Review of regulatory tax approach

AER Public Forum – Response to AER Discussion Paper and Expert Reports

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7 November 2018

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Outline

1. Context for review
2. Key issues and principles
3. Preliminary views on potential areas of change
4. Suggested way forward

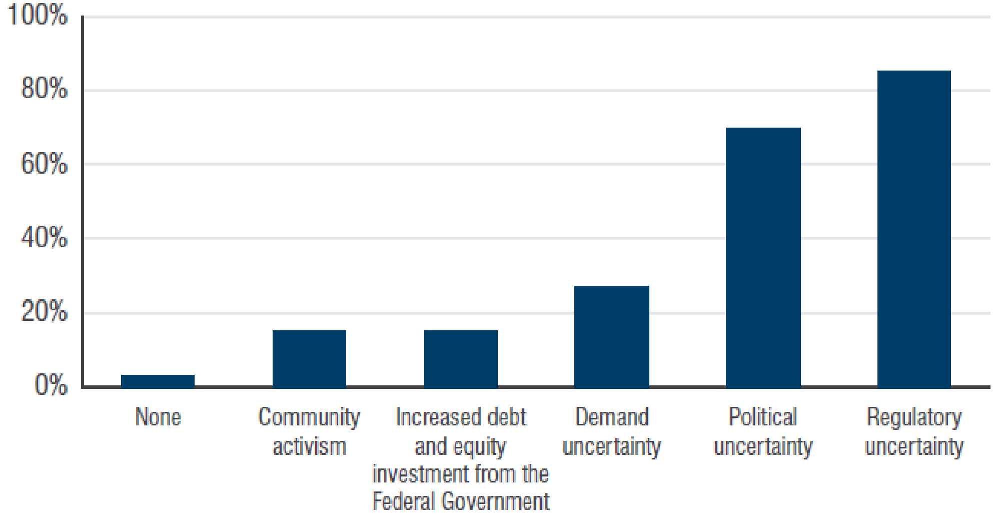
Context for review

"When it came to investment preferences, participants showed an increased preference for unregulated assets, which are substantially more popular than last year when most participants had no preference.

Participants suggested that the increased preference for unregulated assets can be partly attributed to increased uncertainty surrounding regulated assets and the expected returns on investment. A myriad of regulatory reviews and proposals, some influenced by a perception of political objectives, is making investors rebalance their interest toward unregulated assets."

- *Australian Infrastructure Investment Report* (October 2018), p.8

Figure 25: Factors limiting investor interest in the energy sector



Key issues and principles

Issue	AER Position	ENA Preliminary view
Actual tax pass through vs benchmark approach	Maintain benchmark approach	Agree
Entity structure and ownership	Maintain Australian corporate 30% rate	Agree
Asset revaluations	Maintain current approach	Agree
Depreciation	Move to DV where appropriate	Agree
Interest expense	Still considering	Maintain benchmark approach
Refurbishments	Reflect up-front deduction	Maintain current approach
Asset lives for gas pipelines	Reflect 20-year asset life	Maintain current approach

Key Principles:

1. **Incentive-based regulation and benchmark approach:** Under our incentive-based regulatory framework, allowances are based on the efficient cost of the benchmark firm. The corporate tax allowance is no different from any other component of the regulatory allowance.

2. **Prospectivity:** Proposed changes should only be made as new assets are purchased.

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Actual tax pass-through vs. benchmark approach

ENA agrees with the AER and its consultants that the benchmark approach should be maintained within the incentive-based regulatory framework

» Creates incentives to operate efficiently

» Efficient behavior is revealed

» Regulatory benchmark is changed (e.g., move to DV depreciation)

» True-ups could result in inter-generational equity issues (PwC)

Entity structure and ownership

ENA agrees with the AER and its consultants that the approach of using the current agreed corporate tax rate (30%) should be maintained

- Evidence suggests that few entities face a different corporate tax rate
- No obvious alternative – alternative approaches are likely to require the tracing of income flows through entities and into the hands of the final investors
- Would be very difficult to implement even if it were possible

Asset revaluations

ENA agrees with the AER and its consultants that the Tax Asset Base should not be adjusted at the time of a corporate transaction

» Could result in perverse outcomes of customers in different suburbs and different sides of the street paying different charges on the basis of different tax positions of individual businesses arising from sales or transactions

» Consumers do not contribute to any purchase price in excess of the RAB, so they should not receive the benefit of the tax deduction in relation to it

» Would distort the market for such transactions, which is not socially desirable (Lally)

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Depreciation

ENA agrees with the AER and its consultants that it can be efficient for entities to adopt diminishing value depreciation for some assets

» Evidence suggests that some networks are using diminishing value depreciation for some assets – an example of revealed efficient behavior

» **Must be prospective**, applying to new assets only – for the reasons identified by the AER and its consultants:
  - Tax law does not allow changes mid-stream.
  - Immediate change may disadvantage customers.
  - Administrative and modeling complexity from changing mid-stream.

» **Inter-generational equity** requires that each generation of consumers should pay according to the value they obtain. Thus, if the value of a new asset falls (in absolute terms) more in the first year of its life than in the 30th, that should be reflected in the return of capital allowance. That is, inter-generational equity may require that DV is also used for the RAB and return of capital allowance.

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Depreciation

ENA agrees with the AER and its consultants that it can be efficient for entities to adopt diminishing value depreciation for some assets

» More work to be done to determine how to implement the change:
  - Set a benchmark proportion of assets for which diminishing value would be used?
  - Adopt diminishing value for certain types of assets?
  - Case by case analysis – may be efficient to use straight line in some circumstances.

» Further engagement is required

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Interest expense

ENA considers that the same interest expense that is used for the allowed return on capital must also be used for the corporate tax allowance.

» The AER has already made its assessment of the efficient interest expense. That same figure must be used when determining the tax effect of that interest expense. This seems obvious!

» The reasons for a difference between actual interest expense and benchmark efficient interest expense are:
  - The actual interest rate may differ from the AER's allowance. This is an issue of whether the AER's allowance is correct.
  - The firm pays interest on debt issued in relation to unregulated assets. Not relevant. Consumers do not contribute to the servicing of that debt.
  - The firm issues more debt than the 60% regulatory benchmark. Not relevant. Consumers do not contribute to the servicing of that debt.

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Interest expense

ENA considers that the same interest expense that is used for the allowed return on capital should also be used for the corporate tax allowance

» ENA does not understand what information the AER still needs to consider

» What is the possible set of information that would lead the AER to move to using actual interest expense when setting the corporate tax allowance?

» The AER notes that the Independent Panel has made a clear statement on this point:

"The only significant interaction of the gearing ratio with other building blocks is with the taxation component. **Because interest costs are tax deductible, consistency requires the same gearing ratio to be used in the rate of return and taxation building blocks.**" (p.35)

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Refurbishments

ENA considers that careful analysis of the incentive properties should be performed before changing from the current approach

» Refurbishments can be materially more economical than replacing assets, often more than 20% cheaper than a replacement, but with the same functionality. Consumers in aggregate benefit from these refurbishments

» The effect of moving to recognise an up-front tax deduction would be to reduce allowed revenues in the forthcoming regulatory period, relative to the replacement option:
  – This is a relevant consideration for commercial businesses operating in the real world.
  – Such an incentive is not overridden by a theoretical 50-year NPV=0 calculation.

» Thus, if the change were made, strong new incentives are created for businesses to no longer refurbish assets, replacing them instead – this would not be in the short or long-term interests of consumers

Refurbishments

ENA considers that careful analysis of the incentive properties should be performed before changing from the current approach

» If refurbishments *were* made under the new approach, there would be extreme inter-generational equity issues:

- Current consumers would not pay for the asset. Indeed, the immediate allowed revenue would *decrease* when assets are refurbished (i.e., not only do current consumers not pay for the refurbishment, their payments actually fall!).
- Future consumers would pay more than the full cost of the refurbishment – covering the cost, plus the immediate benefit enjoyed by current consumers
- This nets out to NPV=0 over the life of the refurbished asset, but results in a wealth transfer from future consumers to current consumers

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Refurbishments

ENA considers that careful analysis of the incentive properties should be performed before changing from the current approach.

» If the current approach is maintained:

– Refurbishments would continue, to the aggregate benefit of consumers.

– Intergenerational equity would be preserved, where current and future consumers would contribute equitably to the (lower) cost of the refurbishment.

» ENA considers that these practical benefits outweigh any theoretical 50-year NPV=0 analysis.

» Also, not clear that this is a material issue relative to aggregate capital expenditure (Lally).

Asset lives for gas pipelines

ENA considers there may be a need for further shared understanding on operation of relevant tax provisions.

- Should be considered on a case by case basis: law provides option to nominate or adopt ATO life.
- **Mandating a single approach may bring the AER into inconsistency with tax law**
- **If introduced, should be prospective**, applying to new assets only – for the reasons identified by the AER and its consultants.

Suggested way forward

1. AER final recommendations should take into account evidence of heightened regulatory risk perceptions

2. Decisions and implementation of changes should be consistent with Australia's prospective incentive-based regulatory regime

3. Careful analysis is warranted of real world incentive properties and intergenerational equity impacts of proposed refurbishments expensing changes

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