Initial report

Review of regulatory tax approach

June 2018

AUSTRALIAN
ENERGY
REGULATOR

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Request for submissions

The Australian Energy Regulator (AER) invites interested parties to make submissions on this initial report by 26 July 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 Finance and Reporting branch of the AER on (03) 9290 1444.

Shortened forms

Shortened form	Extended form
AEMC	Australian Energy Market Commission
AER	Australian Energy Regulator
APGA	Australian Pipelines and Gas Association
ATO	Australian Tax Office
CESS	capital expenditure sharing scheme
CPI	consumer price index
DNSP	distribution network service provider
EBSS	efficiency benefit sharing scheme
ENA	Energy Networks Australia
energy networks	electricity and gas network service providers
IPA	Infrastructure Partnerships Australia
NEL	national electricity law
NER	national electricity rules
NERL	national energy retail law
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
WACC	weighted average cost of capital

Contents

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 in the National Electricity Law (NEL), National Gas Law (NGL) and the National Energy Retail Law (NERL). These objectives focus on the long term interests of consumers.

This initial report is the second step in a review of our regulatory tax approach, following our release of an issues paper in May 2018. We are undertaking this review to ensure that our approach to estimating the tax allowance in regulatory determinations serves the long term interests of energy consumers. The review was prompted by concerns that there was a material difference between:

- the AER's regulatory forecast of tax costs for regulated electricity networks and gas pipelines (together, energy networks) and

- 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 needed. 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 initial report from all interested stakeholders by 26 July 2018.

1.1 Summary of this report

This initial report builds on the issues paper we released in May 2018. Key developments since the issues paper are highlighted in this summary in boxed text.

We set regulated revenues so that energy networks can recover their efficient costs, including their tax costs. We currently forecast tax costs using a standard tax calculation that has regard to regulatory estimates of taxable revenue, 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 the regulatory forecast of costs retain part of the benefit. This benchmark incentive framework is a foundation of the AER's regulatory approach and promotes the delivery of the national electricity objective (NEO) and national gas objective (NGO). Service providers have an incentive to become more efficient over time, as they retain part of the financial benefit from improved efficiency. Consumers also benefit when efficient costs are revealed and a lower cost benchmark is set in subsequent regulatory periods.

It has been some time since we reviewed our regulatory approach to forecasting tax costs. It is now appropriate to consider whether there are more efficient approaches to taxation that should be reflected in our benchmark approach—approaches that might better reflect the long term interest of consumers.

When we set regulated revenues for the five year period from 2012–17, we forecast $5 billion ($real 2017) in tax costs for the regulated energy networks.

In its note to the AER, the ATO advised us that taxpaying energy networks (listed or privately held) paid less tax than provided for in AER determinations; but state government owned energy networks paid more tax than provided for in AER determinations.[1] Since the ATO note was expressed in general terms, we examined publicly available sources for more detailed data on the actual tax payments by regulated energy networks. The data we examined was scarce and conflicting, though it tended to support the direction of the ATO advice. Our issues paper asked stakeholders if there were any other publicly available sources with relevant tax information that could assist us in our review.

Stakeholder submissions agreed that there was no publicly available data that would allow us to understand in sufficient detail the actual tax practices of the regulated energy networks. Given this, the AER proposes to use its information gathering powers to obtain detailed tax information from the energy networks. This will allow us to better understand whether there is a genuine discrepancy. If there is, the tax information will then allow us to assess the magnitude of the discrepancy, its causes and what might be an appropriate response.

The ATO note identified a number of potential drivers that could be contributing to the discrepancy between forecast tax costs provided for in revenue determinations and actual tax payments.[2] These included drivers that alter the relevant tax rate (ownership structure), interest expense (gearing) and depreciation expense (diminishing value, self-assessed asset lives, low value pools). Stakeholder submissions also proposed a number of other potential drivers for the discrepancy.

We need to better understand these potential drivers and their impact on observed tax payments. Obtaining more detailed tax information through our information gathering powers will allow us to determine which of the potential drivers are material and relevant.

We have identified a range of possible responses to the apparent tax discrepancy. This includes changes to the treatment of tax depreciation in our regulatory models; changes to other aspects of the tax approach that would require a change in the rules (National Electricity Rules, NER; and National Gas Rules, NGR); and changes focused on adjusting tax allowances to reflect actual tax payments by energy networks. Prior to the collection of more data on the tax practices of the networks, it is difficult to determine which (if any) of these changes might be appropriate.

Many stakeholder submissions cautioned us against changing from the current benchmark approach for setting the regulated tax allowance to an approach based on actual tax paid by each energy network (a 'tax pass-through approach'). This would exclude tax costs from the benchmark incentive framework that governs our overall approach to setting regulated revenues. Our current assessment is that we should exercise caution before moving to a tax pass-through approach. Such a move could lead to increased consumer charges across

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1   ATO, *Note to the AER*, 10 April 2018, p. 1.
2   ATO, *Note to the AER*, 10 April 2018, pp. 2–3.

time. It could also create windfall gains or losses at the point of transition, and an incentive to shift tax between unregulated and regulated components of each corporate entity

Actual tax payments by the regulated networks are not readily observed on a disaggregated basis and so it is difficult to determine if the efficient level of tax payments differs from our current benchmark. Using our information gathering powers will allow us to reveal those costs and consider whether we can implement a better benchmark for tax costs that is compatible with the incentive framework.

1.2 Next steps

The current timeline and milestones for this review are shown in Table 1.1. We may be required to alter the timeline and milestones during the review in response to emerging issues.

Table 1.1　Project timeline and milestones

Date	Milestone
28 June 2018	Initial report released
18 July 2018	Public forum on the initial report
26 July 2018	Submissions on initial report close
August 2018	Consultation on draft regulatory information notices (RINs)
September 2018	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) Consult on recommended rule changes
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 our final position is to make changes to our 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 our final position is to propose changes to the rules—the NER and/or NGR—we will recommend changes in the final position and then consult prior to submitting a rule change proposal to the Australian Energy Market Commission (AEMC). The AEMC would undertake further consultation on the proposed rule changes.

The only change to this timeline since the May 2018 issues paper is that we have determined we will need to use our information gathering powers in August–September 2018. We consider the relevant information gathering power will be the issuance of regulatory information notices (RINs). A RIN requires the regulated network service provider (or related provider) to provide to the AER the information specified in the notice.[3] Under the relevant legislation we need to consult with the energy networks on the draft RINs before we issue them.[4] The NEL and NGL require a consultation period of at least 20 business days, and we expect this will occur during August 2018. After considering responses, we will then finalise the RINs and issue them in September 2018.

1.2.1   Scope for submissions

We invite submissions on this initial report from all interested stakeholders by 26 July 2018. Information on how to make a submission is included at the start of this document.

We invite submissions on any part of this initial report. We are particularly interested in stakeholder views on:

- the type of detailed tax information we should seek from energy networks (sections 4.6 and 4.7)

- the list of potential drivers (sections 5.1 and 5.2), including the interaction with timing effects arising from different depreciation profiles (section 2.3)

- the relevance and materiality of potential drivers (sections 5.3 and 5.4)

- the list of potential changes (sections 6.1, 6.2 and 6.3)

- the advantages and disadvantages of a move to a tax pass-through approach (section 6.3.1), including the expert advice from Dr Lally commissioned by the AER and released with this initial report[5]

- the implementation of this review to the April 2019 determinations (section 1.2.2).

There is a summary of the stakeholder submissions we received in response to our issues paper included as an appendix to this report.

1.2.2   Application to April 2019 determinations

The timeline above notes that any required changes to our regulatory models (PTRM/RFM) will be proposed in December 2018 as part of our final position. After consultation on the proposed amended models, final model amendments will be released in April 2019. Our intention is that any changes to regulatory models will apply to the round of network determinations also due for final decision in April 2019. This includes the determinations for

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[3]   The NGR refers to 'scheme pipeline service provider' instead of 'regulated network service provider'. The RIN can also require that the service provider (or related provider) prepare, maintain or keep information. NEL cl. 28D; NGL, cl. 46.

[4]   NEL, cl. 28J; NGL, cl. 52.

[5]   Dr Lally, *Tax payments versus the AER's allowances for regulated businesses*, 16 June 2018. This report is available on the AER website at https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/review-of-regulatory-tax-approach-2018/consultation.

Ausgrid, Endeavour Energy, Essential Energy, Evoenergy, TasNetworks, and NT Power and Water Corporation. The draft decisions for these networks will be released before or around the same time as the release of the draft position (October 2018) for this review, and before the final position (December 2018). This means that any proposed changes to our regulatory models in the final position will be made during the regulatory determination process—shortly after the time some networks submit revised regulatory proposals.[6] Ausgrid and its equity investors submitted in response to our issues paper that Ausgrid would oppose any reforms to be applied to its 2019–24 regulatory period given that the regulatory proposal has already been submitted.[7]

We will undertake thorough consultation with the affected stakeholders, including energy networks on any potential changes to the regulatory models. For the draft decisions, we will use the current PTRM and RFM approaches to modelling the tax allowance, noting the progress of the review and the scope for potential changes. Once the likely direction of the tax review and any model changes are evident we will advise the affected energy networks and engage directly with them on specific implementation issues and possible interactions with other aspects of the determination. We consider that early and extensive consultation on any proposed changes to the regulatory models will ensure that the affected energy networks have the opportunity to comment on the changes.

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[6] TasNetworks, Evoenergy and NT Power and Water are due to submit their revised proposals in November 2018. NSW DNSPs' revised proposals (Ausgrid, Endeavour Energy and Essential Energy) are due to be submitted in January 2019.

[7] Ausgrid, IFM and AustralianSuper (Ausgrid et al.), *Submission – AER review of regulatory tax approach*, 31 May 2018, p. 19.

2 What is the current regulatory tax approach?

We set regulated revenues so that energy networks can recover their efficient costs, including their tax costs. We currently forecast tax costs using a standard tax calculation that has regard to regulatory estimates of taxable revenue, 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 the regulatory forecast of costs retain part of the benefit. This benchmark incentive framework is a foundation of the AER's regulatory approach and promotes the delivery of the national electricity objective (NEO) and national gas objective (NGO). Service providers have an incentive to become more efficient over time, as they retain part of the financial benefit from improved efficiency. Consumers also benefit when efficient costs are revealed and a lower cost benchmark is set in subsequent regulatory periods.

It has been some time since we reviewed our regulatory approach to forecasting tax costs. It is now appropriate to consider whether there are more efficient approaches to taxation that should be reflected in our benchmark approach—approaches that might better reflect the long term interest of consumers.

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):[8]

- 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 (opex, 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 an NSP to run an efficient business and ensure consumers pay no more than they need to for safe and reliable service. Once regulated revenue is set for this period, the NSP has an incentive to provide services at the lowest possible cost because its returns are determined by its actual costs of providing services. If an NSP reduces its costs to below the regulatory estimate of efficient costs, the

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[8] There is also a fifth building block for 'revenue adjustments', which reflects revenue increments or decrements arising from the operation of incentive schemes and other adjustments.

savings are shared with consumers in future regulatory periods. This benchmark incentive framework is embedded in the building block allowances specified under the NER and NGR.

We form a view as to the benchmark costs that an efficient network operator would incur in providing regulated service on a standalone basis when calculating these allowances.[9] The building block assessment also reflects the change in productivity of inputs such as capital and operating expenditures. These benchmark costs include the capital expenditure and operating expenditure as well as an estimate of the costs of capital input parameters.

Our incentive based form of regulation locks in the forecast capital expenditure and operating expenditure a business will require to meet its predefined service and reliability targets at the start of each regulatory period. A business also is allowed to recover capital costs, including the return on capital and return of capital, to compensate investors for their opportunity cost of funds while returning the initial investment in the regulated assets through depreciation. An estimated cost of corporate tax is then calculated using these inputs based on underlying assumptions (discussed in the next section), including assumptions on how the ATO will assess the tax liability for the business.

The observation of actual costs is important to the current benchmark incentive framework. Service providers have an incentive to become more efficient over time, as they retain part of the benefit where actual costs are below the regulatory forecast of costs. Consumers also benefit when the reduced efficient costs are revealed and a lower cost benchmark is set in subsequent regulatory periods. For capex and opex, we can observe expenditure outcomes and allow these to inform subsequent regulatory forecasts. This is not the case for tax costs, which are not readily observed. This means the benchmark tax calculation should be updated from time to time so that it reflects any change in the efficient level of tax costs.

Further, we operate incentive schemes for both capex (the capital expenditure sharing scheme or CESS) and opex (the efficiency benefit sharing scheme or EBSS) that determine what portion of the efficiency gain is retained by the business. There is no such scheme relating to tax. The Consumer Challenge Panel (CCP 22) submitted:[10]

> We are not opposed to networks seeking out ways of lowering their tax below the efficient level provided consumers can share in the benefits of this, just as we are not opposed to networks seeking to reduce their capex and opex to below their allowed levels to benefit from CESS and EBSS. The efficient level of capex and opex are continually assessed. Likewise, the efficient tax level should also be continually assessed and adjusted if networks find new ways to reduce their tax burden.

2.2 Estimated cost of corporate income tax

Figure 2.1 on the following page provides an overview of the AER's regulatory tax approach.

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9   'Standalone' refers to the assessment of efficient costs for the NSP as if it were operated as a separate entity, rather than as a group operating multiple regulated networks and/or unregulated business activities.

10   Consumer Challenge Panel (sub-panel 22) (CCP 22), *Submission to the AER on review or regulatory tax approach issues paper*, 31 May 2018, p. 3 (see also pp. 8–9).

Figure 2.1   Diagram showing the key steps in the AER's regulatory tax approach
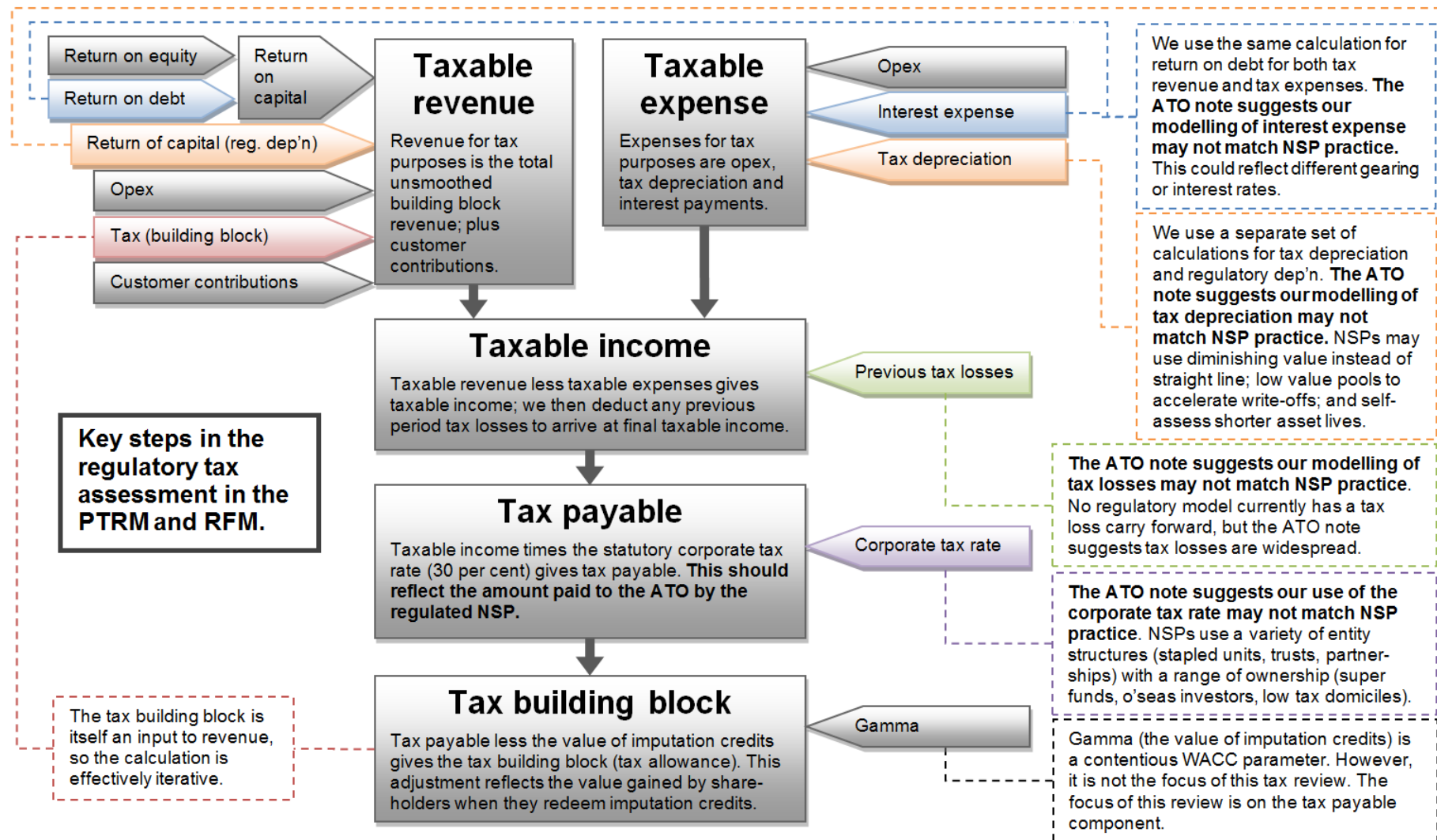
An NSP's taxable income is its taxable revenue less its tax expenses. Taxable revenue is dependent on all the building block components, which in turn are based on forecast costs. The corporate income tax building block is one of these components, and feeds directly into the annual revenue requirement used to form taxable revenue.

The building block components are also used to derive tax expenses. Tax expenses represent deductions used to offset taxable revenue and will reduce taxable income. Some building block components give rise to tax expenses, but others do not (particularly the return on equity component of the return on capital). A change in any factor that affects our determination of forecast revenue will affect our forecast of taxable revenue in that year. The net effect on taxable income will depend on whether the change in that factor has an equal effect on our forecast of tax expenses.

Rule requirements

Our approach to estimating the cost of corporate income tax is governed by the rules applying to the electricity and gas markets. The NER and NGR specify:[11]

> The estimated cost of corporate income tax of a network service provider for each regulatory year (ETC_t) must be estimated in accordance with the 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 regulated services[12] if such an entity, rather than the network service provider, operated the business of the network service provider, such estimate being determined in accordance with the post-tax revenue model.[13]

> r_t is the expected statutory income tax rate for the regulatory year as determined by the AER.[14]

> γ is the value of imputation credits.

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 an NSP's assets.[15] This is the total building block revenue explained above.[16]

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[11]   The NER contains separate chapters for the economic regulation of distribution and transmission services. Clauses 6.5.3 and 6A.6.4 of the NER define the estimated cost of corporate income tax for distribution and transmission services, respectively. Clause 87A of the NGR is the equivalent clause for gas transmission and distribution pipelines services.

[12]   The regulated services are standard control services (electricity distribution, NER cl. 6.5.3), prescribed services (electricity transmission, NER cl. 6A.6.4) and reference services (gas distribution and transmission, NGR cl. 87A).

[13]   The NER/NGR estimate of corporate tax allowance reflects the benchmark assumptions applied to the forecast of approved efficient costs, such as the level of interest expense which is calculated using the benchmark gearing assumption of 60 per cent and the cost of debt. While the NER prescribe the use of the AER's PTRM, the NGR do not.

[14]   The PTRM applies the legislated corporate tax rate in determining the tax payable before deducting the value of imputation credits. The current corporate tax rate is 30 percent.

[15]   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.

[16]   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,

We then estimate tax expenses—interest, depreciation (for tax purposes) and operating expenditure. All tax expenses are offset against the NSP's forecast revenue to estimate the taxable income. We apply the Australian statutory corporate income tax rate of 30 per cent to the estimated taxable income to arrive at an estimated amount of tax payable. From this amount, we then deduct the expected value of imputation credits (gamma). The final output is the tax building block—our assessment of the tax allowance for the business—which is added to the total revenue to be recovered by the service provider.

The corporate income tax allowance is an output of the AER's PTRM.[17] 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[18]

- the value of imputation credits (gamma).[19]

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

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

- Operating expense is set to equal the 'opex' building block.

- 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.

- Tax depreciation expense is a function of the TAB, tax asset lives and the tax depreciation method applied in the regulatory determination. The TAB reflects the value of initial capex (with no adjustment for inflation) less previously recorded tax depreciation. The tax asset lives are usually the standard tax asset lives prescribed by the Commissioner for Taxation. We currently depreciate tax assets using a straight-line approach which spreads the depreciation evenly (in nominal terms) over the life of the asset.

Tax depreciation expense is the most complicated of these three expenses:

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this means that the calculation is iterative.

[17] NER, cl. 6.4.2(b)(4) and cl. 6A.5.3(b)(4). The NGR does not prescribe the use of the AER's PTRM to determine an NSP's annual revenue, but in practice it is used by almost all gas transmission and distribution pipelines.

[18] As per cl. 6.5.3, we apply the statutory corporate income tax rate specified in tax legislation. If the statutory corporate tax rate were to be amended we would apply the amended rate in the PTRM.

[19] 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.

- The tax depreciation expense (and so asset values in the TAB) differs from the regulatory depreciation expense (and so asset values in the RAB). We apply the straight-line approach to depreciate both the TAB and the RAB. However, in the RAB we adjust for inflation (real straight line depreciation) so that the depreciation is spread evenly in real terms over the life of the asset. Each year we index the RAB for inflation to ensure the real value of the initial capex is returned to investors over the life of the asset. In contrast, the TAB is not adjusted by inflation to maintain its real value and reflects the nominal value of the original investment that is, in the dollar value of the day. Therefore, the value of the TAB and the benefit from tax depreciation expense is reduced by inflation over the tax standard life.

- Further, tax asset lives (used with the TAB to calculate tax depreciation) can differ from regulatory asset lives (used with the RAB to calculate regulatory depreciation, usually reflecting the economic life of the asset). Our current approach is to assess the tax asset lives by comparing them against previously approved values, similar asset classes for other NSPs and those prescribed by the Commissioner for Taxation in the latest available tax ruling.[20] Generally, tax standard asset lives are lower than those applied to calculate depreciation on the RAB (see section 2.3).

- The tax depreciation expense in the AER's regulatory determination need not align with the depreciation expense reported by the NSP to the ATO. This reflects the operation of the benchmark incentive approach—the NSP is free to adopt an alternative tax depreciation approach (so long as it complies with the relevant tax law) when preparing its tax assessment for the ATO. The NSP retains the benefit or detriment (relative to the AER's benchmark) that arises. For example, an NSP may adopt different depreciation approaches for tax purposes including diminishing value or accelerated depreciation. These alternative approaches available to the NSP provide for a higher level of tax depreciation earlier in the asset's life relative to straight-line depreciation.

These last three points were the subject of several submissions we received in response to our issues paper. These submissions stated that differing rates of tax depreciation—from the adoption of shorter tax asset lives, use of diminishing value, accelerated depreciation, and/or deferred depreciation—give rise to 'timing differences' in calculation of the cost of tax.[21] In particular:

- Jemena submitted that depreciation drivers resulting in different depreciation rates only 'result in timing differences to tax payable, not the amount of tax payable'.[22] It submitted that this was because both depreciation rates provide for the same total depreciation. Jemena added:

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[20] Australian Taxation Office, *Taxation Ruling (TR 2016/1) Income Tax: effective life of depreciating assets (applicable from 1 July 2016)*.

[21] Ausgrid et al., *Submission – AER review of regulatory tax approach*, 31 May 2018, p. 13; Ergon Energy Corporation Limited and Energex Limited (Ergon Energy and Energex), *Letter to AER - Review of Regulatory Tax Approach*, 1 June 2018, p. 2 (LATE SUBMISSION); APA, *APA response to issues paper - AER review of regulatory tax approach*, 4 June 2018, pp. 13–14 (LATE SUBMISSION); Infrastructure Partnerships Australia (IPA), *Submission to the AER on the Review of the Regulatory Tax Approach*, 5 June 2018, p. 5 (LATE SUBMISSION).

[22] Jemena, *Response to Issues Paper - Review of Regulatory Tax Approach*, 31 May 2018, pp. 5.

It seems unnecessary to make a change based on timing differences that do not affect the aggregate regulatory tax allowance associated with an asset.[23]

- AusNet Services submitted that in its electricity distribution business the diminishing value method is used predominantly and contributes to some of the differences between benchmark costs of tax and actual tax. Whereas, its gas distribution and electricity transmission businesses predominantly use the straight-line method of depreciation.[24]

- Energy Networks Australia (ENA) submitted that 'The first point to note in relation to the speed of depreciation is that it is NPV-neutral.'[25] That is, ENA submitted that accelerating or delaying tax depreciation shifts the tax expense through time in an NPV neutral way. The ENA submission noted, however, that this may still have intertemporal effects on prices paid by current vs future customers. ENA also stated:

    If it is apparent that regulated asset owners are using methods to accelerate depreciation for tax purposes, that effect can be accommodated within the current incentive-based framework and PTRM. Such evidence would indicate that the efficient benchmark is one that involves accelerated depreciation and the regulatory allowance would then reflect that efficient benchmark.[26]

2.3 Timing effects under the current approach

This section clarifies the mechanism behind two related depreciation 'timing effects' that were referenced in stakeholder submissions described above.[27]

Firstly, the current regulatory approach separately tracks the value of an asset for regulatory purposes (in the RAB) and tax purposes (in the TAB). Even where we assume that the regulatory asset life equals the tax asset life, the two asset values will not be the same except at the very start (the initial purchase price) and end of an asset's life (zero dollars). In this context, a 'timing effect' arises because tax depreciation is faster than regulatory depreciation, and this produces predictable changes in the size of the tax building block. All else being equal, the tax building block will be reduced in the earlier part of the asset's life (when tax depreciation is greater than regulatory depreciation), but increased towards the end of the asset's life.

Secondly, the NSP's tax depreciation approach can lead to faster (earlier) depreciation than the benchmark tax depreciation forecast by the AER. For example, the net present value (NPV) of tax depreciation for an asset with a shorter tax asset life will be greater than that with a longer tax asset life. This is despite the total nominal tax depreciation remaining unchanged over the life of the asset. In this context, the 'timing effect' arises because tax

23 Jemena, *Response to Issues Paper - Review of Regulatory Tax Approach*, 31 May 2018, pp. 5–6.
24 AusNet Services, *Letter to AER Review of Regulatory Tax Approach – Issues Paper*, 31 May 2018, pp. 2–3.
25 Energy Networks Australia (ENA), *Response to AER Issues Paper*, 31 May 2018, p. 23.
26 ENA, *Response to AER Issues Paper*, 31 May 2018, pp. 23–24.
27 Ausgrid et al., *Submission – AER review of regulatory tax approach*, 31 May 2018, p. 13; Jemena, *Response to Issues Paper - Review of Regulatory Tax Approach*, 31 May 2018, p. 5; ENA, *Response to AER Issues Paper*, 31 May 2018, p. 23; Ergon Energy and Energex, *Letter to AER - Review of Regulatory Tax Approach*, 1 June 2018, p. 2 (LATE SUBMISSION); APA, *APA response to issues paper - AER review of regulatory tax approach*, 4 June 2018, pp. 13–14 (LATE SUBMISSION); IPA, *Submission to the AER on the Review of the Regulatory Tax Approach*, 5 June 2018, p. 5 (LATE SUBMISSION).

depreciation is not adjusted for inflation or the time value of money (that is, the real weighted average cost of capital or WACC). Faster or earlier tax depreciation will mean the regulated network receives more in NPV terms (that is, after accounting for inflation and the cost of capital). This provides an incentive to depreciate assets faster in order to maximise tax benefits from depreciation.

One way to illustrate both these effects is to consider the effective tax rate—the ratio of pre-tax cash flows to post-tax cash flows. The first timing effect (where tax depreciation occurs faster or earlier than regulatory depreciation) causes the effective tax rate to be below the statutory corporate tax rate in the early years of the asset's life, and above the statutory tax rate in later years. The second timing effect (where NSP tax depreciation occurs faster or earlier than the regulatory forecast of tax depreciation) causes the effective tax rate to be lower overall.

Real vs nominal depreciation

The first 'timing effect' arises because tax depreciation is faster than regulatory depreciation, and this produces predictable changes in the size of the tax building block. The ATO assesses expenditure on assets on an historical cost basis. This requires the explicit modelling of the corporate tax allowance to recognise the TAB in nominal terms, while the NER requires the RAB depreciation schedules to equal the value at which that asset was first included in the RAB in real terms.[28] This means that the value of the TAB—and therefore tax depreciation—is reduced by inflation over the life of the asset.

We can illustrate these effects by way of example. Consider an investment in a regulated asset of $1000 and asset lives of 30 years for both RAB and TAB. Inflation is assumed to be 2.5 per cent per annum and a nominal vanilla WACC of 7.0 per cent. Figure 2.2 demonstrates how the TAB depreciates relative to the RAB.

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[28]   NER, cl. 6.5.5(b)(2).

Figure 2.2 Regulatory asset base and tax asset base straight-line depreciation profiles ($, nominal)
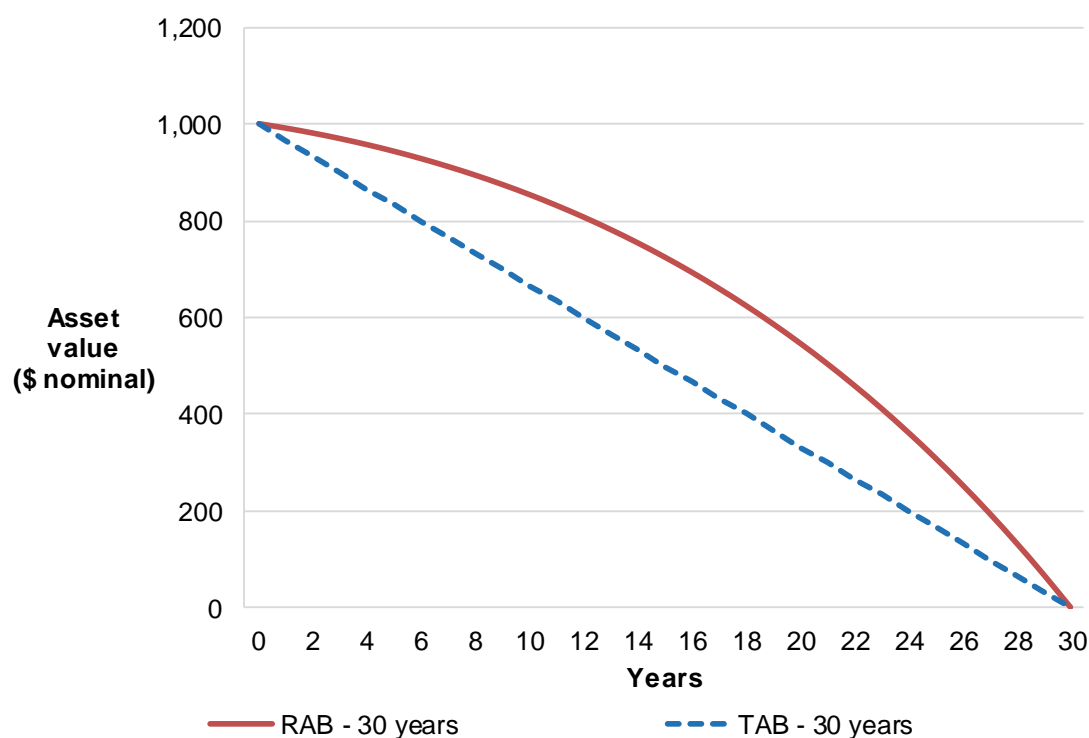
Source: AER analysis.

This shows that the value of the TAB is consistently lower than that of RAB. This is because the original value for tax purposes is not adjusted for inflation—consistent with tax rules— whereas the RAB value is adjusted for inflation in each year—consistent with the NER. The inflation effect leads to a TAB value below the RAB value across the life of the asset.

Further, under our current tax approach, most assets have tax asset lives that are shorter than the regulatory asset lives. This will accentuate the difference between TAB and RAB. Alternative tax depreciation approaches (such as using the diminishing value approach instead of straight-line) could also increase the rate at which the TAB depreciates and so increase the gap between RAB and TAB.

Net present value differences from tax depreciation

Extending the previous example to include shorter tax asset lives of 10 and 20 years, the NPV of tax depreciation expenses is shown in Table 2.1.

Table 2.1 The effect of inflation on tax depreciation under different asset life assumptions

Tax asset life	10	20	30
Net present value of tax depreciation[a]	702	530	414
Original investment cost	1000	1000	1000
Difference	−298	−470	−586

Source: AER analysis.

(a) Using a discount rate of 7.00 per cent.

Table 2.1 shows that this NPV difference is reduced with a shorter tax asset life, providing an incentive to front load tax depreciation expenses by reducing tax lives. In contrast, the NPV differential does not exist for the RAB depreciation, as the sum of the present value of the return of capital (depreciation) and the present value of the return on capital is always equal to the original investment, regardless of the life of an asset. A shorter (longer) asset life will increase (decrease) the PV of the return of capital (depreciation) building block, but this is offset by a lower (higher) PV of the return on capital building block.[29]

However, applying shorter tax asset lives relative to RAB lives means that assets will cease to provide tax depreciation expenses while the RAB value continues to provide revenue in the form of return on capital and regulatory depreciation. The reduction in tax expense creates a step up in taxable income and therefore tax allowance once the assets reach the end of their effective tax lives.[30]

Impact on effective tax rate

We can illustrate this effect through differences in the effective tax rate. The effective tax rate in each year is calculated as the percentage difference in ratio of pre-tax cash flows to post-tax cash flows. Figure 2.3 shows the effective tax rate for two scenarios, with tax asset lives of 20 and 30 years. In both cases the regulatory asset life is 30 years.

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29 NER, cl. 6.5.5(b)(2).

30 All else being equal, higher tax expense reduce the taxable income and therefore total tax payable.

Figure 2.3   The effect of tax asset life (years) assumptions on effective tax rate (per cent)
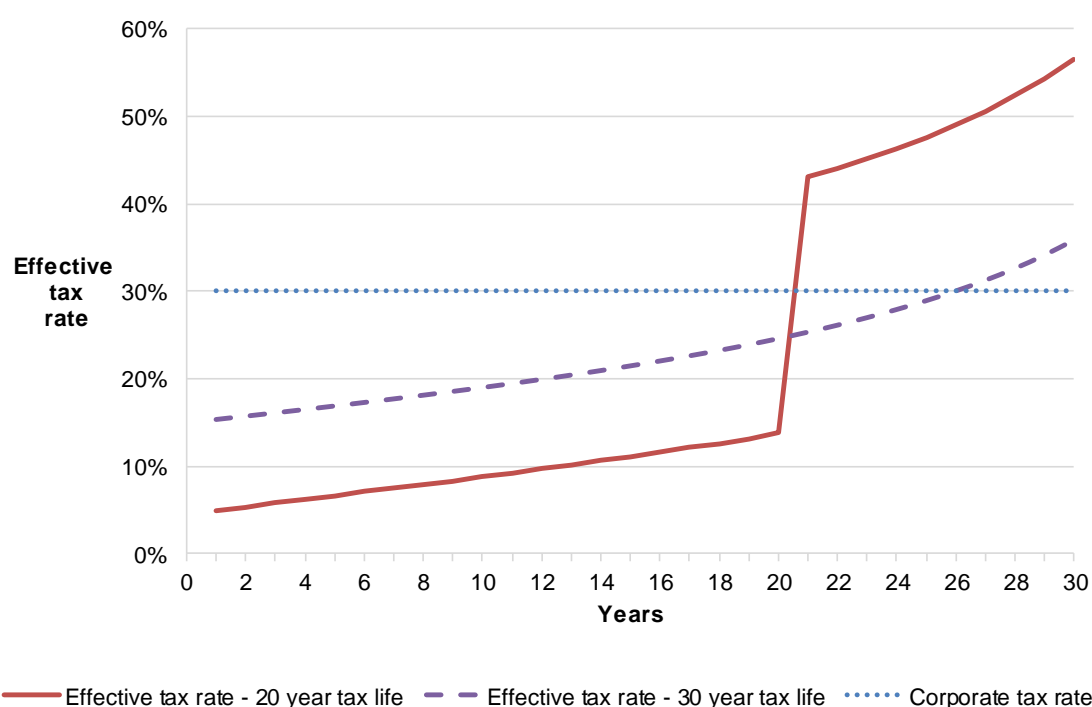
Source: AER analysis.

Regulatory depreciation (in the RAB) occurs on a real straight line basis over 30 years, so investors receive their return of capital spread evenly over that period. Tax depreciation is on a nominal straight-line basis; the two scenarios determine whether tax depreciation expense is recorded over 20 years or 30 years. Under the 20 year tax asset life assumption (red line) the asset is depreciated faster (earlier) for tax purposes, increasing tax depreciation expense that can be claimed relative to the 30 year life. This in turn reduces the tax payable in those years and therefore the effective tax rate relative to the statutory corporate tax rate. However, this benefit ceases to be available after 20 years while the firm continues to earn revenues on the RAB for another 10 years. The effective tax rate to equity holders then increases above the statutory rate as taxable income increases.

By comparison setting the tax asset life equal to the regulatory economic life (at 30 years – dashed purple line) the effective tax rate is higher prior to year 20, though still below the statutory tax rate. The delay in claiming tax benefits is partially offset by tax benefits from depreciation expense over the remainder of the asset life.

3 How much was provided for tax costs?

When we set regulated revenues for the five year period from 2012–17, we provided for $5 billion ($real 2017) in tax costs for the regulated energy networks.

Tax payments by some of 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 building block tax allowance, the PTRM takes the estimate of total tax costs and removes the forecast value of imputation credits.

3.1 Forecast tax costs

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 total tax costs for the business within the PTRM.[31] This is shown in Table 3.1. All figures relate to regulated activities only.

Table 3.1   AER forecast of tax costs across 2012–17, regulated activities ($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 forecast tax costs have 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).[32] 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

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31   The tax payable (regulatory forecast of tax costs) calculation is on the 'Analysis' tab, row 57.
32   The AER forecast of total tax costs for 2017–18 is $869.4 million.

networks comprise the bulk of the forecast tax costs, reflecting the relative size of revenue determinations for these networks.

These tax costs are the appropriate starting point for comparisons against actual tax payments to the ATO. Both reflect the payment of tax at the corporate level before any consideration of imputation credits.

3.2 Regulatory tax allowance

Although each AER determination includes an estimate of tax costs for 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 PTRM takes the forecast of tax costs and removes the value of imputation credits to calculate the tax allowance (or tax building block). This is shown in Table 3.2. All figures relate to regulated activities only.

Table 3.2   AER tax allowances across 2012–17, regulated activities ($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 forecast tax costs in Table 3.1.[33]

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.

Caution should be exercised before comparing these tax allowances against figures for actual corporate tax payments to the ATO, as the two figures are expressed on a different basis. Actual tax payments to the ATO will be expressed before any adjustment for

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

imputation credits. This pre-imputation credit basis aligns with the forecast of tax costs (Table 3.1) but not the tax allowance (Table 3.2), which is after a deduction to reflect the value of imputation credits.

Imputation credits effectively transform some part of company tax into a pre-payment of personal taxes for eligible shareholders. In other words, the equity investors in a business receive their required return partly via dividends/capital gains, and partly through the receipt of imputation credits that reduce their personal taxes (or are directly rebated if no taxes are owed). The building block tax allowance set by the AER is lower than the forecast of total tax costs for the network; but this does not imply that businesses are under compensated. The payment of company taxes generates imputation credits that flow through the tax system to equity investors so that they receive the correct return.[34] The building block tax allowance therefore reflects the remaining corporate tax that is not an effective pre-payment of personal taxes.

3.3 Tax costs and tax allowances by ownership

We can also reclassify the data on forecast tax costs 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.[35] This data is presented in Table 3.3 (estimated tax payable) and Table 3.4 (tax allowances).

Table 3.3   AER forecast of tax costs across 2012–17, by ownership, regulated activities ($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 listed, privately held or overseas owned (including overseas government owned).

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

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[34]   In other words, the regulatory framework is on a post-company pre-personal tax basis, so the tax allowance needs to net out the proportion of company tax which is used by investors as a pre-payment of personal tax via the redemption of imputation credits.

[35]   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 partially (about 51%) privatised during 2016–17; we have classified them as state government owned for all years in these tables. Evoenergy, previously known as ActewAGL (ACT Electricity and Gas DNSP), has 50% share of state government and private ownership; we have split its tax data accordingly.

Table 3.4   AER tax allowances across 2012–17, by ownership, regulated activities ($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 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 forecast tax costs and tax allowances during the period specified.[36]

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

4 How much tax was actually paid?

In its note to the AER, the ATO advised us that taxpaying energy networks (listed or privately held) paid less tax than provided for in AER determinations; but state government owned energy networks paid more tax than provided for in AER determinations.[37] Since the ATO note was expressed in general terms, we examined publicly available sources for more detailed data on the actual tax payments by regulated energy networks. The data we examined was scarce and conflicting, though it tended to support the direction of the ATO advice. Our issues paper asked stakeholders if there were any other publicly available sources with relevant tax information that could assist us in our review.

Stakeholder submissions agreed that there was no publicly available data that would allow us to understand in sufficient detail the actual tax practices of the regulated energy networks.

Given this, the AER proposes to use its information gathering powers to obtain detailed tax information from the energy networks. This will allow us to better understand whether there is a genuine discrepancy. If there is, the tax information will then allow us to assess the magnitude of the discrepancy, its causes and what might be an appropriate response.

4.1 ATO note

The ATO reviewed the actual tax paid by electricity distribution businesses over the four year period from 2013–16.[38] This included 'taxpaying entities'—networks listed on the sharemarket 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:[39]

> 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. In these statements the ATO references to 'AER tax allowance' refer to the AER's provision for total tax costs for the relevant energy networks, rather than the tax building block set by the AER (which is smaller, as explained in section 3.2). In this initial report, we reserve the term 'tax allowance' for this latter concept.

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

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

38 The ATO note is available on our website at https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/review-of-regulatory-tax-approach-2018.

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

(excluding electricity transmission and gas businesses) these comprise the majority of forecast tax costs for all regulated networks (see Table 3.1).

However, the ATO's published findings were largely qualitative in nature and did not include specific figures. The ATO noted that it had to make assumptions and exclusions in undertaking its analysis, and was restricted in the nature of the information it could provide to preserve confidentiality for taxpayers.

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.[40] The reports provide tax payable data on Australian public and foreign-owned corporate tax 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.[41] From the reports, we identified entities who wholly or partially owned one or more of the regulated energy networks.[42] 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 for privately owned entities involved in regulated energy networks, inclusive of regulated and unregulated activities ($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 do not have access to information that would allow us to disaggregate into sectors where businesses have an interest in multiple networks. The ATO note stated that this information on the split between regulated and unregulated activities is not available to the ATO.[43] In addition, the tax transparency report does not include NTER payments, so no state government owned networks were included in this data.

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40   Available at https://data.gov.au/dataset/corporate-transparency.
41   Data for 2016–17 is expected to be made available in January 2019.
42   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.
43   ATO, *Note to the AER*, 10 April 2018, p. 1.

4.3 Tax payments based on cash flow statements

The ATO note does not provide sufficient disaggregated information that would allow us to gain further insight into the actual tax payments of individual regulated networks. This limitation is also noted by a numbers of stakeholders.[44] ENA stated:

> However, the ATO note provides only very high-level analysis which is subject to material limitations. It is certainly not evidence that the regulatory tax allowance no longer represents a benchmark efficient tax allowance. Before any change is made in this regard, the AER would require proper evidence about the practice of firms and would have conduct a consultation process in which all stakeholders could fully evaluate that evidence.[45]

We have 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 state government owned 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. The figures include any unregulated activities undertaken by the state government owned NSPs. However, in general, unregulated activities will only represent a small proportion of total entity revenue as most state government owned NSPs are structured around the provision of regulated services.

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44   Jemena, *Response to Issues Paper - Review of Regulatory Tax Approach*, 31 May 2018, p. 3; ENA, *Response to AER Issues Paper*, 31 May 2018, p. 6.; and Ausgrid et al., *Submission – AER review of regulatory tax approach*, 31 May 2018, pp. 3–4; J. Doueihi, *Submission to AER issues paper – Review of regulatory tax approach*, 31 May 2018, pp. 3–5.

45   ENA, *Response to AER Issues Paper*, 31 May 2018, p. 24 (see also p. 6).

Table 4.2   Reported tax payment data from cash flow statements for state government owned NSPs across 2012–17, inclusive of regulated and unregulated activities ($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.

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

The figures in Table 4.2 will include any unregulated activities undertaken by the state government owned NSPs. However, in general, unregulated activities will only represent a small proportion of total entity revenue as most state government owned NSPs are structured around the provision of regulated services.

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 of these networks. The apparent decline in total tax payments in 2015–16 and 2016–17 should be treated with caution given the reduced coverage.[46] 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 share market listed companies, trusts and overseas firms (including overseas government owned). We looked to annual reports and financial statements from these entities that reported this data.

The data we obtained related to entities that owned multiple regulated networks (multi-network entities). Publicly available annual reports and financial statement for 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 flow statements) for privately owned NSPs.

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46   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, inclusive of regulated and unregulated activities ($millions, 2017)

Sector	2012–13	2013–14	2014–15	2015–16	2016–17
Multi-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 2012–15, Financial Report; 2015–17, 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.[47] 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—in some cases this may be a substantial portion of the entities' revenue.

4.4 Tax payments based on income tax expense

Building on the previous section, we also considered income tax expense reported in the annual reports and financial statements we obtained. This reflects the accounting measure for income tax incurred by the corporate entity that year, but may not reflect an actual cash payment to the ATO.[48]

This distinct 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 corporate entities of the 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, inclusive of regulated and unregulated activities ($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 2012–15, Financial Report; 2015–17, 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.

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[47]   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.

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

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

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 detailed information is useful for identifying the drivers of any difference between actual tax payments and the AER's provision for tax costs.

Stakeholder submissions received in response to the issue paper agreed that there was no publicly available data that would allow us to understand in sufficient detail the actual tax practices of the regulated energy networks.[49] For example, Jemena stated:[50]

> Jemena is not aware of publicly available sources of data additional to those identified in the issues paper, or that would provide accurate, comparable data as companies do not arrange tax matters on the basis of regulation or their regulated businesses.

4.6 Information needed for our review

We consider that data on the actual tax payments by energy networks is relevant information when assessing our approach to calculating the efficient tax costs for the benchmark efficient entity. This tax information—including detailed information on the basis of preparation for the tax assessment submitted to the ATO—is necessary for our review to identify key drivers of the apparent discrepancy between actual tax payments and the

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[49] Jemena Limited, *Response to Issues Paper - Review of Regulatory Tax Approach*, 31 May 2018, p. 4; Ausgrid et al., *Submission – AER review of regulatory tax approach*, 31 May 2018, p. 15; ENA, *Review of regulatory tax approach, Response to AER Issues Paper*, 31 May 2018, p. 29; Australian Pipelines and Gas Association (APGA), *Submission to the AER Issues Paper*, 31 May 2018, p. 2; CCP 22, *Submission to the AER on Review of regulatory tax approach Issues paper*, 31 May 2018, p. 6; J. Doueihi, *Submission to AER issues paper – Review of regulatory tax approach*, 31 May 2018, pp. 3–5; Network Shareholders Group (NSG), *Submission to the AER on Review of regulatory tax approach*, 1 June 2018, p. 4 (LATE SUBMISSION)

[50] Jemena Limited, *Response to Issues Paper - Review of Regulatory Tax Approach*, 31 May 2018, p. 4.

current provision for tax costs. We consider that this information should be collected across the sector so that the aggregate pattern of current tax practice can be used to inform the benchmark.

Stakeholder submissions were split on this issue. CCP 22 and Business SA submitted that the AER should collect the relevant actual tax payment information from the NSPs.[51] The CCP 22 stated:[52]

> [W]e believe that the best way to obtain this information is by the AER exercising its information gathering powers through the issuance of a Regulatory Information Notice (RIN) to each network

However, Energy Networks Australia (ENA) questioned what might be interpreted from data on actual tax paid, and submitted that any data relating to costs beyond the benchmark is irrelevant.[53]

> ENA considers that the issues are largely conceptual in nature, as set out in this submission. ENA submits that the only data that is relevant is data that would inform the issue of the corporate tax that would be paid by the benchmark efficient entity.

The Major Energy Users Inc (MEU) submission noted that the benchmark efficient entity would manage tax affairs differently to individual firms. Therefore, it submitted that the data sourced from the NSPs have little to do with the assessment of the benchmark tax payable.[54]

We do not agree with this aspect of the ENA and MEU submissions. We consider that data on actual tax payments of the regulated networks—collected across the sector, not just for any one firm in isolation—is relevant to our forecast of the tax costs for the benchmark efficient entity. Obtaining more detailed information on the actual tax practices of regulated networks will help us assess whether the current regulatory approach to forecasting tax costs reflects efficient practices. Under the benchmark incentive framework we operate, regulated businesses have an incentive to pursue the lowest cost means of providing the regulated services. If the regulated businesses are employing a more efficient approach to taxation than the benchmark determined under the current framework, then this should inform the benchmark set in future determinations.

Given the limitations highlighted in section 4.5 on the actual tax payment information we obtained from annual reports and financial reports, we asked for stakeholder submissions on the availability of an alternative source of this data. The responses we received indicated that there was no other source of relevant publicly available information on the actual tax paid by the regulated networks other than those already identified in our issues paper.[55]

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51 CCP 22, *Submission to the AER on Review of regulatory tax approach Issues paper*, 31 May 2018, p. 6; Business SA, *Submission - Review of Regulatory Tax Approach Issues Paper*, 31 May 2018, p. 2.

52 CCP 22, *Submission to the AER on Review of regulatory tax approach Issues paper*, 31 May 2018, p. 6.

53 ENA, *Review of regulatory tax approach, Response to AER Issues Paper*, 31 May 2018, p. 29

54 Major Energy Users Inc (MEU), *Response to Issues Paper - Review of Regulatory Tax Approach*, 29 May 2018, p. 5

55 Jemena Limited, *Response to Issues Paper - Review of Regulatory Tax Approach*, 31 May 2018, p. 4; Ausgrid et al., *Submission – AER review of regulatory tax approach*, 31 May 2018, p. 15; ENA, *Review of regulatory tax approach, Response to AER Issues Paper*, 31 May 2018, p. 29; APGA, *Submission to the AER Issues Paper*, 31 May 2018, p. 2; CCP 22, *Submission to the AER on Review of regulatory tax approach Issues paper*, 31 May 2018, p. 6; J. Doueihi,

4.7 Use of information gathering powers

The AER has information gathering powers under the NEL and NGL to request information relevant to setting our revenue determinations.[56] We have attempted to gather the relevant tax information from publicly available sources, noting that if we could do so there would be no need to use formal information gathering powers.[57] However, stakeholders' submissions and our own research have confirmed that there is no other source of relevant publicly available information on the actual tax paid by the regulated entities.

Some service providers have indicated a willingness to provide what data they can without the need for us to resort to using our formal information gathering powers. For example, AusNet Services has voluntarily provided data on actual tax paid over the 2013–17 period.[58] However, submissions from other NSPs indicate that they will not do so.[59] Consideration of tax information for a limited subset of firms would make it difficult to establish a benchmark for efficient tax practices across the sector.

Submissions from the NSPs and their investors highlighted concerns that the information—even if collected through our information gathering powers—might not be available and would be costly to produce. The available data might be limited to the consolidated level, making it difficult to allocate to the regulated activities of the entity. In particular, EnergyAustralia, Jemena, Ausgrid, the Australian Pipelines and Gas Association (APGA) and APA Group submitted that actual tax payment information might not be available for some networks as their tax reporting entity did not align with the regulated component of their business.[60] APA stated:[61]

> APA lodges its tax returns as a consolidated group. As discussed further in this submission, the amount of tax payable attributable to a particular business within the APA Group would be infected by the arbitrary allocation of debt interest expense.

Jemena, Ausgrid, APGA and APA Group submitted that even if the AER was to request an estimate of tax payments attributable only to the regulated business, this information would have to be provided at a consolidated level and any attempt to allocate to particular assets would be arbitrary and therefore not useful for comparison purposes.[62] The APGA stated:[63]

Submission to AER issues paper – Review of regulatory tax approach, 31 May 2018, pp. 3–5; NSG, *Submission to the AER on Review of regulatory tax approach*, 1 June 2018, p. 4 (LATE SUBMISSION).

[56] NEL, section 28; NGL, section 42.

[57] We have regard to the likely costs that may be incurred by an NSP in complying with an information request.

[58] AusNet, *Response to Issues Paper - Review of Regulatory Tax Approach*, 31 May 2018, p. 1, NSG, *Submission to the AER on Review of regulatory tax approach*, 1 June 2018, p. 3 (LATE SUBMISSION).

[59] Ausgrid et al., *Submission – AER review of regulatory tax approach*, 31 May 2018, p. 9, 15; APA Group, *APA response to issues paper - AER review of regulatory tax approach*, 4 June 2018, pp. 2–3 (LATE SUBMISSION).

[60] EnergyAustralia, *Review of regulatory tax approach*, 28 May 2018; Jemena Limited, *Response to Issues Paper - Review of Regulatory Tax Approach*, 31 May 2018, p. 4; Ausgrid et al., *Submission – AER review of regulatory tax approach*, 31 May 2018, pp. 5, 9, 17; Australian Pipelines and Gas Association (APGA), *Submission to the AER Issues Paper*, 31 May 2018, pp. 2–3; APA Group, *APA response to issues paper - AER review of regulatory tax approach*, 4 June 2018, p. 3 (LATE SUBMISSION).

[61] APA Group, *APA response to issues paper - AER review of regulatory tax approach*, 4 June 2018, p. 4 (LATE SUBMISSION).

[62] Jemena, *Response to Issues Paper - Review of Regulatory Tax Approach*, 31 May 2018, p. 4; Ausgrid et al., *Submission –*

In particular, there are almost no stand-alone assets within the AER's regulatory scope, and most assets are owned by larger companies, which rarely assess tax on the basis of individual assets, requiring considerable 'unscrambling' of a corporate tax return to try and understand how much of the overall corporate tax bill can be attributed to a given asset. Moreover, such unscrambling is inter-temporal in nature, because tax paid (or not paid in the case of tax losses) in one year can affect tax paid in the next. This makes the process very complex.

In preparing this initial report, we commissioned advice from Dr Martin Lally on the conceptual basis for amending our regulatory tax approach to reflect the tax practices of the networks. Dr Lally considered the presence of unregulated activities would require rules for allocating the taxes paid by a firm between regulated and unregulated activities. Any choice of rules would inevitably give rise to errors and also provide incentives for firms to game the system.[64]

We accept that obtaining meaningful information on tax paid by regulated businesses may not be straightforward and that the incentive framework is based on the benchmark efficient entity. Nevertheless the information is required for our assessment of whether the current tax approach needs to be adjusted. As such, we propose to exercise our information gathering powers to obtain this information by serving a RIN on each of the regulated entities.

We also engaged McGrathNicol to provide some external advice on the type of information that would be required in the next stage of our review.[65] McGrathNicol recommended that we should engage an advisory firm with relevant taxation experience and provided some comments on the scope of information we should seek in the next stage of our review.

We acknowledge the concerns raised by stakeholders and will take them into consideration in preparing the RINs. We expect to release a draft RIN in August 2018, and in accordance with the NEL and NGL we will consult with NSPs before the final RINs are issued.[66] Section 1.2 has more information on the timetable for issuing RINs.

AER review of regulatory tax approach, 31 May 2018, p. 5; APGA, *Submission to the AER Issues Paper*, 31 May 2018, p. 2; APA, *APA response to issues paper - AER review of regulatory tax approach*, 4 June 2018, p. 3 (LATE SUBMISSION).

[63] APGA, *Submission to the AER Issues Paper*, 31 May 2018, p. 2.

[64] Dr Lally, *Tax payments versus the AER's allowances for regulated businesses*, 16 June 2018, p. 17.

[65] McGrathNicol, *Implications of ownership structures on tax paid by regulated entities,* 26 June 2018, p. 5. This report is available on the AER website at https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/review-of-regulatory-tax-approach-2018/consultation.

[66] NEL, s. 28J; NGL s. 52.

5 What could be driving the difference?

The ATO note identified a number of potential drivers that could be contributing to the discrepancy between forecast tax costs provided for in revenue determinations 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). Stakeholder submissions also proposed a number of other potential drivers for the discrepancy.

We need to better understand these potential drivers and their impact on observed tax payments. Obtaining more detailed tax information through our information gathering powers will allow us to determine which of the potential drivers are material and relevant.

5.1 Key drivers from the ATO note

Table 5.1 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). We briefly explain how each could result in a difference between our regulatory forecast of tax costs and actual tax paid by NSPs.

Several of the drivers in Table 5.1 act through increasing the tax depreciation expense (relative to our benchmark approach). Different tax depreciation expense profiles have different effects on short term and long term actual tax payments. In the short term (first five year regulatory period), a higher depreciation expense means lower taxable income and lower tax payable. However, this higher depreciation expense also means a lower tax asset base at the end of the regulatory period compared to the AER regulatory forecast. This in turn, leads to lower depreciation expenses in the long term (subsequent regulatory periods) and eventually higher tax payments than otherwise. 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 compared to forecast (see section 2.3).

The expert advice we commissioned from Dr Martin Lally addressed several of the potential drivers relating to depreciation. Dr Lally considered that there was little merit in the AER shortening the tax asset lives to reflect an amount less than the asset lives prescribed by the ATO.[67] However, Dr Lally considered the AER should consider changing the tax depreciation method to use diminishing value (instead of straight line) as doing so would reduce the allowed revenue of the business to a level consistent with the NPV=0 principle.[68]

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 when tax payment for a particular year is being calculated. Our regulatory models (PTRMs) are constructed so that tax losses from one period will be carried forward into the following period. However, the approved regulatory models in earlier regulatory determinations did not suggest that any regulated networks

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[67] Dr Lally, *Tax payments versus the AER's allowances for regulated businesses*, 16 June 2018, pp. 5, 26-27, 33.

[68] Dr Lally, *Tax payments versus the AER's allowances for regulated businesses*, 16 June 2018, pp. 5, 25-26, 33.

would incur tax losses (where tax expenses more than offset taxable revenue). This appears to be inconsistent with the ATO note which identified prior tax losses as a key driver. A possible cause of this inconsistency could be that the ATO analysis is based on the tax losses from both regulated and unregulated activities, while networks only reports tax losses related to the regulated activities in our models. Hence, this driver may be a secondary effect arising from the effect of other potential drivers noted in this section from earlier periods. Dr Lally recommended against the AER adjusting for tax losses that are the result of unregulated activities or tax minimisation activities associated with regulated activities.[69] We will further investigate this issue when more detailed tax information is available.

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 have the effect of attracting a lower statutory tax rate 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 our models.
Gearing	NSPs may be highly geared (greater than 60 per cent).	Use the benchmark gearing (60 per cent).	Interest expense is higher than in our models, 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 our models, 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 our models, and so taxable income is lower (in 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 our models, and so taxable income is lower (in this period).
Prior tax losses	NSPs may have available tax losses.	Our 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 our models.

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

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69   Dr Lally, *Tax payments versus the AER's allowances for regulated businesses*, 16 June 2018, pp. 5, 24, 33.

5.2 Other potential drivers

Table 5.2 describes several other potential drivers that may contribute to the difference between the regulatory forecast of tax costs 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. The ATO note stated that a number of other factors not explicitly outlined in its note contributed to the tax discrepancy; but that the impact of these factors was not material.

Our issues paper asked for stakeholder submissions on other potential drivers. In general, stakeholders acknowledged that the AER and the ATO had identified the key drivers of potential discrepancy between the regulatory forecast of tax costs and actual tax payments, but also identified a few potentially significant drivers. We have included these drivers in Table 5.2.

Table 5.2   Additional potential drivers

Potential driver	Current tax practice	AER approach	Effect of difference
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 our 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 our models, 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 ('corporate transactions' in some submissions).	Tax asset base is not revalued.	If the revaluation is upward, TAB is higher than in our models. Subsequent depreciation expenses will be higher than in our models, 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 our models, and so taxable income is lower (this period).

Stamp duty paid as part of ownership change	New owners of network assets may have to pay stamp duty as part of the ownership change. This cost is eligible for tax deduction, although the type of deduction varies under different tax regimes over time (several submissions)	No stamp duty deductions included in models.	Tax expense is higher than in our models, and so tax payable is lower.
Unregulated Activities	NSPs may incur additional expenses through unregulated activities, which may be tax expenses (several submissions).	Only regulated activities are factored into the calculation of the building block allowance.	No effect on taxable income for regulated activities; however, may affect tax payments observed at the aggregate level (regulated and unregulated).
Capital Contributions (customer contributions)	Level of capital contributions may differ from the regulatory forecast (CCP 22, Doueihi submissions).	In the PTRM, capital contributions are added to taxable revenue, but are not considered a tax expense	If contributions are lower (higher) than regulatory forecast, taxable income will be lower (higher).
Provision movements	Provision is treated as a tax expense when paid (AusNet Services submission).	Tax expense when provision is accrued.	Timing difference between payment/accrual will lead timing difference between actual tax payments and regulatory forecast of tax costs.
Form of control	NSPs under a price cap form of control pay tax based on revenue which is subject to volume fluctuation (several submissions).	Assumes actual volume is consistent with projected volume.	Under a price cap, increases (decreases) in volume may lead to higher (lower) taxable income and higher (lower) tax payments.

Source: ATO, *Note to the AER*, 10 April 2018; AER analysis; ENA, *Review of regulatory tax approach, Response to AER Issues Paper*, 31 May 2018; Ausgrid et al., *Submission – AER review of regulatory tax approach*, 31 May 2018; APGA, *Submission to the AER Issues Paper*, 31 May 2018, AusNet, *Response to Issues Paper - Review of Regulatory Tax Approach*, 31 May 2018, Jemena, *Response to Issues Paper - Review of Regulatory Tax Approach*, 31 May 2018; CCP 22, *Submission to the AER on Review of regulatory tax approach Issues paper*, 31 May 2018; SA Power Networks, Australian Gas Infrastructure Group, CitiPower, United Energy and Powercor (SAPN et al.), *Submission in response to AER's Issues paper*, 31 May 2018; APGA, *Submission to the AER Issues Paper*, 31 May 2018; J. Doueihi, *Submission to AER issues paper – Review of regulatory tax approach*, 31 May 2018; Ergon Energy Corporation Limited and Energex Limited, *Letter to AER - Review of Regulatory Tax Approach*, 1 June (LATE SUBMISSION).

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.

Some submissions have identified new potential drivers of the tax discrepancy. One common submission from the ENA, Ausgrid and APGA was that the treatment of stamp duty related to the transfer of ownership of regulated assets could cause tax payments to the ATO to fall below the regulatory forecast of tax costs.[70]

The ATO noted that a number of other technical tax factors not explicitly outlined in its note contributed to the tax discrepancy, but that these factors were not material. We will need to have regard to the materiality of potential drivers in our review when we consider potential changes to our regulatory approach.

After we have gathered the relevant information through our RINs, we will be able to determine whether these drivers are relevant or material.

5.3 Relevance of the drivers

An important aspect of our review of potential drivers is the relevance of each driver to the determination of benchmark tax costs. We received a number of submissions from regulated networks on this issue. They submitted that some potential drivers we identified should not be considered by the review as they were:[71]

- not relevant to their particular business

- not relevant to the determination of a benchmark regulatory allowance

- outside the jurisdiction of the AER.

We note a common view expressed in a number of submissions is that different entity ownership structures may be a driver for the apparent tax discrepancy, but that tax effects arising from ownership structures are outside the bounds of our tax review.[72] These submissions suggested that the Commonwealth Treasury or ATO were better placed to consider these issues, rather than the AER considering changes to the regulatory tax approach for NSPs. For example, the APGA stated:[73]

> There appears to be some concern in the position paper, and in the ATO note, that businesses may be adopting particular tax structures and that, potentially, not all of these tax structures are equally desirable. This may or may not be the case. To the extent that it is, then this is an issue which should appropriately be dealt within the tax regime, not in the regulatory regime.

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[70] ENA, *Review of regulatory tax approach, Response to AER Issues Paper*, 31 May 2018, pp. 8–9; Ausgrid et al., *Submission – AER review of regulatory tax approach*, 31 May 2018, p. 4; APGA, *Submission to the AER Issues Paper*, 31 May 2018, p. 4

[71] For a summary of these points, see ENA, *Review of regulatory tax approach, Response to AER Issues Paper*, 31 May 2018, p. 29

[72] APGA, *Submission to the AER Issues Paper*, 31 May 2018, p. 4; NSG, *Submission to the AER on Review of regulatory tax approach*, 1 June 2018, p. 6 (LATE SUBMISSION); Ausgrid, Australian Super, IFM, *Review of regulatory tax approach – Response to issues paper*, 31 May 2018, p. 4; ENA, *Review of regulatory tax approach, Response to AER Issues Paper*, 31 May 2018, p. 22; IPA, *Submission to the Australian Energy Regulator on the Review of the Regulatory Tax Approach*, 5 June 2018, pp. 5–6.

[73] APGA, *Submission to the AER Issues Paper*, 31 May 2018, p. 7.

We agree that it is appropriate for Treasury and the ATO to consider these issues. However, it is also appropriate for our review to consider ownership structures where they are relevant to our regulatory determinations. For example, our regulatory forecast of tax costs needs to have regard to an estimate of taxable income and the statutory income tax rate.[74] Different ownership structures will interact with both these tax components, and it is therefore appropriate for our review to consider the ownership structure that would be adopted by a benchmark firm.

We have obtained advice from McGrathNicol to assist us in establishing a preliminary view on the ownership structures of some of the entities we regulate and the tax implications of these structures. Their report noted a role for external expert tax advice as we consider issues around ownership structures.[75] Dr Lally's report also provides his perspective on our regulatory tax approach and different ownership structures. Dr Lally considered that the ATO was best placed to address many of the tax minimisation strategies involving different ownership structures. He advised the AER against adjusting the regulatory taxation allowance for non-corporate ownership structures.[76]

Another view expressed in many submissions was that costs not included in the allowed building block costs, but borne by the businesses, contributed to tax deductions (that is, reduced taxable income) and resulted in lower tax payments.[77] For example, the ENA stated:[78]

> If the research and development cost itself remains uncompensated, but the benefit of the tax deduction is passed through to consumers, the net effect of an actual tax paid approach is that the network has funded that expense in full, and would receive a lower regulatory allowance for having done so (via a reduction in the corporate tax allowance), compared to a business that had not undertaken this activity.

These submissions considered that since businesses bear these costs, not consumers, the tax deductions should also be fully passed on to the businesses and not shared with consumers in a form of tax allowance deduction. In particular, Ausgrid, ENA, APGA and Infrastructure Partnerships Australia (IPA) submitted that research and development (R&D) expenses were a cost incurred beyond the benchmark efficient regulatory allowance and should not lead to the reduction of the tax allowance.[79] ENA, Ausgrid and APGA submitted that the treatment of stamp duty related to the transfer of regulated assets, also outside the building block framework, could be a driver of the apparent tax discrepancy.[80]

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[74] NER, cl. 6.5.3; NGR, r. 87A.

[75] McGrathNicol, *Implications of ownership structures on tax paid by regulated entities,* 26 June 2018, p. 5.

[76] Dr Lally, *Tax payments versus the AER's allowances for regulated businesses*, 16 June 2018, pp. 4, 18-21, 32.

[77] Jemena, *Response to Issues Paper - Review of Regulatory Tax Approach*, 31 May 2018, pp. 6–7; Ausgrid et al., *Submission – AER review of regulatory tax approach*, 31 May 2018, p. 13; ENA, *Review of regulatory tax approach, Response to AER Issues Paper*, 31 May 2018, p. 23; SAPN et al, *Submission in response to AER's Issues paper*, 31 May 2018, p. 2; APGA, *Submission to the AER Issues Paper*, 31 May 2018, p. 3.

[78] ENA, *Review of regulatory tax approach, Response to AER Issues Paper*, 31 May 2018, p. 5.

[79] Ausgrid et al., *Submission – AER review of regulatory tax approach*, 31 May 2018, p. 4; ENA, *Review of regulatory tax approach, Response to AER Issues Paper*, 31 May 2018, p. 10; APGA, *Submission to the AER Issues Paper*, 31 May 2018, p. 3; IPA, *Submission to the Australian Energy Regulator on the Review of the Regulatory Tax Approach*, 5 June 2018, p. 5.

[80] ENA, *Review of regulatory tax approach, Response to AER Issues Paper*, 31 May 2018, p. 14; Ausgrid et al., *Submission*

5.4 Materiality of the drivers

The previous section discussed stakeholders' submissions and our preliminary views on the relevant drivers we should take into account in our analysis. This section discusses the materiality of these potential drivers.

There were divergent views across submissions on the materiality of drivers in the issues paper. These included:

- AusNet Services submitted that ownership structure and R&D deductions were not a material driver of any tax difference for its business.[81]

- The Network Shareholders' Group (NSG), MEU, APGA, Ergon Energy and Energex, and CCP 22 suggested that ownership structure could be a significant driver.[82]

- Jemena, Ausgrid, APGA, IPA and ENA submitted that many drivers result only in timing differences to tax payable, not the total amount over the life of the asset, and were therefore immaterial.[83] This includes the use of diminishing value rather than straight-line depreciation approach, immediate deduction of refurbishment expenditure, self-assessed asset lives, and use of low value pools to write off assets. As we have discussed in section 2.3, we consider that the application of different tax depreciation approaches does not always result in NPV-neutral outcomes, and therefore it should be treated as a potentially material driver.

- CCP 22 considered it was difficult to discuss materiality without seeing the data the AER would collect, and that the focus should be on the drivers with the largest quantitative impact.[84]

- APGA submitted that the assessment of materiality should not be based on dollar values, but on the integrity of the regulatory system.[85]

Reflecting these divergent opinions, we consider it is not possible to establish a view on the materiality of each driver based on the qualitative information currently available to us. We consider a quantitative analysis based on actual tax information from regulated entities is the best approach to assess the materiality of the drivers.

– *AER review of regulatory tax approach*, 31 May 2018, p. 4; APGA, *Submission to the AER Issues Paper*, 31 May 2018, p. 4.

[81] AusNet, *Response to Issues Paper - Review of Regulatory Tax Approach*, 31 May 2018, p. 2.

[82] AusNet, *Response to Issues Paper - Review of Regulatory Tax Approach*, 31 May 2018, p. 2; NSG, *Submission to the AER on Review of regulatory tax approach*, 1 June 2018, p. 3 (LATE SUBMISSION); MEU, *Response to Issues Paper - Review of Regulatory Tax Approach*, 29 May 2018, p. 5; APGA, *Submission to the AER Issues Paper*, 31 May 2018, pp. 3–4; Ergon Energy and Energex, *Letter to AER - Review of Regulatory Tax Approach*, 1 June, p. 2 (LATE SUBMISSION); CCP 22, *Submission to the AER on Review of regulatory tax approach Issues paper*, 31 May 2018, p. 8.

[83] Jemena, *Response to Issues Paper - Review of Regulatory Tax Approach*, 31 May 2018, p. 4; Ausgrid et al., Submission – AER review of regulatory tax approach, 31 May 2018, pp. 13,16; APGA, *Submission to the AER Issues Paper*, 31 May 2018, p. 3; IPA, Submission to the AER on the Review of the Regulatory Tax Approach, 5 June 2018, p. 4 (LATE SUBMISSION); ENA, Review of regulatory tax approach, Response to AER Issues Paper, 31 May 2018, pp. 22, 25.

[84] CCP 22, *Submission to the AER on Review of regulatory tax approach Issues paper*, 31 May 2018, p. 7.

[85] APGA, *Submission to the AER Issues Paper*, 31 May 2018, p. 4.

The advice from Dr Lally also considered the materiality of the potential drivers identified in the ATO note. Dr Lally considered that the diminishing value method for tax depreciation was superior to the straight-line method and is consistent with the NPV=0 principle.[86] However, in regard to self-assessed asset lives and the use of low value asset pools, Dr Lally considered that adjustments for these factors might not have a material impact.[87]

The focus of this review—once we have gathered the required tax information—is to establish the materiality of each driver and consider what (if any) changes to the regulatory treatment of tax might be appropriate in response. Our preliminary assessment of possible responses to the different potential drivers are set out in the next chapter.

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[86] Dr Lally, *Tax payments versus the AER's allowances for regulated businesses*, 16 June 2018, pp. 5, 25-26, 33.

[87] Dr Lally, *Tax payments versus the AER's allowances for regulated businesses*, 16 June 2018, pp. 5-6, 26-28, 33.

6 What changes might be made?

We have identified a range of possible responses to the apparent tax discrepancy. This includes:

- changes to the treatment of tax depreciation in our regulatory models

- changes to other aspects of the tax approach that would require a change in the rules (NER and NGR)

- changes focused on adjusting tax allowances to reflect actual tax payments by energy networks.

Prior to the collection of more data on the tax practices of the networks, it is difficult to determine which (if any) of these changes might be appropriate.

Many stakeholder submissions cautioned us against changing from the current benchmark approach for setting the regulated tax allowance to an approach based on actual tax paid by each energy network (a 'tax pass-through approach').[88]

This would exclude tax costs from the benchmark incentive framework that governs our overall approach to setting regulated revenues. Our current assessment is that we should exercise caution before moving to a tax pass-through approach. Such a move could lead to increased consumer charges across time. It could also create windfall gains or losses at the point of transition, and an incentive to shift tax between unregulated and regulated components of each corporate entity.

Actual tax payments by the regulated networks are not readily observed on a disaggregated basis and so it is difficult to determine if the efficient level of tax payments differs from our current benchmark. Using our information gathering powers will allow us to will reveal those costs and consider whether we can implement a better benchmark for tax costs that is compatible with the incentive framework.

6.1 Possible changes to tax depreciation

Table 6.1 sets out the possible changes that we could make to the tax depreciation calculated in our regulatory models (RFM and PTRM). Such changes would only require changes to regulatory model templates, without making changes to the current rules (NER and NGR). Tax depreciation is a non-cash expense and represents the change in the value of an asset for tax purpose. Different depreciation schedules will result in different annual tax expenses. All else being equal, a higher depreciation expense in a given year results in a lower tax payable for that year. However, given that an asset can only be depreciated once,

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[88] APGA, Submission to the AER Issues Paper, 31 May 2018, p. 5; Ausgrid, et al., *Submission – AER review of regulatory tax approach*, 31 May 2018, p. 3; CCP 22, *Submission to the AER on Review of regulatory tax approach Issues paper*, 31 May 2018, p. 9; ENA, *Response to AER Issues Paper*, 31 May 2018, p. 3; Jemena Limited, *Response to Issues Paper - Review of Regulatory Tax Approach*, 31 May 2018, p. 2; Ergon Energy and Energex, *Letter to AER - Review of Regulatory Tax Approach*, 1 June 2018, p. 2 (LATE SUBMISSION); IPA, *Submission to the AER on the Review of the Regulatory Tax Approach*, 5 June 2018, p. 4 (LATE SUBMISSION).

the total tax depreciation (in nominal terms) over the life of an asset should not be impacted by the depreciation method used to depreciate an asset.[89]

Table 6.1   Possible changes to address potential drivers – Depreciation

Potential driver	Type of change	Summary of change	Implementation
Diminishing value	Model	Use diminishing value instead of straight-line method (for tax purposes)	Change the tax depreciation calculations in PTRM/RFM. Regulatory depreciation (return of capital building block) would continue to be determined on a straight-line basis.
Self-assessed asset lives	Model	Use self-assessed asset lives instead of assessing asset class lives against ATO tax rulings.	Change the tax life inputs in the PTRM/RFM to reflect the self–assessed asset lives for certain asset classes (with disaggregation and/or reallocation of some asset classes). AER would then monitor the self-assessed asset lives of regulated businesses via processes such as the RIN.
Low-value pools	Model	Use low-value pools to write off some assets (combined with change to diminishing value)	Create a new asset class in the PTRM/RFM for low value assets, with relevant assigned tax asset life. Some assets from the primary asset classes with ATO standard tax lives will be reclassified to this new low value asset category once the remaining value reduces below a threshold.
Immediate expensing of refurbishment	Model	Allow refurbishments to be immediately expensed	Reclassify refurbishments in the PTRM/RFM as operating expenditure for tax purposes. Alternatively, make refurbishments a separate asset class in the PTRM/RFM with a tax asset life of one year. Disaggregation and/or reallocation of asset classes may be required.

While Table 6.1 describes (in high level terms) a number of possible changes, it does not attempt to evaluate the relative merits of any of these changes. Prior to the collection of more data on the tax practices of the networks, it is difficult to determine which (if any) of these changes might be appropriate.

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89   However, as noted in section 2.3, the net present value of tax depreciation is affected by inflation and the time value of money.

6.2 Possible changes not related to depreciation

Table 6.2 sets out potential changes to the calculation of the tax allowance that (in most cases) would require a change in the rules (and consequential changes to our models) to implement. Such changes include changing the statutory tax rate to reflect ownership structures commonly used by regulated businesses, using a different debt gearing for tax purposes than that used in the rate of return, as well as other factors that impact the tax allowance.

For several possible changes in Table 6.2 it is not clear if there is scope for the change to be made under the current rules. As with the earlier table, we have not attempted to evaluate the relative merits of any of these changes.

Dr Lally's advice encompassed several of the possible changes in this table. Dr Lally recommended that the AER adjust its approach to account for TAB revaluations. He considered that if the TAB is uplifted for revaluations, this would reduce the allowed revenue of the businesses to the level consistent with the NPV=0 principle, which is in the long term interests of consumers.[90] Dr Lally advised the AER against adjusting its approach for accounting for prior tax losses or to reflect actual debt gearing and ownership structure of the NSPs.[91]

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[90] Dr Lally, *Tax payments versus the AER's allowances for regulated businesses*, 16 June 2018, pp. 6, 28-29, 33-34.

[91] Dr Lally, *Tax payments versus the AER's allowances for regulated businesses*, 16 June 2018, pp. 4-5, 24, 32-33.

Table 6.2 Possible changes to address potential drivers – Other

Potential driver	Type of change	Summary of change	Implementation
Ownership structure	Rule	Reduce the statutory tax rate below the company tax rate (30%) to account for tax minimisation structures.	Amend rule references to statutory corporate income tax rate in the rules. Change the tax rate inputs in the PTRM (already capable of handling this change). AER would then monitor the tax structures adopted by regulated businesses and assess what impact these structures have on tax rates (company, passive income, personal, withholding and other).
Gearing	Model and possible rule	Use a different gearing ratio for the tax expense calculation rather than the gearing in the rate of return building block to reflect that the regulated businesses' gearing for tax purposes is higher than the WACC gearing.	Amend rules to differentiate gearing for tax and WACC purposes. Create a new input in the PTRM for gearing for tax purposes. Use gearing for tax purposes to calculate the interest expense for tax purposes. Continue to use rate of return gearing when calculating the return on capital building block.
Other expenses	Model and possible rule	Recognise new expenses (outside of regulated opex and capex) that have tax implications, such as Research and development, stamp duty, and others.	Amend references to calculation of expected taxable incomes in rules. Create new inputs for tax deduction costs in the PTRM Use the new 'tax only expenses' when calculating taxable income and the tax building block. Continue to use existing inputs for opex and capex calculations for tax expenses.
TAB revaluation	Model and possible rule	Adjust the TAB in the PTRM/RFM for asset revaluations adopted by the ATO.	Amend rules to recognise TAB revaluation effects on tax building block. Adjust TAB roll forward in the PTRM/RFM for TAB revaluations that were permitted by the ATO.
Prior tax losses	Model and possible rule	Adjust the PTRM for prior tax losses that have not been accounted for.	Amend rules to recognise effects of prior tax losses on tax building block. Using the existing tax losses input in the PTRM, the AER can make one-off adjustment to reflect discrepancy in tax losses.

6.3 Possible changes for actuals

Table 6.3 sets out possible changes focused on adjusting tax allowances to reflect actual tax payments. These require rule changes before they could be implemented as well as consequential changes to regulatory models. In some cases they would also require changes to the annual tariff variation or cost pass-through mechanisms, or changes to the regulatory framework (see section 6.3.1).

Table 6.3 does not attempt to evaluate the relative merits of any of these changes, but potential framework changes (the possible move to a tax pass-through) are discussed in the following section.

Dr Lally commented on several of the possible changes in this table. His report advised against both full pass-through of actual tax costs and a partial pass-through of actual costs, labelled 'capping'. Capping describes a regulatory approach where the NSP receives the lower of forecast tax costs (under a benchmark approach) and actual tax payments by the network. Dr Lally's consideration of the advantages and disadvantages of a possible framework change is discussed in more detail in the following section. Dr Lally also advised against any adjustment for actual debt gearing.[92]

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[92] Dr Lally, *Tax payments versus the AER's allowances for regulated businesses*, 16 June 2018, pp. 3-5, 12-14, 24, 31-32.

Table 6.3   Possible changes to address potential drivers – Adjustment for actuals

Potential Driver	Type of change	Summary of change	Implementation
Tax allowance	Model, rule and possible framework (Section 6.3.1)	Use actual tax paid for the taxation building block.	Amend references to the tax building block in the rules. True up for the difference between forecast tax payable and actual tax payable in the PTRM (or annual pricing process). Adjustment could be made with a time lag due to tax payable information not being known until the end of the financial year. AER would then monitor the regulated businesses' actual tax paid.
Tax allowance	Model, rule and possible framework (Section 6.3.1)	Use lower of actual tax payments and benchmark tax allowance.	As row above, but the AER would only update the tax allowance if actual tax payable was below the forecast. Otherwise the tax allowance would remain unchanged.
Tax allowance	Model and rule	Develop a tax allowance incentive scheme where over time the benefits of lower tax payments are passed onto consumers.	Amend rules to establish basis for new incentive scheme. Develop an incentive mechanism based on CESS/EBSS (including guideline). This incentive mechanism would use existing input sections in PTRM for adjustments (as with CESS/EBSS). The AER would develop a new spreadsheet to implement incentive payments.
Tax depreciation	Model and possible rule	Use 'actual' depreciation expense in the PTRM/RFM.	Amend rule references to tax building block and depreciation. Change RFM/PTRM to use 'actual' tax depreciation reported to the ATO (adjusted to remove unregulated activities)
Cost of debt	Model and rule	Adjust the interest tax expense for the actual gearing level.	In the PTRM the forecast interest tax expense would be set with reference to the regulated businesses' actual debt reported to the ATO, rather than using the benchmark gearing.
Cost of debt	Model and rule	Adjust the interest tax expense for the actual interest costs.	In the PTRM the forecast interest tax expense would be set with reference to the regulated businesses' actual interest costs, rather than the benchmark cost of debt.

6.3.1 Framework changes

Our regulatory determinations operate under an incentive-based framework. Revenues are set based on the costs that a benchmark efficient entity operating an NSP's assets expects to incur in running its electricity network or gas pipeline.[93] Networks who keep actual costs below the regulatory forecast of costs are able to retain part of the benefit. This provides an incentive to the business to minimise its costs. Under the current approach, the tax allowance is based on an estimate of tax payable by a benchmark efficient entity and not on the NSPs' actual tax costs.

Submissions received in response to our issues paper were supportive of the continuation of this incentive-based regulatory framework. Submissions noted that the differences between actual tax costs and tax allowances identified in the issues paper were to be expected and indicative of a working incentive-based regime.[94] IPA submitted:[95]

> The benefit of this regulatory framework is that it incentivises firms to innovate and become more efficient, thus revealing information that can be used by the regulator to set higher benchmarks of efficiency in subsequent regulatory periods, which in turn benefits consumers.

For expenditure streams such as opex, if NSPs innovate and improve on the benchmark costs they are able to retain part of the benefit. These revealed efficiencies will inform the benchmark level of opex that is provided for in subsequent regulatory periods. A similar situation occurs with capex, where cost reductions below the regulatory forecast are readily observable. There are also schemes in place (EBSS/CESS) to directly share these efficiencies with consumers. If NSPs are able to keep the savings indefinitely—with no adjustments to the benchmark—then consumers never benefit from lower costs. Unlike capex or opex, actual tax payments are not readily observed on a disaggregated basis. There is no CESS or EBSS equivalent sharing scheme in place for tax.[96] If revealed tax efficiencies are not considered when setting the regulatory forecast of tax costs at a revenue determination then tax costs will not align with the benchmark incentive framework. This would mean NSPs are able to keep the savings from reducing their tax costs below the benchmark indefinitely, and consumers will not benefit from lower costs.

Therefore, this review into the drivers of NSPs' actual tax costs is an essential part of an incentive-based regulatory regime that works in the long-term interest of consumers, consistent with the NEO and NGO. If we find that there is a more efficient way of providing network services to consumers then we should consider changing our benchmark to reflect

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[93] 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.

[94] Ausgrid et al., *Submission – AER review of regulatory tax approach*, 31 May 2018, p. 3; ENA, *Response to AER Issues Paper*, 31 May 2018, p. 4; Jemena, *Response to Issues Paper - Review of Regulatory Tax Approach*, 31 May 2018, p. 2; SAPN et al., *Submission in response to AER's Issues paper*, 31 May 2018, p. 1; J. Doueihi, *Submission to AER issues paper – Review of regulatory tax approach*, 31 May 2018, p. 3; APA, *APA response to issues paper - AER review of regulatory tax approach*, 4 June 2018, p. 2 (LATE SUBMISSION); IPA, *Submission to the AER on the Review of the Regulatory Tax Approach*, 5 June 2018, p. 4 (LATE SUBMISSION).

[95] IPA, *Submission to the AER on the Review of the Regulatory Tax Approach*, 5 June 2018, p. 4 (LATE SUBMISSION).

[96] In its submission the CCP 22 noted it might be possible to consider an EBSS/CESS style incentive scheme for tax. CCP 22, *Submission to the AER on Review of regulatory tax approach Issues paper*, 31 May 2018, p. 6.

this. This will lead to consumers sharing in the NSPs' tax efficiency gains in the long term. The alternative to an incentive-based approach to tax—as noted by a number of submissions—is 'cost-plus', or 'rate-of-return' regulation, in which the tax allowance for each NSP reflects the actual tax costs incurred.

Pass-through of actual tax costs

A number of submissions raised the potential for this review to recommend a pass-through of actual tax costs. Many stakeholder submissions cautioned us against such a change.[97] Several of these submissions commented on the consequences of changing the incentives for NSPs. Ausgrid, IFM and AustralianSuper jointly submitted: [98]

> Alternatives which are based on pass through of actual tax would remove all incentives on businesses to pursue tax cost efficiency.
>
> A pass through approach would expose customers to the actual tax costs of their energy network service provider, regardless of whether this tax cost was efficient or not. It would also expose customers to volatility in network prices due to volatility in actual tax paid, which can vary significantly from year to year.

The prospect of volatility in end prices was also raised by the IPA, who stated:[99]

> The alternative to incentive based regulation, would be to move to a cost-plus regulatory model whereby the regulated business passes through its actual costs to consumers, while also recovering a fixed margin. Under this framework, the issue of difference between actual tax payable and allowed tax is resolved, as the regulatory allowance is always equal to the actual cost. However, this gives rise to greater price volatility as consumers pay the actual costs incurred by businesses, which could be higher or lower than those of an efficient benchmark entity. Importantly, under a cost-plus model, there is no incentive for businesses to operate more efficiently as any costs incurred are passed through to customers.

The APGA submission also noted the potential for adverse consumer price outcomes from such a change, and the potential for windfall gains or losses at the point of transition:[100]

> However, it is possible that any switch to tax as a cost pass-through could result, within the next decade, in customers facing prices which include a tax allowance which is greater than the current 30 percent; depending upon where the 'crossover point' is for the bulk of the asset base. Had actual tax payments been used from the outset, this might not matter much; prices for consumers at the start of regulation might be lower and prices later on higher, but overall, consumers would pay for the 'right' amount of tax over the life of the relevant asset. However, switching regimes partway through might result in businesses being able to crystallise gains and consumers losses. We would urge further study of this if actual taxes paid are ever seriously considered, and more sophisticated modelling than shown in Figure One.

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97 APGA, Submission to the AER Issues Paper, 31 May 2018, p. 5; Ausgrid, et al., *Submission – AER review of regulatory tax approach*, 31 May 2018, p. 3; CCP 22, *Submission to the AER on Review of regulatory tax approach Issues paper*, 31 May 2018, p. 9; ENA, *Response to AER Issues Paper*, 31 May 2018, p. 3; Jemena Limited, *Response to Issues Paper - Review of Regulatory Tax Approach*, 31 May 2018, p. 2; Ergon Energy and Energex, *Letter to AER - Review of Regulatory Tax Approach*, 1 June 2018, p. 2 (LATE SUBMISSION); IPA, *Submission to the AER on the Review of the Regulatory Tax Approach*, 5 June 2018, p. 4 (LATE SUBMISSION).

98 Ausgrid, et al., *Submission – AER review of regulatory tax approach*, 31 May 2018, p. 3.

99 IPA, *Submission to the AER on the Review of the Regulatory Tax Approach*, 5 June 2018, p. 4 (LATE SUBMISSION).

100 APGA, *Submission to the AER Issues Paper*, 31 May 2018, pp. 6–7.

> However, our view at the present time is that the shift is unlikely to be in the long run interests of consumers

The ENA submission noted a number of 'significant adverse consequences and practical problems would arise' with such a change. ENA considered that a move toward tax pass-through would entail an inconsistent standard between regulatory cost allowances, introduce customer price differentials based on corporate transactions, add complexity and cost when attempting to determine the amount of tax paid; and that it may have potential retrospective impact. ENA stated:[101]

> Such a framework clearly makes no economic sense, which is why the Australian model (which is reflected in the Rules) has always been to set the regulatory allowance in relation to the efficient costs of a benchmark efficient entity.

CCP 22 raised the concept of a tax pass-through and stated:[102]

> This approach does have advantages. A network has a strong incentive to minimise its tax payments but under the current approach customers do not benefit from this. In the context of the total tax burden, any under recovery from networks places a greater burden on all taxpayers to make up this under recovery.

However, the CCP 22 submission also noted that this would be a substantial change from the current incentive-based regulatory approach and could also be very difficult to administer.

Many submissions also noted that under the current incentive-based framework it was to be expected that individual NSP's actual tax costs would differ from the benchmark efficient allowance—just as actual opex and capex incurred would differ from the forecast allowance.[103]

Passing through actual tax costs instead of using a benchmark entity to set efficient tax costs also results in customers' charges varying due to the tax status of their NSP's ownership. Business SA submitted that whether or not the state government owned networks could minimise tax to the same extent as private sector businesses should be irrelevant to the charges paid by consumers in those networks.[104] Passing through actual tax costs could create perverse incentives for the networks and result in consumers paying for tax costs above the benchmark efficient level. Business SA submitted that the tax allowance should be based on what can be achieved by a competitive and efficient entity.

Dr Lally also recommended against setting the regulatory tax costs in accordance with actual taxes paid. He noted that such an approach would encourage firms to undertake actions that raise their corporate tax payments but are not efficient or desirable—such as eliminating all

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101 ENA, *Response to AER Issues Paper*, 31 May 2018, p. 10.

102 CCP 22, *Submission to the AER on Review of regulatory tax approach Issues paper*, 31 May 2018, p. 9.

103 Ausgrid, et al., *Submission – AER review of regulatory tax approach*, 31 May 2018, p. 3; ENA, *Response to AER Issues Paper*, 31 May 2018, p. 4; Jemena, *Response to Issues Paper - Review of Regulatory Tax Approach*, 31 May 2018, p. 2; SAPN et al., *Submission in response to AER's Issues paper*, 31 May 2018, p. 1; APA, *APA response to issues paper - AER review of regulatory tax approach*, 4 June 2018, p. 2 (LATE SUBMISSION); IPA, *Submission to the AER on the Review of the Regulatory Tax Approach*, 5 June 2018, p. 4 (LATE SUBMISSION).

104 Business SA, *Submission - Review of Regulatory Tax Approach Issues Paper*, 31 May 2018, p. 2.

debt financing.[105] Using actual tax costs would eliminate the incentive to reduce tax costs which would likely lead to increased consumer charges across time, as NSPs would have the incentive to increase their actual tax costs because they would be assured full recovery of these costs from customers. This may include shifting tax costs between unregulated and regulated components of each corporate entity where possible. This in turn may lead to increased ring-fencing requirements and compliance monitoring costs which is not in the long-term interest of consumers. We also consider that a change to a pass-through approach would not necessarily be NPV neutral and may generate windfall gains or losses for NSPs and consumers based on the particular tax situation of each network at the time of implementation.

An alternative approach proposed by Dr Lally is a 'capped pass-through' approach. Such an approach would only pass-through the actual tax costs of a network if they were below the benchmark efficient allowance. He noted that—while superior to an uncapped pass-through—'capping' also suffers from numerous disadvantages. Dr Lally considered that a capped pass-through wrongly attributes all shortfalls between taxes paid and the regulator allowance to tax minimization. This results in tax allowances that are less than that required in NPV terms to cover the networks' actual tax burden which is not in the long-term interest of consumers.[106] Both capped and uncapped pass-through approaches also rely on the actual tax paid for an individual network's regulated operations being readily available to the regulator and easily split from unregulated operations run by the parent company or upstream investor.

Submissions from network businesses and their investors raised the issue of complexity in determining the actual tax costs that would be reflected in such a pass-through regime. The ownership structure of many networks means that tax is only paid on a consolidated basis including revenues and costs from both regulated and unregulated sources. The tax profiles of the upstream investors can differ by business and from year-to-year. The process of unpacking these tax costs to isolate the tax paid on an individual network's operations in each year would involve considerable administrative difficulty and costs to both the networks and regulator.

The general consensus from stakeholder submissions is that the framework of incentive-based regulation should be maintained, and that administering a pass-through approach for tax costs would have significant difficulties and costs without providing benefits for consumers.

Given the available evidence, our current assessment is that we should exercise caution before moving to a tax pass-through regime. Rather, we should consider whether we can implement a better benchmark for tax costs that is compatible with the incentive framework. The use of our information gathering powers will allow us to better understand the efficient tax practices of the energy networks and consider what changes (if any) are appropriate.

Finally, we note that any move to a tax pass-through approach would require changes to the NER and NGR. This means the AEMC would undertake consultation on the rule change

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105 Dr Lally, *Tax payments versus the AER's allowances for regulated businesses,* 16 June 2018, pp. 12–13.

106 Dr Lally, *Tax payments versus the AER's allowances for regulated businesses*, 16 June 2018, pp. 4, 14.

proposal in a broader forum than this tax review. There would be an additional opportunity for affected stakeholders to comment.

Appendix A   Summary of submissions

In response to the AER's issues paper, we received 16 submissions.[107] The majority of submissions from service providers and investor groups noted that a discrepancy between benchmark tax costs and actual tax paid is to be expected under an incentive-based regulatory regime and that it is unlikely that any change is warranted. Submissions from both networks and consumer groups considered a move towards passing through actual tax costs was undesirable and difficult to administer. Submissions by consumer groups also acknowledged that this review should focus on finding out the reasons for the discrepancy between benchmark tax costs and actual tax paid. Below is a summary of the submissions.

Stakeholder	Summary
EnergyAustralia	AER should use publicly available tax information for the review, and engage experts to provide advice
Major Energy Users Inc	The privately owned networks benefit from the rules much the same as government owned networks, however the privately owned networks have tools available to them to reduce their tax liabilities.
	The MEU agrees with the listing of the drivers identified in the issues paper but considers that the ownership structure is a core element of how a network might seek to reduce its tax payable.
	MEU considers that an approach based on accessing market data is basically flawed as the benchmark efficient entity (BEE) would have to manage its tax affairs differently to what listed firms might be able to do. This means the data which can be sourced from the various network firms really have little to do with what the tax payable by the BEE is as all of the network firms have different features and so the tax approach by each is unique to them.
TransGrid	Supports the current Incentives-based approach which allows energy networks to retain the benefit (or detriment) where costs are lower (or higher) than the benchmark efficient costs. It is wrong to observe a difference between an actual cost and the regulatory allowance and then conclude that the regulatory approach to estimating the allowance should be adjusted. Supports the more detailed submission by Energy Networks Australia to this review.
	Encourage the AER to undertake ongoing consultation with a broad range of stakeholders, particularly with the stakeholders directly impacted by the review.

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[107]   These are available on the AER's website: https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/review-of-regulatory-tax-approach-2018/initiation.

AusNet Services	The taxation of capital intensive infrastructure businesses is an extremely complex area. Support the benchmark approach in setting the tax allowance.
	Differences between actual tax paid and regulated tax allowance for AusNet Services across the three regulated networks relates to timing difference including:
	–higher tax deductions for interest expenses
	–immediate tax deduction of some fixed asset expenditure for regulatory and
	–settlement of tax disputes with the ATO
	–tax treatment of movements in provisions such as employee entitlements
	Entity structure is not a driver of the difference for AusNet Services
Jemena	The current incentive framework with regulatory tax allowances based on the benchmark efficient entity provides the best outcomes for customers and encourages efficient investment in the industry.
	Changes to current approach so that tax allowances more closely reflect actual tax paid by each business would
	–lose the incentives, symmetry and consistency of the framework
	–risk of capital withdrawal from the industry
	–revenues and prices might arbitrarily increase for the customers of one regulated business and decrease for another
	Form of control is relevant when analysing tax allowances and actual tax paid. Under a price cap, the business is exposed to volume risk, meaning revenue and therefore tax may be higher or lower than the allowance in any given year.
	Support ENA's submission and note that almost all the drivers of difference raised by the AER are due to timing differences or are symmetrical in nature.
Ausgrid, AustralianSuper, IFM	Current incentive-based arrangements work well, departure from the current arrangements is likely to lead to negative impacts on business and customers.
	Differences between actual tax costs and benchmark efficient allowances expected in an incentive-based regulatory framework. Majority of the difference relate to payments made by network owners beyond the benchmark efficient regulatory allowance including, additional interest expenses, R&D expenses, stamp duty costs.
	Entity structure (trust and partnership) can result in less tax paid because profits are passed through to the ultimate investors who face low tax rates. This should be addressed in a broader setting such as the recently released Stapled Securities Exposure Draft.
	It would be highly complicated for any regulator to attempt to isolate the range of potential causes of differences between tax allowances and estimated tax paid. Ausgrid does not have information on the tax affairs of its equity investors.

Business SA	There are many legitimate reasons for minimising tax, and AER's analysis should focus on ones that are broadly used and can be linked to ownership of regulated Utility networks. It should be considered 'any' efficient entity would utilise comparable tax structures to minimise tax, and the allowances should be set accordingly.
Energy Networks Australia	Differences between actual and benchmark efficient costs are to be expected under an incentive-based regulatory framework.
	If there are sufficient evidence that the benchmark efficient cost of tax is lower than current regulatory allowance, the allowance should be adjusted to match the benchmark efficient cost. (eg. depreciation methods)
	If the cause of discrepancy is the departure from regulatory benchmarks in form of additional costs (such as gearing, R&D, higher interest rates), no change should be made. Since the asset owner fully bears these costs, tax deduction resulting from these extra costs should also flow to the owner, not consumers.
	Any corporate transaction relating to the regulated assets has no effect on prices paid by consumers.
	When it comes to ownership structure leading to lower tax rate paid, the issues must be handled in a broader setting, as the issue is nationwide. Also, many companies do pay tax at the corporate rate.
	Some issues, such as tax loss carry forwards, are simply timing differences.
	Distinguishing state-owned and private sector networks departs from the AER's current approach of setting benchmark cost independent to the identity of the owner
	Actual cost pass through is undesirable as it is inconsistent with incentive framework, adds complexity and potentially has a retrospective impact on investors.
SA Power Networks, Australian Gas Infrastructure Group, CitiPower, United Energy and Powercor	Current approach means consumers are protected from any costs associated with change in ownership of a service provider.
	Actual costs of the service provider will necessarily differ from the benchmark efficient allowances.
	Majority of the reasons for any difference relate to costs outside the benchmark and are uncompensated in the revenue allowance.
	Further investigation is appropriate if it is identified that regulatory tax allowance is different from benchmark efficient tax costs.

Australian Pipelines and Gas Association	Only issue with high policy importance is the ownership structure. This issue relates to government tax policy, not regulatory policy.
	Preserving the overall integrity of the regulatory system should be a priority.
	Tax pass through not only moves away from incentive outcomes, but also is likely to have poor price consequences for consumers in the future
	Actual tax paid is a function of other actual costs, which also deliberately differ from allowed costs. Investigating all these costs is inefficient and may move towards cost-plus regulation.
	In case of foreign ownership, AER's information gathering powers stops at borders and it is difficult to capture tax paid by overseas owners.
CCP 22	Efficient tax level should be continually assessed and adjusted if networks find new ways to reduce their tax burden.
	Best way to collect relevant information is the AER exercising its information gathering powers through issuing Regulatory Information Notice (RIN)
	AER may seek consultation on whether there treatment of private and public owned networks should be differentiated for the purposes of calculating tax allowance.
	Changes in the Tax Act to eliminate tax advantages achieved by ownership structure could take years and it may not have direct benefit to consumers.
	Pass through is a substantial change from incentive based approach and it may be difficult to administer. Achieving transparency on actual tax payments may help in assessing the practicality of this approach.
Josephine Doueihi	There are various potential source of discrepancies that the AER may need to collect data on.
	AER needs to be able to accurately extract information relevant to the regulated entity from the consolidated data.
	Economic benchmarking RIN is an excellent source of data on income expenses, provisions and assets.
	Differences occurring from depreciation, low value pools and other asset related deduction may be resolved by using 'actual' forecast tax depreciation.
	AER may adopt a true-up mechanism, change its methodology of dealing with tax depreciation by using actual depreciation sourced by from the business, or review treatment of tax losses.
Ergon Energy, Energex	Practice of immediately deducting capitalised overhead costs, tax depreciation, repair costs and unregulated activities may be attributing to the discrepancy.
	5 year snapshot is not representative of an asset with expected life of 30 to 50 years

Network Shareholders' Group	Changes to tax allowance treatment would require consideration of other elements of the building blocks for internal consistency. The review must not diminish fundamentals of incentive based framework.

The major driver of the difference between expected tax and actual tax paid exists across the economy and therefore is better examined by the Commonwealth Treasury or through the Australian Tax Office (ATO).

Measuring variation in the tax allowance and the actual tax paid would require significant data to be provided. Cost of this will be borne by taxpayers, NSPs, shareholders and customer.

This review could impose additional costs on customers that are unlikely to be outweighed by any outcome of this review. |
| APA group | Differences between tax liability and cash tax paid are normal occurrences.

Potential benefits from review are small, but potential framework damage is significant.

Drivers relating to the tax regime are matters to be addressed by the government, not the AER.

It is not possible to separate out a regulated business from a consolidated group, and it will be difficult to regulate according to individual corporate structure.

Different tax depreciation methods only lead to timing differences.

Tax loss carryovers are already reflected in the PTRM. |
| Infrastructure Partnerships Australia | Investor uncertainty and additional risk must be considered

Incentive regulation will always involve differences between actual and allowed.

Differences may be driven by different gearing ratios, cost of debt and R&D. If this leads to extra costs, they are borne by networks not customers, hence the networks should also benefit from the tax deduction associated with these expenses.

Diminishing value depreciation, self-assessed asset lives and low value pools are solely timing difference issues.

Ownership structure issues are relevant to entire economy and best dealt with via the Stapled Structures Exposure Draft. |

Appendix B   List of relevant NER/NGR clauses

This appendix provides NER and National Electricity Law 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.[108]

Clause 6.5.3 of the NER specifies the following requirement:[109]

> **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.[110]

The basis for preparing, publishing and amending the post-tax revenue model (PTRM) is specified in clause 6.4.1 of the NER.[111] 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.[112] Similarly, clauses 6.5.1(b)–(d) of the NER provide the basis for preparing, publishing and amending the roll forward model (RFM).[113]

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.[114]

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

[109] NER, cl. 6A.6.4; NGR, r. 87A.

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

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

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

[113] NER, cll. 6A.6.1(b)–(d). There is no equivalent provision in the gas rules.

[114] 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:[115]

- 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.[116]

- 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.[117]

- 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.[118] Clause 28G provides additional matters to be considered for related provider regulatory information instruments.[119]

- Clause 28J of the NEL provides that there must be an opportunity to be heard before a regulatory information notice is served.[120]

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[115] NER, cl. 6A.20.

[116] These NEL sections apply to both electricity distribution and transmission. The equivalent gas clauses are in sections 42–63 of the NGL.

[117] NGL, s. 46.

[118] NGL, s. 48.

[119] NGL, s. 49.

[120] NGL, s. 52.