



Issues paper

Review of regulatory tax approach

May 2018

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Request for submissions

The Australian Energy Regulator (AER) invites interested parties to make submissions on this issues paper by 31 May 2018.

We prefer that all submissions are in Microsoft Word or another text readable document format. Submissions on our issues paper should be sent to:

TaxReview2018@aer.gov.au.

Alternatively, submissions can be sent to:

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We prefer that all submissions be publicly available to facilitate an informed and transparent consultative process. Submissions will be treated as public documents unless otherwise requested. Parties wishing to submit confidential information should:

- clearly identify the information that is the subject of the confidentiality claim
- provide a non-confidential version of the submission in a form suitable for publication.

We will place all non-confidential submissions on our website. For further information regarding our use and disclosure of information provided to us, see the ACCC/AER Information Policy (June 2014), which is available on our website.

Please direct enquires about this paper, or about lodging submissions to TaxReview2018@aer.gov.au or to the Network Reporting and Finance branch of the AER on (03) 9290 1444.

Shortened forms

Shortened form	Extended form
AEMC	Australian Energy Market Commission
AER	Australian Energy Regulator
ASX	Australian Stock Exchange
ATO	Australian Tax Office
CPI	consumer price index
DNSP	distribution network service provider
energy networks	electricity and gas network service providers
NEL	national electricity law
NER	national electricity rules
NGL	national gas law
NGR	national gas rules
NSP	network service provider
NTER	national tax equivalent regime
PTRM	post-tax revenue model
R&D	research and development
RAB	regulatory asset base
regulatory period	an access arrangement period for gas network service providers and/or a regulatory control period for electricity network service providers
RFM	roll forward model
RIN	regulatory information notice
TAB	tax asset base
the rules	collectively, the NER and NGR
TNSP	transmission network service provider

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1 Overview

The Australian Energy Regulator (AER) is the independent regulator for Australia's national energy market. We are guided in our role by the national electricity, gas, and energy retail objectives set out in the National Electricity Rules (NER) and the National Gas Rules (NGR). These objectives focus on promoting the long term interests of consumers.

This issues paper is the first step in a review of our regulatory tax approach. We are undertaking this review to ensure that our approach to estimating tax in regulatory determinations serves the long term interests of consumers. The review was prompted by concerns that there was a material difference between:

- the AER's expected tax costs for regulated electricity networks and gas pipelines
- actual tax payments to the Australian Tax Office (ATO) by these regulated energy networks.

This review will consider whether changes to our regulatory tax approach are appropriate. This will ensure that energy consumers pay no more than necessary for the safe and reliable delivery of electricity and gas services.

We invite submissions on this issues paper from all interested stakeholders by 31 May 2018. To guide submissions, there are targeted questions at the end of chapters 4 and 5.

1.1 Summary of the issues paper

We set regulated revenues so that energy networks can recover their expected costs, including their expected tax costs. We calculate the expected tax costs using a standard tax calculation that has regard to expected taxable revenue, expected tax expenses (depreciation, interest, opex) and the statutory corporate income tax rate (30 per cent). We use an incentive approach where, once regulated revenues are set for a five year period, networks who keep actual costs below expected costs retain part of the benefit.

We estimated the regulated energy networks would pay about \$5 billion in tax across the five year period from 2012–17 (\$real 2017).

The ATO advised us that taxpaying energy networks, Australian Stock Exchange (ASX) listed or privately held, paid less tax than estimated by the AER; but state government owned energy networks paid more tax than estimated.¹ We examined publicly available sources for data on the actual tax payments by regulated energy networks. The data we examined was scarce and conflicting, though it tended to support the ATO advice.

The ATO note identified a number of potential drivers that could be contributing to the discrepancy between expected tax costs and actual tax payments.² These included drivers that alter the relevant tax rate (ownership structure), interest expense (gearing) and

¹ ATO, *Note to the AER*, 10 April 2018, p. 1.

² ATO, *Note to the AER*, 10 April 2018, pp. 2–3.

depreciation expense (diminishing value, self-assessed asset lives, low value pools). The AER needs to understand these potential drivers and their impact on observed tax costs.

1.2 Next steps

The proposed timeline and milestones for this review are shown in Table 1.1. We will decide on the final timeline and milestones for the review after reviewing responses to this issues paper. We may alter the timeline and milestones during the review in response to emerging issues.

Table 1.1 Proposed project timeline and milestones

Date	Milestone
15 May 2018	Issues paper released
31 May 2018	Submissions on issues paper close
Late June 2018	Initial report released
July 2018	Four week submission period on initial report Public forum
August 2018	(If required) Consultation on draft RINs
September 2018	(If required) Final RINs issued
October 2018	Draft position released
November 2018	Four week submission period on draft position Public forum
December 2018	Final position released (If required) Proposed PTRM/RFM amendments and explanatory statement released (If required) Proposed rule changes released
January 2019	(If required) Six week submission period on proposed model amendments
April 2019	(If required) Final PTRM/RFM amendments released

The proposed timeline includes several conditional milestones:

- If the AER considers that it is necessary to use its information gathering powers, this could occur between the initial report and the draft position (August to September 2018). When issuing a regulatory information notice (RIN), the AER first consults on the RIN then, after considering the responses it receives, issues the final RIN.
- If the AER's final position is to make changes to its models—the post-tax revenue model (PTRM) and/or roll forward model (RFM)—we will then consult on the implementation of these changes in the early part of 2019.

- If the AER's final position is to propose changes to the rules—the NER and/or NGR—we will publish proposed changes in the final position. We would then develop and submit a rule change proposal to the Australian Energy Market Commission (AEMC). The AEMC would undertake further consultation on the proposed rule changes.

We invite submissions on this issues paper from all interested stakeholders by 31 May 2018. Information on how to make a submission is included at the start of this document.

2 What is the current regulatory tax approach?

We set regulated revenues so that energy networks can recover their expected costs, including their expected tax costs. We calculate the expected tax costs using a standard tax calculation that has regard to expected taxable revenue, expected tax expenses (depreciation, interest, opex) and the statutory corporate income tax rate (30 per cent). We use an incentive approach where, once regulated revenues are set for a five year period, networks who keep actual costs below expected costs retain part of the benefit.

2.1 Building block incentive approach

Our regulatory determinations set regulated revenue based on the efficient costs that a network service provider (NSP) expects to incur in running its electricity network or gas pipeline. The forecast revenue stream is derived using a 'building block' assessment, where total revenue is the sum of four components (building blocks):

- return on capital (to compensate investors for the opportunity cost of funds invested in the business)
- return of capital (depreciation, to return the initial investment to investors over time)
- operating expenditure (to cover the day-to-day costs of maintaining the network and running the business)
- cost of corporate taxation.

Regulatory determinations usually occur every five years for each regulated business. The regulatory framework aims to provide incentives for the NSP to run an efficient business and ensure consumers pay no more than they need to. Once regulated revenue is set for this period, the network business is better off if it keeps actual costs below expected costs. Conversely, it is worse off if actual costs are above expected costs.

2.2 Estimated cost of corporate tax

Our current approach to calculate the cost of corporate income tax begins with an estimate of taxable revenue that would be earned by a benchmark efficient entity operating a network service provider's assets.³ This is the total building block revenue explained above.⁴

We then estimate tax expenses—interest, depreciation (for tax purposes) and operating expenditure. All tax expenses are offset against the service provider's forecast revenue to estimate the taxable income. The statutory corporate income tax rate of 30 per cent is applied to the estimated taxable income to arrive at an estimated amount of tax payable.

³ A benchmark efficient entity is defined as a pure play, energy network business operating within Australia with a similar degree of risk as a service provider providing regulated services.

⁴ It also includes a minor adjustment for customer contributions (also called capital contributions)—payments from customers for specific network connection assets, which fall outside the standard building block revenue but are still assessed as taxable revenue by the ATO. Also note that since the cost of corporate tax is itself one of the building blocks, this means that the calculation is iterative.

From this amount, we then deduct the expected value of imputation credits. The final output is the tax building block—our assessment of the tax allowance for the business.

Figure 2.1 on the following page provides an overview of this regulatory tax approach.

The corporate income tax allowance is an output of the AER's PTRM.⁵ The assessment of the NSP's estimated cost of corporate income tax allowance requires analysis of its proposed inputs to the PTRM, including:

- the opening value of the tax asset base (TAB)
- the standard tax asset lives
- the remaining tax asset lives
- the corporate tax rate
- the value of imputation credits (γ).⁶

After determining the level of pre-tax revenue, these inputs are used to determine the tax allowance.

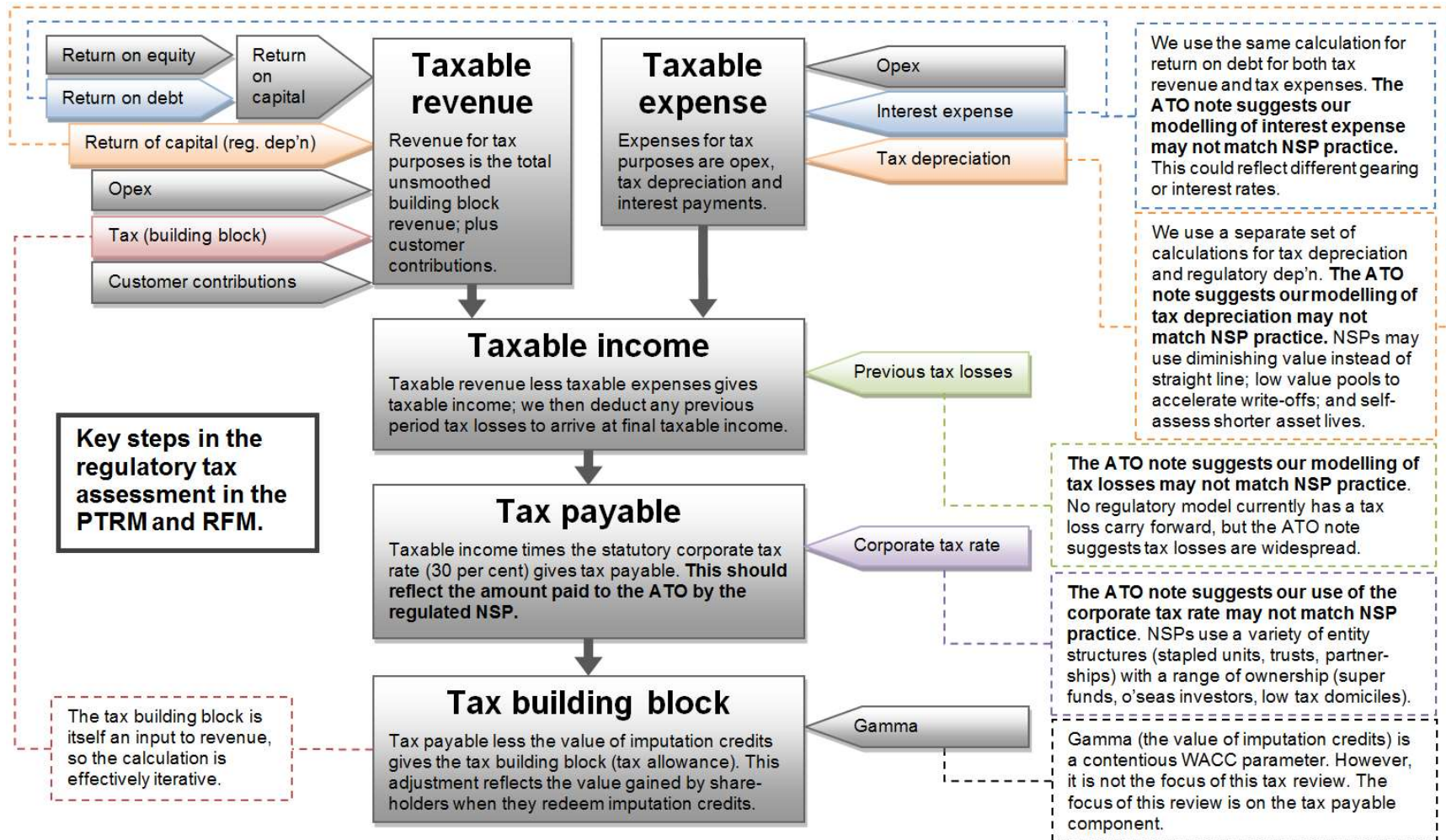
The estimation of tax expenses under our current approach is as follows:

- Interest expense is a function of the size of the regulatory asset base (RAB), the benchmark gearing assumption (60 per cent) and the regulated cost of debt. The interest expense calculation for tax purposes is identical to the calculation in the return on capital building block.
- Depreciation expense is a function of the tax asset base, tax asset lives and the depreciation method approved by the AER in its regulatory determination. The depreciation expense calculation for tax purposes differs from the depreciation calculation in the return of capital building block, which uses regulatory/economic asset lives (not tax asset lives) and includes an adjustment for inflation.
- Operating expense is set to equal the 'opex' building block.

⁵ NER, cl. 6.4.2(b)(4) and cl. 6A.5.3(b)(4). Currently, the NGR does not specify a building block model to determine a network service provider's annual revenue.

⁶ While the value of imputation credits is an input to the estimated cost of tax allowance, it is not a direct focus for this review. See our current review of our Rate of return guideline available at <https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/review-of-rate-of-return-guideline>.

Figure 2.1 Diagram showing the key steps in the AER's regulatory tax approach



3 How much was given in tax allowances?

We estimated the regulated energy networks would pay about \$5 billion in tax across the five year period from 2012–17 (\$real 2017).

The amount set to be directly recovered from customers for expected tax costs was \$3.1 billion across the same period. This was lower than the estimated tax payable because we adjusted for the value of imputation credits. Tax payments by the energy networks generate imputation credits that are then distributed to shareholders and reduce their personal income tax (or provide a rebate). Some portion of company tax will therefore be a pre-payment of personal taxes. To determine the tax allowance—also known as the tax building block—the AER's PTRM takes the estimate of tax payable and removes the value of imputation credits.

3.1 Tax payable

We have reviewed the tax calculations for regulated NSPs (both electricity networks and gas pipelines) in our regulatory decisions over the five year period from 2012–17. In each decision, there is a calculation of the expected tax payable to the ATO within the PTRM.⁷ This is shown in Table 3.1.

Table 3.1 AER estimate of tax payable across 2012–17 (\$millions, 2017)

Sector	2012–13	2013–14	2014–15	2015–16	2016–17	Total
Electricity						
Distribution	900.5	953.0	742.8	651.3	719.7	3967.3
Transmission	174.9	169.0	120.0	126.6	152.8	743.4
Gas						
Distribution	47.7 ^a	67.5	75.3	62.6	43.2	296.1
Transmission	7.3	10.1	10.1	8.8	7.4	43.7
Total	1130.4	1199.5	948.3	849.2	923.1	5050.4

Source: Figures taken from most recent PTRM for each NSP (final decision, post-appeal or annual return on debt update).

Notes: We removed forecast CPI and then used actual CPI to bring to June 2017 values. We converted to June-end financial years by pro-rata adjustment of calendar years or March-end financial years.

(a) Excludes three gas DNSPs where data was not available for this year.

Table 3.1 shows that estimated tax payable has generally declined across the five year period from more than \$1 billion in 2012–13 and 2013–14 to \$923 million in 2017–18 (\$real 2017).⁸ This reflects the overall decline in regulated revenue (and in particular the rate of return on capital) across this time. Table 3.1 also shows that the electricity distribution

⁷ The tax payable calculation is on the 'Analysis' tab, row 57.

⁸ The AER calculation of tax payable for 2017–18 is \$869.4 million.

networks comprise the bulk of the expected tax payable, reflecting the relative size of revenue determinations for these networks.

These tax payable figures are the appropriate starting point for comparisons against the actual tax paid to the ATO.

3.2 Regulatory tax allowance

Although each AER determination includes an estimate of tax that will be paid by the regulated network, the tax allowance set by the AER is a lower figure. This is because Australia operates an imputation credit (franking credit) system. The AER's PTRM takes the estimate of tax payable and removes the value of imputation credits to calculate the tax allowance (or tax building block). This is shown in Table 3.2.

Table 3.2 Tax allowances across 2012–17 (\$millions, 2017)

Sector	2012–13	2013–14	2014–15	2015–16	2016–17	Total
Electricity						
Distribution	567.6	603.2	522.8	402.2	435.6	2531.4
Transmission	82.2	75.4	51.0	53.9	70.0	332.4
Gas						
Distribution	34.4 ^a	49.2	55.1	46.0	30.0	214.6
Transmission	4.9	7.5	7.6	6.6	5.5	32.1
Total	689.1	735.3	636.4	508.7	541.0	3110.5

Source: Figures taken from most recent PTRM for each NSP (final decision, post-appeal or annual return on debt update).

Notes: Calculation of the tax building block reflects the gamma applied in each decision. We removed forecast CPI and then used actual CPI to bring to June 2017 values. We converted to June-end financial years by pro-rata adjustment of calendar years or March-end financial years.

(a) Excludes three gas DNSPs where data was not available for this year.

The tax allowances in Table 3.2 show the same general pattern as the estimated tax payable amounts in Table 3.1.⁹

The tax building block represents a small portion of the overall building block revenue collected by the regulated energy networks, usually around 4 per cent of total revenue.

These tax allowance figures are an appropriate starting point for consideration of the amount paid by consumers in tax costs. However, it is not appropriate to directly compare them against figures for actual tax payments to the ATO, as the two figures are expressed on a different basis.

⁹ The tax allowance for 2017–18 is \$520.4 million.

3.3 Tax payable and tax allowances by ownership

We can also reclassify the data on expected tax payable and tax allowances based on the ownership of each regulated energy network. The relevant distinction is whether the NSP is owned by a state government or not.¹⁰ This data is presented in Table 3.3 (estimated tax payable) and Table 3.4 (tax allowances).

Table 3.3 AER estimate of tax payable across 2012–17, by ownership (\$millions, 2017)

Ownership	2012–13	2013–14	2014–15	2015–16	2016–17	Total
State government owned	804.2	853.7	593.1	497.4	474.9	3223.2
Privately owned ^a	326.2 ^b	345.8	355.2	351.8	448.2	1827.2
Total	1130.4	1199.5	948.3	849.2	923.1	5050.4

Source: Figures taken from most recent PTRM for each NSP (final decision, post-appeal or annual return on debt update).

Notes: We removed forecast CPI and then used actual CPI to bring to June 2017 values. We converted to June-end financial years by pro-rata adjustment of calendar years or March-end financial years.

(a) 'Privately owned' includes ASX listed, privately held or overseas owned (including overseas government owned).

(b) Excludes three private sector DNSPs where data was not available for this year.

Table 3.4 Tax allowances across 2012–17, by ownership (\$millions, 2017)

Ownership	2012–13	2013–14	2014–15	2015–16	2016–17	Total
State government owned	463.2	494.1	389.6	291.2	276.9	1915.0
Privately owned ^a	225.9 ^b	241.2	246.8	217.5	264.1	1195.5
Total	689.1	735.3	636.4	508.7	541.0	3110.5

Source: Figures taken from most recent PTRM for each NSP (final decision, post-appeal or annual return on debt update).

Notes: Calculation of the tax building block reflects the gamma applied in each decision. We removed forecast CPI and then used actual CPI to bring to June 2017 values. We converted to June-end financial years by pro-rata adjustment of calendar years or March-end financial years.

(a) 'Privately owned' includes ASX listed, privately held, or overseas owned (including overseas government owned).

(b) Excludes three private sector DNSPs where data was not available for this year.

State government owned networks comprise the majority of both estimated tax payable and tax allowances.¹¹

¹⁰ TransGrid (NSW TNSP) was privatised during 2015–16; we have classified it as state government owned up to 2015–16 and then privately owned for 2016–17. Ausgrid and Endeavour Energy (NSW DNSPs) were 50% privatised during 2016–17; we have classified them as state government owned for all years in these tables. ActewAGL (ACT Electricity and Gas DNSP) has 50% share of state government and private ownership; we have split their tax data accordingly.

¹¹ This data also reveals that state-government owned networks had a higher gamma (on average) than non-state government owned networks. Our approach to setting gamma does not vary based on network ownership. This variation

4 How much tax was actually paid?

The ATO advised us that taxpaying energy networks (ASX listed or privately held) paid less tax than estimated by the AER; but state government owned energy networks paid more tax than estimated. We examined publicly available sources for data on the actual tax payments by regulated energy networks. The data we examined was scarce and conflicting, though it tended to support the ATO advice.

4.1 ATO note

The ATO reviewed the actual tax paid by electricity distribution businesses over the four year period from 2013–16. This included 'taxpaying entities'—networks listed on the ASX or privately held (including trusts and foreign-owned networks) and 'NTER entities'—networks owned by state governments who pay notional 'tax' under the National Tax Equivalent Regime (NTER). The ATO stated:¹²

In general, our analysis indicates that:

- the aggregate AER tax allowance provided to taxpaying entities consistently overstated the actual tax payable by those entities; and
- the aggregate AER tax allowance provided to NTER entities consistently understated the 'notional' tax payable by those entities.

Elsewhere the ATO noted that the tax paid by the taxpaying entities was 'significantly less' than the tax allowance they received.¹³

The ATO note was based on examination of the income tax return data for the relevant businesses. Although the ATO's analysis focused only on electricity distribution businesses (excluding electricity transmission and gas businesses) these comprise the majority of expected tax payable for all regulated networks (see Table 3.1).

However, the ATO's published findings were qualitative in nature and did not include specific figures.¹⁴ The ATO noted that it had to make assumptions and exclusions in undertaking its analysis, but the full details of the assumptions and exclusions were not set out in the ATO note.

Given this background, we examined other sources of tax payment data.

4.2 ATO tax transparency reports

The ATO has also published three years of corporate income tax transparency reports.¹⁵ The reports provide tax payable data on Australian public and foreign-owned corporate tax

arises because the gamma set in AER decisions has changed across time, and regulatory determinations occur on a staggered cycle.

¹² ATO, *Note to the AER*, 10 April 2018, p. 1.

¹³ ATO, *Note to the AER*, 10 April 2018, p. 1.

¹⁴ ATO, *Note to the AER*, 10 April 2018, p. 3.

¹⁵ Available at <https://data.gov.au/dataset/corporate-transparency>.

entities with a total income of \$100 million or more; and Australian-owned resident private companies with an income of \$200 million or more. The report is available over a period of three years from 2013–14 to 2015–16.¹⁶ From the reports, we identified entities who wholly or partially owned one or more of the regulated energy networks.¹⁷ Table 4.1 shows the total tax paid by these entities from this reporting source. It is important to note that the data represents tax payable accrued from both regulated and unregulated activities conducted by the businesses.

Table 4.1 Reported tax payment data from the ATO tax transparency report (\$millions, 2017)

	2012–13	2013–14	2014–15	2015–16	2016–17
All sectors	n/a	62.3	100.3	133.5	n/a

Source: ATO, *Corporate tax transparency reports 2013–16*, AER analysis.

Table 4.1 is not disaggregated into sectors since the tax transparency report covers each entity as a whole, and we were not able to disaggregate into sectors where businesses have an interest in multiple networks. Since the tax transparency report does not include NTER payments, no state government owned networks were included in this data.

4.3 Tax payments based on cash flows

We also reviewed annual reports and financial statements for the owners of regulated networks, where these were available in the public domain. We focused first on the cash based reporting of tax payments (taken from the statement of cash flows or equivalent) because it appeared to align with the reporting basis in the ATO note.

This approach allowed us to obtain data for several of the state government owned networks that were excluded from the ATO's tax transparency reports. These networks make NTER payments (to their state government owners) that are reported on an equivalent basis to cash-based tax payments. We have been able to locate tax payment data for nine out of ten state-owned NSPs. However, for a number of NSPs, data is not available for the entire period from 2012–17.

Table 4.2 shows the reported tax payment data (based on cash flows) for state government owned NSPs.

¹⁶ Data for 2016-17 is expected to be made available in January 2019.

¹⁷ Specifically Australian Pipeline Trust, Australian Gas Networks Holdings Pty Ltd, AusNet Services (distribution) Ltd, AusNet Services Ltd, DUET Company Ltd, DUET Investment Holdings Ltd, ElectraNet Pty Ltd, Energy Infrastructure Investments Pty Ltd, IFM Renewable Energy Trust, IFM Social Infrastructure Holding Trust, SGSP (Australia) Assets Pty Ltd, Spark Infrastructure Holdings No 1 Pty Ltd, Spark Infrastructure Holdings No 2 Pty Ltd, United Energy Distribution Holdings Pty Ltd, and Victoria Power Networks Pty Ltd.

Table 4.2 Reported tax payment data from cash flow statements for state government owned NSPs across 2012–17 (\$millions, 2017)

Sector	2012–13	2013–14	2014–15	2015–16	2016–17
Electricity transmission	361	188.4	240.8	95.9	114.5
Electricity distribution	533.6	792.7	693.9	212.9	70.3
Gas	n/a	n/a	n/a	n/a	n/a
Total	894.5	981.1	934.8	308.9	184.8
Number of NSPs included in data	9 of 10	8 of 10	9 of 10	6 of 10	4 of 9

Source: Powerlink, Annual Reports 2012–17; TasNetworks, Annual Reports 2013–17; Endeavour Energy, Annual Performance Report 2012–16; Essential Energy, Annual Report 2012–17, Energex, Annual Report 2012–16; Ergon Energy, Annual Financial Statement 2013–15; Ergon Energy, Annual Stakeholder Report 2015-16; Ergon Energy Queensland Pty Ltd Annual Financial Statements 2016-17; TransGrid, Annual Report 2012–15; Ausgrid, Annual Report 2012–16.

Notes:

n/a No report available; or no tax data available within the report.

The bottom row in Table 4.2 shows that we were able to obtain fewer reports in recent years, reflecting the publication delay for some networks. The apparent decline in total tax payments in 2015–16 and 2016–17 should be treated with caution given the reduced coverage.¹⁸ Nonetheless, we have obtained data for most state government owned networks in the first three years of the period. The total actual tax payments in these three years exceed the equivalent expected tax payable figures in Table 3.3.

We also considered tax payment data from cash flow statements for privately owned networks—that is, privately held or ASX listed companies, trusts and overseas firms (including overseas government owned). We looked for annual reports and financial statements from these entities that reported this data.

The data we obtained related to entities that owned multiple regulated networks. These entities did not provide information that could be apportioned to specific regulated networks or pipelines, so we have not attempted to disaggregate these sectors in the table.

Table 4.3 shows the reported tax payment data (based on cash flows) for privately owned NSPs.

¹⁸ This is also the reason why we have not calculated a total figure across the five year period.

Table 4.3 Reported tax payment data from cash flow statements for privately owned NSPs across 2012–17 (\$millions, 2017)

Sector	2012–13	2013–14	2014–15	2015–16	2016–17
Multiple-network entities	42.5	41.9	78.6	173.0	55.0
Number of entities	3	3	2	3	2

Source: AusNet Services, Statutory Annual Report 2013–14, Financial Report; 2015-16, Jemena, Financial Statements 2014–2016; ActewAGL, Annual Report 2012-13; Our Year in Review 2013–17; Australian Gas Networks, 2013 Annual Report; 2014 Annual Report; APA Group, Annual Report 2012–17.

The bottom row in Table 4.3 shows the number of multi-network entities in each year, with coverage of only a limited subset of the total privately-owned networks.¹⁹ It is also important to note that this tax data pertains to the entire entity, and so will include any non-regulated activities it undertakes.

4.4 Tax payments based on income tax expense

Building on the previous section, we also considered the income tax expense reported in the annual reports and financial statements we obtained. This reflects the accounting measure for income tax incurred by the entity that year, but may not reflect an actual cash payment to the ATO.²⁰

This reporting basis was less relevant for the state-government owned NSPs since NTER payments occur each year. However, we were able to examine the income statements for the same set of privately owned NSPs who reported cash flow tax data. This is shown in Table 4.4.

Table 4.4 Reported tax payment data from income statements (income tax expense) for privately owned NSPs across 2012–17 (\$millions, 2017)

Sector	2012–13	2013–14	2014–15	2015–16	2016–17
Multiple-network entities	226.3	173.6	432.4	257.9	230.8
Number of entities	3	3	2	3	2

Source: AusNet Services, Statutory Annual Report 2013–14, Financial Report; 2015-16, Jemena, Financial Statements 2014–2016; ActewAGL, Annual Report 2012-13; Our Year in Review 2013–17; Australian Gas Networks, 2013 Annual Report; 2014 Annual Report; APA Group, Annual Report 2012–17.

Tax payments reported on this basis are higher than those reported as cash flows. However, the data set is still limited and this restricts any conclusions that could be drawn.

¹⁹ We have not attempted to quantify the maximum number of possible entities because (unlike the government owned networks) there are joint ownership arrangements around some privately owned networks.

²⁰ For instance, where there are previous tax losses (as mentioned in the ATO note) or deferred tax considerations.

4.5 Limitations of currently available tax payment data

We have encountered significant difficulties in obtaining accurate and consistent information in the public domain on actual tax payments and other relevant tax information for the energy networks. This includes:

- data is not available or incomplete for a majority of privately owned NSPs and a number of state-owned NSPs
- where data is available, it is often reported in aggregate form, which means it cannot be allocated to specific networks. Further, tax pertaining to non-network (unregulated) activities undertaken by an entity will also be included in the reported figures
- conflicting reporting of tax information from different sources, including parts of the annual report or financial statements
- data is often only available over a short timeframe and not always reported in a consistent format over time
- very limited information on the value of the tax asset base, tax depreciation, tax losses and deferrals, tax revaluations and adjustments. This information is useful for identifying the drivers of any difference between the actual tax payments and the approved allowance.

4.6 Questions

Q1. Are there other publicly available sources that provide tax data for the regulated networks?

Q2. Of the available data sources, which are the most appropriate for the purposes of the AER's review?

Q3. What information would the AER need to obtain on actual tax payments in order to inform this review and any potential adjustments to the regulatory treatment of taxation?

5 What could be driving the difference?

The ATO note identified a number of potential drivers that could be contributing to the discrepancy between expected tax costs and actual tax payments. These include drivers that alter the relevant tax rate (ownership structure), interest expense (gearing) and depreciation expense (diminishing value, self-assessed asset lives, low value pools). The AER needs to understand these potential drivers and their impact on observed tax payments.

5.1 Key drivers from the ATO note

The ATO note identified potential drivers for the tax discrepancy and classified them based on materiality. Table 5.1 (on the following page) summarises the potential drivers the ATO identified as being material to the lower tax payments being made by privately owned regulated networks ('taxpaying entities' in the ATO note). The table briefly explains why each could result in a difference between the AER's expected tax costs and actual tax paid by regulated networks.

Several of the drivers in Table 5.1 act through increasing the depreciation expense (relative to the AER's benchmark approach). This may have different effects on short term and long term actual tax payments. In the first five year regulatory period, a higher depreciation expense means lower taxable income and lower tax payable. However, a higher depreciation expense also means a lower tax asset base at the end of the regulatory period. This will lead to lower depreciation expenses in subsequent regulatory periods and eventually higher tax payments than expected under the AER's baseline. For long-lived assets, it may take multiple regulatory periods (perhaps fifteen or twenty years) before this inversion point is reached and higher tax costs are incurred.

The effect of tax losses is also noted in Table 5.1, where current period taxable income will be reduced by prior period tax losses. The AER's models are constructed so that tax losses from one period will be carried forward into the following period. However, the operation of the AER's models in earlier regulatory periods did not suggest that any regulated networks would incur tax losses. Hence, this driver may be a secondary effect arising from the effect of other potential drivers (listed in Table 5.1) in earlier periods.

Table 5.1 Potential drivers from the ATO note—material drivers of lower tax payments for privately owned networks

Potential Driver	Current tax practice	AER approach	Effect of difference
Ownership structure	Some ownership types may attract a lower statutory tax rate (15% or 0%), including where the tax is payable at the investor level.	Use the statutory corporate income tax rate for Australian companies (30 per cent).	A lower tax rate means a lower tax payable amount than in the AER model.
Gearing	NSPs may be highly geared (greater than 60 per cent).	Use the benchmark gearing (60 per cent).	Interest expense is higher than in the AER model, and so taxable income is lower.
Diminishing value	NSPs may adopt diminishing value depreciation for tax purposes, which front-loads asset depreciation.	Use straight-line depreciation for tax purposes.	Depreciation expense is higher than in the AER model, and so taxable income is lower (in this period).
Self-assessed asset lives	NSPs may self-assess shorter asset lives for tax purposes.	Use the ATO standard asset lives for tax purposes.	Depreciation expense is higher than in the AER model, and so taxable income is lower (this period).
Low-value pools	NSPs may aggregate assets worth less than \$1000 and then rapidly depreciate them.	Always use the tax asset lives that apply to the original asset class.	Depreciation expense is higher than in the AER model, and so taxable income is lower (in this period).
Prior tax losses	NSPs may have available tax losses.	The AER models recognise prior tax losses, but at present no NSPs were expected to accrue tax losses.	Current taxable income is offset (reduced) by past tax losses, so tax payable is lower than in the AER model.

Source: ATO, *Note to the AER*, 10 April 2018; AER analysis.

5.2 Other potential drivers

Table 5.2 describes several other potential drivers that may contribute to the difference between AER expected tax payments and actual ATO tax payments. Some of these are drawn from the ATO note and its description of tax payments for state government owned networks ('NTER entities' in the ATO note). Others were identified from our examination of annual reports where notes to the financial statements identified significant events with taxation implications.

Table 5.2 Additional potential drivers

Potential driver	Description	AER approach	Effect
R&D deductions	NSPs may reduce their taxable income to reflect expenditure on research and development.	No R&D deductions included in models.	Taxable income is lower than in the AER models and so tax payable is lower. ^a
Cost of debt	NSPs may borrow at rates above (below) the regulated cost of debt; this may also include borrowing from related parties.	Use the benchmark regulated cost of debt.	If interest rates are higher (lower) than the regulated cost of debt, interest expense is higher (lower) than assumed in the AER model, and so taxable income will be lower (higher). ^a
TAB revaluation	NSPs may revalue their tax asset base as a result of a sale or corporate restructure.	Tax asset base is not revalued.	If the revaluation is upward, TAB is higher than in the AER model. Subsequent depreciation expenses will be higher than in the AER model, and so taxable income will be lower.
Immediate expensing of refurbishment	NSPs may treat refurbishment capex as an expense, so that it is immediately depreciated for tax purposes.	Use standard tax asset lives for the refurbishment capex.	Depreciation expense is higher than in the AER model, and so taxable income is lower (this period).

Source: ATO, *Note to the AER*, 10 April 2018; AER analysis.

Notes:

- (a) The ATO note referenced the absence of these potential drivers for state government owned networks—that is, the absence of R&D deductions or related party dealings may explain why state government owned NSPs have higher tax (NTER) payments than expected by the AER.

The ATO noted that a number of other factors not explicitly outlined in its note contributed to the tax discrepancy, but that they were not material. We will need to have regard to the materiality of potential drivers in our review.

5.3 Questions

Q4. Are there other potential drivers that could cause the difference (between expected tax costs and actual tax paid) identified in the ATO note?

Q5. How should we assess materiality of the potential drivers?

Q6. Which of these potential drivers should be the focus for the AER's review?

Appendix A Consolidated list of questions

Questions from chapter 4

- Q1. Are there other publicly available sources that provide tax data for the regulated networks?
- Q2. Of the available data sources, which are the most appropriate for the purposes of the AER's review?
- Q3. What information would the AER need to obtain on actual tax payments in order to inform this review and any potential adjustments to the regulatory treatment of taxation?

Questions from chapter 5

- Q4. Are there other potential drivers that could cause the difference (between expected tax costs and actual tax paid) identified in the ATO note?
- Q5. How should we assess materiality of the potential drivers?
- Q6. Which of these potential drivers should be the focus for the AER's review?

Appendix B List of relevant NER/NGR clauses

This appendix provides NER and National Electricity Law (NEL) references for electricity distribution networks in body text; there are equivalent clauses for electricity transmission and gas.

Clause 6.4.3(a)(4) of the NER specifies that one of the building blocks used to calculate the annual revenue requirement is the estimated cost of corporate income tax and refers to clause 6.4.3(b)(4) for details, which then refers to clause 6.5.3.²¹

Clause 6.5.3 of the NER specifies the following requirement:²²

6.5.3 Estimated cost of corporate income tax

The estimated cost of corporate income tax of a *Distribution Network Service Provider* for each *regulatory year* (**ETC_t**) must be estimated in accordance with the following formula:

$$ETC_t = (ETI_t \times r_t)(1 - \gamma)$$

where:

ETI_t is an estimate of the taxable income for that *regulatory year* that would be earned by a benchmark efficient entity as a result of the provision of *standard control services* if such an entity, rather than the *Distribution Network Service Provider*, operated the business of the *Distribution Network Service Provider*, such estimate being determined in accordance with the post-tax revenue model.

r_t is the expected statutory income tax rate for the regulatory year as determined by the AER; and

γ is the value of imputation credits.

Clause 6.4.2 of the NER states that the PTRM must specify the manner in which the estimated cost of corporate income tax is to be calculated.²³

The basis for preparing, publishing and amending the post-tax revenue model (PTRM) is specified in clause 6.4.1 of the NER.²⁴ Clause 6.4.1(b) provides that the AER may, from time to time and in accordance with the distribution consultation procedures, amend or replace the PTRM.²⁵ Similarly, clauses 6.5.1(b)–(d) of the NER provide the basis for preparing, publishing and amending the roll forward model (RFM).²⁶

The gas rules are less prescriptive and do not mandate the use of an AER-authored PTRM and RFM, and so do not contain formal requirements around their publication or amendment.²⁷

²¹ NER, cl. 6A.5.4(a)(4), 6A.5.4(b)(4); NGR r. 76(c).

²² NER, cl. 6A.6.4; NGR, r. 87A.

²³ NER, cl. 6A.5.3(b)(4). There is no equivalent provision in the gas rules.

²⁴ NER, cl. 6A.5.2. There is no equivalent provision in the gas rules.

²⁵ NER, cl. 6A.5.2(b). There is no equivalent provision in the gas rules.

²⁶ NER, cl. 6A.6.1(b)–(d). There is no equivalent provision in the gas rules.

²⁷ In practice almost all gas transmission and distribution pipelines use the electricity versions of these models.

Clause 6.16 of the NER specifies the distribution consultation procedures, which provide that:²⁸

- Before making a decision on a guideline, methodology, model, scheme, test or amendment; the AER must publish a proposed guideline, methodology, model, scheme, test or amendment along with an explanatory statement.
- The explanatory statement must set out the applicable legislative requirements and our reasons for our proposal.
- The AER must invite written submissions on its proposal and allow for no less than 30 business days for the making of submissions.
- Within 80 business days of publishing a proposed guideline, methodology, model, scheme, test, amendment, or invitation for submissions; the AER must make its final decision and reasons. The AER may extend the timeline but only if “the consultation involves issues of unusual complexity or difficulty” or “the extension of time has become necessary because of circumstances beyond the AER’s control”.
- In making its final decision, the AER must have regard to submissions and include a summary of each issue raised and the AER’s response.
- The AER may publish issues, consultation, and discussion papers and may hold conferences and information sessions.

Divisions 3 and 4 of Part 3 of the NEL specify the AER’s information gathering powers and the use of regulatory information notices (RINs) and general regulatory information orders.²⁹

- Clause 28D of the NEL describes how a RIN requires a regulated NSP (or related provider) to provide to the AER the information specified in the RIN, or to prepare, maintain or keep the information specified in the RIN.³⁰
- Clause 28F of the NEL provides for the service and making of regulatory information instruments, including matters the AER must have regard to when considering whether it is reasonably necessary to serve a regulatory information instrument.³¹ Clause 28G provides additional matters to be considered for related provider regulatory information instruments.³²
- Clause 28J of the NEL provides that there must be an opportunity to be heard before a regulatory information notice is served.³³

²⁸ NER, cl. 6A.20.

²⁹ These NEL sections apply to both electricity distribution and transmission. The equivalent gas clauses are in sections 42–63 of the National Gas Law (NGL).

³⁰ NGL, s. 46.

³¹ NGL, s. 48.

³² NGL, s. 49.

³³ NGL, s. 52.