Appendix A – High level publishable summary

Review of the Gas Network Service Providers' (NSPs') Responses to the Australian Energy Regulator's (AER) Profitability Measures Information Request

30 June 2022

Purpose of this summary report

This Appendix provides a summary of the findings of PwC's review of the fully-regulated Gas NSPs' (being the gas network operators) responses to the AER's Profitability Measures Information Request (**Information Request**), in accordance with our Order of Services from the AER dated 23 May 2022.

In accordance with the Order of Services, PwC has been engaged to assist the AER in considering the reasonableness of the responses provided by the Gas NSPs in relation to the allocation of tax and interest expense for the purpose of determining Return on Regulated Equity (**RoRE**).

Our assistance has consisted of reviewing the information provided by the NSPs, discussions with the AER regarding further information requests which may be required, preparation of a detailed confidential (non-publishable) report outlining the findings of our review, and preparation of this (publishable) summary of our findings.

In accordance with the Order of Services, our review has been limited to the fully-regulated gas network operators only on the basis that the review of the electricity NSPs was completed in June 2021 by PwC. Our review focuses solely on the appropriateness of the NSP responses relating to the allocation of tax and interest expense to Regulatory Net Profit After Tax (**NPAT**) for the purpose of determining RoRE within the AER's reporting profitability measures, for responses provided by the Gas NSPs for the 2014 to 2021 reporting periods (**Review Period**).

Disclaimers

PwC is Australia's largest professional services firm and provides material taxation, financial and consulting services to the NSPs which are subject to this Information Requests across various lines of service.

In accepting this engagement to assist the AER on this matter, we have undertaken as assessment of any potential conflicts arising, and applied safeguards where relevant to ensure that an

PricewaterhouseCoopers Consulting (Australia) Pty Limited
Brookfield Place, 125 St Georges Terrace, PERTH WA 6000, GPO Box D198, PERTH WA 6840
T: +61 8 9238 3000, F: +61 8 9238 3999, www.pwc.com.au

independent assessment of the matters can be achieved.

This summary report has been based on the relevant taxation legislation, applicable case law and published Australian Taxation Office (**ATO**) rulings, determinations and statements of administrative practice at the date of this Report. The opinions in this Report may alter if there is a change to the legislation, or a change of interpretation of the legislation by the courts or the ATO, after the date of this Report. We are not responsible for updating this Report for changes in the law or its interpretation.

This summary report is not to be reproduced or used for any purpose other than as outlined in the Order of Services, without our or PwC Australia's written consent in each specific instance. If this Report is to be relied upon in the future or in any other context other than this specific engagement, it is important you ask us to review this Report as our original opinions may no longer be applicable or appropriate in such circumstances.

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Summary of findings

Allocation of tax expense

As recommended in our previous advice to the AER regarding allocation methodologies to be used by regulated businesses in determining tax and interest expense for profitability measures reporting purposes dated 28 June 2019[1] (**PwC Allocation Advice**), the calculation of tax expense for the purpose of determining Regulatory NPAT should be consistent with the principles for determining income tax expense in accordance with Australian Accounting Standards Board (**AASB**) 112: Income Tax Expense, to ensure comparability and understandability of responses. As such, Regulatory Profit Before Tax (**PBT**) should be used as the starting point for determining tax expense allocable to the regulated businesses, with adjustments made in respect of any "permanent" tax adjustments, which will impact the effective tax rate of the business. Tax adjustments which are timing in nature should not impact income tax expense for these purposes, due to the deferred tax accounting methodology stipulated in AASB 112. Further information in this regard is outlined in the PwC Allocation Advice.

From our perspective, the tax adjustments which are likely to have a material permanent impact on income tax expense for the regulated businesses and therefore should be included in the determination of Regulatory NPAT are limited to:

- Adjustments to remove the impact of indexation on depreciation of the Regulated Asset Base (**RAB**);

[1] PwC, Australian Energy Regulator: Profitability measures review – Advice on the allocation of interest and tax expense, 28 June 2019.

- Adjustments relating to interest expense which is allocable to the regulated business but treated as non-deductible for income tax purposes;

- Amendments to prior year income tax assessments following an ATO dispute or change in law which are permanent in nature; and

- Differences in tax rate attributable to the ownership structure of the regulated business (e.g. where the applicable tax rate differs from the benchmark rate for regulatory purposes of 30%).

The AER released its final view in relation to the information requirements for the purpose of determining Regulatory NPAT in its Final Position Paper on the Profitability Measures for Electricity and Gas Networks dated December 2019[2] (**Final Position Paper**), which broadly agreed with the recommendations from the PwC Allocation Advice, however made some further adjustments to information requirements resulting from consultation with the industry and the AER's own experience. The AER subsequently provided information requests to each NSP in respect of the allocation of tax and interest expense for the purpose of Regulatory NPAT. Responses were received by the NSPs by way of completed Profitability Measures Workbooks and supporting Basis of Preparation (**BoP**) documentation.

We outline our findings from review of the information received by the AER from the fully-regulated gas network operators (on a summarised and confidential basis) below.

Permanent adjustments to tax expense

In accordance with the AER's information request, the Profitability Measures Workbooks prepared by the NSPs contain adjustments to income tax expense in relation to the following areas.

*Permanent adjustments relating to capital expenditure (**Capex**)*

The key issue in determining permanent adjustments relating to Capex is the identification of the impact of historic indexation on RAB depreciation (given this is a permanent difference between RAB and tax treatment). This difficulty was acknowledged in the PwC Allocation Advice, noting complex formulas may be required to determine the correct adjustments. Following further consultation, the AER's Final Position Paper has determined that an appropriate approach to this adjustment is to remove the RAB depreciation and include the Regulatory Tax Asset Base (**TAB**) depreciation in the tax adjustment section of the Profitability Measures Workbook for each year.

While this approach will eliminate the impact of indexation of the RAB, there is a risk that adjustments to income tax expense will also be made for differences between RAB and TAB depreciation which are timing in nature only. This would be inconsistent with the principles of AASB 112 and lead to a lack of comparability of the measures.

For periods prior to the release of the AER's Final Position Paper in 2019, we agree that this approach should broadly result in appropriate in reporting the tax expense of NSPs, in particular

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2 AER, Final position: Profitability measures for regulated electricity and gas network businesses, December 2019.

given the historic practice of the AER to recognise depreciation for both RAB and TAB purposes on a straight-line basis (which would result in no timing difference in this regard). The most material timing difference which would have been expected over those prior years related to customer contracts and gifted assets (given these items may be recognised as assessable upfront and depreciable over time for tax purposes) and any assets where the effective lives differ for RAB and TAB purposes. In our review of the Electricity NSP profitability measure responses, we found that these timing items did not appear to have a significant impact on the RoRE of the respondents on an average basis.

Similar considerations apply in relation to the Gas NSP respondents. However, we note that the impact of timing differences to inappropriately increase the income tax expense of each entity (based on the approach adopted by the AER to remove RAB depreciation and include TAB depreciation) is expected to increase in future years. This is due to the following updates to the TAB determinations following completion of the AER's Regulatory Tax Approach Review in 2019 (which started taking effect from the 2020 income year, although timing differences have not materially affected RoRE estimates to date):

- The applicable TAB depreciation method for new assets relating to determination periods from April 2019 will be diminishing value, to align with what is more commonly used in practice;

- The effective life for certain assets of the Gas NSPs for TAB purposes will be reduced to 20 years, to align with the legislated cap for income tax purposes; and

- Immediate capex deductions will also be factored into the determination of the regulatory cost of taxation. The impact of this may be magnified by the recent introduction of the Temporary Full Expensing regime under which some NSPs may elect to claim immediate deductions for all eligible Capex (including "second element costs", being improvements or augmentations to a single asset) which is (broadly) incurred after 6 October 2020 and relates to assets first used or installed ready for use by 30 June 2023[3], in addition to immediate deductions which may be claimed in relation to capital maintenance or major asset replacement programs.

In addition, there is a risk the approach to substitute RAB for TAB depreciation will also be impacted by the treatment adopted in relation to customer contributions and gifted assets. While such assets are not included for the purpose of the RAB, certain receipts of customer cash contributions or gifted assets may in certain circumstances be treated as assessable income for the purpose of determining the tax allowance included in the regulatory framework, and subsequently depreciated within the TAB. Any such depreciation would generally represent a timing difference (given recognition of upfront assessable income would generate a Deferred Tax Asset (**DTA**) under AASB 112) and therefore should not impact the effective tax rate of each business. This is consistent with the intention of the accounting standards to smooth the recognition of tax expense relating to transactions which have a temporal effect on tax expense only.

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[3] The concession is broadly available to taxpayers which satisfies either the "basic test" (being an entity which is part of a group with less than A$5b of "aggregated turnover" on a global basis) or the "alternative test" (being an Australian company which has incurred more than $100m on eligible tax depreciable assets over the 30 June 2017, 2018 and 2019 income years). The concession allows taxpayers to choose not to claim the immediate deduction.

Having regard to the above, we note that the average impact of the adjustments relating to Capex in the Profitability Measures Workbook is an average decrease to RoRE of 0.84% p.a. for all NSPs on an aggregated basis over the Review Period. While a portion of this would relate to the removal of indexation from RAB depreciation, there is a risk that some of the adjustment also relates to the timing differences outlined above.

Recognition of income from customer contributions and gifted assets

The Profitability Measures Workbook also provides for a tax adjustment to Regulatory NPAT to recognise the impact of assessable income arising from receipts of customer contributions and gifted assets. This income is generally recognised for TAB and actual tax purposes (subject to our comments below in respect of gifted assets), but not otherwise recognised as income for regulatory purposes. It appears this adjustment has been included in the Profitability Measures Workbook to counter the impact of TAB depreciation on such assets as discussed above.

Adjustments relating to assessable income arising from customer contributions and gifted assets should generally be considered timing in nature for income tax purposes (as a DTA will be created, which will unwind over time as the underlying asset is depreciation), and therefore should not impact the year on year income tax expense which is a component of Regulatory NPAT.

From the NSPs which have responded to the information request, 5 of the 9 NSPs have included assessable income relating to customer contributions and gifted assets. The NSPs which have not reported assessable income relating to customer contributions or gifted assets are generally transmission network owners, which in our experience are less likely to make such adjustments. The average impact of the adjustments relating to customer contributions and gifted assets is an average decrease to RoRE across the entities reporting an adjustment of 0.49%.

For completeness, we note the actual tax treatment (and therefore the TAB treatment) of gifted assets is likely to be revisited by some NSPs in light of the Full Federal Court's decision in *Victoria Power Networks Pty Ltd v Commissioner of Taxation 2020 ATC 20-768* (**VPN case**). In the VPN case, the Full Federal Court found that while customer contributions paid to the electricity distributor to construct connections which would otherwise be considered uneconomic were assessable for income tax purposes as ordinary income, assets which were constructed by customers and "gifted" to the distributor would only represent assessable income under section 21A of the Income Tax Assessment Act 1936 (**ITAA 1936**) to the extent of the rebate provided to the customer (e.g. the economic value of the asset) rather than to the extent of the construction costs. This was on the basis the economic value of the asset to the distributor represented the "arm's length value" under section 21A of the ITAA 1936.

This decision differs from the way the ATO has previously sought to administer the tax law in relation to gifted assets, and therefore we expect some NSPs are likely to reconsider the recognition of assessable income in relation to gifted assets for Federal tax (including potentially making prior year adjustments for the over payment of tax).

Permanent differences due to disallowed interest expense

The PwC Allocation Advice noted that permanent denials of interest expense for tax purposes may arise where:

- Debt levels attributable to the regulated assets exceed allowable thin capitalisation thresholds;
- Interest payments to related parties exceed an arm's length price under transfer pricing principles;
- The hybrid mismatch rules deny deductions on payments which give rise to hybrid outcomes; or
- The debt/equity classification of an instrument differs for reporting and tax purposes.

None of the NSPs subject to this review reported disallowed interest deductions in relation to the factors above. This is largely consistent with the findings of our previous Tax Allowance Report[4] (including Addendum[5]) which found that NSPs did not as a general rule exceed maximum allowable gearing levels (under the thin capitalisation rules) for actual tax purposes.

Notwithstanding, our findings in our Tax Allowance Report considered the impact of interest expense deductions under the thin capitalisation regime at that time, which included the safe harbour (broadly limiting tax deductible debt to 60% of the value of an entity's assets, reduced by certain liabilities), arm's length and worldwide gearing tests. As part of the proposed labour Government reforms announced in 2022, the safe harbour test is to be replaced from 1 July 2023 with a new test to limit debt related deductions to 30% of profits (i.e. EBITDA) to ensure alignment with the Organisation for Economic Co-operation and Development (**OECD**) approach. This change could potentially adversely impact the ability of the NSPs to rely on the safe harbour debt amount calculation, and therefore more entities may need to have regard to the arm's length debt test which can be more complex to apply in practice. As such, this adjustment will continue to be an important measurement point in future Review Periods.

Permanent differences due to adjustments to prior year returns

Prior year income tax assessments may be amended following disputes with the ATO or a change in law. Where this results in adjustments that are within the regulatory ring-fence and permanent in nature, regulatory tax expense will be impacted. Any adjustments related to interest expense would likely be disclosed in the responses discussed above, and therefore this item should capture any other amendments relating to the regulatory ringfence which would be permanent in nature.

None of the NSPs subject to this review reported adjustments to prior year returns over the Review Period.

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[4] PwC, AER Tax Review – Expert Advice, 26 October 2018.

[5] PwC, AER Tax Review – (Addendum) Expert Advice, 10 December 2018.

Carried forward tax losses

We would generally not expect tax losses to be relevant when considering income tax allocable to the regulatory ring-fence, on the basis it is unlikely a regulated network would generate material tax losses on a stand-alone basis. This is consistent with the findings of PwC's Tax Allowance Report, whereby it was noted that tax losses observed were generally generated by transactions outside of the regulatory ring-fence. No further recommendations were made in respect of tax losses in the AER's Final Position Paper.

Notwithstanding, the Profitability Measures Workbooks distributed to NSPs provided an ability for NSPs to adjust the regulated NPAT for the effect of any carried forward tax losses attributable to the regulated business.

None of the NSPs subject to this review reported adjustments relating to carried forward tax losses over the Review Period.

Differences in tax rate attributable to ownership structure

As noted above, an adjustment is required to the effective tax rate of the NSPs in determining Regulatory NPAT to reflect the tax rate applicable to each business in light of the various ownership structures which arise in practice.

The PwC Allocation Advice noted the following recommendations in respect of the tax rate for the purpose of Regulated NPAT and RoRE:

- NSPs which are taxed as a company and NTER entities should apply the corporate tax rate of 30%; and
- NSPs which are taxed on a flow-through basis should self-assess the blended tax rate which would be applicable to taxable profits of the regulated network assets having regard to investor profiles. For stapled structures, the PwC Allocation Advice noted the blended tax rate would not be expected to be any higher than 19.5%[6] (and may be lower in some cases), however would likely increase to 30% as the grandfathering period in relation to the recent tax reforms relating to stapled structures ceases on 30 June 2034.

The AER's Final Position Paper agreed with the observations above, and in addition, noted that profitability measures for NTER entities and also state owners of regulated assets which are not subject to the NTER would be reported such that stakeholders can understand profitability both where a 30% tax rate applies, and also a 0% tax rate (e.g. assuming NTER tax equivalent payments are akin to a dividend to the State).

In relation to the Gas NSPs which were subject to this current profitability measures review, we note that all respondents have been disclosed as subject to the 30% corporate tax rate, and therefore no blended tax rates have been reported in the determination of income tax expense for profitability

[6] The blended tax rate of 19.5% assumes a 70/30 split between the Asset Trust and the Operating Trust, with a rate of 15% applicable to the Asset Trust distributions (e.g. the MIT rate) and a rate of 30% applicable to the Operating trust distributions (e.g. the non-resident trust distribution withholding rate).

measures reporting purposes. This is consistent with the findings of our Tax Allowance Review, whereby "flow-through" structures where primarily noted in the electricity sector as a result of recent privatisation transactions. Any flow-through structures noted in the Gas NSP respondents reported that all immediate investors were subject to the 30% corporate tax rate (or NTER equivalent).

Allocation of interest expense

The AER has recommended in its Final Position Paper that NSPs adopt the following self-assessment approach in allocating interest expense to the regulated businesses for the purpose of determining Regulatory NPAT:

- Identify debt instruments which can be specifically identified as having been used to fund the acquisition or construction of regulated assets ("specific debt"), and allocate interest attributable to this debt to the regulated assets;

- For other debt interests of the corporate group which are not directly traceable to funding the acquisition or construction of regulated assets ("general debt"), perform an appropriate allocation of interest expense across the regulated and unregulated aspects of the business based on an appropriate methodology, to be determined by each business having regard to factors which the NSP deems appropriate.

We have reviewed the information provided by the NSPs in relation to the allocation of interest expense both in the Profitability Measures Workbook and the BoP documents, and note that each NSP has generally taken a tailored approach to the allocation of interest expense in relation to their regulated assets having regard to their specific debt funding and asset profile. This is consistent with the AER's views that self-assessment of the allocation of interest by NSPs will result in the most accurate allocations, as the AER notes on page 49 of the Final Position Paper:

> *"We consider self-allocation of interest expense is most likely to achieve our objectives of a meaningful and accurate allocation, as the NSP is best position to make judgments about its use of funds, having regard to its individual circumstances."*

We make the following observations from our review of the approaches adopted by the NSPs in allocating interest expense for the purpose of determining Regulated NPAT:

- 5 of the 9 NSPs have identified specific allocation having regard to the debt used to acquire or construct regulated assets. In each case the debt has generally been either allocated directly to the regulated assets where possible, or in some cases has been allocated across different regulated businesses based on the proportionate RAB of each business.

- The remaining NSPs have utilised methods which allocate general corporate group debt based on a formula either having regard to regulated assets in comparison to book assets, or regulated revenue in comparison to group revenue. The explanations provided by the NSPs to support the allocation methodology in the BoP responses appear reasonable and in most instances have resulted in allocated gearing levels broadly consistent with the 60% benchmark gearing ratio applied for regulatory purposes. Where gearing ratios depart from the 60% benchmark rate, this appears to be reflective of the differential in the actual gearing levels adopted by relevant NSP in relation to the regulated assets.

- We have observed a general consistency of effective interest rates applicable to the debt allocated to the regulated assets across the private sector respondents, and across the NTER entity respondents.

- In accordance with the Information Request, each NSP has also been requested to disclose interest expense attributable to related party debt in the Profitability Measures Workbooks. 2 of the 9 NSPs have disclosed related party interest expense throughout the Review Period, albeit in both instances the related party appears to be a special purpose financing company which is used to borrow external debt, which is subsequently on-lent to the relevant asset holding group members as appropriate.

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Please do not hesitate to contact Chris Paull or Vaughan Lindfield if you would like to discuss our findings in this report in further detail.

Yours sincerely

Chris Paull
Partner
Tax & Legal

Vaughan Lindfield
Partner
Tax & Legal

www.pwc.com.au