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AER Tax Review 2018

PwC Report – Findings and recommendations

November 2018

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Agenda

- Overview of review
- Findings
- Recommendations

Overview of review

- PwC engaged to address the following questions:
  1. Is there a discrepancy?
  2. If yes, what are the drivers?
  3. Based on above, recommend any changes

- Process to date
  - Formal RINS v voluntary questions
  - Report based on voluntary questions
    - Substantial Capex information received
    - Lodged income tax returns received from majority of NSPs
    - Group structures received (NSP level only)
  - Impact of financing deductions to be addressed in Addendum

Findings

- **Regard needs to be given to tax effect of efficient costs of network operation**

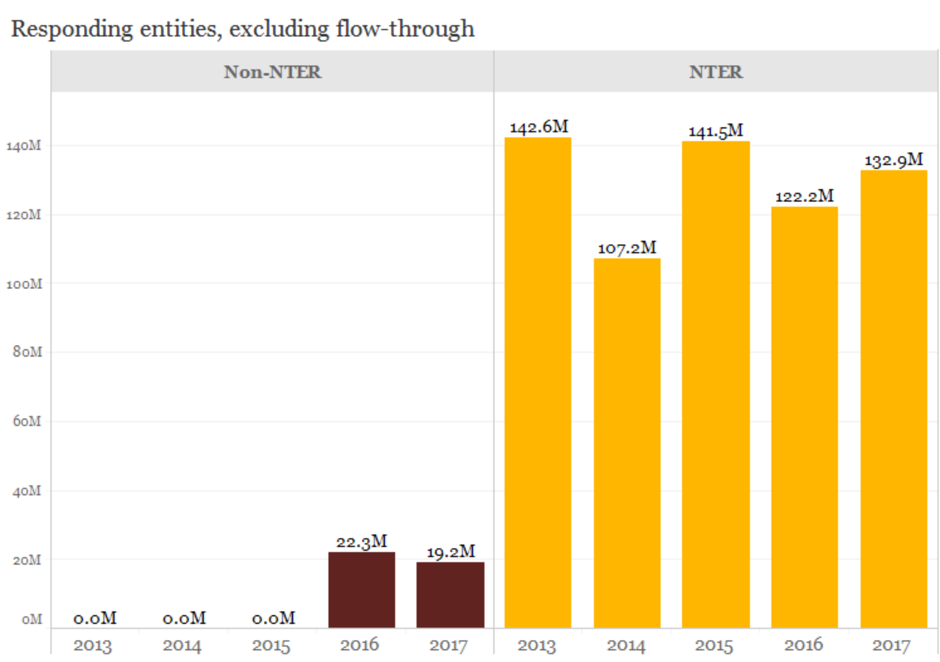
  - Tax drivers <u>within</u> ring-fence:
    - Regulated Revenue
    - Tax rate – assumed 30% under benchmark efficient entity approach
    - Opex – no difference to regulatory Opex
    - Capex – TAB (depreciation)
    - Financing – cost of debt per rate of return calculation

  - Tax drivers <u>outside</u> of ring-fence
    - Impact of unregulated activities
    - M&A costs (including step ups and stamp duty)

Findings

- **Is there a discrepancy?**
  - NTER entities actual tax is materially more than forecast
  - Private entities actual tax is materially less than forecast

Figure 2: Tax payable per tax returns for corporate entities (including NTER)



Findings

- **Drivers – NTER**

  a) Tax return revenue higher than regulatory income (may be referable to unregulated activities)

  b) OWDV of TFAR lower than TAB resulting in lower depreciation for tax than forecast for the regulatory cost of tax. Offsetting this to a degree is immediate deductions for Capex included in TAB

  c) Financing cost not considered to date but likely to be lower than financing costs assumed for the purposes of determining the tax allowance.

Figure 6: NTER– Forecast regulated revenue as a percentage of total income per NTER return

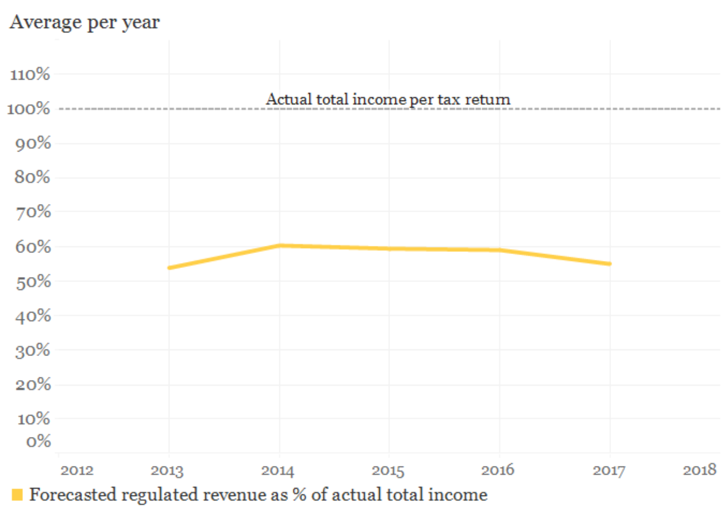
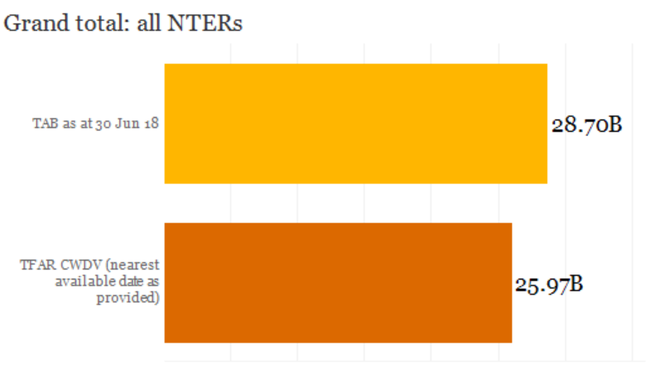


Figure 7: NTER – TFAR opening value v TAB opening value



Findings

- **Drivers – Private sector**

  a) Holding structures: Level at which tax is paid (NSP v investor), impact of tax rate under flow through models

  b) Allocation of tax attributable to efficient operation of network (ring-fencing) – M&A costs and other costs substantial (drivers for tax losses)

  c) Tax practices attributable to capex and financing within the ring-fence

Findings – Private sector

Holding structures: Level at which tax is paid (NSP v investor), impact of tax rate under flow through models

- From 17 businesses subject to review:
  - 7 NSPs taxed as a company (private sector, tax paid at NSP level)
  - 5 NSPs subject to NTER regime (tax paid at NSP level)
  - 5 NSPs taxed on a flow through basis (tax paid at investor level)

- **72.3%** (per TAB value) pay tax at corporate tax rate (30%)
- **11.10%** (per TAB value) tax exempt States (have not elected to apply NTER)
- Impact of tax rate needs to be considered further for remaining **16.6%** taxed on flow through basis
  - Refer table on next slide

Findings – Private sector

Holding structures: Level at which tax is paid (NSP v investor), impact of tax rate under flow through models

Figure 13: Tax profile of regulated asset holders tracing flow-through vehicles

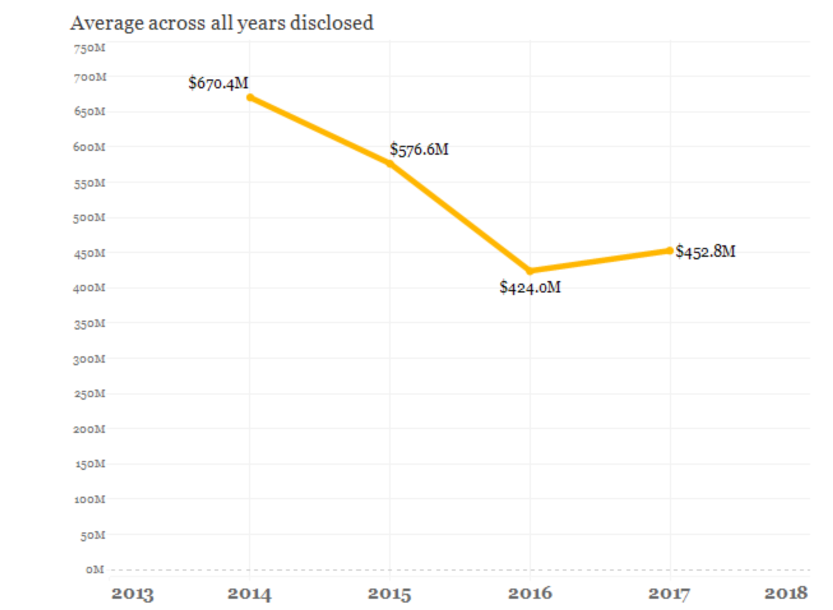
Investor tax profile	% of TAB	Expected tax rate
1. NTER entity	**40.00%**	30%
2. Australian company	**29.98%**	30%
3. Australian States or Territories (tax exempt, non-NTER)	**11.10%**	N/A
4. Australian managed investment fund[15,16]	**7.86%**	15%-30%
5. Australian superannuation funds	**3.79%**	15%
6. Foreign Sovereign Wealth Funds[17]	**2.90%**	0%-30%
7. Foreign pension funds[18]	**2.07%**	15%-30%
8. Foreign companies	**2.30%**	30%

Findings – Private sector

Allocation of tax attributable to efficient operation of network (ring-fencing)

- Private: Tax losses, consolidation, M&A (stamp duty)

Figure 5: Tax losses carried forward



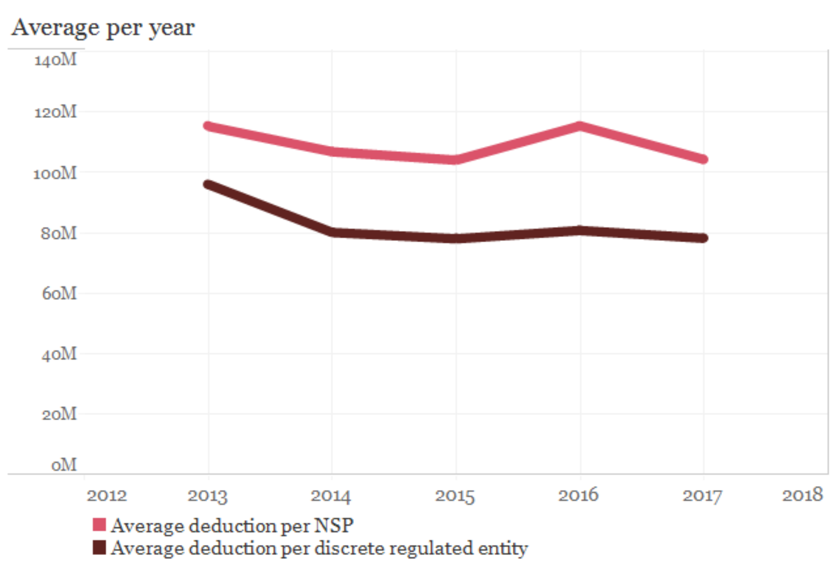
Findings – capex (generally)

<u>Tax practices attributable to capex and financing within the ring-fence.</u>

Treatment of Capex creates a misalignment between actual tax paid and regulatory cost of tax.

In most instances we observed that immediate deductions for Regulatory Capex is being claimed immediately

Figure 15: Average amount of Capex in the TAB immediately deducted annually for actual tax purposes



Findings

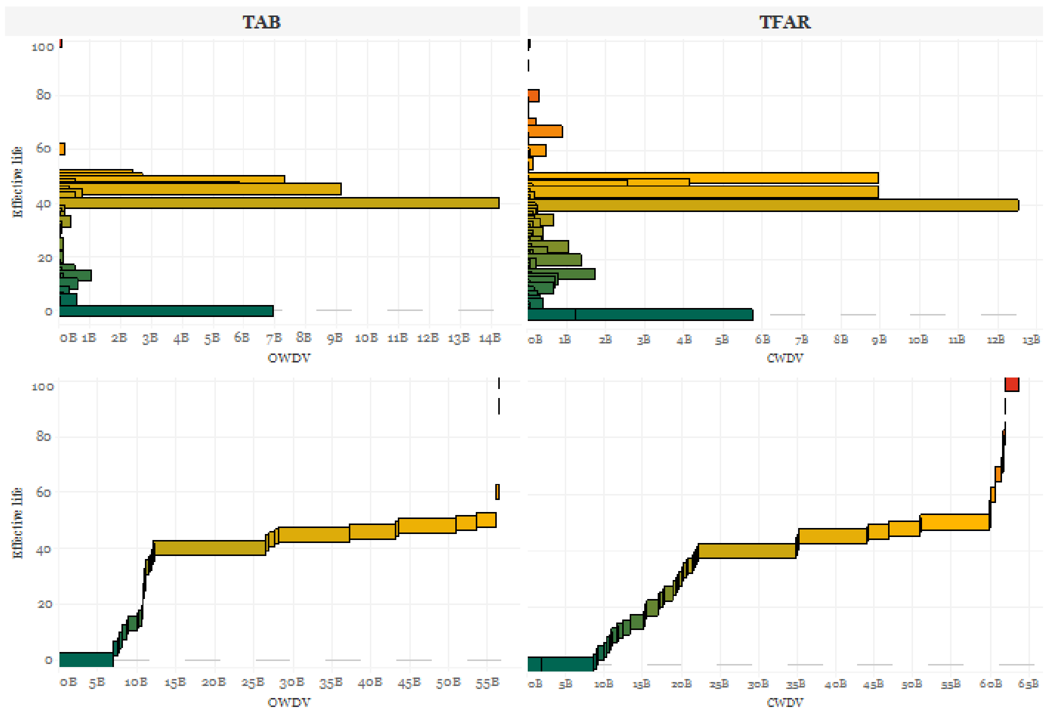
<u>Effective life</u>

- No material difference in the electricity industry
- There is a material discrepancy in respect of gas participants given effective life capping is not being uniformly adopted for all participants.
- See graphs on following slides

Findings

Effective life - Electricity

Figure 26: Effective life of Electricity Assets

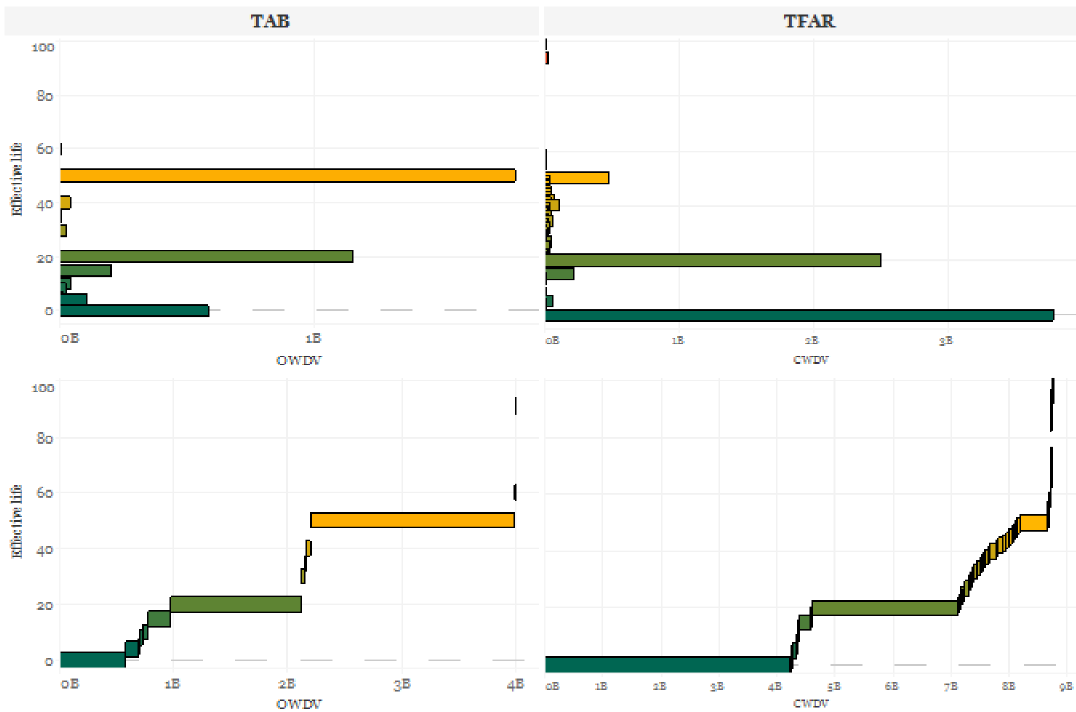


TAB opening value (all respondents)	$55.85B	TFAR CWDV (nearest available date as provided)	59.62B
TAB average effective life by value	41.56 years	TFAR average effective life by value	39.94 years

Findings

Effective life - Gas

Figure 27: Effective life Gas Assets



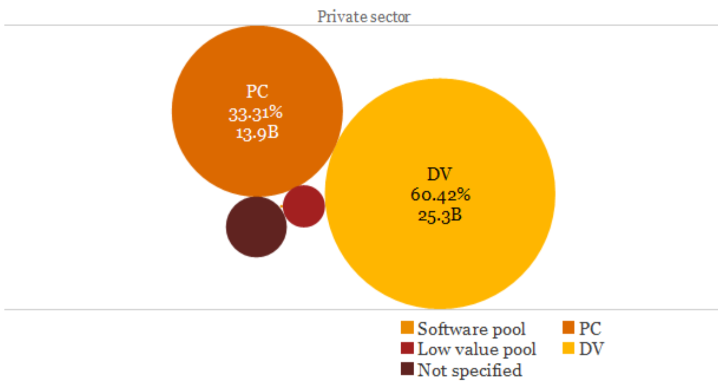
TAB opening value (all respondents)	$3.99B	TFAR CWDV (nearest available date as provided)	8.29B
TAB average effective life by value	35.12 years	TFAR average effective life by value	27.83 years

Findings

Depreciation method

- Objective evidence that a benchmark efficient entity would adopt diminishing value method. It's unclear whether this is a material driver for the historical tax differential

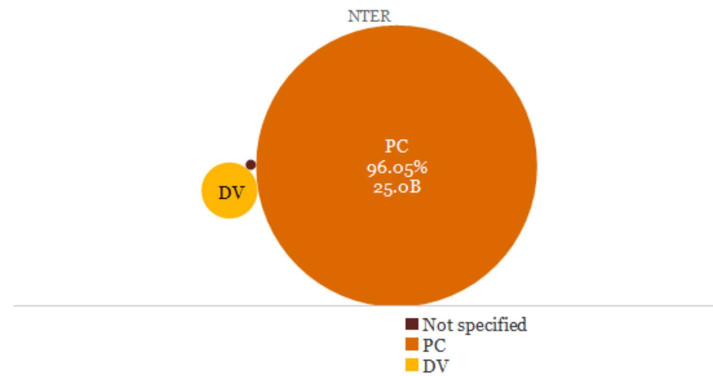
Figure 23: Depreciation method adopted by private sector entities



Overall (Electrical & Gas assets)

	TFAR CWDV (nearest available date as provided)	% of total CWDV
PC	13.94B	33.31%
DV	25.29B	60.42%
Not specified	1.76B	4.22%
Low value pool	0.85B	2.04%
Software pool	0.00B	0.01%
Grand Total	**41.85B**	**100.00%**

Figure 24: Depreciation method adopted by NTER entities



Overall

	TFAR CWDV (nearest available date as provided)	% of total CWDV
PC	25.03B	96.05%
DV	0.99B	3.82%
Not specified	0.03B	0.13%
Grand Total	**26.05B**	**100.00%**

Recommendations

1. Do not recommend tax pass through approach due to inability to identify actual tax rates and actual tax payments attributable to efficient operation of network assets
2. Do not recommend a change to benchmark efficient entity (72.3% of participants by TAB value are subject to corporate tax rate)
3. Do not recommend that M&A cost (step ups) and other non recoverable costs be taken into account given they do not relate to the efficient operation of the regulatory businesses.
4. Recommend changes to align treatment of actual tax practices re Capex as follows:
    - Amend the calculation of the tax cost to take into account regulatory capex which is being immediately deductible for tax purposes
    - Uniformly adopt the 20 year effective life capping to all gas industry participants. Currently only being applied to 6 out of 11 participants.
    - Adopt the diminishing value method to all new depreciating assets albeit that this is unlikely to narrow the gap between actual tax paid and the regulatory cost of tax in initial years due how assets are identified for tax purposes.
5. Reserve our views of financing until responses to formal RINs have been analysed