Allocations of interest and tax expenses - return on equity profitability measure

Response to AER Discussion Paper

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Energy Networks Australia

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Key messages

- Energy network businesses support the development of a clear suite of profitability measures to promote transparency and confidence to stakeholders and appreciate that such measures may help inform policy discussions around the performance of the regulatory framework in the future.
- The allocation methods chosen must provide the best estimate of Regulatory Net Profit After Tax and be flexible to account for changes in business circumstances over time.
- Clear explanation and context around measures is paramount.
- The network profitability measures must only be used to provide context to the industry and an individual network's performance and not to undermine the regulatory framework. Regulating profits is not in the long-term interest of consumers.
- The profitability measures will require periodic review to ensure they are delivering the information benefits to stakeholders and that the associated costs to networks are reasonable.
- For fairness and practicality, a tax rate of 30 per cent should be assumed for all networks.
- Interest may be better allocated for some networks based on statutory reported property, plant and equipment.

Overview

Energy Networks Australia is the national industry body representing Australia's electricity transmission and distribution and gas distribution networks. Our members provide more than 16 million electricity and gas connections to almost every home and business across Australia.

Energy Networks Australia welcomes the opportunity to provide a submission to the Australian Energy Regulator's (AER) Discussion Paper "*Allocations of interest and tax expenses for the calculation of return on equity (regulatory) profitability measure*" (the Discussion Paper) and the "*Advice on the allocation of interest and tax expense*" from PwC (the PwC Advice Paper).

A clear suite of profitability measures will help promote transparency and confidence in network businesses. They may also help inform discussions around policies and the performance of the regulatory framework.

Energy Networks Australia reiterates its concern as to the relevance of a Regulatory Return on Equity (Regulatory ROE) measure derived using actual interest and tax expenses. It is also worth highlighting that some network businesses operating under flow through structures are not required to prepare Australian statutory accounts and so do not currently report statutory financial information to the AER. It is unclear how the AER will be able to compel the publication of information concerning business activities outside their remit. Whilst this does not impact the current Discussion Paper, it will impact the statutory based profitability measures.

More detail on our key messages can be found in the following sections. Our response to the questions posed in the Discussion Paper can be found in the Appendix.

Setting and balancing goals for allocation

To allow for comparability, interest and tax must be allocated to provide the best estimate of Regulatory Net Profit After Tax (Regulatory NPAT) that can be realistically and cost effectively achieved. As such, networks must be able to allocate interest and tax using the most appropriate, cost effective method(s) for their business.

It is equally important that there is flexibility in the allocation method chosen and that it can be altered over time as the business changes. For example, a change in ownership structure or the risk profile of (a) different business unit(s) may render a previous allocation approach invalid. The business may need to alter its allocation approach accordingly. This sort of flexibility is offered to businesses under accounting standards. Allowing the same sort of flexibility in reporting regulatory information will ensure that reported data remains meaningful and true.

With these points in mind, whilst consistency in the approach to allocating interest and tax may be desirable, the set of circumstances where this is possible will likely be quite small. This expected variation in approach is supported by PwC[1].

To aid transparency, Energy Networks Australia agrees that where networks have estimated interest and/or tax expenses, the allocation method(s) adopted should be clearly reported.

Clear guidance on methods and context

Given the AER intends the profitability measures to provide transparency for stakeholders, a clear explanation of how the Regulatory ROE measure is derived and how to interpret the results is necessary. More importantly, however, the limitations of the measure in terms of its quantification and, therefore, its reliability for comparing networks, must be made clear to avoid potential misinterpretation.[2]

In this regard, it is important that the AER considers not just how they intend to use and consider the data, but how the data will be interpreted and used by others. This is particularly important given the profitability measures will be adding another layer of data into the marketplace where networks are seeking to efficiently raise capital to deliver service outcomes to customers.

As such, stakeholders should be consulted on the wording of any proposed Explanatory Statements for the profitability measures. In addition, networks should be provided the

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[1] See p.8 of PwC advice paper where either method 1, 2 or 3 in relation to allocating the interest expense "…may be considered as alternatives … in light of the circumstances of the relevant network…" and recommendations 1 and 2 which indicate that the allocation of tax will vary depending on the circumstances of the entity.

[2] Take for example the National Irrigators' Council press release implying networks were making excess profits based on a Sapere Research Group report for the Agriculture Industries Energy Taskforce using initial AER return on assets data https://www.irrigators.org.au/energy-regulator-must-crack-down-on-potentially-rule-breaking-excess-profit/

timely opportunity to provide appropriate commentary on their annual results and expect the AER to include these comments in any associated publications.

Need for periodic review of measures

Energy Networks Australia considers that the suite of profitability measures should be regularly reviewed by the AER, in conjunction with stakeholders, to ensure the data is providing the additional transparency and information required and that the associated costs are not significantly onerous. These costs will include implementation costs, on-going data collection costs as well as any time spent defending or clarifying any incorrect interpretation of AER published data by the community.

Such a review should also include changes to Explanatory Statements. It is likely that these will need refining over time as misinterpretations are identified.

Use of network profitability measures

Energy Networks Australia emphasises the need for the AER to ensure the network profitability measures are used only to provide context to the industry and an individual network's performance and not to directly make any adjustments to the regulatory determinations of individual businesses given:

- The proposed measures have limited ability to allow for meaningful comparisons between businesses given the intrinsic differences in network characteristics and business compositions; and
- The measures should not undermine the business incentive to earn returns above or below the allowed cost of capital via the delivery of cost savings or beating the benchmarks set by the AER. Incentive-based regulation is a key component of the regulatory framework that delivers substantial benefits to customers. It is important that the profitability measures do not erode businesses incentive to reduce costs and improve services in the interests of customers. Regulating profits is not in the long-term interest of consumers.
- The results of profitability metrics are driven by regulatory assumptions, so using past results to validate those assumptions or decisions going forward would result in circularity. This would be a particularly risky undertaking given the significant transformation networks are experiencing at this time.

In addition, Energy Networks Australia again reiterates the need to consider comparing networks profitability with information from outside the regulatory sector to provide a cross check that the regulated returns are commensurate with those earned by comparable businesses operating in a competitive environment – for example 'defensive' stocks that have physical assets.

A 30 per cent tax rate

The proposed taxation approach for flow through entities may unfairly overstate the profitability position of some networks simply because of how they are structured. It will also be difficult for networks to implement in practice.

Instead, Energy Networks Australia believes that **a 30 per cent tax rate should be applied to all networks**, including structures held by Australian State / Territories in vehicles which are not subject to the National Tax Equivalent Regime (NTER).

Such an approach provides a cost-effective alternative approach that offers comparability, simplicity and a reduction in the regulatory burden for flow through entities. It also more appropriately recognises that the Regulatory ROE necessarily entails a degree of estimation and is just one measure in a suite of profitability measures being provided by networks. More importantly, stakeholders will have the necessary high-level data to consider the Regulatory Return on Equity (ROE) measure for networks under alternative tax rates, if they so desire.

Possible unfairness

Applying some other blended tax rate below 30 per cent may unfairly overstate the profit position of some NSPs relative to others:

- Take for instance a network that is a corporate entity owned by an Australian Superannuation Fund.

  Under the proposed tax allocation approach the network is assumed to pay 30 per cent tax on its earnings before they are distributed to the owner. This network's *regulatory NPAT would be the remaining 70 per cent*, even though the Australian Superannuation Fund owner will only pay 15 per cent tax on the income and receive the difference back as a franking credit.
- Compare this to a network that operates under a flow through structure owned by an Australian Superannuation Fund.

  The proposed allocation approach would assume this network pays 15 per cent tax on its earnings before they are distributed to the owner. *This network's regulatory NPAT would be the remaining 85 per cent*.

Even though the ultimate owner in both examples will pay only 15 per cent tax, the second network would be perceived as having a much higher level of profitability, simply because of its ownership structure.

Applying a 30 per cent tax rate across all networks will remove such anomalies and ensure a fair and consistent approach. It also aligns with the AER's findings in the 2018 Regulatory Tax Approach review which found that 70 per cent of energy networks combined Tax Asset Base was taxed at the 30 per cent statutory corporate tax rate.

Practicality concerns

Some networks cannot realistically achieve visibility of all their upstream investors, nor are they able to compel data relating to their associated tax profiles. Even if they could do so:

» there would be significant costs and time involved in obtaining sufficient data points to determine an average blended tax rate, though both the Discussion Paper and Advice Paper are unclear as to what would be considered reasonable in this regard.

» There is no reason to stop at the initial recipients of any distributions when calculating a blended rate. The tax rates applicable to those initial recipients may give a misleading picture. For example, those initial recipients may, themselves, be flow-through entities having a zero-tax rate. There may be long chains of flow through entities with recipients bearing a multitude of tax rates with some Australian and foreign investors bearing tax rates as high as 45 per cent.

In practical terms, this makes any requirement to estimate an associated taxation rate not reasonably possible to comply with and may result in significant errors – a standard 30 per cent rate, even with its known limitations, would likely produce the most understandable and comparable outcome.

- The administrative costs for entities with tax losses from other sources would also be significant. As mentioned in the PwC Advice Paper "*…tax losses were likely to be attributable to factors outside of the regulatory ring-fence*[3]" It is therefore assumed that any blended rates would be calculated on the assumption that tax losses are not available. Calculating such rates would be a significant administrative burden for entities with tax losses, as such entities do not need to calculate withholding tax rates in order to comply with the tax law.

  The ATO has recently released '*LCR 2019/D2 Non-concessional MIT income*', which implies that complex calculations are required to compute relevant withholdings for entities without tax losses, and that a mixture of rates may apply in some cases. For entities with tax losses, these complex calculations would only be required to calculate a blended rate.

Foreign taxes

There is no compelling reason to exclude foreign taxes from the applicable blended tax rate – foreign taxes imposed on distributions are a very real cost to investors.

Including such tax costs would improve comparability between entities as total applicable taxes would be measured for each entity. However, foreign tax regimes can be complex and vary by country, meaning that making a reasonable estimate of foreign taxes would be a costly and fraught exercise, particularly if foreign investors do not provide the necessary information about their affairs. A 30 per cent rate provides a cost-effective alternative approach.

An alternative interest allocation approach

Energy Networks Australia proposes a fourth interest allocation method: Regulated Business Statutory Property, Plant and Equipment (PP&E) /Statutory PP&E, then RAB/Regulated Assets.

This method would first see the interest expense allocated across all businesses in a group based on their relative share of Statutory PP&E. From this, a total interest expense for the Regulated Business could then be determined. If necessary, this expense would then be split between the regulated business units based on their relative RAB proportions.

The benefits of this approach are:

- It recognises that debt is taken out to finance assets when they are built. As such, it is the book value of assets that more appropriately represents the associated value of outstanding debt.
- It excludes the impact of intangible assets, which can be significant and not necessarily related to the profitability of the benchmark regulated business. This aligns with the views of consumer representatives at the AER Profitability workshops.

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[3] PwC Advice Paper, p.14

- It avoids the issues that would otherwise arise where the statutory asset base is formed on a completely different basis to the RAB and so is not comparable. For example, the Recovered Capital Methodology applied to gas assets and the impact of RAB indexation.

In this regard, this approach will reduce the number of instances where 100 per cent of the interest expense is allocated to the Regulated Business simply because RAB indexation has led to a RAB value that exceeds that of Statutory Non-Current Assets. This is an additional benefit as it is unlikely that all the interest expense in a group entity relates solely to the Regulated Business.

Further consultation is required

Permanent differences in depreciation

As outlined in the Discussion Paper, additional stakeholder consultation is required in relation to determining an appropriate method for adjusting the tax expense for the permanent difference in depreciation attributable to indexation of the regulatory asset base.

Energy Networks Australia recognises the complexity of this issue and the likely impossibility of deriving a uniform methodology that accurately represents each business. Such an approach is a purely theoretical exercise that bears no relation to actual tax or statutory tax reporting. It would require many assumptions to be made yet it will still never lead to an accurate representation of the underlying profitability for all businesses.

Energy Networks Australia therefore suggests that the AER consider developing a simple methodology that meets the overall principle of the profitability measures – namely to provide a suite of measures to allow for the relative comparison of networks. This will also minimise potential confusion for users of the profitability reports who may otherwise misinterpret an incorrectly applied assumption as a reflection of the underlying business performance.

As such, Energy Networks Australia and its members would value being involved in this additional AER consultation when it occurs.

Non-National Tax Equivalent Regime investors

PwC did not provide definitive advice on the appropriate tax rate to apply to flow through structures held by Australian State/ Territories in vehicles which are not subject to the NTER. The PwC advice paper leaves the decision open, though suggests that a 30 per cent tax rate, like that to be applied to tax exempt State/Territory owned entities may be comparable.

As outlined in the *A 30 per cent tax rate* section above Energy Networks Australia agrees that an assumed 30 per cent tax rate for non-NTER investors offers simplicity and would likely satisfy the comparability objective. However, if the AER intends to determine an alternative non-NTER rate, then Energy Networks Australia and its members would like to be involved in the associated consultation process.

Appendix – Feedback on questions raised

1. **Do you agree with the key principles identified by PwC for the allocation of interest and tax expense to the regulated entity?**

   Energy Networks Australia agrees with PwCs ring-fencing principle that in determining Regulatory NPAT, only regulatory income and expenditure should be considered and must relate to the efficient operation of the network.

2. **Do you agree with PwC's recommended approach for allocating tax expenses for corporate structures?**

   Energy Networks Australia agrees with the recommended approach but would like the AER to confirm that gifted assets are not mistakenly double counted in the calculation. To this effect, '*Figure 2: Calculation of income tax in respect of regulated assets'* in the PwC advice Paper may need adjusting.

   In addition, the appropriate method for adjusting the taxation expense for the permanent difference in depreciation attributable to indexation of the regulatory asset base is yet to be determined – see the *Permanent differences in depreciation* section.

3. **Do you agree with PwC's recommended approach for allocating tax expenses to flow through tax structures?**

   No. Whilst the approach has merit in principle, Energy Networks Australia has some concerns as to its fairness and how it will play out in practice.

   Energy Networks Australia instead suggests that **a 30 per cent tax rate should be applied to all flow through entities**, including structures held by Australian State / Territories in vehicles which are not subject to the National Tax Equivalent Regime (NTER). For more detail see the *A 30 per cent tax rate* section.

   The outstanding issue in relation to an appropriate method for adjusting the taxation expense for the permanent difference in depreciation attributable to indexation of the regulatory asset base also applies to flow through structures - see the *Permanent differences in depreciation* section.

4. **In light of the advantages and disadvantages that PwC sets out for its three interest allocation approaches, which of these allocations should be used, and why?**

   As mentioned in the body of our submission, Energy Networks Australia also proposes a fourth approach – see the *An alternative interest allocation approach* section.

   All the approaches have merit and businesses should be free to choose the method that provides the best estimate of regulated interest for their entity, recognising that this allocation approach may change over time.

The AER should not expect that all businesses can use the same interest allocation approach as the composition, complexity and risk profile of each entity is unique. The AER should have no concerns in this respect as the method adopted will provide the best estimate of regulated interest (verified through the audit process) and the approach will be clearly reported by the business.

5. **Are there any further allocation approaches we should consider for tax and/or interest expenses? If so, please identify why you consider these approach/es preferable to those identified in the advice.**

   As discussed in the *A 30 per cent tax rate* section, Energy Networks Australia believes applying a 30 per cent tax rate to all networks is fairer and more practical.

   Energy Networks Australia has also suggested an alternative approach for allocating interest – see the *An alternative interest allocation approach* section.

   Should other stakeholders identify any other approaches, then Energy Networks Australia would like to be a part of any further consultation process.