# AER Review of Regulatory Tax Approach

## APGA Presentation

Scott Young, APA Group
7 November 2018

# Summary

APGA supports ongoing improvements to the regulatory framework.

It is critical to protect the internal integrity of the regulatory framework

For long term investment confidence & the long term interests of consumers

The review of the tax allowance must be conducted in the context of the regime that gives rise to the tax allowance

*"Consumers were concerned that tax payments were below the AER's forecasts and so they might be paying more than the efficient cost of providing electricity and gas services."*

The "efficient cost of providing electricity and gas services" is a function of this regime.

Analysis conducted in the context of the regulatory framework indicates that there are no material errors in the calculation of the tax allowance.

Some minor refinements are possible, but with significant implementation and transitional costs.

On balance, APGA believes that a change in approach is not required

# The analysis must be conducted in the context of the regulatory regime

**Once the regulatory framework was created by economists, it was clear that it could never be reconciled to the world created by accountants**

| *Economists* | *Accountants* |
| --- | --- |
| • Started with a fresh value of the regulatory asset base | • Insist on observed historical cost |
| • Index the asset base for inflation | • Use nominal dollars (dollars of the day) everywhere |
| • Assume a benchmark entity | • Apply the facts of the business |
| • Apply investor tax benefits (γ) to estimate cash tax payable | • Use cash measures to estimate cash tax payable |

*Any meaningful analysis must be conducted in the context of the relevant framework*

# The analysis must be conducted in the context of the regulatory regime

| **The AER RIN asked for:** | | **The analysis in context:** |
|---|---|---|
| EBIT per stat accounts | | EBIT per stat accounts |
| | → | +/- Regulatory incentives |
| - Book interest expense | ↔ | - Regulatory cost of debt |
| + Permanent additions | | + Permanent additions |
| + Timing additions | | + Timing additions |
| accounting depreciation | ↔ | straight line RAB depreciation |
| - Permanent deductions | | - Permanent deductions |
| | | indexation of the capital base |
| - Timing deductions | | - Timing deductions |
| tax depreciation | ↔ | regtax depreciation |
| = Taxable Income | | = Regulatory Taxable Income |
| x 30% tax rate = cash tax payable | | x 30% tax rate = Reg Tax Allowance |

Is the AER signalling a departure from the regime here?

***When conducted in the correct context, the analysis shows that the regulatory tax allowance is not materially mis-stated. There is no case for a change in approach.***

# Asset transactions, asset valuations and interest expense

- The AER does not propose to make a change to the calculation of the tax allowance to reflect higher interest deductibility where an asset has been acquired at a value greater than the RAB:
  - *"We consider that it remains appropriate to preserve a consistent regulatory approach that insulates consumers from changes in market valuation on both the RAB and TAB. Where an asset trades at a multiple in excess of its RAB, the incremental value sits outside the regulatory framework. Customers do not pay a higher return on capital and return of capital building blocks associated with the asset value that exceeds the RAB; but they also do not pay a lower tax building block." (AER p19)*

- APGA supports this conclusion.
  - It would otherwise also be necessary to consider the reciprocal case where an asset has been acquired at a value lower than the RAB

- BUT: the AER RIN asked for accounting net income after interest expense, which would reflect the capital financing of any acquired asset reflecting the transaction cost, rather than the RAB value.
  - Any acquisition-related interest expense differential must be excised from the analysis to be consistent with the AER's stated approach.

# Immediate expensing of minor capex Table 6.1

- Incentive regulation relies on accessing the skills of management to deliver the most efficient outcomes for the business, which will ultimately be reflected in lower costs to consumers.
- Management must be able to choose the most efficient approach to an issue, between:
  - Maintenance (operating expenditure);
  - Minor capex (immediately deductible); or
  - Capex (depreciable)
- Changing the balance between these actions will impact management decision-making in ways that we cannot predict.
  - Particularly where the RAB Rollforward treatment differs from the tax allowance treatment
  - The behavioural response may outweigh any tax allowance benefit.

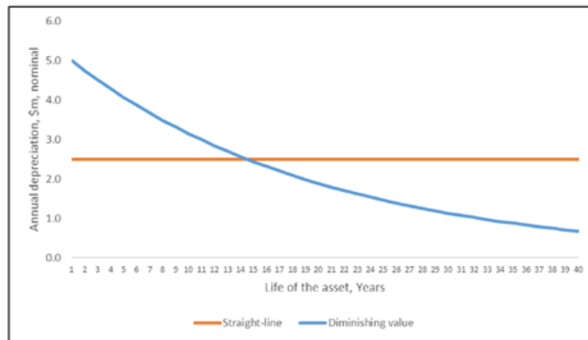
- Implementation is concerning and complex
  - Pipeline minor capex is variable – a benchmark would be very difficult to ascertain and sustain
  - Must consider behavioural implications for actual vs benchmark approach

- APGA understands that legislative change is in train to remove the immediate deductibility for tax purposes (PWC?). This change would align the tax treatment with current regulatory practice.

- APGA does not recommend this change

# Diminishing balance depreciation Table 6.2

- Straight-line vs diminishing balance is strictly a timing difference




  - AER has recognised that this change may result in a reduction in the tax allowance today, but will result in an offsetting increase in tax costs in future years
  - How does this align with the long term interests of consumers? Is this short-termism?

- Must be clear that this would be a prospective change
  - Retrospective implementation would undermine confidence in the regulatory framework
  - PWC and Lally note the importance of prospective adoption

- APGA accepts that this change could be applied with a modelling change
  - don't under-estimate the complexity of the modelling required

# Depreciation – Cap gas lives to 20 years Table 6.3

*"Asset lives determined by tax legislation are shorter than those used by us for some pipelines in the gas sector. This has the effect of bringing forward tax depreciation, relative to the AER's approach." (AER p16)*

*"Tax legislation caps tax asset lives for gas pipelines at 20 years, but the current AER regulatory models use higher tax asset lives…" (AER p18)*

**But for all the gas transmission pipelines for which the AER sets a tax allowance, the regulatory tax asset lives align to the ATO allowed lives:**

RBP:

| Asset Class Name | Tax Standard Life (Year) |
|---|---|
| OriginalPipeline (DN250) | 20.0 |
| Pipelines | 20.0 |
| Compressor | 20.0 |
| Regulators and meters | 20.0 |
| Easements | n/a |
| Communications | 20.0 |
| Other | 20.0 |
| Capitalised AA costs | 5.0 |
| Group IT | 5.0 |
| SIB Capex | 5.0 |
| PMA | 5.0 |

VTS:

| Asset Class Name | Tax Standard Life (Year) |
|---|---|
| Pipelines | 20.0 |
| Compressors | 20.0 |
| City Gates & Field Regulators | 20.0 |
| Odourant Plants | 20.0 |
| Gas Quality | 20.0 |
| Other | 7.5 |
| General Building | 60.0 |
| General Land | n/a |

AGP:

| Asset Class Name | Tax Standard Life (Year) |
|---|---|
| Pipelines | 20.0 |
| Compression | 20.0 |
| Meter Station | 20.0 |
| SCADA | 15.0 |
| O&M Facilities | 10.0 |
| Buildings | 40.0 |
| Not used | n/a |
| Corporate Assets (IT Software) | n/a |
| Land and Easement | n/a |

# Questions?