Review of Regulatory Tax Approach

Response to the AER Initial Report

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Energy Networks Australia

Contents

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1 Overview

Key messages

- Energy Networks Australia (ENA) agrees with the AER's Initial Report that the framework of incentive-based regulation should be maintained and that the focus of this review should be on determining whether the AER can implement a better benchmark for tax costs that is compatible with the incentive framework.[1]
- ENA considers that three broad principles should be used to guide the consideration of any potential change to the approach to estimating the benchmark efficient corporate tax allowance:
  - A change should only be made if there is evidence that such a change would better reflect the efficient practice of the benchmark efficient firm.
  - Any changes should only be made prospectively and not have any retrospective effects, consistent with the proper operation of the incentive-based regulatory framework and the NPV=0 principle; and
  - A cost and its tax effect must be treated consistently – either both are outside the regulatory framework (in which case NSPs are entirely responsible for the cost and its tax consequences) or both are inside the regulatory framework (in which case the cost and its tax effect fall to customers).
- Networks will work closely with the AER and its advisers to ensure the AER can understand the drivers of current outcomes, and inform itself as to how to best set the benchmark efficient corporate tax allowance.

Energy Networks Australia (ENA) welcomes the opportunity to provide this contribution to the AER's review of its regulatory tax approach.

ENA's participation in this review is aimed at supporting outcomes that are acceptable to all stakeholders, including the AER, while delivering sustainable business outcomes for networks that are a precondition for the long-term investment in energy infrastructure that is vital for Australia's growing energy needs.

The key principles that underpin this submission are set out above.

ENA also notes that some aspects of this review involve complex inter-relationships that must be thoroughly understood to avoid changes having unintended consequences that may not be in the long-term interests of consumers. These issues will require detailed consultation processes. ENA looks forward to participation in these consultations with the AER and other stakeholders to ensure that proper consideration is given to any proposed change.

[1] AER Initial Report, p.47

2 Incentive-based regulation and the benchmark efficient cost of tax

- ENA considers that the appropriate task for this review is to determine the amount of corporate tax that would be paid by a benchmark efficient entity, as a result of the provision of the relevant services, if such an entity, rather than the actual NSP, operated the business. (NER cl. 6A.6.4; NGR r. 87A).
- ENA agrees that it is appropriate for the AER to reconsider, from time to time, whether its regulatory allowances are consistent with the benchmark efficient practice. Indeed, that is the purpose of incentive-based regulation – to encourage NSPs to seek efficiencies and to fold those efficiencies into the regulatory framework when they are identified, for the long-term benefit of consumers.
- ENA considers that the benchmark efficient practice in relation to corporate tax should be determined by examining the standard practices of NSPs.
- ENA considers that a key plank of the incentive-based regulation framework is that changes are not made retrospectively. For incentive-based regulation to work as intended, it is crucial that businesses are able to make investment decisions based on the rules of the day, knowing that those rules will not be changed retrospectively some years later.

2.1 Potential reasons for differences between AER allowance and actual corporate tax payments

In its Initial Report, the AER notes that there is some evidence that actual corporate tax payments exceed the regulatory allowance for some firms and that the reverse is true for other firms. Three broad potential reasons have been identified as potentially contributing to differences between the regulatory tax allowance and actual corporate tax paid:

- **AER allowance differs from benchmark efficient cost of tax**: Part of the difference may arise because of differences between the AER's corporate tax allowance and the corporate tax paid by the benchmark efficient entity. That is, the AER's tax allowance may differ from the efficient amount of tax that would be paid by a BEE in the circumstances of the business in question.
- **Expenses outside the regulatory framework**: Part of the difference may arise due to expenses that are paid entirely by the regulated firm and not by customers, such that these expenses fall outside the regulatory framework. The AER has provided the example of research and development expenses, which are not compensated in the regulatory revenue allowance, but which give rise to a tax deduction.

- **Business structuring**: Part of the difference may arise because the structure of the regulated firm differs from a simple corporate structure. For example, certain stapled and partnership structures can affect the quantum of corporate tax paid by shifting tax obligations to the personal level.

2.2 Review should focus on the efficient cost of tax for the benchmark efficient entity

ENA considers that the focus of the current tax review should be on the efficient amount of corporate tax that would be paid by the benchmark efficient entity. This is the only approach that is consistent with the incentive-based regulatory framework (and see also NER cl. 6A.6.4 and NGR r. 87A).

Our previous submission dealt with this point in some detail, concluding that:

> *...the appropriate policy or regulatory response will depend on the reason why actual tax payments differ from the regulatory allowance. If the difference occurs because the benchmark efficient firm would pay less tax than the regulatory allowance (i.e., the estimate of the tax allowance does not reflect the benchmark efficient tax costs) the regulatory allowance should be adjusted. But if the difference arises due to the firms bearing costs beyond the regulatory allowance (i.e. unrelated to the benchmark efficient approach) there is no reason to adjust the regulatory tax allowance. Under incentive-based regulation, those additional costs (and the tax impacts of them) are entirely up to the regulated firm to bear and manage and have nothing to do with benchmark efficient regulatory allowances or prices paid by consumers.*
>
> *Consequently, it would be wrong to observe a difference between an actual cost and the relevant regulatory allowance and to immediately conclude that the regulatory allowance or the approach to estimating the allowance should be adjusted. Indeed, under an incentive based framework the expectation is that there will be a difference.*
>
> *The reason for the difference must be identified. A change to the regulatory approach should only be made if there is strong evidence that the regulatory allowance differs from the benchmark efficient cost.*[2]

In its Initial Report, the AER notes the key role of incentive-based regulation within the context of the NEO and NGO. ENA agrees with the AER's conclusion that the focus of the current review should be on determining whether the regulatory allowance is consistent with the efficient cost of corporate tax for the benchmark efficient firm:

> *We use an incentive approach where, once regulated revenues are set for a five year period, networks who keep actual costs below the regulatory forecast of costs retain part of the benefit. This benchmark incentive framework is a foundation of the AER's regulatory approach and promotes the delivery of the national electricity objective (NEO) and national gas objective (NGO). Service providers have an incentive to become more*

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[2] ENA, 31 May 2018, Review of regulatory tax approach: Response to AER Issues Paper, p. 8.

> *efficient over time, as they retain part of the financial benefit from improved efficiency. Consumers also benefit when efficient costs are revealed and a lower cost benchmark is set in subsequent regulatory periods.*
>
> *It has been some time since we reviewed our regulatory approach to forecasting tax costs. It is now appropriate to consider whether there are more efficient approaches to taxation that should be reflected in our benchmark approach—approaches that might better reflect the long term interest of consumers.*[3]

ENA agrees that under the incentive-based regulation framework, service providers have an incentive to become more efficient over time and these improvements in efficiency are revealed over time through the regulatory process. This results in a periodic resetting of the benchmark efficient allowance to be commensurate with the AER's estimate of the efficient costs of the benchmark efficient entity at the time of each determination. In this way, the incentive for the business to operate efficiently with respect to corporate tax, and for the regulatory allowance to reflect the benchmark efficient cost, is in the long-run interests of consumers.

In its Initial Report, the AER notes that:

- There is some evidence that actual corporate tax exceeds the regulatory allowance for some firms and that the reverse is true for other firms; and
- The AER is unclear about the extent to which any differential can be attributed to improvements in efficiency since the AER last reviewed its process for setting the benchmark efficient tax allowance.

> *We consider that data on actual tax payments of the regulated networks—collected across the sector, not just for any one firm in isolation—is relevant to our forecast of the tax costs for the benchmark efficient entity. Obtaining more detailed information on the actual tax practices of regulated networks will help us assess whether the current regulatory approach to forecasting tax costs reflects efficient practices. Under the benchmark incentive framework we operate, regulated businesses have an incentive to pursue the lowest cost means of providing the regulated services. If the regulated businesses are employing a more efficient approach to taxation than the benchmark determined under the current framework, then this should inform the benchmark set in future determinations.*[4]

ENA also agrees that it is appropriate for the AER to reconsider, from time to time, whether its regulatory allowances are consistent with the benchmark efficient practice. Indeed, that is the purpose of incentive-based regulation – to encourage NSPs to seek efficiencies and to fold those efficiencies into the regulatory framework when they are identified, for the long-term benefit of consumers.

[3] AER, June 2018, Initial Report, p. 6.
[4] AER, June 2018, Initial Report, p. 27.

In this regard, the AER's Issues Paper notes that the NER and NGR state that the estimated cost of corporate income tax must be computed using an estimate of the taxable income that would be earned by a benchmark efficient entity as a result of the provision of the relevant services if such an entity, rather than the actual NSP, operated the business.[5]

The AER's Initial Report also reaches the same conclusion:

> *The general consensus from stakeholder submissions is that the framework of incentive-based regulation should be maintained, and that administering a pass-through approach for tax costs would have significant difficulties and costs without providing benefits for consumers.*
>
> *Given the available evidence, our current assessment is that we should exercise caution before moving to a tax pass-through regime. Rather, we should consider whether we can implement a better benchmark for tax costs that is compatible with the incentive framework.*[6]

ENA considers that the appropriate task for this review is to determine the amount of corporate tax that would be paid by a benchmark efficient entity, as a result of the provision of the relevant services, if such an entity, rather than the actual NSP, operated the business.

Thus, the potential reasons set out in Section 2.1 above should be examined to determine which might be relevant to the benchmark efficient cost of corporate tax and which are not relevant to the regulatory framework.

2.3 Identifying benchmark efficient practices

When identifying the efficient practice of the benchmark efficient firm, the AER's general approach is to consider the approach of the firms that it regulates – on the basis that these firms are, on average, expected to be operating efficiently. For example, the benchmark efficient level of gearing is computed having regard to the average level of gearing adopted by the firms regulated by the AER, and the benchmark efficient credit rating is computed having regard to the average credit rating maintained by those firms.

ENA considers that the same approach should be adopted for the benchmark corporate tax allowance – the benchmark efficient approach to corporate tax should be informed by the average practice of the firms that are regulated by the AER. Thus, there would be reason for the AER to change its approach to setting the benchmark efficient corporate tax allowance if there was evidence that the general practice of regulated firms differed from the approach that underpins the AER's regulatory allowance.

[5] AER Issues Paper, p. 19; NER cl. 6A.6.4; NGR r. 87A.
[6] AER, June 2018, Initial Report, p. 47.

2.4 Retrospective changes have no place in incentive-based regulatory frameworks

The purpose of the incentive-based regulation framework that operates in Australia is to create an incentive for service providers to become more efficient over time. When these efficiencies are identified, the regulatory benchmark is changed to reflect them. Thus, network businesses benefit to the extent that they are able to improve efficiency and beat the existing regulatory benchmark for a period, and customers benefit as the regulatory benchmark is adjusted over time to reflect the improved efficiency.

An indication of the incentive-based framework working well is that many networks have invested in research and development (R&D) to improve efficiency. Much of this R&D expenditure is made outside the regulatory framework and is not included in the calculation of allowed revenues. This R&D expenditure is borne entirely by the network business (i.e. there is not regulatory allowance for it), but it is still made because networks will receive some benefit from any efficiency improvements that might come from it – until the regulatory benchmark is revised to reflect that efficiency improvement. Customers then receive the benefit of that efficiency improvement via the changed regulatory benchmark, without having contributed to the R&D expenditure at all.

If changes are made to the regulatory benchmark retrospectively, the incentive to improve efficiency is destroyed. Certainly, the incentive for a network to make investments to improve efficiency is destroyed. For incentive-based regulation to work as intended, it is crucial that businesses are able to make decisions (improve efficiency) based on the rules of the day, knowing that those rules will not be changed retrospectively some years later.

As well as interfering with the incentive to improve efficiency, retrospective changes can also involve a form of expropriation. Consider, for example, a corporate transaction that involves the payment of a material amount of stamp duty. The immediate tax deductibility of that stamp duty payment is a source of value to the bidder and would presumably be reflected in the bid price. Under the current rules and regulatory framework the buyer is entitled to the full benefit of that tax deduction on the basis that it is the buyer (and not consumers) that paid the full amount of the stamp duty that gave rise to the tax deduction. Thus, the buyer has (via the bid price) paid something for that tax benefit. Now suppose that, some time later, the rules and regulatory framework are changed so that the value of the tax deduction is transferred from the network buyer to customers. In this case, an asset (the value of the immediate tax deduction) that the network buyer has paid for in accordance with the rules that were in operation at the time, has been transferred away from them, in effect representing a form of retrospective expropriation.

For the reasons set out above, ENA considers that any changes to rules or regulatory frameworks should be made on a prospective basis only. ENA notes the general agreement with this proposition expressed by participants, including Dr Lally, at the forum held by the AER on 18 July 2018.

3 Matters that have been identified as being potentially relevant to the benchmark efficient cost of tax

- ENA considers that it is reasonable for the AER to examine whether the benchmark efficient corporate tax allowance should accommodate diminishing value depreciation. Any such change in this regard should be:
  - Based on evidence about how diminishing value depreciation is used by network service providers in practice; and
  - Applied on a prospective basis.
- ENA considers that it is reasonable for the AER to examine whether the benchmark efficient corporate tax allowance should accommodate the immediate deductibility of corporate overhead costs, whether any change would require transition arrangements for some businesses, and what effect any change might have on consumer prices in the short-run.
- ENA considers that there is no evidence to support the use of anything other than a standard corporate structure as the basis for calculating the benchmark efficient corporate tax allowance. ENA notes that the advice commissioned by the AER is that the standard corporate structure should be maintained for the purpose of computing the corporate tax allowance.
- In relation to refurbishment costs, ENA recommends that:
  - The AER maintain the current approach, which is to treat refurbishments and replacements symmetrically in all respects, such that the lowest cost alternative will always be selected; and
  - Any proposed change in this area should be the subject of a detailed consultation process to avoid unintended consequences. For example, a change in the regulatory model to incorporate an immediate tax deduction for (efficient) refurbishments is likely to result in a *reduction* in allowed revenues over the regulatory period. That is, the network business would have to fund the refurbishment expenditure and would end up with *less* revenue. The network could not ignore this outcome and may be led to adopt a (less efficient) asset replacement or operating expenditure solution that is not in the *long-term* interests of consumers.

3.1 Overview

As noted above, ENA considers that:

- The appropriate task for this review is to determine the amount of corporate tax that would be paid by a benchmark efficient entity, as a result of the provision of the relevant services, if such an entity, rather than the actual network business, operated the business; and that
- ENA considers that the benchmark efficient practice in relation to corporate tax should be determined by examining the standard practices of networks.

In its Initial Report, the AER has identified a number of areas where there are potential differences between the general practice of regulated firms and the approach that underpins the AER's regulatory allowance. Each of these is considered below.

3.2 Depreciation allowances

The AER has noted that its regulatory tax allowance is based on assets being depreciated using the straight line method, whereas it appears that at least some regulated firms use the diminishing value method for some of their assets. Since the diminishing value method permits greater tax deductions early in the life of an asset, it would have the effect of:

- Reducing the actual corporate tax payment below the current regulatory allowance in the early years of an asset's life; and
- Increasing the actual corporate tax payment above the current regulatory allowance in the later years of an asset's life.

ENA recognises that the regulatory allowance should be commensurate with benchmark efficient costs, which would be informed by the actual practice of the firms that the AER regulates (as is done for other parameters such as gearing and credit rating).

This would require the AER to collect information on:

- The extent to which each firm uses diminishing value depreciation;
- What sorts of assets are depreciated using the diminishing value method versus the straight line method;
- The rates that are used when the diminishing value method is applied;
- Whether straight line depreciation might be considered to be more appropriate and efficient in the circumstances of a particular firm. On this point, the question is whether a benchmark efficient operator would efficiently choose straight line depreciation if they were operating the particular firm in question. That issue was addressed by the ERA in its 2015 ATCO Gas Determination. In allowing straight line depreciation to be used for tax purposes, the ERA cited advice from EY[7] and concluded that:

    > *The Authority now considers that a benchmark efficient entity would seek to minimise its tax liabilities over the lives of the assets, rather than over one access arrangement period only. Such an entity would select the tax depreciation methodology that achieves this, based on its circumstances. In a neutral NPV context, and in line with the National Gas Objective, the benchmark efficient entity would also safeguard the long term interests of*

[7] Ernst & Young, *Review of the regulated tax asset base for regulated revenue purposes – addendum to the report of Vaughan Lindfield*, 21 November 2014.

> *consumers through making sure that costs are evenly spread out through the lives of assets.*[8]

ENA members will assist the AER in the collection of this information.

If the evidence suggests that diminishing value depreciation is relevant, in some respect, to the efficient cost of corporate tax for some businesses, that would give rise to a number of implementation issues that should be the subject of more detailed consultation. For example:

- Any change to the regulatory allowance should be based on evidence about:
  - The extent to which diminishing value depreciation is used in practice;
  - The rates that are used in practice;
  - The sorts of assets that are depreciated in this manner; and
  - Whether there is evidence that the efficient form of depreciation depends upon the circumstances of the firm.
- The AER would have to consider whether any change to the depreciation profile for tax purposes should be matched with a corresponding change in the profile for regulatory depreciation – so that depreciation is treated consistently throughout the regulatory process.
- The AER would have to consider, in accordance with the Rules, whether to adopt a very approximate high-level approach (e.g., assume that X% of the RAB is depreciated at a rate of Y% per annum) or a detailed approach (where a different rate might be applied to each type of asset or for different firms depending upon their circumstances).
- The AER would have to consider whether to apply any changes to the existing asset base or only to new assets as they are added to the RAB. On this point, we reiterate our support for the general principle that changes should be made on a prospective basis only. We note that the application of such a change to the existing asset base would generally be to the advantage of NSPs, particularly those with older assets.[9] However, ENA is of the view that the prospectivity principle should be applied consistently throughout the regulatory framework.

3.3 Corporate overhead allowances

Corporate overhead costs are generally immediately deductible. Some businesses capitalise those costs (or a portion of them), in which case they do not appear as a (deductible) cost that is included in the annual regulatory revenue allowance. Rather, they have the effect of increasing the RAB and consequently the allowed return on capital in future years. The result is that the immediate tax deduction reduces the actual tax payment below the regulatory allowance for corporate tax.

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[8] ERA, September 2015, ATCO Gas Amended Final Decision, Paragraph 2170.
[9] For older assets, the diminishing value depreciation is likely to be materially lower than straight line depreciation. Thus, a lower estimated tax deduction would result in a higher corporate tax allowance.

If it is the case that networks are able to claim an immediate tax deduction for their corporate overhead expenses, it is reasonable for that deduction to be included in the benchmark efficient tax allowance. That is, the benchmark regulatory tax allowance would reflect the immediate deductibility of the corporate overhead allowance, whether the firm chose to capitalise it or claim it as an expense through the annual opex allowance. Any change in this regard would require transition arrangements for those businesses that currently capitalise overhead costs to allow them to align their capitalisation practice with any changed regulatory allowance.

ENA members will assist the AER in the collection of information about the immediate deductibility of corporate overhead costs and the effect that any changes may have on prices paid by consumers in the short-run.

3.4 Structures that differ from the standard corporate structure

In its Initial Report (p. 35) the AER notes that there are two separate issues relating to different ownership structures. One question is whether a particular ownership structure *should* be able to be used to reduce tax payments. This is a question for government – it is clearly not a matter for the AER to determine who should pay what rate of tax or for the AER to have any such 'policy objectives.'

A separate question is whether the evidence suggests that regulated firms have tended to structure in a particular way. For example, if regulated firms generally tended to adopt a particular ownership structure, it would be reasonable for the AER to consider that to be the benchmark efficient structure, and to determine the benchmark efficient corporate tax allowance in accordance with that structure.

That is, whereas it is appropriate for the AER to have regard to how firms *have* structured and the tax consequences that *do* flow from that, it would be inappropriate for the AER to have a view about what it thinks the tax consequences *should* be.

In practice, a relatively small number of firms have been identified as adopting a stapled structure or using trusts in the corporate structure. For example, the McGrathNicol (2018) report commissioned by the AER considers a sample of 32 firms and identifies 6 firms using a stapled structure and 9 using trusts.

Moreover, the AER notes that Lally (2018) advises the AER against adjusting the regulatory taxation allowance for non-corporate ownership structures.[10]

ENA recommends that the AER should continue to set the benchmark efficient corporate tax allowance on the basis of the benchmark efficient entity operating under a standard corporate structure. The reasons for this recommendation include:

- There is no obvious alternative structure to use;

[10] AER, June 2018, Initial Report, p. 35.

- The advice commissioned by the AER is to maintain the standard corporate structure as the basis for the benchmark efficient corporate tax allowance;
- Any departure from the standard corporate structure would materially complicate the regulatory framework. For example:
  - A departure from the corporate structure would require a re-working of the approach to dividend imputation and gamma – since only tax paid by a company is capable of creating imputation credits;
  - The adoption of a flow-through structure such as a trust or a partnership would require the AER to estimate the personal tax payments of individual investors. Thus, the AER would have to make a determination about the composition of the investor base for the benchmark efficient entity and the personal tax position of each (see Lally, 2018, p. 19).

ENA also notes that in a trust structure, where there has been a change of 50% or more of the investors, prior year carried forward tax losses are forfeited and cannot be used to offset against future taxable income. In this instance, the benefits of the up-front deductions relating to stamp duty or the use of diminishing value depreciation would be lost. Thus, any change from the current approach of modelling a standard corporate structure would have to set out:

- A specific description of the alternative structure that should be adopted; and
- Assumptions about the 'efficient' amount of ownership change that might occur in such a structure.

3.5 Refurbishment costs

In maintaining its network, a service provider will frequently weigh up the alternatives of refurbishing an asset versus replacing it with a different asset versus increasing operating costs as an alternative solution versus doing nothing and taking on more risk. If the asset is refurbished or replaced with a different asset, the cost is capitalised into the RAB, but the cost can be immediately deductible for tax purposes if it meets the criteria for being a refurbishment. If an operating cost solution is adopted, the entire cost is reflected in both the allowed revenues and the corporate income tax solution in the year of the expenditure.

ENA recommends that any proposed change in this area should be the subject of a detailed consultation process to avoid unintended consequences. The example below demonstrates that a change in the regulatory model to incorporate an immediate tax deduction for (efficient) refurbishments is likely to result in a *reduction* in allowed revenues over the regulatory period. That is, the network would have to fund the refurbishment expenditure *and* would end up with *less* revenue. The network could not ignore this outcome and may be led to adopt a (less efficient) asset replacement or operating expenditure solution that is not in the *long-term* interests of consumers.

Example: Immediate tax deduction for refurbishment expenditure

This example is based on the DNSP PTRM that is available on the AER web site.[11] We begin by updating a number of parameters to better reflect current AER allowances, as follows:

- Return on equity is set to 6.5%;
- Return on debt is set to 5%;
- Gamma is set to 0.5;
- Starting RAB is increased by $3 billion to better reflect the size of an average network.

All other input parameters are left unchanged.

In this base case, allowed revenues over the five-year regulatory period is $2,627 million (**Analysis** tab, Row 43).

We then include $100 million of refurbishment CAPEX in each year of the regulatory period in Row 49 of the **PTRM input** tab. We set the standard life of this asset to 50 years and the tax life to 1 year in Row 15 of the **PTRM input** tab, and we adjust Row 596 of the **Assets** tab to reflect the immediate deductibility of these payments.[12] Thus, the return on capital is made over the 50-year life of the asset, but the tax deduction is recorded in full in the following year. This adjustment reduces the total allowed revenues to $2,594 million.

That is, the NSP would be required to fund the $100 million of CAPEX in each year, and the allowed revenues would be *reduced* by $33 million. No network can ignore the fact that this form of expenditure would result in a reduction in allowed revenues.

The result of this change to the current regulatory model is likely to drive the network towards solutions that involve replacement CAPEX in relation to a new asset (where the tax deduction would occur over a longer tax asset life) or an OPEX solution (where the full expenditure would enter allowed revenues immediately). These alternative solutions may be pursued even though the refurbishment solution is most efficient from a long-run perspective.

Whereas a reduction in allowed revenues in the immediate regulatory period might appear to be in the very short-run interest of current consumers, it may not be in the *long-run* interests of current and future consumers. Indeed, it is quite conceivable that the network would be led away from adopting the solution with the lowest lifetime NPV cost. This raises intergenerational equity issues whereby current consumers might benefit in the very short-term at the expense of the broader set of consumers over the long-run.

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[11] https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/post-tax-revenue-models-transmission-and-distribution-january-2015-amendment.
[12] Otherwise, the deductibility will be delayed by one year in each case.

ENA recommends that:

- The AER maintain the current approach, which is to treat refurbishments and replacements symmetrically in all respects, such that the lowest cost alternative will always be selected; and
- Any proposed change in this area should be the subject of a detailed consultation process to avoid unintended consequences. For example, a change in the regulatory model to incorporate an immediate tax deduction for (efficient) refurbishments is likely to result in a *reduction* in allowed revenues over the regulatory period. That is, the network would have to fund the refurbishment expenditure and would end up with *less* revenue. The network could not ignore this outcome and may be led to adopt a (less efficient) asset replacement or operating expenditure solution that is not in the *long-term* interests of consumers.

4 Matters that are not relevant to the benchmark efficient cost of tax

- In relation to payments that are made outside the regulatory system (such as research and development expenditure, interest in excess of the regulatory allowance, and stamp duty) ENA notes that such payments are funded entirely by networks and that consumers make no contribution to them. Where the payment is made entirely by the network, the tax consequences are also entirely a matter for the network.
- In relation to such payments, ENA considers that either:
  - The payment of the expense and the tax consequences of it are both outside the regulatory framework – the network makes the payment and receives any tax consequences; or
  - The payment of the expense and the tax consequences of it are both inside the regulatory framework – the network is compensated for the payment via the regulatory revenue allowance and the tax consequences of the payment are factored into the regulatory tax allowance.

ENA considers that costs that are beyond the benchmark efficient allowance (and which are therefore excluded from allowed revenues), but which might create tax deductions for an asset owner that bears those costs in full, to be irrelevant to the question of tax paid by the benchmark efficient entity.

In its Initial Report (p. 35), the AER cites the example of research and development expenditure that sits outside the regulatory framework. This expenditure is borne entirely by the network, with the expected outcome of benefitting consumers in the future via a reduction in costs or improvement in the level of service. Of course, that expenditure also provides the NSP with a tax deduction, reducing actual tax paid.

If the R&D cost itself remains uncompensated, but the benefit of the tax deduction is passed through to consumers, the net effect is that the network has funded that expense in full, and receives a lower regulatory allowance for having done so (via a reduction in the corporate tax allowance).

By contrast, customers pay nothing for the R&D, receive the future benefit of it (via reduced regulatory allowances in relation to any efficiencies created by that expenditure), and also receive (in effect) an up-front payment (via the reduced regulatory tax allowance). This would create a disincentive for the business to make such R&D expenditure at a time when technological change means that customers are even more likely to benefit from network's funding such expenditure.

ENA's May 31 submission cites a number of expenses that are borne entirely by the regulated firm and to which customers make no contribution at all as they are made outside of the regulatory framework. These include:

- Research and development expenditure;
- Interest payments beyond the regulatory allowance;

» Stamp duty paid on corporate transactions; and

» Tax loss carry-forwards arising from historical circumstances:

ENA continues to hold the view that any payments that are made entirely by networks outside the regulatory framework (i.e., for which no regulatory compensation is received) are irrelevant to the regulatory tax allowance.

ENA considers that either:

» The payment of the expense and the tax consequences of it are both outside the regulatory framework – the network makes the payment and receives any tax consequences; or

» The payment of the expense and the tax consequences of it are both inside the regulatory framework – the network is compensated for the payment via the regulatory revenue allowance and the tax consequences of the payment are factored into the regulatory tax allowance.

Example 1: Interest beyond the regulatory allowance

An example of a payment (and tax deduction) that is entirely outside the regulatory framework is interest payments that are beyond the regulatory allowance. This point can be best illustrated via a simple example. Consider a firm that has a RAB of $100 that has recently been purchased for $120. Thus, the buyer has paid $100 for the RAB and $20 for what we will generically call 'growth options' in this example. Also suppose that the buyer finances 60% of the RAB ($60) and 60% of the growth options ($12) with debt.

In this case:

» The $60 of debt that pertains to the RAB will be included inside the regulatory model. The interest on that debt and the tax deduction associated with it are included in the regulatory allowed revenue; and

» The $12 of debt that pertains to the growth options is outside the regulatory model. Neither the interest on that debt nor the tax deduction associated with it have any impact on the allowed revenue. Consumers do not contribute at all to the payment of any interest on that debt.

In summary, the growth options in this example are the same as any other unregulated asset. The funding of that cost, and any tax consequences, is entirely borne by the network and consumers do not contribute to it at all.

A model in which the network continues to be entirely responsible for interest on the $12 of debt, but where consumers receive the benefit of the tax deduction in relation to that payment (via a reduction to the regulatory corporate tax allowance), would represent a material departure from the current framework. There is no logic in a model where one party funds an expense in its entirely and a different party receives the benefit of the tax deduction that arises from the payment of that expense.

Example 2: Asset revaluations

ENA recognises that a transaction between a private sector seller and a private sector buyer can result in a revaluation of the tax asset base. This has the effect of increasing the depreciation deductions that arise in relation to that asset, but the source of those increased deductions is a payment made entirely by the network. This can be shown in the context of the previous example where a firm with a RAB of $100 is purchased for $120. Suppose in this case that the transaction allows the tax asset base to be increased to $120. As above, the purchaser can be thought of as having paid $100 to buy the RAB plus an additional payment of $20.

The owner will recover the $100 from consumers over the life of the assets – via regulatory depreciation allowances. As consumers fund the $100, they are entitled to the tax deductions in relation to it – via a reduction in the regulatory corporate tax allowance.

However, consumers make no contribution at all to the payment of the additional $20 – that is funded entirely by the new owner. Consequently, the new owner would be entitled to the tax deductions (depreciation) associated with that payment. That is, the source of the additional tax deductions is the $20 payment made by the new owner – it is not simply gifted by government. Due to the fact that payment is borne entirely by the new owner, it is the new owner who should be entitled to the tax deduction that attaches to that payment.

5 Potential changes identified by the AER

- ENA considers that three broad principles should be used to guide the consideration of any potential change to the approach to estimating the benchmark efficient corporate tax allowance:
  - A change should only be made if there is evidence that such a change would better reflect the efficient practice of the benchmark efficient firm;
  - A cost and its tax effect must be either both outside the regulatory framework or both inside the regulatory framework; and
  - Any changes should only be made prospectively and not have any retrospective effects, consistent with the proper operation of the incentive-based regulatory framework.
- In relation to potential changes to tax depreciation calculations, ENA considers that any changes should be based on evidence of the general practice of networks. ENA proposes to assist the AER in the collection of relevant evidence from members.
- ENA agrees with the AER's advisors that no form of corporate tax pass-through should be given any further consideration. ENA considers that there is more than enough evidence already available to formally rule out any form of pass-through at this point.
- In relation to other potential changes that the AER has identified, ENA considers that:
  - No change should be made to the current approach of adopting a standard corporate structure.
  - The same estimate of benchmark efficient gearing should be used consistently throughout the regulatory process.
  - Costs and their tax consequences should be treated consistently throughout the regulatory process – either both are within the regulatory framework or both are outside it.
  - Any revaluation of the TAB arises (by definition) only due to a new buyer paying a price in excess of the RAB. Since the excess that is the source of the revaluation is paid entirely by the new owner with no contribution from consumers, the new owner would be entitled to the depreciation tax deductions that pertain to their payment.
  - The PTRM should not be changed to retrospectively accommodate historical tax loss carry-forwards. ENA notes that the PTRM already accommodates any prospective tax loss carry-forwards that are relevant to the benchmark efficient entity.

5.1 Overview

In its Initial Report, the AER identifies a number of potential changes that might be considered. ENA considers that three broad principles should be used to guide the consideration of any potential change to the approach to estimating the benchmark efficient corporate tax allowance:

1. **Goal is to determine efficient practice of benchmark efficient entity**: Consider what the evidence suggests about the practice of the benchmark efficient firm. As noted above, there would be reason for the AER to change its approach to setting the benchmark efficient corporate tax allowance if there was evidence that the general practice of regulated firms differed from the approach that underpins the AER's regulatory allowance. In this regard, ENA members will seek to assist the AER in compiling the required data so that the AER is able to form an informed view about the efficient practice of the benchmark efficient firm.
2. **Consistent treatment of costs and tax effects**: A cost and its tax effect must be either both outside the regulatory framework or both inside the regulatory framework. For example, if the tax effect of R&D is to be considered in making the regulatory tax allowance, the R&D expense itself must be included in the operating expenditure allowance.
3. **No retrospective effects**: Any changes should only be made prospectively and not have any retrospective effects, consistent with the proper operation of the incentive-based regulatory framework.

5.2 Changes to tax depreciation calculations

The AER's Initial Report sets out four potential changes that might be considered in relation to the assessment of regulatory tax depreciation:

- Use of diminishing value method;
- Use of self-assessed asset lives;
- Use of low-value asset pools; and
- Moving R&D costs (both the expenditure and its tax effect) inside the regulatory framework.

ENA considers that any changes to tax depreciation calculations should be based on evidence of the general practice of networks and applied prospectively, as noted above. ENA notes the general agreement among participants at the AER forum of 18 July, including Dr Lally, for any such change to apply prospectively as new assets are purchased. The retrospective application of any such change would result in either a windfall gain or loss to businesses depending on the average age of their assets.

5.3 Pass-through of actual tax payments

The AER's Initial Report notes that one option is to abandon the incentive-based regulatory framework in favour of a simple pass-through of actual tax payments. The AER notes that Lally (2018) has strongly advised against a pass-through:

> *Dr Lally also recommended against setting the regulatory tax costs in accordance with actual taxes paid. He noted that such an approach would encourage firms to undertake actions that raise their corporate tax*

payments but are not efficient or desirable—such as eliminating all debt financing. Using actual tax costs would eliminate the incentive to reduce tax costs which would likely lead to increased consumer charges across time, as NSPs would have the incentive to increase their actual tax costs because they would be assured full recovery of these costs from customers. This may include shifting tax costs between unregulated and regulated components of each corporate entity where possible. This in turn may lead to increased ring-fencing requirements and compliance monitoring costs which is not in the long-term interest of consumers. We also consider that a change to a pass-through approach would not necessarily be NPV neutral and may generate windfall gains or losses for NSPs and consumers based on the particular tax situation of each network at the time of implementation.[13]

The AER also notes that Lally (2018) has considered, and rejected, a partial pass-through approach known as 'capping':

An alternative approach proposed by Dr Lally is a 'capped pass-through' approach. Such an approach would only pass-through the actual tax costs of a network if they were below the benchmark efficient allowance. He noted that—while superior to an uncapped pass-through—'capping' also suffers from numerous disadvantages. Dr Lally considered that a capped pass-through wrongly attributes all shortfalls between taxes paid and the regulator allowance to tax minimization. This results in tax allowances that are less than that required in NPV terms to cover the networks' actual tax burden which is not in the long-term interest of consumers.106 Both capped and uncapped pass-through approaches also rely on the actual tax paid for an individual network's regulated operations being readily available to the regulator and easily split from unregulated operations run by the parent company or upstream investor. [14]

The AER concludes that:

The general consensus from stakeholder submissions is that the framework of incentive-based regulation should be maintained, and that administering a pass-through approach for tax costs would have significant difficulties and costs without providing benefits for consumers.

Given the available evidence, our current assessment is that we should exercise caution before moving to a tax pass-through regime.[15]

ENA concurs with the above advice and conclusion and recommends that no form of corporate tax pass-through should be given any further consideration. ENA considers that there is more than enough evidence already available to formally rule out any form of pass-through at this point.

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[13] AER, June 2018, Initial Report, pp. 46-47.
[14] AER, June 2018, Initial Report, p. 47.
[15] AER, June 2018, Initial Report, p. 47.

5.4 Other potential changes

The AER's Initial Report also considers a number of other potential changes, each of which is addressed in turn below.

- **Set the corporate tax allowance on the basis of an ownership structure different from the standard corporate structure.**

  As noted above, there is no evidence of any clear alternative to the standard corporate structure and the Lally (2018) report commissioned by the AER recommends that the AER should make no change to its approach of adopting a standard corporate structure for the benchmark efficient entity.

- **Change to benchmark efficient gearing estimate.**

  In the regulatory setting there is a benchmark efficient entity with a benchmark efficient level of gearing. The AER is free to adopt whatever level of benchmark efficient gearing it deems to be appropriate. Once it has adopted a gearing figure, that should be used consistently throughout the regulatory framework. That is, that same level of gearing should be used when estimating WACC, when determining the benchmark credit rating, when re-levering equity betas, and when setting the benchmark efficient tax allowance.

  ENA considers that it would be internally inconsistent and economically illogical to assume that the benchmark efficient firm has one level of gearing when estimating WACC and that the same benchmark efficient firm has a different level of gearing for the purpose of estimating the corporate tax allowance. This point is explained further in Example 1 in the previous section.

- **Include other expenses such as research and development costs.**

  As noted in Section 4 above, ENA considers that every expense and its tax consequences must be treated consistently. Either both should remain outside the regulatory framework (the network makes the payment and receives any tax consequences) or both should be brought inside the regulatory framework (the network is compensated for the payment via the regulatory revenue allowance and the tax consequences of the payment are factored into the regulatory tax allowance).

- **Adjust the tax asset base to reflect asset revaluations allowed by the ATO.**

  ENA recognises that a transaction between a private sector seller and a private sector buyer can result in a revaluation of the tax asset base. However, because the source of the additional depreciation deductions is a payment made entirely by the new owner, the new owner is entitled to those deductions. This point is explained in more detail in Example 2 in the previous section.

  Although the AER has not suggested it as a potential change, for clarity and completeness ENA emphasises that no retrospective changes should be made to any tax asset base in relation to any past corporate transactions. Any such re-setting of tax asset bases would apply only to future transactions.

» Adjust the PTRM to retrospectively account for historical tax loss carry-forwards.

The current PTRM already accounts for tax loss carry-forwards that arise under the AER's regulatory allowances. If the AER's allowances would give rise to a tax loss, given the particular circumstances of the firm being regulated, the PTRM carries that tax loss forward to be offset against tax obligations in the following year. Thus, any such tax losses would have the effect of reducing the regulatory allowance for corporate tax in future years – until those tax losses are exhausted.

ENA's May 31 submission notes that a number of networks have tax losses that arise from the payment of stamp duty in the context of the purchase of a network business. Under current taxation rules, such stamp duty payments are deductible in full in the year of purchase. The result of the transaction is that actual taxable income in the year of purchase is negative, so no actual corporate tax will be paid. Moreover, because taxable income is negative, there will be tax loss carry-forwards that can be offset against future tax obligations.

We noted in our May 31 submission that the source of such tax loss carry-forwards is a stamp duty payment made entirely by the network outside of the regulatory framework and that customers do not contribute to such payments:

> *It is important to recognise that the additional tax deductions arise in relation to expenses that are borne by the new owner that are not compensated under the regulatory regime – the regulatory allowed revenues are unchanged by the transaction. These are additional uncompensated expenses that are borne entirely by the new owner, and under Australian tax law those additional expenses are tax deductible. As the asset owner is entirely responsible for bearing these additional costs, they are also entitled to the tax deduction in relation to them.*[16]

ENA considers that it would be internally inconsistent to treat the payment of stamp duty as being outside the regulatory framework, but the tax consequences of it as being inside the regulatory framework. ENA considers that such stamp duty payments (and their tax consequences) should have no role at all in the regulatory framework and should have no impact on the prices paid by consumers.

The only tax loss carry-forwards that are relevant to the benchmark efficient corporate tax allowance are those that apply to the benchmark efficient entity. The PTRM already accommodates any such tax losses, so requires no change in this regard.

[16] ENA, May 31 2018, Review of regulatory tax approach: Response to AER Issues Paper, pp. 18-19.

6 Regulatory information collection

The AER considers that information about actual tax payments by energy networks is necessary in this review to identify and understand the key drivers for the apparent discrepancy between actual tax paid and regulatory tax allowances and their material.[17]

In the absence of publically available accurate and consistent actual tax information, the AER proposes to exercise its information gathering powers to obtain this information by serving regulatory information notices (RINs) on each regulated entity.[18]

Energy Networks Australia acknowledges that meaningful and accurate information about actual tax payments by regulated networks is not readily available and that RINs are likely the only way such information, on an industry wide basis, could be obtained by the AER.

As outlined at the recent AER public forum, ENA is keen to commence collaborative and constructive expert discussions on how the best information can be brought to bear on the issues of the review, in the most efficient way. As the AER notes, however, obtaining data that is accurate and relevant to the AER's purpose in this review will be difficult.

There will be many varying tax positions and reporting approaches across the industry and the use of tax consolidated groups means it may be difficult to identify the actual tax paid by the regulated business. It is crucial that any information requested by way of RINs is very carefully scoped and considered and that the regulated entities are given sufficient time to provide input into the development of the RINs. Further, guidance for allocating tax paid between regulated and unregulated businesses may need to be developed to ensure information is provided on a consistent basis.

Under the National Electricity Law and National Gas Law, the process for issuing RINs is as follows:

- The AER may issue a RIN if it considers it reasonably necessary for the performance or exercise of its functions of powers under the Law or the Rules.[19] While the AER does not expressly address this requirement in the Initial Report, it states that it considers that data on actual tax payments by energy networks is relevant information when assessing the approach to calculating efficient tax costs for the benchmark efficient entity.
- In considering whether it reasonably necessary to serve a RIN, the AER must have regard to[20]:
  - The matter to be addressed by the service of the RIN.

[17] AER Initial Report, pages 26-27.
[18] AER Initial Report, page 29.
[19] National Electricity Law Section 28F(1), National Gas Law, Section S48(1) NGL
[20] S28F(2)/ NGL, S48(2) NGL

- The likely costs that may be incurred by an efficient network service provider in complying with the notice.

» Before a RIN is served, the AER must give the regulated network service provider notice and a draft of the RIN it intends to serve. The AER must invite the service provider to make written representations as to whether the AER should serve the RIN, providing at least 20 business days for the service provider to make the representations.[21]

» The RIN must specify the information required to be provided, and may specify the manner and form in which the information is required to be provided.[22]

In order to ensure that information gathered is relevant and meaningful and enables the AER to achieve its purpose of understanding the drivers for the difference between tax paid and regulatory allowances, Energy Networks Australia considers that the following principles should be applied as part of the development of the RINs, following the procedure outlined above:

» Given the difficulty in extracting consistent and meaningful information across the industry, it will be important for the RINs to be targeted and very carefully drafted. Energy Networks Australia supports the recommendation from McGrathNicol that the AER obtain external advice from a taxation advisory firm and encourages the AER to seek advice in respect of the scope of the information sought and allocation approaches.

» The consultation process should also extend to any guidance or "rules" to be imposed in respect of how tax paid is to be allocated between regulated and unregulated businesses.

» The consultation process on the draft RINs should include allowing the service providers to comment on the scope and any external advice the AER obtains on the scope of the request and any allocation rules.

» As required by the Rules, consideration must be given to the costs of providing the information sought in the RINs. The complexity of extracting actual tax information relevant to regulated businesses within a broader consolidated group and producing it in a form that is meaningful to the AER should not be underestimated. This consideration needs to be given significant weight in the assessment of whether the RINs are *reasonably* necessary for the performance or exercise of the AER's functions or powers.

[21] NEL S28J(1) and (5), NGL S52(1) and (5)
[22] NEL S28K(1), NGL S53(1)