Exhibit C: Summary of electricity and key financial flows



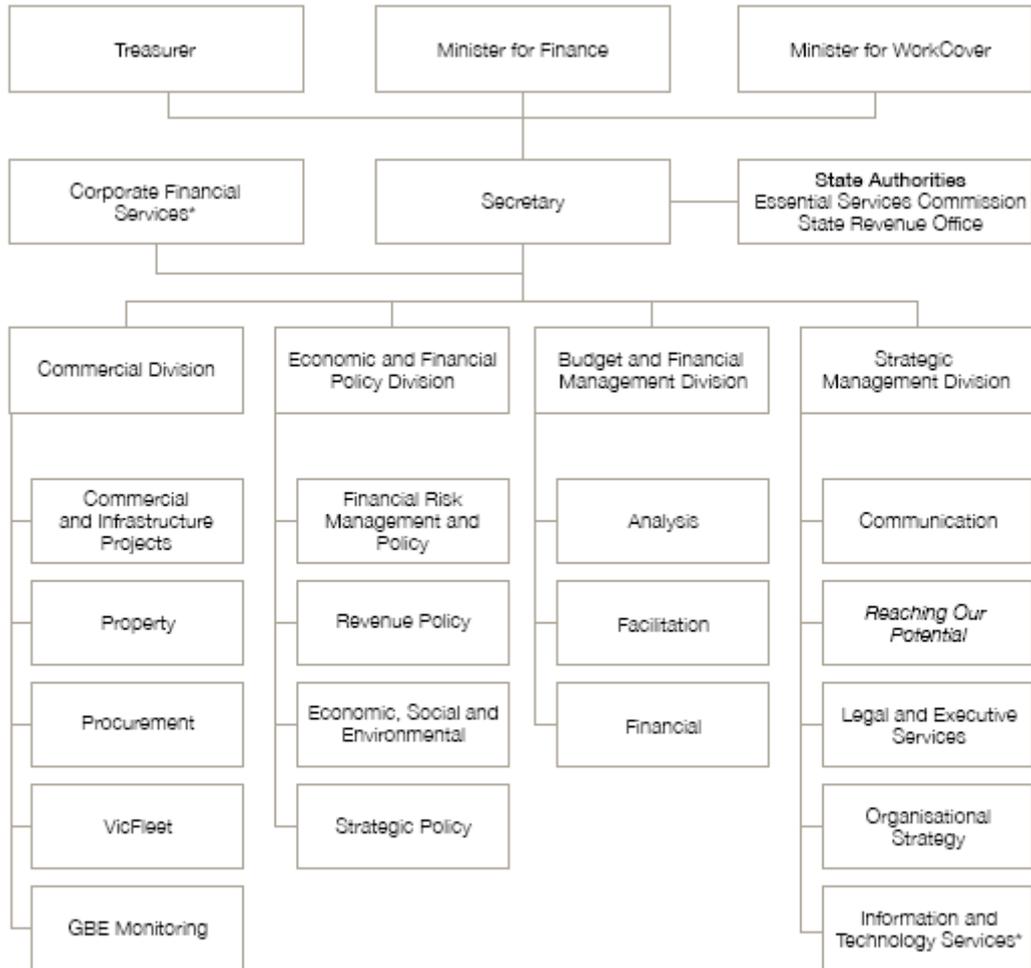
**Exhibit D: Victorian-sourced taxation and Commonwealth grants as a percentage of total revenue**

*From 2005-06 Victorian Budget Paper No 2 p.76*



## Exhibit E: Department of Treasury and Finance Structure 2003-04

DTF's Organisational Chart



\* Provides Shared Services to DPC and DTF