Final report

Review of regulatory tax approach

December 2018

AUSTRALIAN ENERGY REGULATOR

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Shortened forms

Note: A glossary with plain English explanations of some technical tax terms is included at the end of this document.

Shortened form	Extended from
ACCC	Australian Competition and Consumer Commission
AEMC	Australian Energy Market Commission
AER	Australian Energy Regulator
APGA	Australian Pipelines and Gas Association
ATO	Australian Tax Office
ATO Note	Note issued by the ATO to the AER dated 10 April 2018 with the subject: "Indicative comparative analysis of the AER electricity distribution tax allowance and tax payable"
Augex	Augmentation capex, sometimes labelled growth capex
Capex	Capital expenditure
CCP	Consumer Challenge Panel (sub-panel 22)
CESS	Capital expenditure sharing scheme
COAG	Council of Australian Governments
CPI	Consumer price index
DoEE	Department of the Environment and Energy
DNSP	Distribution network service provider
DV	Diminishing value
EBIT	Earnings before interest and tax
EBSS	Efficiency benefit sharing scheme
ENA	Energy Networks Australia
Energy networks	electricity and gas network service providers
ITAA 1997	Income Tax Assessment Act 1997
M&A	Mergers and acquisitions
MIT	Managed Investment Trust
NEL	National Electricity Law
NEO	National Electricity Objective
NER	National Electricity Rules
NERL	National Energy Retail Law
NGL	National Gas Law
NGR	National Gas Rules

NPV	Net present value
NSP	Network service provider
NTER	National Tax Equivalent Regime
Ofgem	Office of Gas and Electricity Markets
Opex	Operating expenditure
PTRM	Post-tax revenue model
PwC	PricewaterhouseCoopers
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
Repex	Replacement capex
RFM	Roll forward model
RIN	Regulatory information notice
SL	Straight–line, or Prime cost
TAB	Tax asset base
The rules	Collectively, the NER and NGR
TNSP	Transmission network service provider
WACC	Weighted average cost of capital

Contents

1 Process 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 report is the final step in our regulatory tax approach review, following the release of our issues paper in May 2018, initial report in June 2018 and discussion paper in November 2018. It extends on the analysis based on the information network service providers (NSPs) voluntarily provided by incorporating the detailed tax information received in the Regulatory Information Notices (RINs). It recommends changes to our regulatory tax approach, which will now proceed to the implementation stage and a formal model change process. It also outlines potential changes that we do not consider should be pursued. We have focussed on testing potential changes to our regulatory tax approach with regard to the long term interests of consumers as framed in the National Electricity Objective (NEO) and National Gas Objective (NGO).

1.1 Why are we undertaking this review?

The estimate of expected tax payments is one component we consider when we set revenue allowances for regulated electricity and gas networks. These allowances are set using a 'building block' approach in which revenue is expected to equal the total efficient costs incurred by the regulated networks, including expected tax costs. The AER determines the expected cost of corporate tax in accordance with the relevant rules—that is, the National Electricity Rules (NER) and National Gas Rules (NGR).

The incentive framework operates differently than a cost of service framework. The former provides for a forecast of efficient costs based on a benchmark efficient firm whereas the latter provides for actual costs incurred by the individual network. We would expect an individual network's actual costs to differ from the benchmark. The incentive framework encourages networks to increase efficiency through reduction in costs while still maintaining safe and reliable services. Periodic examination is necessary where actual costs of many networks are all above or all below the benchmark. The cost of service framework allows the pass through of all costs regardless of whether they are efficient or not.

Stakeholder concerns

Consumer submissions in 2017 and early 2018 asked the AER to examine whether our forecast of tax costs materially differed from the actual tax payments made by regulated networks.[1] Consumers were concerned that tax payments were below the AER's forecasts

[1] For example, see Consumer Challenge Panel (CCP) 9, *Submission to the AER, Response to TransGrid for a revenue reset for 2018-19 to 2022-23*, 12 May 2017, pp. 36–38, 80–83; Consumer Challenge Panel (CCP) 9, *Submission to the AER, Response to draft decision and revised proposal for revenue reset for Murraylink for 2018-23*, 29 January 2018,

and so they might be paying more than the efficient cost of providing electricity and gas services.

We initiated the review by publishing preliminary advice from the Australian Tax Office (ATO).[2] This identified several potential drivers causing an apparent material difference between the provision for tax costs in AER determinations and the actual tax payments made to the ATO by the regulated networks. The Minister for the Environment and Energy requested that we investigate this issue and produce a final report with recommendations by December 2018.[3]

Purpose of the review

In this review we are investigating the nature of the identified difference between the regulatory forecast of tax costs and actual tax payments. We are examining the drivers of any tax difference and considering whether changes to our regulatory tax approach are required. We are looking to see whether an alternative regulatory treatment will better measure efficient tax costs. We also need to consider how recently introduced or imminent tax legislation changes will impact any difference between our assumed tax and what the businesses pay.

In assessing options for possible change to our approach to assessing tax costs, we are not seeking to reduce the tax difference as an aim in itself insofar as there may be valid and enduring reasons for the regulatory forecast of tax costs and actual tax payments to differ. Rather, our focus remains on making decisions in relation to revenue proposals that are in the long term interest of consumers as required under the NEO and NGO. We consider the immediate implications for consumers, but also the longer term effects once businesses have responded to the incentives that regulation provides. We are identifying possible changes to our tax approach that might reduce the tax difference, but only where to do so helps ensure customers pay only efficient costs over the long term. Options may include changes to how the AER regulates the tax aspects of its revenue determinations (for instance, through changes to the regulatory models) and/or changes to the NER and NGR.

1.2 What has happened since the discussion paper?

We held a second public forum about our initial report on 7 November 2018 and received 24 written submissions from stakeholders in response to the discussion paper.[4] We commissioned a second report from the technical tax advisors PricewaterhouseCoopers (PwC) regarding the new information received in the RINs that was not considered in the discussion paper.[5]

We met with stakeholders, including meetings with:

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p. 36.

2 ATO, *Note to the AER–Comparison of regulatory tax allowances and tax paid*, 10 April 2018.

3 The Hon Josh Frydenberg, Minister for the Environment and Energy, *Letter to the AER re: tax allowances*, 3 May 2018.

4 Submissions are available on our website at https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/review-of-regulatory-tax-approach-2018/consultation

5 PwC, *AER tax review 2018–Addendum, Expert advice*, 10 December 2018.

- The ATO, Department of the Environment and Energy (DoEE), and Commonwealth Treasury (7, 15 November and 3 December)
- The Consumer Challenge Panel (16, 21 November and 5, 6 December)
- Energy Networks Australia (22 November and 6 December).

1.3 How can stakeholders contribute?

We will implement the recommendations of this review through a model change process, in order to implement depreciation related changes in our approach.

Engaging with those affected by this review assists us to make better decisions because it enables us to understand all stakeholder perspectives and evaluate the merits of any possible changes. It also increases regulatory transparency and confidence in the regulatory regime.

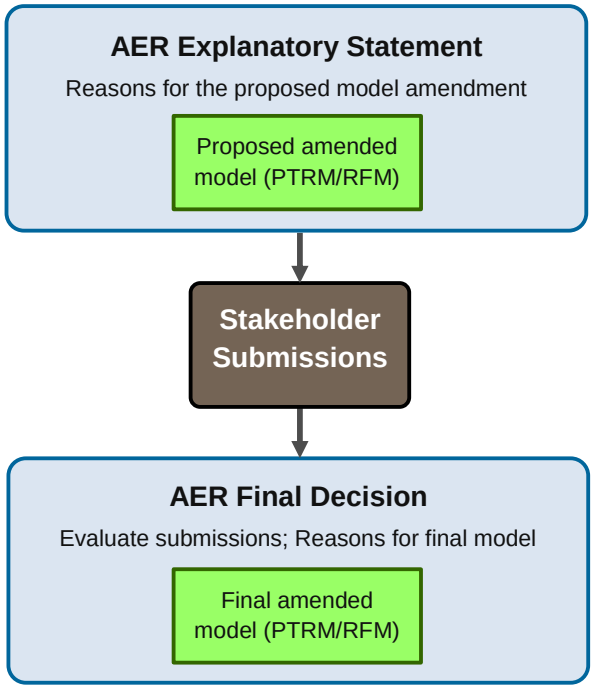
The regulatory model change process

We consider that the three depreciation related changes can now proceed to implementation, which requires a formal model change process for two of the three recommended changes (immediate expensing and diminishing value). A third recommendation around depreciation (capping gas asset lives) does not require a model change to implement. These three areas were identified as possible changes in our November discussion paper. We have had the opportunity to consider stakeholder submissions on the case for and against these changes. The additional RIN information now available to us confirms the earlier findings based on the voluntary information phase. There will be further stakeholder consultation as part of the process for making changes to the two key regulatory models, the post-tax revenue model (PTRM) and the roll forward model (RFM).[6]

The model change process is illustrated in Figure 1.1.

6 These models are legislated under the NER, but not the NGR. In practice, most gas businesses use the electricity templates. NER, r. 6.4.1(b), 6.5.1(c) and 6.16 (distribution consultation procedures). There are equivalent transmission clauses.

Figure 1.1 Consultation leading to a model change



The AER will produce an explanatory statement that includes the proposed model changes and the reasons for those changes in late January 2019. At this stage, we will focus on making changes to the PTRM because this model leads the implementation of the depreciation changes set out in this final report for a regulatory period. The RFM implementation of the depreciation changes follows in the subsequent regulatory period and so we will make changes to the RFM at a later stage.

We will invite stakeholder submissions on the proposed model changes and the reasons for those changes for a period of 30 business days.[7]

After considering submissions, we will finalise the model changes and publish our decision with the final model and accompanying reasons.[8] These model changes would be finalised no more than 80 business days after the publication of the proposed amendments.

Consistent with our initial report and discussion paper, our intention is to apply these model changes to the group of revenue determinations with final reset decisions due in April 2019.[9] It will be necessary to undertake additional consultation with the affected businesses on the specific implementation of the model changes for their network, but this could be done simultaneously with the general model changes.[10]

7 This would be at least 30 business days under NER cl. 6.16(c).

8 We would finalise model changes within 80 days under NER cl.6.16(e).

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

10 The initial report explicitly asked for stakeholder views on whether the model changes should be applied to the April 2019 reset decisions. Stakeholder submissions from the affected networks (where they made such a submission) did not address this issue. Ausgrid made an earlier submission to the issues paper opposing the application of model changes to

What happens next?

The updated timeline and milestones for this review are shown in Table 1.1. We have distinguished upcoming milestones based on whether they relate to the model change process or the subsequent report. We may alter the timeline and milestones during the review in response to emerging issues.

Table 1.1 Project timeline and milestones

Date	Milestone
November 2018	Publish discussion paper (2 November)
	Submission period on discussion paper ends (23 November)
	Public Forum (7 November)
December 2018	Publish final report and recommendations (17 December)
	COAG Energy Council meeting (19 December)
January 2019	Publish proposed regulatory model amendments and explanatory statement (end January)
	Submission period on regulatory model amendments (six weeks)
February 2019	Submission period on regulatory model amendments continued (six weeks)
March 2019	Submission period on regulatory model amendments ends
April 2019	Publish final regulatory model amendments and final decision on amendments

its 2019 reset. See Ausgrid, IFM and AustralianSuper, *Submission – AER review of regulatory tax approach*, 31 May 2018, p. 19.

2 Findings and recommendations

Overall

We recognise that it has been some time since we reviewed our regulatory approach to forecasting tax costs. The purpose of our review is to consider whether there are approaches to taxation that better promote the long-term interests of consumers. The scope of our review, however, has been limited by the timeline to deliver our final report.

At the start of our review, there was a perception that there was a large gap between our regulatory allowance for tax and the tax actually paid by the regulated networks. Through this review we have found that the gap is not as large as it appears. Some of the gap is because of the impact of taxable revenue and expenses that are outside the scope of the regulated networks. When we isolate the tax position of the regulated networks the gap closes, but some gap remains.

Our final report recommends implementing changes to tax depreciation to better align the regulatory treatment with actual practices. Such changes are able to be implemented through the PTRM in time to apply to the April 2019 revenue determination decisions. These changes will further narrow the gap, but not close it entirely. We have examined options that might eliminate the gap, but consider these options have potential consequences that mean that consumers could ultimately be worse off. Therefore, we are not recommending these options.

Tax pass through

In the discussion paper, our preliminary finding was that we would not adopt a tax pass through, but instead maintain the current incentive benchmark approach. We concluded that given the available evidence, we should exercise caution before moving to a tax pass-through regime.

We noted the key advantages and disadvantages of changing to a tax pass through:

- It would directly target a reduction in the difference between the AER's forecast of tax costs and actual tax paid. However, reducing the tax difference was not an end in itself—for instance, if it resulted in increased costs overall.
- Costs to consumers may increase in the long run, as there is no incentive for a regulated network to reduce its tax costs. Costs to consumers may also increase in the short run, where depreciation had been brought forward in advance of the regulatory benchmark.
- There would be an incentive to shift tax obligations from unregulated activities into the regulated framework, and associated monitoring/enforcement costs in preventing this.

In this final report, we further consider that:

- Corporate income tax differs from the type of costs where we currently apply pass throughs—it is not exogenous to the business (rather, it is inherently linked to the operation of the other building block components); is not unforeseen; the obligation does

not directly fall on the businesses we regulate; and there is a lag in determining quantum of the tax obligation.

- There are disaggregation and allocation questions when isolating relevant tax outcomes as the basis for a tax pass through, although the ATO may be better placed to calculate the tax paid that is related to only the regulated activities of the firm.

The general consensus from stakeholder submissions to our discussion paper was that the incentive approach to tax costs should continue, and that administering a pass through approach for tax costs would have significant difficulties and costs without providing benefits for consumers.

The exception was the submission we received from the DoEE, which stated that the regulatory framework could provide a pass through of tax to cover the costs of this statutory obligation as it does with various imposts such as industry specific or state-based levies or charges. The DoEE urged us to work closely with the ATO in preparing our final report to fill in any information gaps, and consider the practicalities of operating an alternative mechanism for calculating company tax. The DoEE identified areas where it considered it would be possible to obtain more information.

The DoEE's submission prompted responses (late submissions) from Energy Networks Australia (ENA) and the Consumer Challenge Panel (CCP). These advanced more material on the advantages and disadvantages of potential changes to the incentive framework.

We note that the potential costs and benefits of a tax pass through approach have been a direct focus of stakeholder consultation and discussions since the commencement of the AER's review in May this year. We also commissioned expert reports on these issues, including from tax advisors.

We have been asked to deliver a final report to COAG Energy Council on the results of our investigation and provide recommendations on any changes by December 2018. The former Minister for the Environment and Energy the Hon. Josh Frydenberg MP wanted us to apply any changes to the April 2019 revenue determinations.

Moving to a pass through approach to tax would be a material change to the current incentive based regulatory framework. We have relied on both publicly available information and information we have received through our compulsory information gathering powers (which we also consulted on). There has not been additional material and reasoning that would support a change in approach that has been provided to us for consideration for this final report. As such, for the purposes of this final report we maintain our conclusion that an incentive approach to tax costs is appropriate and should continue.

Multiple benchmarks

In our discussion paper, our preliminary finding was that we would maintain the standard company tax rate (30 per cent) for all network decisions.

We noted the key reasoning behind the maintenance of this benchmark, as opposed to a different rate:

- This reflects the most commonly observed tax profile of regulated networks.[11] This is true when considering all regulated assets, or when considering only private-sector networks.
- It also appears to be the relevant basis for assessing tax in the future, particularly with regard to legislative changes affecting the tax treatment of structures and certain classes of owners.

Many stakeholder submissions were received in response to the discussion paper, and almost all agreed with this benchmark. There were two exceptions. The CCP submission stated that the AER should consider a second benchmark (15 per cent tax rate) in addition to the primary benchmark, and apply that benchmark to any structure other than a company structure. The ECA submission stated that the benchmark tax allowance (not just the tax rate) could be set using the observed average tax paid for all networks, expressed as a percentage of EBIT (or another metric).

In this final report, we further consider that:

- Maintaining the single benchmark tax rate would be consistent with our approach to setting the rate of return, and ensures the correct overall revenue recovery package. It is not clear if this would be the case under multiple benchmarks or an alternative benchmark construction.
- It is not clear that the proposed second benchmark would be appropriate where owners in flow through structures still pay the standard corporate tax rate, or where joint owners of one entity have different tax rates.

Introducing a second benchmark for the purposes of calculating our tax costs would be a material departure from the current regulatory framework. In particular, careful consideration and consultation needs to be given to potential consequential impacts in other parts of the regulatory framework and the overall impact on incentives for efficient outcomes. For the purposes of this final report and based on the information before us, we are not recommending the adoption of a second benchmark or an alternative benchmark construction.

2.1 Findings

The relevant entities

1. The relevant tax outcomes are those that relate only to regulated activities. Regulated activities are strictly limited to the operation of the assets contained in the regulatory asset base (RAB) in order to provide specific regulated energy services. In electricity, this means the operation of the RAB in order to provide specified distribution or transmission services covered under the NER. In gas, this means the operation of the capital base to provide specified reference services covered under the NGR.
2. The value of the RAB is established in accordance with the NER and NGR provisions for the roll forward of the asset base from one period to the next. The RAB is not revalued as a result of market transactions, but reflects an unbroken chain of capital expenditure,

11 PwC, *AER tax review 2018, Expert advice*, 26 October 2018, p. 50.

disposals and regulatory depreciation back to the initial valuation for each network or pipeline.

For electricity distribution networks, these initial values are prescribed in Schedule 6.2.1(c) of the NER, as shown in Table 2.1.

Table 2.1 Prescribed initial RAB values for distribution networks

Jurisdiction	Distribution network service provider	Regulatory asset base ($m)
Australian Capital Territory	ActewAGL (now known as Evoenergy)	510.54 (as at 1 July 2004 in July 2004 dollars)
New South Wales	Country Energy (now known as Essential Energy)	2,440 (as at 1 July 2004 in July 2004 dollars)
	EnergyAustralia (now known as Ausgrid)	4,116 (as at 1 July 2004 in July 2004 dollars)
	Integral Energy (now known as Endeavour Energy)	2,283 (as at 1 July 2004 in July 2004 dollars)
Queensland	ENERGEX	4,308.1 (as at 1 July 2005 in July 2005 dollars)
	Ergon Energy	4,198.2 (as at 1 July 2005 in July 2005 dollars) but, if the Queensland Competition Authority nominates a different amount in writing to the AER, the regulatory asset base is the amount so nominated.
South Australia	ETSA Utilities (now known as SA Power Networks)	2,466 (as at 1 July 2005 in December 2004 dollars)
Tasmania	Aurora Energy (now known as TasNetworks)	981.108 (as at 1 January 2008 in July 2006 dollars)
Victoria	AGL Electricity (now known as Jemena)	578.4 (as at 1 January 2006 in July 2004 dollars)
	CitiPower	990.9 (as at 1 January 2006 in July 2004 dollars)
	Powercor	1,626.5 (as at 1 January 2006 in July 2004 dollars)
	SP AusNet (now known as AusNet Services)	1,307.2 (as at 1 January 2006 in July 2004 dollars)
	United Energy	1,220.3 (as at 1 January 2006 in July 2004 dollars)

For electricity transmission networks, these initial values are prescribed in schedule 6A.2.1(c)(1) of the NER, as shown in Table 2.2.

Table 2.2 Prescribed initial RAB values for transmission networks

Transmission Network Service Provider	Regulatory Asset Base ($m)
EnergyAustralia (now known as Ausgrid)	635.6 (as at 1 July 2004)
TransGrid	3,012.76 (as at 1 July 2004)
Powerlink	As per transitional revenue determination in accordance with clause 11.6.12
ElectraNet	823.75 (as at 1 January 2003)
Transend (now known as TasNetworks)	603.6 (as at 31 December 2003)
SP AusNet (now known as AusNet Services)	1,835.60 (as at 1 January 2003)
Murraylink Transmission Company	102.96 (as at 1 October 2003)
Directlink	116.68 (as at 1 July 2005)

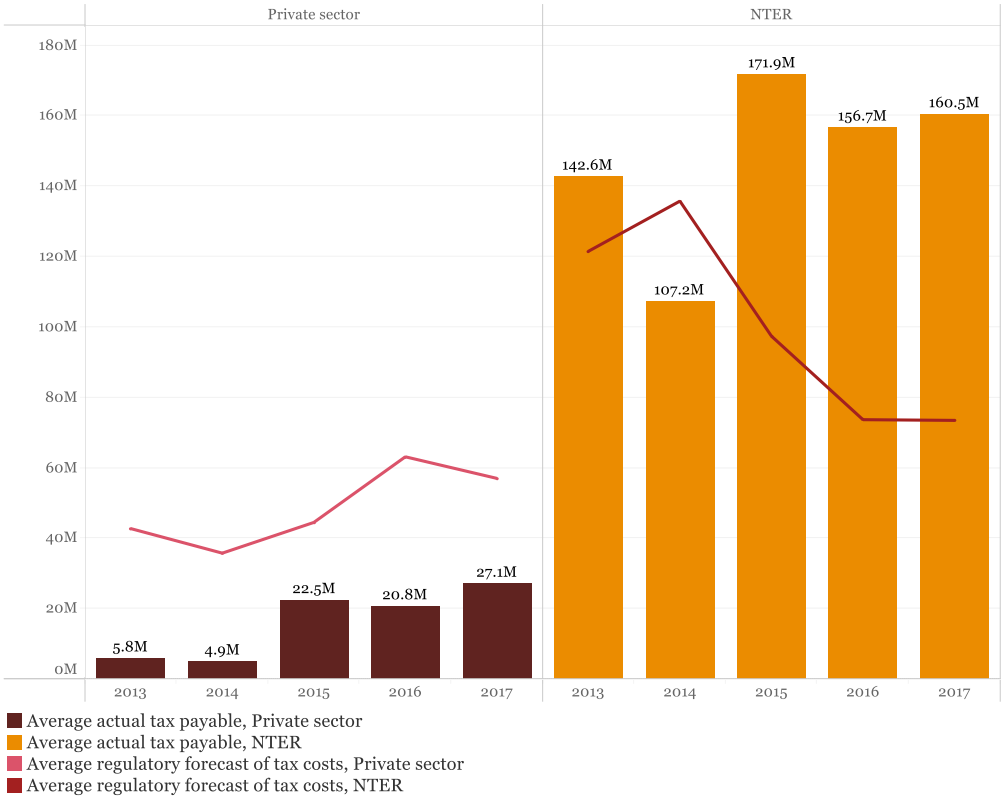
For gas transmission pipelines and distribution networks, the initial valuation was not legislatively prescribed but was established in the initial ACCC or AER decision for each network/pipeline under either the National Gas Code or the NGR.

3. The value of the tax asset base (TAB) is set to align with the basis for valuing the RAB. Market transactions do not result in a revaluation of the TAB, just as they do not result in the RAB being revalued. The same capex contributes to the TAB as the RAB. There is an unbroken chain of capex, disposals, and tax depreciation back to the initial TAB valuation for each network or pipeline.
4. The taxable revenue and expenses relevant to the regulated activities are always combined with taxable revenue and expenses that are not relevant to the regulated activities to come up with aggregated taxable income, and in turn any relevant tax liability.
5. To undertake a valid comparison we must isolate taxable income generated from regulated activities from taxable income generated from outside of regulated activities.
6. Asset transactions (mergers, acquisitions or privatisations) have no impact on the valuation of the RAB nor the TAB. The incremental financial impact of these transactions sits outside the regulated activities of the networks. Customers of regulated networks do not pay the additional costs to fund these events; nor do they receive the additional tax benefit (through either depreciation or interest expense). These transactions impact the taxable revenue and expenses reported to the ATO and therefore contribute to the face value difference, but do not contribute to the taxable revenue or expenses of the regulated activities.
7. After we have isolated the regulatory income and expenses, we find that there is an approximate correspondence between our estimate of taxable income and taxable profits actually incurred by the businesses.

The tax difference

8. The observed tax outcomes over the analysis period, before any adjustment to isolate regulated activities, indicate a substantial tax difference between the AER's provision for tax costs and actual tax payments made to the ATO or equivalent payments under the ATO. This face value tax difference is consistent with the ATO's April 2018 note and our earlier reports, and is illustrated in Figure 2.1.

Figure 2.1 Tax paid by entities owning regulated networks (before consideration of flow-through entities)—from PwC addendum



Source: PwC, *AER tax review 2018–Addendum, Expert Advice*, 10 December 2018, p. 36 (figure 6)

Notes: Data from RIN responses. This graph does not isolate the tax outcomes attributable to only regulated activities. It also does not include flow-through entities. This is a paired comparison, including only firms with both actual tax (or NTER equivalent) information and regulatory information.

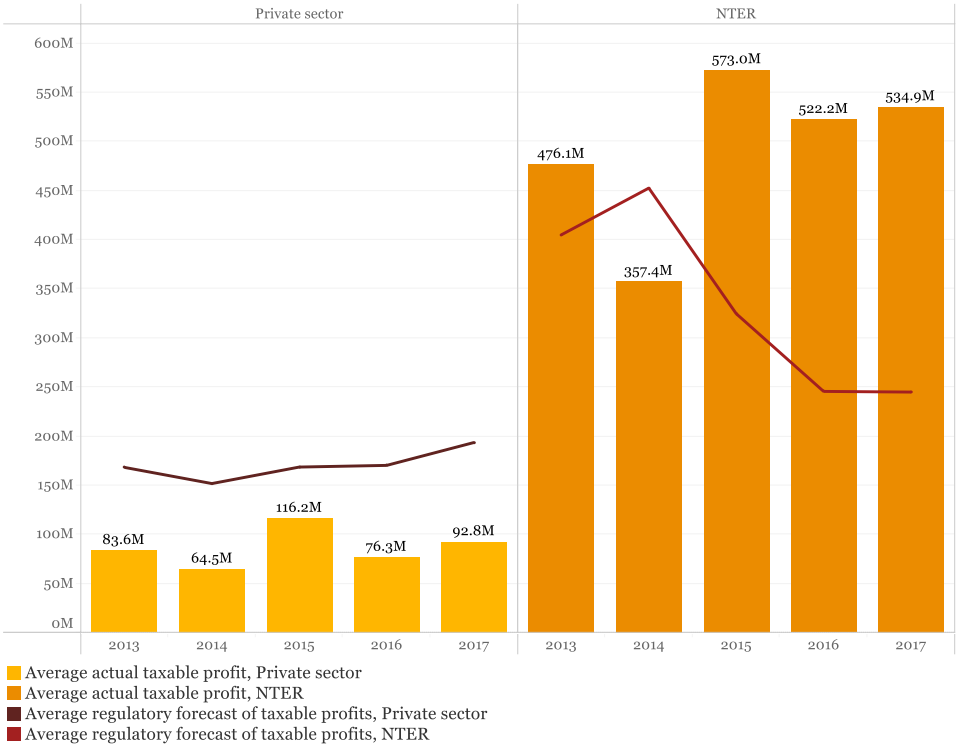
9. This tax difference varies by ownership status. Privately owned networks pay less tax than the AER forecasts. State or territory government-owned networks pay more (equivalent) tax than the AER forecasts.

10. When we isolate the tax outcomes relevant to regulated activities, we observe evidence that the relevant tax difference is less than the face value tax difference. There are three primary reasons for this: chains of ownership, exclusion of taxable revenue and expenses arising from unregulated activities, and accrued tax losses.

11. Where energy networks are held in flow through structures (partnerships and trusts), it is necessary to track tax outcomes up the chain of ownership to the first level at which tax is required to be paid. This is illustrated in Figure 2.2. This figure is similar to Figure 2.1,

but presents taxable profits (the tax assessment step prior to the calculation of tax paid) so that distributions to upstream investors can be included. When we undertake this tracking we find that more taxable profits are recorded and this has the effect of reducing the gap between the yellow columns and the red line on the left hand side of Figure 2.2.

Figure 2.2 Taxable profits (including flow through entities) based on RIN responses—from PwC addendum



Source: PwC, *AER tax review 2018–Addendum, Expert Advice*, 10 December 2018, p. 38 (figure 8).

Notes: Figure 2.2 shows taxable profits, before the application of a statutory tax rate (for example—30 per cent, 15 per cent or 0 per cent), unlike Figure 2.1 which shows tax paid after the application of the standard corporate tax rate (30 per cent). Data from RIN responses. This graph does not isolate the tax outcomes attributable to only regulated activities. This is a paired comparison, including only firms with both actual tax (or NTER equivalent) information and regulatory information

12. Figure 2.2 includes tax outcomes arising from unregulated activities and these need to be excluded to provide a valid comparison with our estimate of regulated tax. The two largest effects are:

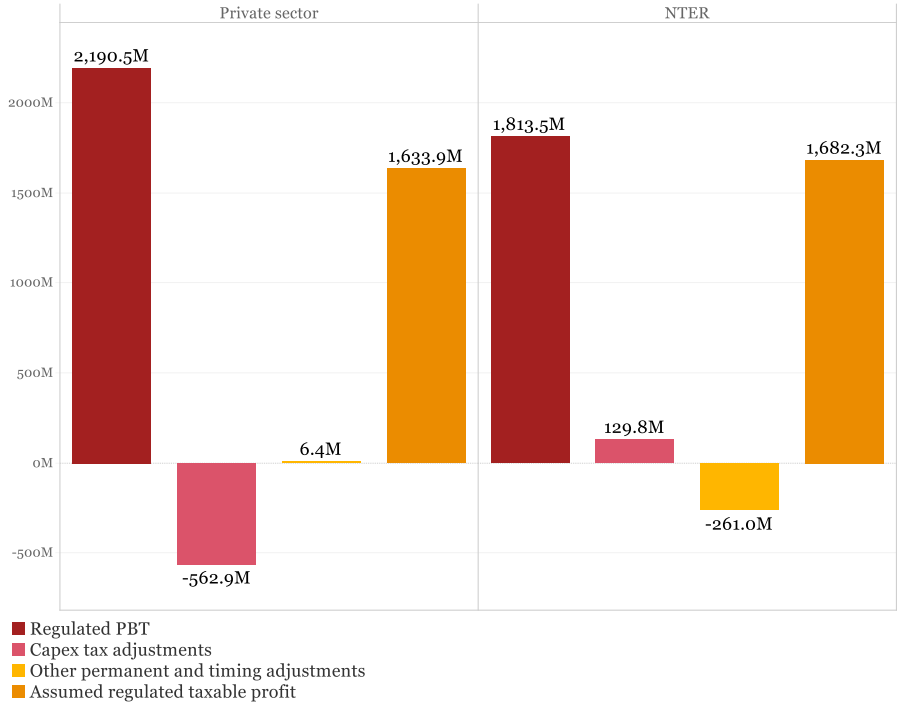
    - For private entities—asset values recorded in tax accounts used to calculate tax payments to the ATO tend to be higher than the TAB used by the AER to forecast tax costs for regulated entities. Consumers do not fund these higher asset values through our regulatory allowance, so the taxable expenses associated with these higher asset values also need to be excluded from our comparison. Excluding these taxable expenses has the effect of increasing the height of the yellow columns in Figure 2.2.

- For National Tax Equivalent Regime (NTER) entities—taxable revenue includes other sources which is not revenue earned in the provision of regulated activities. This additional taxable revenue includes: revenues transferred for upstream network use of system charges; and transfers to cover payment of feed-in tariffs to retailers and other state government taxes. Excluding these taxable revenues has the effect of decreasing the height of the orange columns in Figure 2.2.

13. The detailed tax information obtained by the AER included material that attempts the disaggregation of tax outcomes to isolate tax outcomes relevant to regulated activities from the financial accounts prepared by the regulated networks. This is presented in Figure 2.3. Under this comparison:

    - For privately owned networks, we observe an approximate correspondence between the AER's provision for tax costs and stand-alone tax positions. The equivalent figure in the regulatory models would be $1,616 million, against $2,191 million (derived from financial accounts) and $1,634 million (derived from tax return working papers).
    - For government owned networks, we do not observe an approximate correspondence between the AER's provision for tax costs and stand-alone tax positions. The equivalent figure in the regulatory models would be $978 million, against $1,814 million (derived from financial accounts) and $1,682 million (derived from tax return working papers). This may reflect that this approach still has not been able to isolate a like-for-like comparison of the taxable revenue and expenses for the regulated networks.

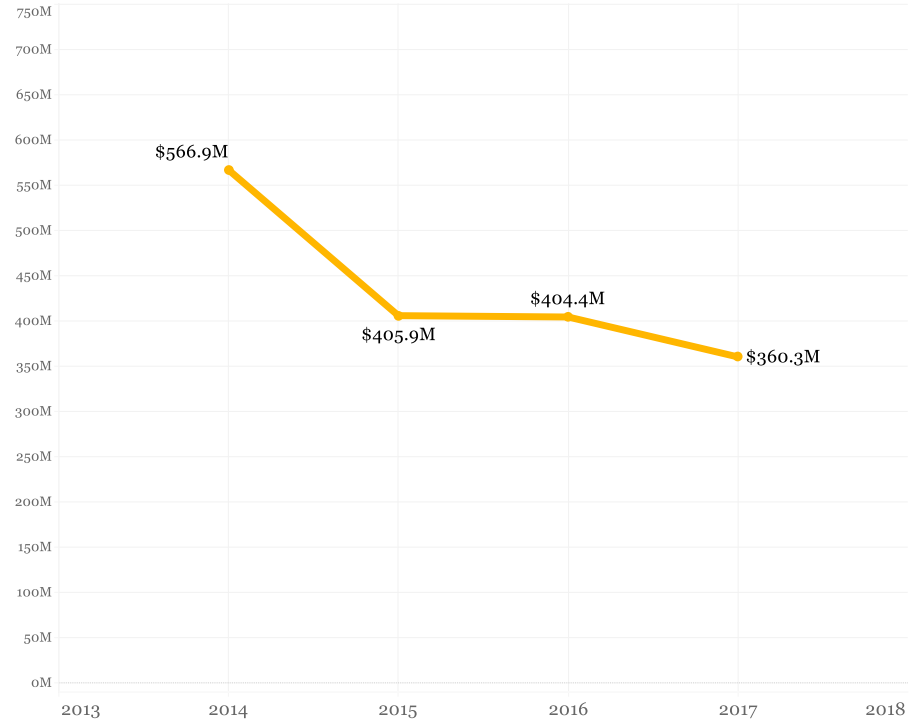
Figure 2.3 Estimated stand-alone regulated tax position, comparison of privately owned vs government owned networks—from PwC Addendum



Source: PwC, *AER tax review 2018–Addendum, Expert Advice*, 10 December 2018, p. 45 (figure 12).

14. Where energy networks had accrued tax losses at the commencement of the ATO analysis period, it is necessary to consider the extent to which these previous tax losses were being used up during the period. It is also relevant whether the historical generation of these tax losses related to regulated activities. We have not been able to distinguish the quantity of accrued tax losses arising from regulated and unregulated activities, however, we have some information suggesting that the quantum arising from unregulated activities is likely to be material. If we could exclude tax losses accrued from unregulated activities it would have the effect of increasing the height of the yellow columns in Figure 2.2. There is also a timing effect in play. Once accrued tax losses are exhausted, in future the yellow columns in Figure 2.2 will be higher. Figure 2.4 shows the trend in accrued tax losses.

Figure 2.4 Accrued tax losses across the ATO analysis period—from PwC addendum



Source: PwC, *AER tax review 2018–Addendum, Expert Advice*, 10 December 2018, p. 42 (figure 11).

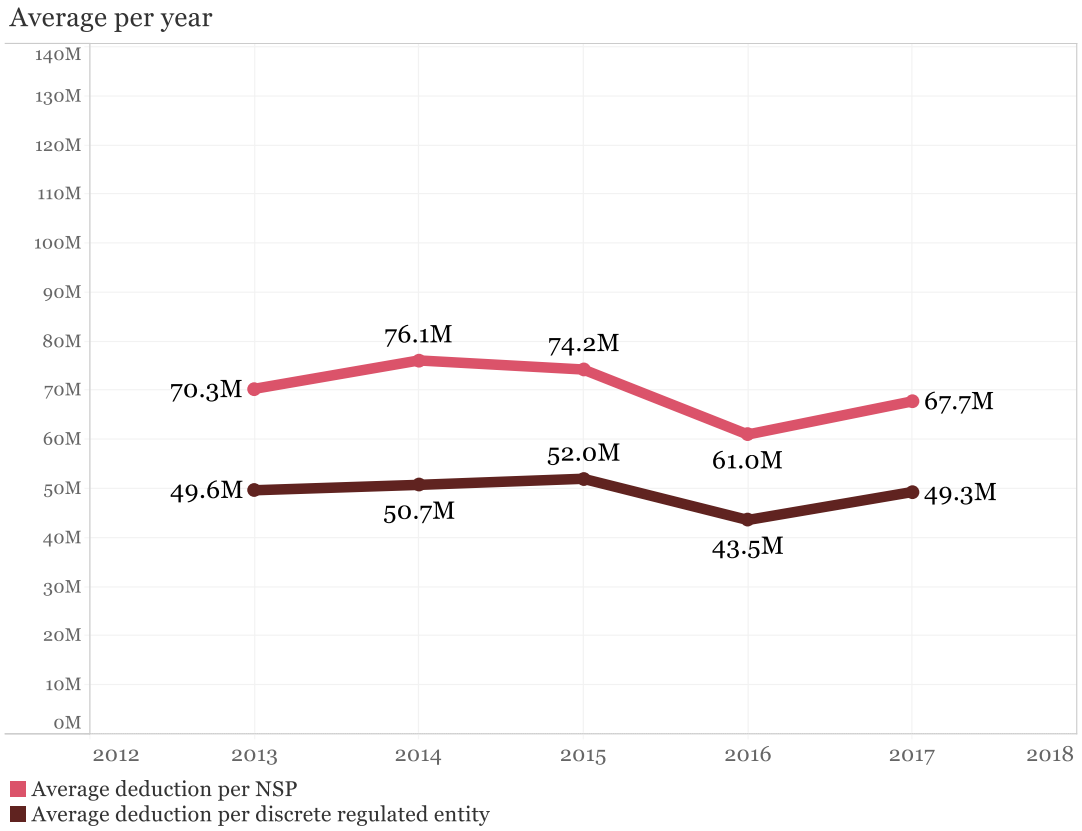
15. Once we make these adjustments, the gap between taxable profits incurred and our estimate of taxable profits reduces. Nevertheless, we still observe that privately owned networks pay less tax than the AER forecasts, while state or territory government owned networks pay more (equivalent) tax than the AER forecasts.

Depreciation and the tax difference

16. Three depreciation related timing effects contribute to the tax difference, are relevant to regulated activities, and could be addressed under the current benchmark approach. These are the effect of immediate expensing for some capex (see Figure 2.5), diminishing value (DV) depreciation (Figure 2.6), and tax asset lives for gas pipelines

(Figure 2.7). In each case, the difference in depreciation timing generates a benefit (in NPV terms) for the networks.

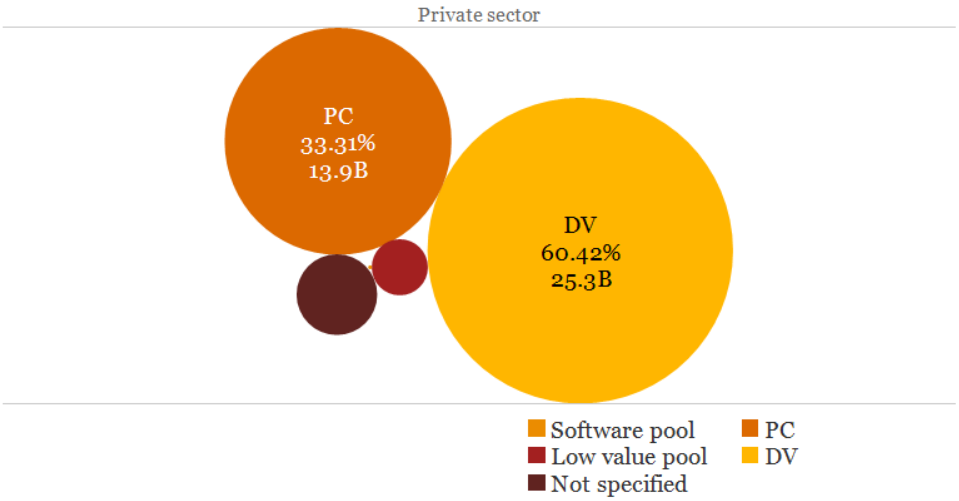
Figure 2.5 Average amount of Capex in the TAB immediately deducted annually for actual tax purposes—from PwC addendum



Source: PwC, *AER tax review 2018–Addendum, Expert Advice*, 10 December 2018, p. 50 (figure 13).

- Figure 2.5 shows the extent of immediate expensing across the ATO analysis period, with around $50 million in annual average deductions per network (around $70 million per NSP, noting that some operate multiple networks). Immediate expensing is not currently recognised in the AER's regulatory models, where the AER forecasts tax costs assuming capex is depreciated over many years.

Figure 2.6 Use of diminishing value by privately owned energy networks—from PwC advice



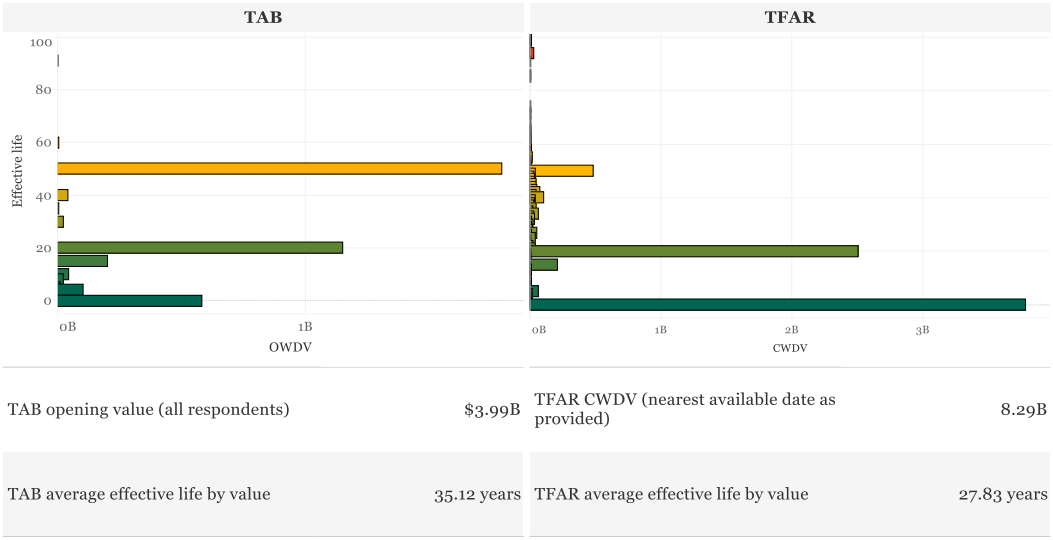
Overall (Electrical & Gas assets)

	TFAR CWDV (nearest available date as provided)	% of total CWDV
PC	13.94B	33.31%
DV	25.29B	60.42%
Not specified	1.76B	4.22%
Low value pool	0.85B	2.04%
Software pool	0.00B	0.01%
Grand Total	**41.85B**	**100.00%**

Source: PwC, *AER tax review 2018, Expert Advice*, 26 October 2018, p. 76 (figure 23).

- Figure 2.6 shows the DV approach is the most prevalent depreciation method used by privately owned networks in actual tax returns The AER currently forecasts tax costs assuming that the straight line (SL) method is used.

Figure 2.7 Effective life spread of gas assets, Non-NTER and NTER entities—from PwC advice



TAB opening value (all respondents)	$3.99B	TFAR CWDV (nearest available date as provided)	8.29B
TAB average effective life by value	35.12 years	TFAR average effective life by value	27.83 years

Source: PwC, *AER tax review 2018, Expert advice*, 26 October 2018, p. 84 (figure 27, extract)

- Figure 2.7 shows that effect of the 20 year cap on the tax life of gas pipeline assets in the tax fixed asset register (TFAR) used to calculate depreciation for actual tax returns (see the green bar on the right hand side of Figure 2.7). The AER does not currently apply the 20 year cap for all gas pipelines/networks, which is evident in the significant proportion of gas assets with lives above 20 years in the TAB (see the yellow bar on the left hand side of Figure 2.7).

17. It appears that a number of regulated networks are close to or have already exhausted the tax depreciation allowance relevant to regulated activities, and will therefore face a higher tax obligation than the forecast under the current benchmark approach in the near future.

Interest expense and the tax difference

18. Interest expense related effects contribute to the face value tax difference in three ways—via interest rates, total asset value and gearing ratio. However, after isolating the interest expense relevant to regulated activities, the difference in interest expense does not indicate that changes to the regulatory tax approach are required in this area. It is important to maintain consistency between the assumptions underlying our rate of return on capital calculations and our regulatory tax calculations.

19. Observed actual interest rates broadly align with the regulatory estimates used to forecast interest expense, noting that this is also affected by (i) the use of a trailing average portfolio for regulatory purposes; (ii) the transition to the trailing average from the previous on-the-day approach; (iii) term differences between actual debt and regulatory benchmarks; and (iv) currency swaps. The recently published rate of return guideline includes changes to the method for estimating the regulated return on debt that will then flow through to future tax calculations, further aligning the regulatory approach with observed tax outcomes.

20. Differences arising from the total asset value (where additional debt is incurred because the total asset value exceeds the RAB) do not appear relevant to the regulated income and expenses of the firm. Consumers do not fund the additional interest charges for debt not related to the value of the RAB of the firm and do not benefit from the additional interest expense for tax purposes.

21. Observed gearing figures broadly align with the regulatory gearing estimates used to forecast interest expense, after adjusting for total asset value, and noting the difference between book value and market value calculations.

Tax rates

22. We have traced tax obligations arising from regulated activities through the chain of ownership to the first level where the tax is required to be paid. In more than 80 per cent of cases (by TAB value) the ultimate tax paying entity is either a government owned entity or a company, who are all notionally taxed at 30 per cent. Of privately held networks, at least two thirds are taxed at 30 per cent. This corresponds to the rate we currently use in our regulatory determinations. This is illustrated in Table 2.3.

Table 2.3 Tax profile of regulated asset holders tracing flow-through vehicles—from PwC advice

Investor tax profile	% of TAB	Expected tax rate
1. NTER entity	40.00%	30%
2. Australian company	29.98%	30%
3. Australian States or Territories (tax exempt, non-NTER)[a]	11.10%	N/A[a]
4. Australian managed investment fund	7.86%	15%–30%
5. Australian superannuation funds	3.79%	15%
6. Foreign sovereign wealth funds	2.90%	0%–30%
7. Foreign pension funds	2.07%	15%–30%
8. Foreign companies	2.30%	30%

Source: PwC, *AER tax review 2018, Expert Advice*, 26 October 2018, p. 17 (Figure 1).

Notes:

(a) There is no effective difference in the investor tax profiles of the 11 per cent identified in this row, and the NTER entities in row 1 (with an expected tax rate of 30%). The classification (30% tax equivalent rate or tax-exempt) reflects a policy decision by the State or Territory owner on whether to participate in the NTER. The total distribution to owners is unchanged.

23. However, up to seventeen per cent of taxpayers do not currently face the 30 per cent tax rate. This includes superannuation funds, overseas sovereign wealth funds, and those that use a stapled structure to obtain a concessional tax rate, as shown in Table 2.3.

24. Recent and imminent legislative changes will restrict the use of these concessional tax rates. Some of these changes are already having an effect, but others take up to fifteen years to have an effect. There have also been recent restrictions on the use of related party interest deductions (after the *Chevron* court outcome) and double gearing to reduce

tax payments. The increase in tax rates over time for stapled structures is illustrated in Table 2.4.

Table 2.4 Changing tax rates for owners of stapled structures—from PwC addendum

Distribution	Current tax rate	01/07/2019 to 30/06/2026	01/07/2026 to 30/06/2034	From 01/07/2034
Distributions of cross-staple rent from the asset entity	0%[a] / 15%[b]	0%[a] /15% / 30% 15% rate applies to cross-staple rent that satisfies the integrity rules. Otherwise 30% rate applies.	15% / 30% 15% rate applies to cross-staple rent that satisfies the integrity rules. Otherwise 30% rate applies.	30% (depending on investor's tax profile[c])
Distributions of income from the operating entity	0%[a] / 15%[b]	0%[a] / 15%[b]	30%	30%

Source: PwC, *AER tax review 2018–Addendum, Expert Advice*, 10 December 2018, pp. 58–59.

Notes: The rates shown in the table assume that sovereign wealth fund investors will maintain their current ownership interest (i.e. they will not sell down to below 10%).

a Applies to sovereign wealth fund investors who have qualify for the sovereign immunity exemption.

b Assumes investors hold their interests via a MIT and are resident in an information exchange country.

c Independent of the effect of stapled structures, superannuation investors retain access to a 15% concessional tax rates. State government owned networks held outside the NTER have no effective tax rate (N/A%); though this makes no difference to the total distribution to their owners.

25. Maintaining a single benchmark using a 30 per cent tax rate (as proposed in our November discussion paper) will not close the tax difference for entities accessing these concessional tax rates. For these entities, the AER's forecast of tax costs is currently higher than the payments made to the ATO. This is a disadvantage of the current approach.

Multiple benchmarks

26. Introducing a second benchmark for the purposes of calculating our tax costs would be a material departure from the current regulatory framework. In particular, careful consideration needs to be given to potential consequential impacts in other parts of our framework and the overall impact on incentives for efficient outcomes. Based on the information before us, we are not recommending the adoption of a second benchmark at this time.

Tax pass throughs

27. The evaluation of regulatory frameworks (incentive based vs cost of service pass throughs) needs to consider the advantages and disadvantages of each approach, and engage with both conceptual and practical reasoning. Based on the information before us, we are not recommending the adoption of a tax pass through approach at this time.

28. There is evidence that actual tax payments could be higher than the current benchmark. This is currently the case for NTER entities. Further, the depreciation timing effect

suggests some networks could be in the position to make future higher tax payments in the short term.

29. If a pass through of tax payments was to be employed in our regulatory framework it would be necessary to calculate the pass through amount annually for each of the 32 individual entities we regulate. This calculation would need to isolate the taxable revenue and expenses attributable to only regulated activities. As the calculation would need to comply with applicable tax law we consider it would be preferable for the ATO to assess the pass through amounts proposed by the regulated entities annually.

2.2 Recommendations

1. The current regulatory tax approach should be adjusted to address depreciation mismatches arising from immediate expensing. The AER should recognise the scope for this type of tax deduction in its forecast of tax costs in each regulatory determination. It may have regard to the circumstances of the firm and the use of immediate expensing more broadly across the sector. The AER should conduct a formal model change process (with consultation) to consider the implementation of these changes in its regulatory models.
2. The current regulatory tax approach should be adjusted to address depreciation mismatches arising from the use of the DV approach. The AER should use a benchmark DV approach (instead of SL depreciation) for new assets. The AER should conduct a formal model change process (with consultation) to consider the implementation of these changes in its regulatory models.
3. The current regulatory tax approach should be adjusted to reflect the application of a 20 year tax life cap for new gas assets. This does not require a model change and the AER should change its approach for upcoming regulatory decisions.
4. The AER should undertake formal reviews of its regulatory tax approach on a regular basis. A general schedule would be to align tax reviews with its reviews of the rate of return guideline, recognising the interrelationships between the two. The AER may also commence a review in response to new information identifying a significant shift in the tax practices of regulated networks.

3 What is our current approach?

The AER's current tax approach sits within our overall regulatory approach—a building block incentive framework. As it has been some time since we reviewed our regulatory approach to forecasting tax costs, we consider it an appropriate time to review 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.

3.1 How is tax assessed?

We set regulated revenues using a 'building block' approach so that energy networks can recover their efficient costs, including their tax costs. On average, the tax building block comprises about 4 per cent of the total regulated revenue for an energy network.

We currently forecast tax costs using a standard tax calculation based on our estimates of taxable revenue, tax expenses (such as depreciation, interest, operating expenditure) and the statutory corporate income tax rate (30 per cent). This forecast tax is then adjusted for the value of imputation credits (gamma) to set the allowance for corporate income tax.

Our forecast of tax costs broadly aligns with the core steps in the tax calculation undertaken by the ATO. Actual taxable revenue, tax expenses and resulting taxable income for the energy networks is reported to the ATO, which then becomes the basis for calculating tax payable using the applicable tax rate.

In this review, we are examining the difference between:

- our provision for tax costs in the regulatory determinations (before the adjustment for gamma), and
- the actual tax payments made by the regulated energy networks.

The reason the appropriate comparison point is actual tax paid to forecast tax costs before the value of imputation credits is deducted, is because this reflects our forecast of corporate tax to be paid by the regulated business. Critically, the value of imputation credits reflects a reduction in the regulated allowance to account for the expected imputation credits to be claimed back from this tax payment, not an expected reduction in corporate tax to be paid.

Some of the regulated energy networks are wholly (or partly) owned by State Governments or Territories. These government owned energy networks may participate in the NTER.[12] The NTER is administered by the ATO and is an arrangement under which relevant taxation laws are applied notionally to the NTER businesses as if they were subject to federal income tax laws.

Each NTER entity is assessed annually for its income tax equivalent liability, and is required to pay this amount to the Treasury or Revenue Office in the State or Territory to which the NTER business belongs.

12 http://law.ato.gov.au/atolaw/view.htm?DocID=NTR%2FNTER0001.

Therefore, for government owned energy networks, we are comparing their income tax equivalent liability against our forecast tax costs for those businesses.

3.2 What is the current regulatory framework?

This section describes the operation of the overall regulatory approach, not the details of our specific regulatory tax approach. It is important to understand the purpose and operation of the regulatory framework in which the tax allowance sits.

The building block approach

We set regulated revenues so that energy networks can recover the efficient costs of providing energy services to consumers. We use a 'building block' approach to determine the efficient costs (and therefore total regulated revenues) by adding together expected costs in five different categories.[13] The building block components are:

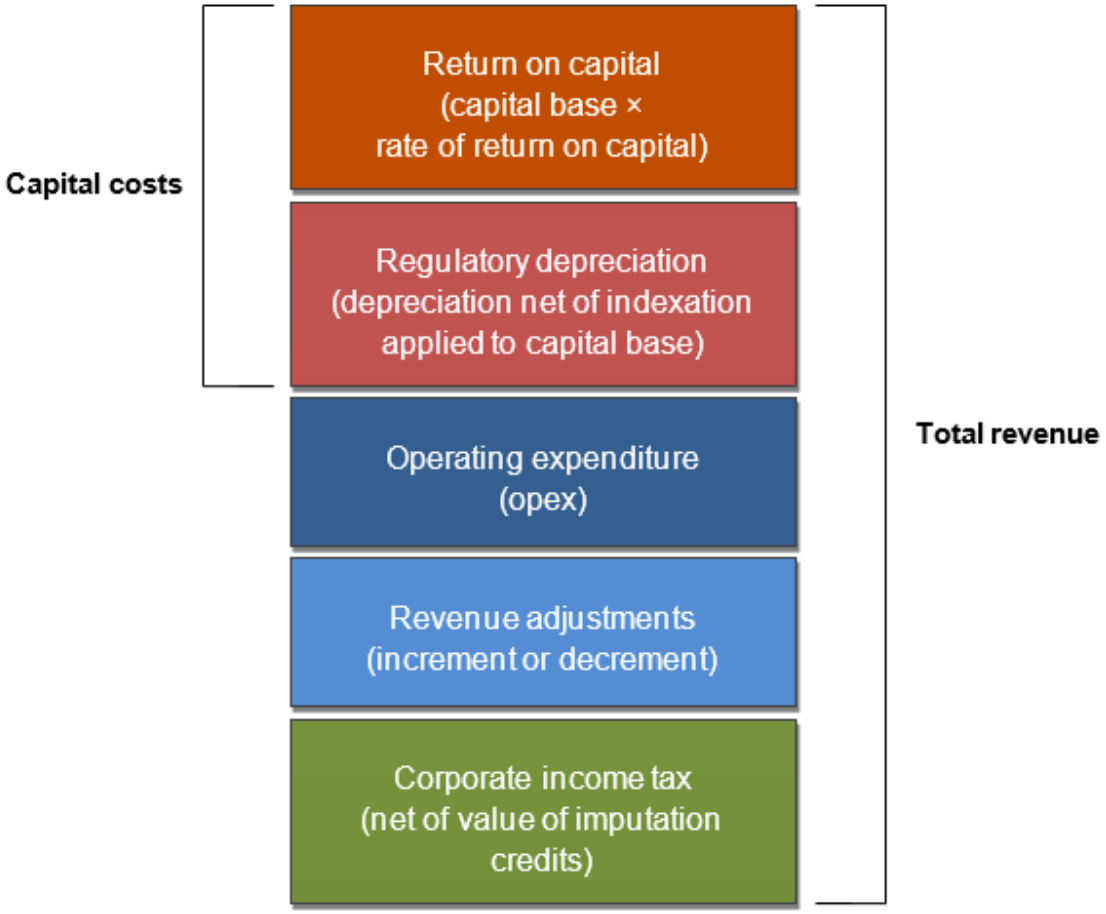
- return *on* capital (to compensate investors for the opportunity cost of funds invested in the business)
- return *of* capital (regulatory depreciation, to return the initial investment to investors over time)
- operating expenditure (to cover the day-to-day costs of maintaining the network and running the business),
- revenue adjustments (increments or decrements from incentive mechanisms[14]), and
- cost of corporate taxation (which is net of value of imputation credits, gamma).

This last building block recognises that corporate tax is a cost incurred by businesses operating in Australia. The building blocks are illustrated in Figure 3.1.

13 The 'revenue adjustments' building block does not directly relate to expected costs; rather, it operates to add or subtract from total revenue in order to incentivise efficient behaviour in other building blocks.

14 Such as the Efficiency Benefits Sharing Scheme for opex, and the Capital Expenditure Sharing Scheme for capex.

Figure 3.1 The AER building block approach for determining total revenue



Source: AER.

The incentive benchmark approach

The building block approach sits within an incentive framework where regulated revenues are generally set for a five-year period based on the forecast costs of a benchmark efficient entity operating that energy network. NSPs who keep actual costs below the regulatory forecast of costs retain part of the benefit.[15] This incentive benchmark framework is a foundation of the AER's regulatory approach and promotes the delivery of the NEO and NGO. This provides for investment in—and operation and use of—energy services that is efficient and in the long-term interests of consumers.[16] Operators of energy networks have an incentive to become more efficient and reduce costs over time, as they retain part of the financial benefit from improved efficiency. Consumers also benefit when efficient approaches or costs are revealed and more accurate or efficient benchmark is set in subsequent regulatory periods. Over multiple regulatory periods this cycle of efficiency gains, revealed costs and lower benchmarks benefits both energy networks and consumers.

15 Likewise, where actual costs are above the regulatory forecast of costs the NSP bears a part of this cost.
16 NEL, s. 7; NGL, s. 23.

Under a benchmark incentive regime it is expected that the inherent incentives will drive actual costs below the regulatory allowance. As such, observation of actual costs is important to the implementation of the incentive approach over time. For capital expenditure (capex) and operating expenditure (opex), we observe actual expenditure outcomes at each regulatory determination. The observed cost outcomes are used to inform the regulatory forecasts of efficient capex and opex for subsequent periods. This provides consumers with a share in efficiency gains and they pay no more than necessary for a safe and reliable supply of energy. It promotes the achievement of the NEO and NGO.

NTER entities and our regulatory benchmarks

The overall revenue recovery package we determine (including the rate of return on capital), is based on private sector ownership for competitive neutrality reasons. In our consideration of the practices of a benchmark efficient entity, it is important to note the different practices between privately held (non-government) NSPs from government (state or territory owned) NSPs.

3.3 What is the current tax approach?

The tax building block approach

The tax building block reflects our estimate of the cost of corporate income tax for the benchmark entity. 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 described the tax calculation in detail in our initial report.[17]

The incentive benchmark approach and tax

As with other building blocks, NSPs who keep actual tax costs below the regulatory forecast of tax costs retain the part of the benefit.[18] This is an intended outcome under the incentive benchmark approach, designed to reward service providers for their efficient improvement while benefiting consumers over the longer term. However, the progression of efficient tax costs across multiple regulatory periods differs in several ways to the revealed cost process for capex and opex. Actual tax outcomes are not as readily observed at each determination stage—and the observed tax payments reflect many other factors outside the regulatory regime. This means that from time to time we need to examine the actual tax management practices of NSPs to inform our view on the practices of a benchmark efficient entity operating an energy network. These observations can then be used to ensure our benchmark regulatory tax approach will generate a forecast of tax costs that reflects efficient costs. This provides consumers with a share in efficiency gains; meaning they pay no more than necessary for the tax costs associated with a safe and reliable supply of energy; and promotes the achievement of the NEO and NGO.

17 AER, *Initial report - Review of regulatory tax approach*, June 2018, pp. 7–12.

18 Likewise, where actual tax costs are above the regulatory forecast of tax costs the NSP bears this cost.

Is reducing the tax difference in the long-term interests of consumers?

The ATO undertook analysis that indicated non-government owned energy networks (listed or privately held) appeared to pay less tax than provided for in our determinations; while government owned energy networks appeared to pay more tax than provided for in AER determinations.

In reviewing our approach to tax, our intent is to ensure that our approach promotes the NEO and NGO. We have not presumed that reducing the tax difference—that is, the difference that might occur between actual tax payments and our regulatory provision for tax costs—is always in the long term interest of consumers. As this discussion paper sets out, certain drivers of the difference may be outside the regulatory regime (e.g. not related to the operation of the regulated network), while others may be an expected consequence of the incentive regime (e.g. outperformance of regulatory estimates) or there may be valid and enduring reasons for the difference. A number of stakeholders noted in their submissions to our initial report that under an incentive based framework the expectation is that there will be a difference between actual costs and regulatory forecasts.[19] The Consumer Challenge Panel (CCP) also notes this expectation, but submits that the AER must understand the reasons for these differences and their relevance as part of its review.[20]

The intent of this review is not to simply reduce the tax difference, but to identify tax practices that a benchmark efficient entity may engage in that are in the long term interest of consumers. The changes that are proposed in this final report are changes that we consider likely to reduce the tax difference, while also promoting more efficient investment in, and efficient operation and use of, energy services for the long term interests of consumers, consistent with the NEO and NGO.

NTER entities and our tax benchmarks

As highlighted by the ATO note, there is a clear difference in the observations of the two groups—with one generally paying less tax than provided for in AER determinations and the other paying more tax than provided for. The NTER is an administrative intergovernmental arrangement that aims to ensure competitive neutrality by notionally applying the tax laws to government owned entities as though they were subject to Federal income tax. While observing patterns of practice based on ownership is useful for understanding the tax practices of NSPs, we note that the tax incentives faced by NTER entities may not align with those in the private sector. NTER entities pay tax equivalent payments to the same shareholders (the relevant state or territory governments) who receive the dividends resulting from their profits. We must take these incentives into account when determining what tax management practices are relevant to a benchmark efficient entity. This ensures our tax allowance is consistent with the overall revenue recovery package we determine (including the rate of return on capital), which is also based on private sector ownership for competitive neutrality reasons.

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19 ENA, *Response to AER Issues Paper*, 31 May 2018, p. 4; SAPN, et al., *Submission to Initial Report*, 26 July 2018, p. 1.

20 Consumer Challenge Panel – sub-panel 22 (CCP), *Submission to Initial Report*, 26 July 2018, p. 7.

3.4 Incentive approach and proposed rule changes

In the discussion paper, we indicated that references to the 'benchmark efficient entity' may be removed from the current NER and NGR provisions governing estimation of the cost of corporate income tax.[21] We have since become aware that such a change will not proceed.

As noted in the discussion paper, the term 'benchmark efficient entity' does not affect our view of the role of the tax building block in an incentive regulatory framework. The legislation continues to require a forward looking estimate of company tax.

3.5 How do we account for imputation credits?

This review has arisen because of a perception that regulated businesses are not paying as much tax as anticipated in our regulatory determinations. A fundamental first step in this review is to establish the correct reference points for comparison. There has been some confusion on this point because the tax allowance we include in our decisions is reduced for our estimate of the value of franking credits to shareholders. As such there are two possible points of comparison:

1. Actual tax paid by regulated businesses compared to the AER's estimate of the actual tax that will be paid by the regulated businesses or
2. Actual tax paid by regulated businesses compared to the AER's regulatory tax allowance included in our decision (where the AER's regulatory tax allowance is the AER's estimate of the actual tax that will be paid by the regulated businesses discounted for the value of franking credits).

This choice has a material impact. In the initial report, we estimated that the regulated energy networks would pay $923 million in corporate tax over the 2016-17 financial year, while the tax allowance included in our decisions amounted to $541 million after discounting to reflect the estimated value of franking credits to shareholders.[22]

Our conclusion is that the correct comparison is point 1. That is, the correct comparison is actual tax paid by regulated businesses compared to the AER's estimate of the actual tax that will be paid by the regulated businesses (i.e. before any reduction for the estimated value of imputation credits).

The reason the appropriate comparison point is actual tax paid to tax expected to be paid before the value of imputation credits is deducted is because this reflects the AER's forecast of corporate tax to be paid by the regulated business. Critically, the value of imputation credits reflects a reduction in the regulated allowance to account for the expected value of imputation credits to be claimed back from this tax payment, not an expected reduction in corporate tax to be paid.

21 AER, *Discussion paper, Review of regulatory tax approach*, 2 November 2018, p. 24.
22 AER, *Initial Report, Review of regulatory tax approach*, June 2018, pp. 17–18.

3.6 How much was provided for tax costs?

In our initial report we included sector level summaries of the provision for tax costs in AER determinations across the five-year period from 2012–17. 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. We calculated the aggregate regulatory forecast of total tax costs from within the PTRMs for all regulated networks.[23] We repeat the key table here for ease of access (See Table 3.1).

Table 3.1 AER forecast of tax costs across 2012–17, regulated activities ($million 2017)—from AER initial report

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 Consumer Price Index (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. 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.

(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.

23 This relates to core regulated activities only and is before any deduction for gamma.

4 How have we evaluated possible changes?

The next five chapters of this final report present more detailed analysis of the tax difference, the drivers of the difference, and the merits of changes in response. We have analysed these drivers and responses having regard to the evaluation criteria discussed below in section 4.1. These evaluation criteria are unchanged from the discussion paper. We received some stakeholder comments on the application criteria, which we also discuss below.

4.1 What are the evaluation criteria?

In analysing each possible change in response to drivers of the tax difference, we have had particular regard to the criteria set out below. Our primary concern is always whether or not the possible change promotes the delivery of the NEO and NGO.[24] Any change resulting from this review must be considered to promote the delivery of these objectives to the greatest degree. As discussed in section 3.1, the benchmark incentive framework is a foundation of our regulatory approach as we consider it promotes the long term interest of consumers. This is why we examine the current tax management practices of regulated networks and consider whether they should be reflected in our regulatory tax approach.

The criteria we use to evaluate the possible changes reflect different aspects that promote the achievement of our overall objective:

- Is it reflecting the efficient costs of operating the regulated network?
- Is it a material change?
- Is it an achievable tax practice?
- Is it a broader tax issue?

Our assessment of each of possible change reflects a joint assessment against all of these criteria.

Efficient costs

The first criterion is whether the possible change reflects efficient costs of operating the regulated network. Efficient costs are the minimum costs required to ensure continuing safe and reliable and secure of supply of energy to consumers. If a change results in a better estimate of the forecast efficient tax costs of a benchmark entity, and NSPs are able recover their forecast efficient costs (i.e. the NPV = 0 principle) then we would consider it to be in the long term interest of consumers.[25] Such a change would mean that customers pay no more than the efficient costs of providing electricity and gas services over the long term. This would promote delivery of the NEO and NGO.

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24 NEL, s. 7; NGL, s. 23.

25 The NPV=0 principle states that the regulatory goal is to set prices so that the PV of the net cash flows equals the initial investment. See Dr Martin Lally, *Review of submissions on the AER's review of its regulatory tax approach*, 25 October 2018, p. 16.

In assessing the recovery of forecast efficient costs we must have regard to the overall revenue recovery package provided. This includes consideration of the interaction of potential changes with the incentives and regulatory decisions in other areas of the regulatory regime. This may include interactions with the rate of return, or implications for the expenditure assessment criteria.

We also consider any issues of inter-generational equity that may arise from a change. Inter-generational equity is concerned with the proportion of costs borne by past, current and future consumers. Consumers should only pay for costs relevant to the delivery of services they receive. This is particularly relevant when considering retrospective changes and depreciation timing effects (chapter 6), where there is tension between:

- spreading tax costs evenly across consumers over the life of the asset, and
- matching the timing of tax costs incurred by a benchmark efficient entity.

Materiality

The second criterion is to assess the materiality of any change. This begins with assessment of the underlying driver. If it is not a material driver of tax costs over the long term, any change to address this driver would be unlikely to be in the long term interests of consumers.

There are two reasonable yardsticks for the assessment of materiality. The first is the proportional impact on the tax allowance (the tax building block) over the longer term (multiple regulatory periods). As noted in our initial report, the tax building block generally accounts for around 4 per cent of total revenue.[26] The second is the absolute dollar value impact on tax costs, again over a longer term. This is a relevant materiality measure when weighing up implementation costs to address a particular change.

In our consideration of the materiality of a change, we must also have regard to the costs to implement the change. This may include:

- increased regulatory burden (increased costs) on NSPs to comply with the changes to the regime
- added complexity of the regulatory regime, making the process less transparent for stakeholders to engage in.

Flowing from this last point, we consider that simplicity is a relevant consideration under this criterion. Simpler changes are likely to incur lower costs in implementation and ongoing maintenance.

Such practical issues are important to consider in ensuring the benefits of a change outweigh the costs, and ensuring that making a change is in the long term interest of consumers.

In its submission, the CCP requested more specificity on the application of our materiality criterion. The CCP submitted the changes we proposed were based on judgement about

26 AER, *Initial report, Review of regulatory tax approach*, June 2018, p. 18.

materiality without data to indicate how that materiality had been measured, and suggested an indication of dollar value impact would assist consumers.[27]

We acknowledge that many of the materiality assessments in the discussion paper were not presented in precise dollar terms. This remains the case in this final report. Our assessment of materiality is over the long term. It is the nature of the tax calculations that the impacts accumulate over time. This issue is unlike many encountered during a regulatory determination where the impact is over five years and materiality is judged over that shorter period. The tax benchmark has long term impacts, which makes assessment based on actual data difficult. We have done so where possible, but this assessment has necessarily been at a high level. We have used realistic examples to show the impact of changes to our approach to provide an indication of the quantum involved in the long run. Therefore, we did not assess materiality in fixed percentage terms. Rather, we relied on qualitative reasoning to conclude whether a change would result in significant benefits accruing to customers in the long term.

Achievable tax practice

The third criterion is whether a possible tax management practice is able to be implemented or adopted by NSPs. Firms that seek to adopt the benchmark efficient approach should be able to do so. Certain practices may be considered efficient for certain situations, but for legal or practical reasons may be unachievable by all networks. This includes an assessment of the validity of such a practice under current tax legislation.

We consider that tax management practices assumed by the benchmark regulatory tax approach should be able to be adopted by NSPs.

This does not imply that we have a role in endorsing any particular tax management practice as complying with Australian tax law (or that it does not comply). The responsibility and authority to do so rests solely with the ATO.

In our assessment of whether tax practices are achievable, we have regard to:

- ATO guidelines, public rulings and private rulings on the practice.
- How widespread the practice is
- Whether there is ongoing ATO enquiry in this area.

As noted in the PwC report, there are often difficulties in consistently administering the tax law in various situations.[28] Such difficulties may result in 'grey areas' where the validity of such a practice is not completely clear, or depends on the specific situation.

The ATO often assists taxpayers to interpret tax legislation by publishing a public guideline or ruling that describe how the ATO will assess a particular tax issue.[29] Generally, these

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27 CCP, *Submission to the AER on Review of regulatory tax approach – Discussion paper*, 25 November 2018, p.15 (LATE SUBMISSION).

28 PwC, *AER tax review 2018, Expert advice*, 26 October 2018, p. 61.

29 The ATO makes both public rulings and private rulings. Private rulings are so called because they respond to a particular taxpayer's circumstances, but they are still published on the ATO website (and hence are public) so as to provide

documents set out a number of complex factors that must be considered in order to determine the appropriate tax assessment. Nevertheless, they are an important tool in assessing whether certain tax practices are available to the efficient benchmark firm.

In addition to these rulings, we acknowledge how widespread such a practice is across the sector. The ATO regularly assesses the tax practices of the regulated networks, through annual reviews and targeted engagement activities. With this background, if a tax practice has been in use for some time and by a number of networks, we consider it reasonable to infer that it is achievable. This would not necessarily imply unconditional ATO acceptance of that approach—as noted above, the ATO has regard to the specific circumstances for each taxpayer—but the circumstances where that practice is able to be adopted appear to be applicable to the circumstances of the regulated networks.

However, where there has been (or is ongoing) ATO compliance activity regarding the practice, we would be more cautious about considering this practice as reflecting the efficient tax practice of a benchmark entity.

Nonetheless, under the benchmark incentive framework, individual NSPs are free to depart from the benchmark assumption where it considers such a departure to be more efficient to their specific circumstance. In this case the NSP accepts the additional risk (relative to the benchmark), and therefore retains the benefit or detriment that arises from this departure. Consumers continue to pay only the efficient costs included in the benchmark. We consider this is in the long term interest of consumers.

The CCP submission commented on the achievable tax practice criterion. The CCP suggested a multiple benchmarks approach would allow the AER to account for those NSPs that are under Australian company structure and those that are not, without forcing a change in their structure.[30]

We accept that a multiple benchmarks approach inverts this aspect of the achievable tax practice criterion. Under such an approach, it is the AER who selects which tax practice is allocated to which network. On face value, it would not matter if the entity could not achieve the benchmark tax practice that it had not been assigned. However, this leads to some separate concerns about the AER's decision to assign regulated networks to one of the set benchmarks, and whether that benchmark was achievable for them. We discuss these in more detail in section 5.3.

Broader tax issues

This review engages with some issues that reflect broader tax considerations across the economy, rather than specific to the treatment of regulated networks. Our fourth criterion is whether the scope of and impact of the issue means it can best be dealt with by ATO action or government changes to tax legislation, rather than by the AER. In this case we would not seek to change the efficient tax practices assumed by the benchmark tax approach.

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guidance to the wider taxpayer community.

30 CCP, *Submission to the AER on Review of regulatory tax approach – Discussion paper*, 25 November 2018, pp.15–16 (LATE SUBMISSION).

The CCP submission commented on this criterion. The CCP stated that the AER's forecast of tax costs should reflect what is actually happening now, rather than observing that government or ATO action would eventually resolve a cause of the tax difference (such as access to concessional tax rates in a transitional period).[31]

We accept that our broader tax issues criterion needs to have regard to the timeframe for those responses. Our discussion of entity structures, different ownership and multiple benchmarks in chapter 5 more clearly engages with current and future changes to the tax landscape.

[31] CCP, *Submission to the AER on Review of regulatory tax approach – Discussion paper*, 25November 2018, pp. 17, 20 (LATE SUBMISSION).

5 Entity structure and ownership

Summary of the issue

The AER's regulatory tax approach currently assumes that the benchmark entity calculates its assessable income in the same way as an Australian company, and is assessed using the standard corporate income tax rate (30 per cent). In practice, regulated networks are held using a variety of structures (e.g. tax consolidated groups, partnerships, trusts) and with a variety of ultimate owners (e.g. state governments, sovereign wealth funds, Australian superannuation funds).

The different real-world structures and owners contribute in several ways to the face value tax difference.[32] We must allow for these factors in calculating the underlying difference relevant to the regulatory approach. We must make a like-for-like comparison by isolating actual tax outcomes relevant to the regulated activities and comparing them to the regulatory forecast of tax costs.

The varied real-world structures and owners also contribute to the underlying tax difference. However, the overall effect arising from these underlying drivers (both historical and forward-looking) appears to be minimal. Our assessment of these factors aligns with the expert advice we received from PwC and Dr Lally in the discussion paper stage, and the PwC addendum.

Consistent with our discussion paper, we consider that we should maintain the current approach where our regulatory provision for tax costs is based on the standard corporate tax rate. This reflects the most commonly observed tax profile of regulated networks.[33] It also appears to be the relevant basis for assessing tax in the future, particularly with regard to legislative changes affecting the tax treatment of structures and certain classes of owners.

Many stakeholder submissions were received in response to the discussion paper, and almost all agreed with our proposed benchmark. There were three exceptions. The DoEE submission did not accept our findings on entity structure; nor did it accept our description of the tax difference relevant to regulated activities. It submitted that an alternative approach, such as a tax pass through, would be more appropriate than the current approach.[34] The CCP submission stated that the AER should consider a second benchmark (15 per cent tax rate) in addition to the primary benchmark, and apply that benchmark where investors can access concessional tax rates.[35] The ECA submission stated that the benchmark tax allowance (not just the tax rate) could be set using the observed average tax paid for all networks, expressed as a percentage of EBIT (or another metric).[36]

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32 PwC, *AER tax review 2018, Expert advice*, 26 October 2018, pp. 31–36, 40–47, 50–56.

33 PwC, *AER tax review 2018, Expert advice*, 26 October 2018, p. 50.

34 We discuss tax pass through approaches in chapter 9. DoEE, *Submission to the AER's review of regulatory tax approach*, 23 November 2018, pp. 3–4.

35 CCP, *Supplementary Submission to the AER Taxation Review*, 10 December 2018, p. 5 (LATE SUBMISSION).

36 ECA, *Submission to the review of regulatory tax approach*, 30 November 2018, p. 3 (LATE SUBMISSION).

Introducing a second benchmark (or alternative benchmark construction) for the purposes of calculating our tax allowance would be a material departure from the current regulatory framework. In particular, careful consideration needs to be given to potential consequential impacts in other parts of our framework and the overall impact on incentives for efficient outcomes. For the purposes of this final report and based on the information before us, we are not recommending the adoption of multiple benchmarks or an alternative benchmark construction.

How does this issue contribute to the tax difference?

Issues around entity structure and ownership contribute to the face value tax difference in three ways:

- the chain of ownership.
- aggregation of tax outcomes.
- accrued tax losses.

It is necessary to adjust for each of these effects in order to isolate the underlying tax outcomes pertinent to the regulated activities of the firm. Issues around entity structure and ownership contribute to the underlying tax difference relevant to the regulated activities in two ways:

- Structures that result in changes to taxable income (via double gearing or related party interest deductions)
- Structures and end-ownership status that result in changes to the relevant tax rates

The ATO note identified entity structure and ownership as a key driver of the tax difference.

Our current approach

The current approach to setting the regulatory provision for tax costs applies a statutory tax rate of 30 per cent, equal to that faced by a standard Australian corporation. This means:

- There is no adjustment for different ownership forms or holding structures.
- The tax forecast in the AERs regulatory models follows the same core steps as for a standard Australian company completing its tax return, for both the calculation of taxable income and the tax rate applied to that income (currently 30 per cent).
- The AER's models allow for tax losses to be carried forward to offset future taxable income. The current regulatory practice is to input into the calculation of tax any tax loss arising from the regulatory model for the previous period, but in past regulatory determinations it had been rare for such losses to be forecast.[37]

[37] The discussion paper stated that no network had been forecast to incur losses to date. However, we have since identified that losses were carried forward in regulatory models for one network at minimal amounts for standard control services; and for a number of networks' alternative control services (though not standard control services, which are the focus of this review).

There are two broad areas where observed real-world tax practices differ from the AER's current regulatory tax approach.

5.1 Entity structures

In practice, regulated networks are held under a variety of more complicated holding structures—including tax consolidated groups, partnerships, stapled partnerships, trusts and stapled trusts. These structures are listed in Table 5.1.

Table 5.1 Observed entity structures and key tax effects

Entity structure	Tax rate	Details
Corporation	30%	Franking credits for tax paid by the corporation can be distributed to investors to reduce investor tax payment.
Tax consolidated group	30%	A head company with at least one Australian subsidiary that is treated as a combined tax entity
Government business enterprise	30%	National Tax Equivalent Regime. Tax equivalent paid to the State, as are dividends. Generally indifferent between tax or dividends.
Partnership	N/A	Tax paid by partners at applicable tax rate.
Trust	N/A[a]	Tax paid by trust beneficiaries at applicable tax rate[a]
Stapled structure	N/A	Tax paid at investor level at applicable tax rate.

Source: PwC, *AER tax review 2018, Expert advice*, 26 October 2018, pp. 12, 15, 17, 25.

Notes:

N/A Not applicable as tax obligation flows through to upstream entities.

(a) Generally speaking, trusts are a flow through vehicle, but some trusts (such as Division 6C public trading trusts) are taxed as a company at the 30% rate.

The tax effects of these different structures are discussed in some detail in the initial PwC report and the PwC addendum.[38] The standard Australian company is both the simplest 'structure' and an owner.[39] A tax consolidated group will also be assessed at the standard corporate rate, and may include the regulated network as just one of a large number of business units. We have included state government business enterprises on this table of structures, though it is also possible for a state government to be an owner of a regulated network while utilising one of the flow-through vehicles (partnerships, trusts and their stapled variants). The flow through vehicles have a 'not applicable' tax rate because they simply pass the tax obligation to owners further up the chain.

There are two ways that these different structures drive the face value difference but not the underlying difference—chains of ownership and the aggregation of tax outcomes.

38 PwC, *AER tax review 2018, Expert advice,* 26 October 2018, pp. 50–58; and PwC, *AER tax review 2018–Addendum, Expert Advice*, 10 December 2018, pp. 57–62.

39 This driver is closely related to the ultimate owner of the network, discussed in the next section.

Chain of ownership and the face value tax difference

Where flow through vehicles are used, observing tax paid at the service provider level will not capture tax payments further up the chain. The tax obligation passes through the partnership or trust to the ultimate taxpaying entity, who pays tax at their applicable statutory tax rate. While zero tax appears to be paid at the NSP level, tax might instead be paid by an upstream owner. Consistent with our discussion paper, we consider that it is necessary to track tax outcomes up the chain of ownership to the first level at which tax is required to be paid.

Observing these upstream tax payments is difficult. Our formal information gathering process did not compel upstream entities to provide tax information, and there is often a significant disaggregation problem where the upstream investor's tax outcomes reflect not just their investment in the regulated network but many other investments as well. The PwC report noted the difficulty inherent in trying to assess these upstream payments.[40]

The DoEE submission noted that the discussion paper had not considered upstream tax information and considered that this limited the validity of our conclusions around the chain of ownership.[41] We agree that this is a limitation of our analysis, and that it would be preferable to have this information. However, while we did not have access to the tax returns of upstream entities (or other detailed upstream information), we did have access to tax returns of the flow-through entities, which show the distribution of taxable income up the chain. We also obtained structure diagrams identifying upstream owners. This is why the PwC advice was able to accurately categorise the upstream owners and their tax status.[42]

The chain of ownership appears to be a key driver for the face value tax difference, with regard to the historical period analysed in the ATO note. In our discussion paper, we noted that based on the initial PwC advice 5 of 17 NSPs, representing 34 per cent of the overall regulated TAB, were flow through entities (partnerships or trusts).[43] Whether assessing by number of service providers or by the proportion of regulated TAB, flow through entities (partnerships and qualifying trusts) comprise a significant portion of the sector. These figures have not changed as a result of the receipt of more information in RIN responses.

The PwC addendum provides a more detailed breakdown of the impact of the chain of ownership on the face value tax difference. Figure 5.1 illustrates the face value difference, though it uses the full data set of RIN information (instead of the voluntary information used in the November discussion paper).

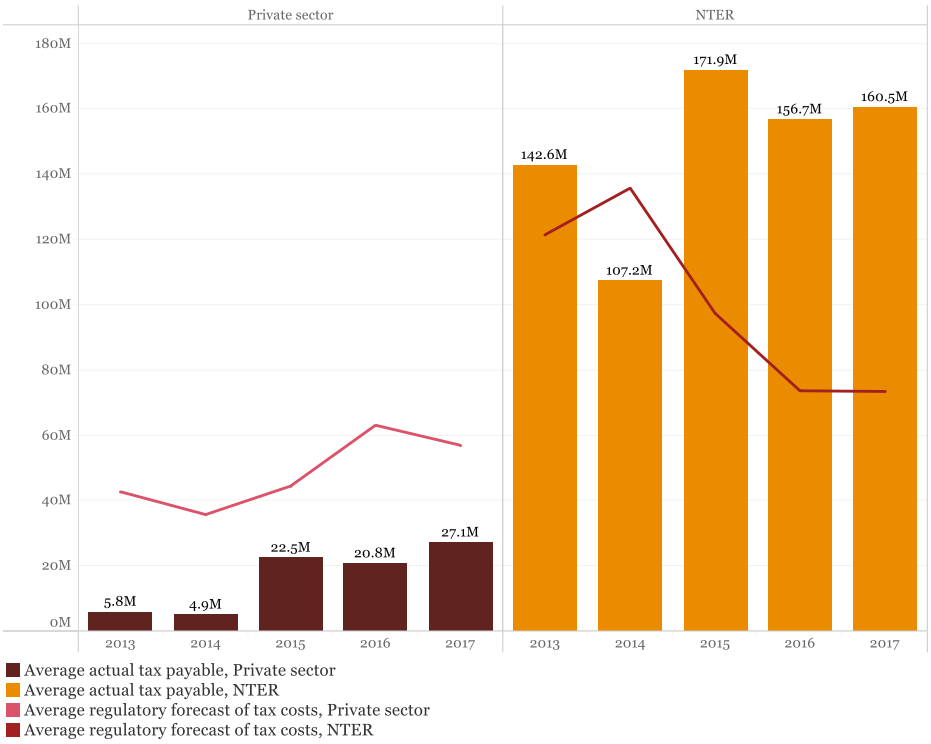
40 PwC, *AER tax review 2018, Expert advice*, 26 October 2018, p. 57.

41 DoEE, *Submission to the AER's review of regulatory tax approach*, 23 November 2018, pp. 9–10.

42 This is also why PwC stated that no sovereign wealth funds had holdings less than 10 per cent. See DoEE, *Submission to the AER's review of regulatory tax approach*, 23 November 2018, p. 10.

43 PwC, *AER tax review 2018, Expert advice*, 26 October 2018, p. 50 (figure 10).

Figure 5.1 Tax paid by entities owning regulated networks (before consideration of flow-through entities)—from PwC addendum



Source: PwC, *AER tax review 2018–Addendum, Expert Advice*, 10 December 2018, p. 36 (figure 6).

Notes: Data from RIN responses. This graph does not isolate the tax outcomes attributable to only regulated activities. It also does not include flow-through entities. This is a paired comparison, including only firms with both actual tax (or NTER equivalent) information and regulatory information.

The columns show tax paid by privately owned networks (left hand side, brown columns) and NTER entities (right hand side, orange columns). In each section is a line showing the regulatory forecast of tax costs for the entities included in that column. The difference between the line and the columns shows the face value tax difference observed in the last five years, which varies based on network ownership:[44]

- For privately owned networks, the AER's provision for tax costs was higher than the amount of actually tax paid to the ATO[45]
- For government owned networks, the AER's provision for tax costs was lower than the amount of equivalent tax paid under the NTER[46]

Figure 5.1 aligns with the tax payments referenced in the ATO note, which focussed on the entity that owned each regulated network, but did not go further up the chain. We do not

44 Caution needs to be exercised with these comparisons, since no adjustment has been made to isolate tax outcomes relevant to regulated activities (this is discussed in the following section).

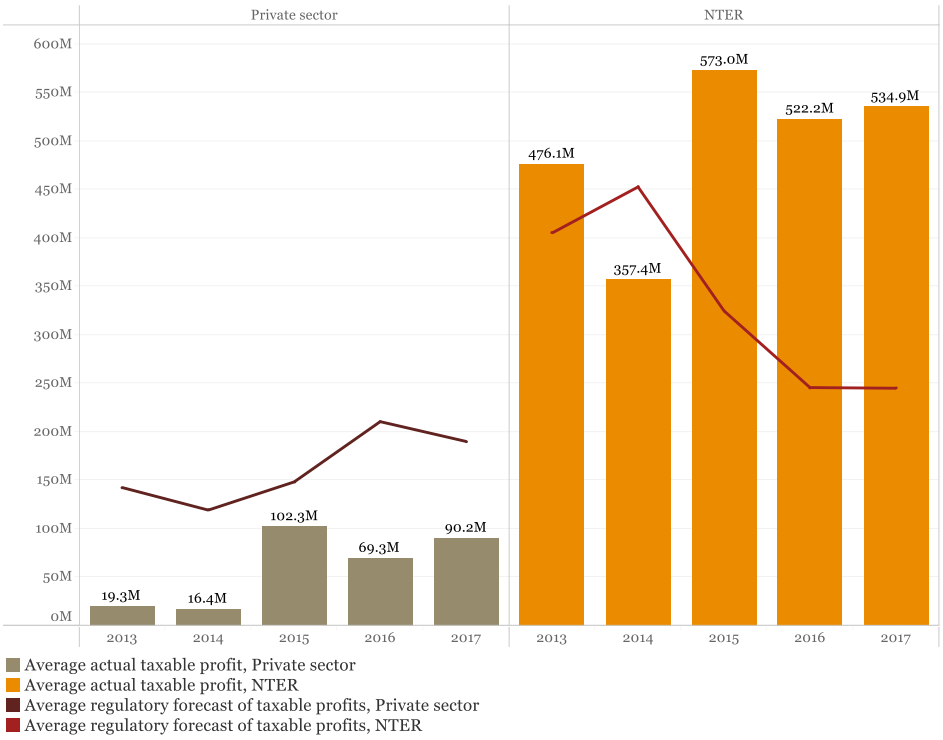
45 Here, 'privately held' means share market listed networks and networks with owners such as superannuation funds, overseas investors, and overseas sovereign wealth funds.

46 Here, 'government owned' means networks owned by Australian state or territory governments, which are usually (but not always) part of the NTER.

consider that this approach has isolated the tax outcomes relevant to the regulated activities of the firm. It does not give a complete picture of tax payments.[47]

We can recalculate Figure 5.1 so that instead of showing tax paid, it instead shows taxable profits (taxable profits x 30 per cent = tax paid) generated at the NSP level. This is Figure 5.2.

Figure 5.2 Taxable profits for entities owning regulated networks (before consideration of flow-through entities)—from PwC addendum



Source: PwC, *AER tax review 2018–Addendum, Expert Advice*, 10 December 2018, p. 37 (figure 7).

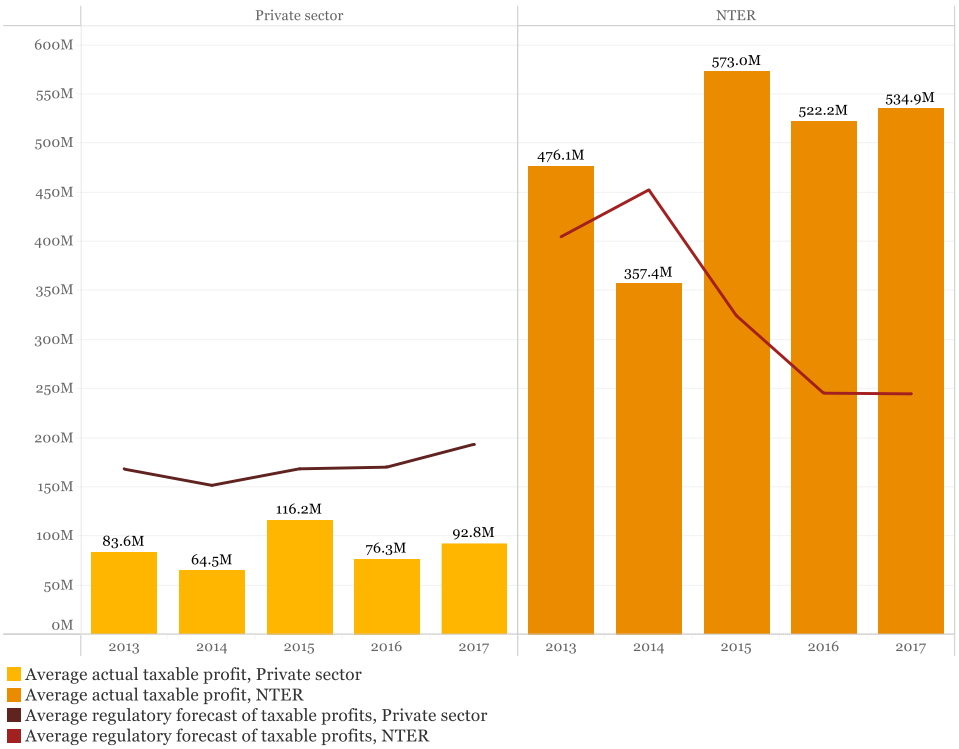
Notes: This graph shows taxable profits, not tax paid. Data from RIN responses. This graph does not isolate the tax outcomes attributable to only regulated activities. It also does not include flow-through entities. This is a paired comparison, including only firms with both actual tax (or NTER equivalent) information and regulatory information.

The pattern of results in Figure 5.2 is unchanged compared to Figure 5.1, but the scale of the axis has changed. No extra entities have been added to this graph.

Since taxable profits are effectively equivalent to the upstream distribution made by flow-through entities, we can add flow through entities in to this figure to illustrate the proportion of the face value difference that could be explained by the chain of ownership. This is shown in Figure 5.3.

47 Further, the cost of intermediate taxes that we would classify as being akin to a company tax—(i.e. tax costs prior to taxes paid by the final investor's overall income) should be included when making a comparison with our provision for tax costs.

Figure 5.3 Taxable profits (including flow-through entities) based on RIN responses—from PwC addendum



Source: PwC, *AER tax review 2018–Addendum, Expert Advice*, 10 December 2018, p. 38 (figure 8).

Notes: Figure 5.3 shows taxable profits, before the application of a statutory tax rate (for example—30 per cent, 15 per cent or 0 per cent), unlike Figure 5.1 which shows tax paid after the application of the standard corporate tax rate (30 per cent). Data from RIN responses. This graph does not isolate the tax outcomes attributable to only regulated activities. This is a paired comparison, including only firms with both actual tax (or NTER equivalent) information and regulatory information.

Additional entities have been added to both the tax paid columns (yellow columns) and the paired comparison of forecast tax costs (dark red line). Including flow through entities helps to narrow the gap between actual and forecast taxable profits for privately owned networks. While this figure helps illustrates the contribution made by upstream entities, and the reason why we need to consider chains of ownership, it is not definitive. In particular, taxable profits (or upstream distributions) still reflect the aggregation of tax for regulated and unregulated activities combined. Second, upstream taxable profits may not be taxed at the standard corporate rate (30 per cent). Both issues are discussed below.

Stakeholder submissions were supportive of the view that we should consider the chain of ownership and isolate upstream tax outcomes relevant to regulated activities. The exception was the DoEE submission, which proposed that flow-through entities should receive no tax allowance at all because this would be double compensation. In the DoEE's view, the flow-through entities were currently compensated twice for one efficiency—'the non-payment of

company tax'—via both the AER's rate of return and tax allowance.[48] The DoEE stated that this 'double compensation' position was supported by the PwC advice, and stated 'PwC's Expert Advice notes that where a NSP is a flow-through entity, its actual cost of debt and equity may be lower when compared to a company.'[49]

The DoEE submission appears to read more into the PwC advice than is said. The PwC advice advanced three general reasons why firms adopt flow-through structures—it is easier to distribute income, it allows higher gearing or a better rate on debt, and moves the reporting point from post-tax to pre-tax.[50] The DoEE appears to have equated the first and third points with obtaining a lower cost of equity, but it is not clear that this is the case.

We agree that the PwC advice stated that entities may use flow-through structures to access obtain cheaper debt or a higher gearing level. Our analysis of the detailed RIN information presented in this report does not indicate that a material advantage has been obtained by flow through structures in these areas. Either the debt advantage has already been incorporated in the regulatory benchmarks, or they are so minimal so as to not require adjustment.

Aggregation of outcomes and the face value tax difference

The structures that hold the regulated electricity and gas networks in Australia include other income generating activities in addition to the regulated network. The clearest example is a tax consolidated group where the regulated network is just one unit among many business units, some of which are unregulated. Even in the simplest structure of a straight corporation the corporate entity is rarely just the regulated network. Further, some effects—such as TAB revaluation—will always be located in the same corporate entity as the regulated network, even though they have an effect on tax outcomes that does not relate to the regulated activities. The tax obligation relevant to the regulated activities may not be clearly visible in the tax return of the reporting entity because it may have a tax position arising from other businesses or unregulated activities.

Since the tax consolidation regime was introduced in 2002, tax is not calculated and paid at the individual business unit level. Instead it is calculated and paid at the overall consolidated tax entity level. This 'single entity rule' means that all members of the corporate group are taken to be part of the consolidated entity for income tax purposes.[51] The tax paying entity still faces a tax obligation in line with that estimated in our regulatory determination, but that obligation is not clearly visible in the tax assessment at the corporate level.[52]

This appears to be a material driver of the face value tax difference in the ATO analysis period. The PwC report notes that all the regulated networks held through corporate entities were held in tax consolidated groups. There may be a case where the unregulated activities would be incurring a tax loss if calculated on a standalone basis. In this case, when the taxpaying entity lodges its tax return the unregulated loss would be combined with the

48 DoEE, *Submission to the AER's review of regulatory tax approach*, 23 November 2018, pp. 6–7.
49 DoEE, *Submission to the AER's review of regulatory tax approach*, 23 November 2018, p. 6.
50 PwC, *AER tax review 2018, Expert advice*, 26 October, pp. 43.
51 Section 701-1 of the ITAA 1997.
52 PwC, *AER tax review 2018, Expert advice*, 26 October 2018, pp. 25, 41.

income from the regulated activities and effectively reduce part of the tax payable by the regulated activities.

While some elements of the tax calculation may be able to be disaggregated to individual business units—such as income and asset depreciation—other elements may only be relevant at taxpaying entity level. For example, debt is generally sourced at the corporate group level and not allocated to the individual business units. This further complicates the comparison, as there is no clear allocation rule to determine the regulated networks' share of this component of tax.

The ATO note also grappled with this disaggregation issue, and noted that it was necessary to make assumptions and exclusions when preparing its analysis for consolidated groups. The ATO was not able to disclose the exact basis on which it was making its comparison between the AER forecast of tax costs for regulated networks and available income tax return data.

Submissions agreed with our position regarding the disaggregation of regulated and unregulated tax outcomes, with the exception of the DoEE submission. The DoEE stated that:

- ATO tax transparency reports indicate privately owned networks were able to retain a benefit of at least $450 million from the AER's provision for tax costs exceeding actual tax payments, *after* accounting for tax paid for unregulated activities.[53]
- There was no evidence that the existence of unregulated activities could reduce consolidated tax paid.
- The AER should review the allocation of revenue between regulated and unregulated activities from published financial accounts.[54]

We note that the DoEE calculation of retained benefit assumes that unregulated activities could only generate a positive contribution to tax payable in the relevant years, rather than possibly reducing the amount that would otherwise have been payable. We consider that the discussion paper adequately described both the conceptual and practical evidence that activities outside the regulatory ring-fence may contribute more in taxable expenses than taxable revenue in some periods. The PwC addendum further quantifies some of these effects, including stamp duty and asset base step-ups.[55] Indeed, broader consideration of the ATO tax transparency reports cited by the DoEE indicates that many large Australian companies (undertaking unregulated activities) do not pay tax in some periods.[56]

Further, the obtained RIN data allows us to engage with the concern that the financial accounts of the regulated networks might provide a different indication of the tax outcomes for regulated and unregulated activities, as shown in Figure 5.4.

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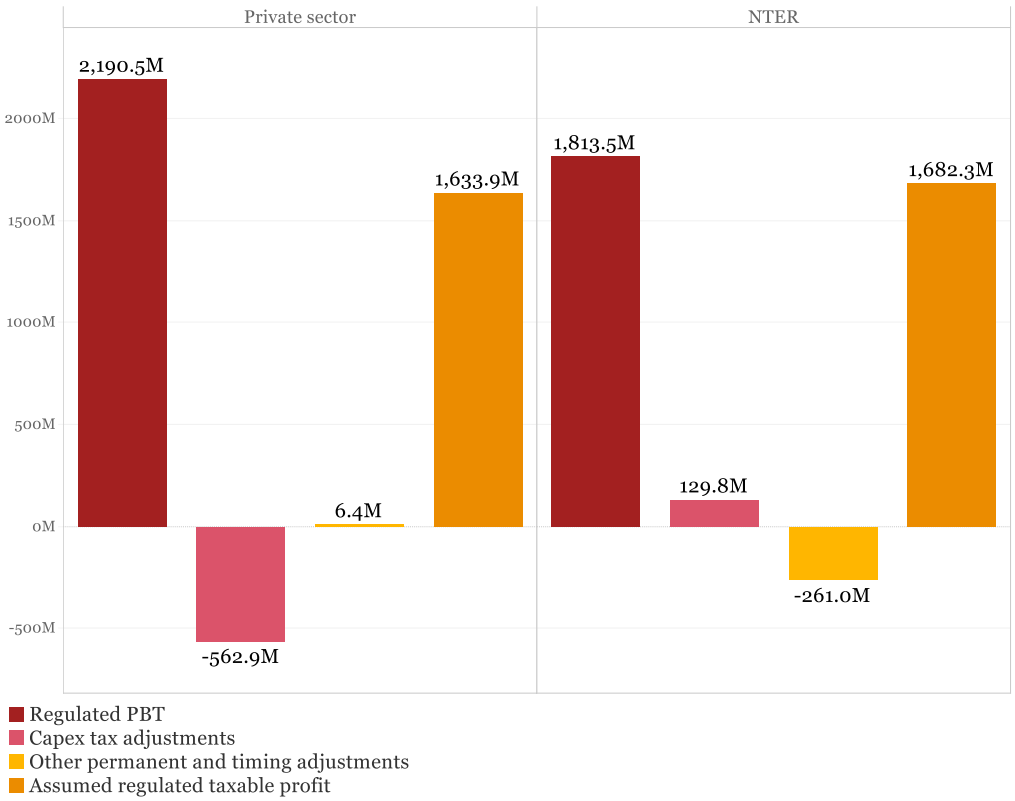
53 DoEE, *Submission to the AER's review of regulatory approach*, 23 November 2018, p. 4.

54 DoEE, *Submission to the AER's review of regulatory approach*, 23 November 2018, p. 7.

55 PwC, *AER tax review 2018–Addendum, Expert advice*, 10 December 2018, pp. 48, 49.

56 ATO, *Media release, ATO releases corporate tax data*, 13 December 2018, available online at https://www.ato.gov.au/Media-centre/Media-releases/ATO-releases-corporate-tax-data/ (accessed 14 December 2018).

Figure 5.4 Estimated stand-alone regulated tax position, comparison of privately owned vs government owned networks—from PwC addendum



Source: PwC, *AER tax review 2018–Addendum, Expert Advice*, 10 December 2018, p. 45 (figure 12).

As explained in the PwC advice,[57] businesses prepare financial accounts in accordance with accounting requirements; but they must also submit a tax assessment in accordance with tax legislation. Entities undertake 'book to tax' reconciliation to show the relationship between the two, since the preparation basis does not necessarily align. On both sides of Figure 5.4 (private and NTER), the leftmost column (dark red) begins with the profit before tax from the financial accounts. The rightmost column (orange) shows the equivalent figure, taxable profits, from their tax return working papers, which are calculations prepared in support of their tax return lodged with the ATO. The middle columns (pink and yellow) reconcile the two by showing two broad categories of adjustments that arise where particular transactions are treated differently by accounting and tax rules.

All of the columns in Figure 5.4 have already been adjusted to present 'stand-alone' figures for the regulated activities of the networks. This required the disaggregation of regulated and unregulated activities and the allocation of any consolidated costs (for instance, centrally held financing or corporate overheads). We consider that:

- For private sector networks, we observe an approximate correspondence between the AER's provision for tax costs and stand-alone tax positions. The equivalent figure in the

57 PwC, *AER tax review 2018–Addendum, Expert advice*, 10 December 2018, pp. 42–46.

regulatory models would be $1,616 million, against $2,191 million (derived from financial accounts) and $1,634 million (derived from tax return working papers).[58]

- The treatment of capex appears to differ between private and government owned networks. Capex related adjustments allow private sector networks to reduce their tax payable (relative to the accounting measure of profit), but contribute to a small increase for government owned networks. The depreciation related changes we have recommended in this report target this component of the tax calculation.
- For government owned networks, we do not observe an approximate correspondence between the AER's provision for tax costs and tax payments to the ATO. The equivalent figure in the regulatory models would be $978 million, against $1,814 million (derived from financial accounts) and $1,682 million (derived from tax return working papers).[59] This is consistent with the finding that government owned networks pay more tax than forecast, though the magnitude of the difference is larger than expected.[60] However, we have been able to establish that the allocation approach adopted by some NTER entities included a number of additional forms of 'regulated' revenue (for example, transmission use of system (TuOS) payments and jurisdictional charges) that would not be expected to be included in the regulated figures, which pertain only to standard reference services.

An important caveat is that each network determined its own approach for allocating revenue and expenses between regulated and unregulated activities. These approaches were not uniform, and it may be that alternative allocation approaches would produce different outcomes. Time constraints meant we did not attempt to enforce a single uniform allocation approach for all networks, or assess the relative merits of the alternative disaggregation approaches.

Structure and the underlying tax difference

There are also ways that the entity structure contributes to the relevant underlying difference. Entity structure can alter both the tax rate and the estimate of taxable income for the regulated network so that they depart from that applicable to a simple corporate structure (assumed in the regulatory models). In particular:

- Entities can hold debt at several levels of the entity structure (double gearing or upstream gearing). This will reduce the estimate of taxable income by increasing deductions for interest expense.
- Entities can issue related party loans between themselves at higher interest rates. This will reduce the estimate of taxable income by increasing deductions for interest expense.
- Entities can structure themselves so that upstream entities received 'passive' income, which attracts a lower tax rate, and so reduces the applicable tax payable.

58 This is a paired comparison, including only firms with both actual tax information and regulatory information.

59 This is a paired comparison, including only firms with both actual tax information and regulatory information.

60 It is also consistent with the findings of the October PwC advice. See PwC, *AER tax review 2018, Expert advice*, 26 October 2018, p. 33 (figure 6).

The October PwC report provided details on the sector-wide use of these structures and describes each of these effects.[61] The first two effects—double gearing and related party loans—are financing effects that are discussed in more detail in the PwC addendum.[62] We discuss the implications of these structural effects for interest expenses in chapter 8. The third effect—on concessional tax rates through the use of stapled trusts—is also discussed further in the PwC addendum, particularly around the transition path for limiting these concessional rates.[63]

What are our findings and recommendations?

When we assess the efficient costs and materiality of this issue, we must also consider tax legislation changes that will affect the future ability of NSPs under certain structures to access tax management practices that reduce tax costs. This includes:

- removing the ability of NSPs to engage in double gearing[64]
- applying the corporate tax rate to the 'passive income' of stapled trusts[65]
- applying a 30 per cent withholding tax on income flowing to foreign pension and sovereign wealth funds.[66]

These changes reflect the government's decision to amend the tax assessment approach across the economy, not just for the electricity and gas sectors.

Though not a legislative change, we also have regard to the recent *Chevron* decision, where the Full Federal Court found in favour of the ATO in a case over related party loans and interest deductibility.[67]

The key considerations that relate to our decision on benchmark entity structure are that:

- We were not able to obtain details of upstream debt through our information gathering process (RINs were issued at the service provider level only).
- Nonetheless, legislative changes will limit the scope for double gearing at the upstream level, effective immediately with no grandfathering or transitional arrangements.[68]
- Following the Chevron decision, there is reduced scope for entities to increase interest expenses for tax purposes via related party loans.[69]

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61 PwC, *AER tax review 2018, Expert advice*, 26 October 2018, pp. 42–50.
62 PwC, AER tax review 2018, *Addendum, Expert Advice*, 10 December 2018, pp. 8–11, 15–34.
63 PwC, AER tax review 2018, *Addendum, Expert Advice*, 10 December 2018, pp. 57–60.
64 PwC, *AER tax review 2018, Expert advice*, 26 October 2018, p. 48.
65 A 15 year transitional rule period will apply to existing economic infrastructure that is held in an MIT. PwC, *AER tax review 2018, Expert advice*, 26 October 2018, p. 48.
66 This applies to new investments post 27 March 2018 or from 2034 for assets acquired before that date. PwC, *AER tax review 2018, Expert advice*, 26 October 2018, p. 49.
67 *Chevron Australia Holdings Pty Ltd vs Commission of Taxation [2017] FCAFC 62*.
68 PwC, *AER tax review 2018, Addendum, Expert Advice*, 10 December 2018, p. 10.
69 PwC, *AER tax review 2018, Addendum, Expert Advice*, 10 December 2018, p. 31.

- There are other legislative restrictions on the use of related party transactions to reduce tax payments in Australia (such as the diverted profits tax, multinational anti-avoidance law.[70]

This indicates that these effects are unlikely to be a relevant for inclusion in a forward looking benchmark structure.

Under the criteria set out in section 4.1, we have regard to whether or not each issue is more appropriately addressed at a higher level. In this case, there has already been a governmental response and there appears to be little need for subsequent changes to the AER's regulatory tax approach. The outcome is that legislative change has already reduced the scope for these tax management practices to reduce the tax paid. This means that potential changes in response to this issue are unlikely to have a material effect on the efficient costs incurred by consumers going forward.

For the reasons set out above, we consider that no change is warranted to respond to the different real world structures adopted by the regulated networks.

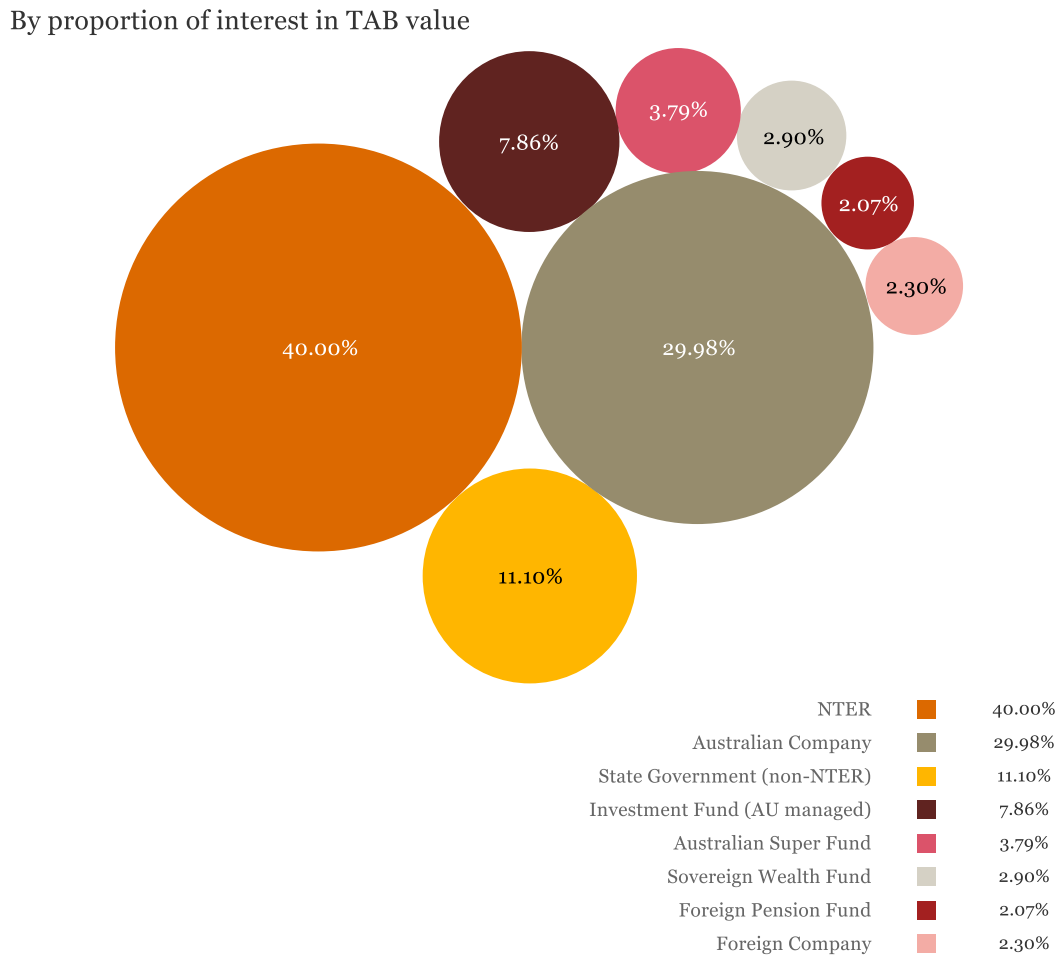
5.2 Entity ownership

Owners of regulated networks may be governments (domestic or foreign), corporate entities (domestic or foreign), individuals (domestic or foreign), superannuation funds, or a combination of various owners. Each of these owners may have a different effective tax rate applied to its income. This may result in the ultimate tax paid on the revenue from regulated services to differ from the standard corporate income tax rate (30 per cent) assumed in the regulatory models. Here, we need to consider the ultimate owner after accounting for flow-through vehicles as identified in the previous section.

Other than stakeholder submissions, we also received an addendum from PwC to its expert consultant report. The addendum includes an updated analysis of information provided by NSPs in response to our formal RINs. In this area, the RIN responses provided little new information because group structure diagrams had been provided in the earlier voluntary information collection. Hence, there is no change to the findings in the earlier PwC advice around the tax profile of all interest holders, shown here as Figure 5.5.

70 PwC, *AER tax review 2018–Addendum, Expert Advice*, 10 December 2018, pp. 32–33.

Figure 5.5 Profile of all interest holders—from PwC advice



Source: PwC, *AER tax review 2018, Expert advice*, 26 October 2018, p. 54 (figure 12)

State and territory governments own about 51 per cent (by TAB value) of the regulated network, with the majority of this stake enrolled in the NTER. The next largest stake is held by Australian companies, who own around 30 per cent of regulated networks (or 61 per cent of the private sector regulated networks). Together these two types of owners comprise around 81 per cent of the regulated networks and pay effective tax at the standard corporate rate (30 per cent). The next largest category, managed investment funds, comprises eight per cent by TAB value, with four small categories (Australian super funds, sovereign wealth funds, foreign pension funds and foreign companies) rounding out the final 10 per cent of regulated networks.

At this point, it is necessary to make a distinction between company tax and personal (or investor) level tax.

Our regulatory framework is a post-company-tax pre-personal-tax model. The allowed 'vanilla' rate of return is after company tax but before personal (or investor level) tax is incurred. We provide a return on equity that includes compensation for the personal taxes

that will be incurred after it is received.[71] Therefore, we must make an allowance for company tax (in addition to the Vanilla allowed rate of return) so investors will receive the required post-company-tax return after the regulated entity pays corporate tax.

This is relatively straightforward in the context of the standard corporate entity with individual investors, but more challenging when different owners are considered. As the AER provides for company tax costs, but the allowance for investor level taxes is already included in the rate of return provided, it is important to correctly classify tax paid as either (effectively) company tax or (effectively) personal tax.

While most of these categorisations are straight forward, we note that:

- State government owners pay no Commonwealth tax at all. However, most then are assessed under the NTER, which applies the 30 per cent rate to determine the equivalent tax payment (made to the relevant State Government, not the ATO). This is effectively a company level tax.
- Foreign investors pay a withholding tax, and this intermediate level tax is best considered to be an effective company tax. Final taxes paid by foreign investors in their home country are akin to personal level taxes.
- Managed investment funds constitute a difficult case where it is not possible to know the relevant tax rate (and whether it is effectively corporate tax) without further information about the identities of upstream investors. This information is not available to us.[72]

These tax rates are detailed in Table 5.2

The tax status of the ultimate owner could contribute to the underlying tax difference where the effective corporate tax rate differs from the standard corporate rate (30 per cent) that is assumed to exist in the AER's models. The investor level tax rates would not contribute to the relevant difference, however, because of the AER's post-company tax pre-personal tax framework. Compensation for investor level taxes (at varying levels) is provided through the rate of return, not the AER's provision for company tax costs.

However, although the different effective corporate tax rates are potential contributors to the underlying tax difference, they appear to have had little effect in the historical period included in the ATO analysis. This is because many private sector networks had large existing tax losses and so it did not matter what tax rate the owner was subject to. We discuss these accrued tax losses in the following section. Accrued tax losses offset the taxable income otherwise generated during the analysis period, bringing taxable income to zero, and so any tax rate would generate tax payable of zero.

71 As estimated in an equilibrium asset pricing model, representing the required return for the marginal investor.

72 As discussed in section 5.1 our formal information gathering process as part of this review does not compel upstream entities to provide tax information.

Table 5.2 Observed tax rates for entity owners

Owner	Tax rate	Effective tax level	Details
Corporation	30%	Corporate	Franking credits for tax paid by the corporation can be distributed to investors to reduce investor tax payment.
State government	30%	Corporate	National Tax Equivalent Regime. Tax equivalence paid to the State as are dividends. Indifferent between receiving tax or dividends.
Sovereign wealth funds	0%	Corporate	Certain non-commercial income derived in Australia by foreign governments is exempt from Australian tax.
Australian Managed investment funds	15%–30%	Corporate	30% for Australian investors 15–30% relates to foreign investors
Foreign investors	15%–30%	Corporate (withholding) Investor (final)	30% withholding tax. 15% concessional rate for Managed Investment Trust (MIT) income only applicable for EOI countries.
Australian super funds	15%	Investor	The taxable income of a superannuation fund is taxed at a flat rate of 15%.
Australian resident investors	0-45%	Investor	Marginal tax rate of individual. Franking credits can be used to reduce effective rate where applicable.

Source: PwC, *AER tax review 2018, Expert advice*, 26 October 2018, p. 55; AER analysis.

The CCP submission noted that the removal of concessional tax rates (below the standard 30 per cent) for some owners would only occur after a transitional period of seven to fifteen years.[73] It considered that the AER's tax calculation needed to reflect current circumstances, not what would happen in the future. The PwC addendum provides further information on the increase in tax rates over time for stapled structures, as illustrated in Table 5.3.

The PwC addendum also includes further information on several other concessional tax categories, including interest withholding tax exemptions for foreign pension funds and sovereign wealth funds.[74] These do not appear to be material ownership categories at present.

73 CCP, *Submission to the AER on review of regulatory tax approach—Discussion paper November 2018*, 25 November 2018, pp. 18–19.

74 PwC, *AER tax review 2018–Addendum, Expert Advice*, 10 December 2018, p. 30.

Table 5.3 Changing tax rates for owners of stapled structures—from PwC addendum

Distribution	Current tax rate	01/07/2019 to 30/06/2026	01/07/2026 to 30/06/2034	From 01/07/2034
Distributions of cross-staple rent from the asset entity	0%[a] / 15%[b]	0%[a] / 15% / 30% 15% rate applies to cross-staple rent that satisfies the integrity rules. Otherwise 30% rate applies.	15% / 30% 15% rate applies to cross-staple rent that satisfies the integrity rules. Otherwise 30% rate applies.	30% (depending on investor's tax profile[c])
Distributions of income from the operating entity	0%[a] / 15%[b]	0%[a] / 15%[b]	30%	30%

Source: PwC, *AER tax review 2018–Addendum, Expert Advice*, 10 December 2018, pp. 58–59.

Notes: The rates shown in the table assume that sovereign wealth fund investors will maintain their current ownership interest (i.e. they will not sell down to below 10%).

a Applies to sovereign wealth fund investors who have qualify for the sovereign immunity exemption.

b Assumes investors hold their interests via a MIT and are resident in an information exchange country.

c Independent of the effect of stapled structures, superannuation investors retain access to a 15% concessional tax rates. State government owned networks held outside the NTER have no effective tax rate (N/A%); though this makes no difference to the total distribution to their owners.

What are our findings and recommendations?

Consistent with our discussion paper, our core finding is that a 30 per cent tax rate reflects the costs incurred by owners of most regulated networks. Less than 17 per cent of regulated energy assets are owned by investors with an applicable tax rate that may be less than 30 per cent.[75] This 17 per cent of regulated energy assets is an upper bound because some portion of these investor groups will pay tax at the 30 per cent rate currently. It is also an upper bound with regard to future tax rates, as some investors currently accessing concessional tax rates below 30 per cent will move back towards the full 30 per cent tax rate over time. As a proportion of privately-held networks (excluding state or territory government owned networks) this upper bound is 34 per cent. Consideration against our efficient cost criteria suggests that the current approach (using a 30 per cent tax rate) should be maintained.

Most submissions received on our discussion paper were in favour of maintaining the 30 per cent benchmark tax rate. We have carefully considered the transition period where concessional tax rates are still available to several investor classes as set out above. Maintaining a single benchmark using a 30 per cent tax rate (as proposed in our November discussion paper) will not close the tax difference for entities accessing these concessional tax rates. For these entities, the AER's forecast of tax costs is currently higher than the payments made to the ATO. We recognise that this is a disadvantage of the current

75 This is calculated as all investor classes outside Government owned networks (51.1 per cent), Australian companies (30.0 per cent), and foreign companies outside stapled structures (2.3 per cent), who together hold 83.4 per cent of the regulated TAB.

approach. Nonetheless, it appears appropriate to reflect the dominant tax rate as a single benchmark. We consider the use of multiple benchmarks in the following section.

Under our achievability criteria, we have also considered whether it would be possible for regulated networks to align with a benchmark tax approach based on non-corporate owners. Overseas sovereign wealth funds currently benefit from the lowest tax rates. If we were to change the benchmark to this level, it would not be possible for the current owners of regulated networks to align with the new benchmark as they cannot change to become overseas sovereign wealth funds. Meeting the benchmark would require a sale transaction where the pool of buyers was relatively small. This would likely impose windfall losses on existing owners and reduce long term investment in the Australian regulated networks. While this is the most extreme example, risks of this nature would also occur if the benchmark was shifted to be a foreign-held MIT or an Australian superannuation fund.[76]

For the reasons set out above, we consider that no change is warranted to respond to ownership structure.

5.3 Multiple benchmarks

In response to our discussion paper, most stakeholders submitted that we should maintain our current approach of applying a company tax rate of 30 per cent under a (single) benchmark incentive approach.

However, the CCP submitted that we should consider two benchmark tax rates to reflect two different entity structures:

1. the existing 30 per cent tax rate for company structures (in line with the AER's discussion paper); and
2. a 15 per cent tax rate for entities with any structure other than a company structure (i.e., flow-through structures).[77]

Although the tax rates would differ, other aspects of the AER's tax approach (including the calculation of taxable income) would be identical between the two benchmarks.

This was mainly due to its concerns that:

- Not all of the NSPs are subject to the Australian company tax rate of 30 per cent, in particular where flow through structures enabled use of tax rates of 15 per cent or 0 per cent.
- This meant consumers were over-providing for tax costs where flow-through structures were in use.
- The CCP recognised that legislative changes meant that entities in flow-through structures, and their owners, might ultimately pay higher rates of tax than they currently

76 With all these changes, it would also be necessary to ensure that the overall revenue recovery package we provided to investors was correct. In particular, we currently estimate the rate of return (and gamma) with regard to the Australian market, recognising both domestic and foreign investors in that market.

77 CCP, Submission to the AER review of regulatory tax approach, *Discussion paper November 2018*, 25 November 2018, p 20. (LATE SUBMISSION)

do (under certain circumstances). However, due to transitional arrangements these changes will not be effective for most entities and their owners for at least another 7 years (and in some cases not for at least another 15 years). This means that consumers would continue to over-provide for tax costs for a considerable number of years.

The CCP noted that in considering multiple benchmarks it is important to assess the additional cost/complexity relative to the improved accuracy of the tax estimates and the scope for gaming. It stated that in suggesting two benchmarks it was making a judgement about the trade-off between consumer benefit and implementation complexity. The CCP considered that the two benchmarks were a reasonable compromise at this stage and could be reviewed in 4 to 5 years' time at the next tax review.

The ECA also submitted that the current approach to calculating the tax allowance may not be appropriate as businesses keep all the gains for any underspends (there is only upside risks for NSPs). It suggested an alternative approach whereby tax costs could be set based on a proxy measure such as the average of tax actually paid by networks as a percentage of revenue (or EBIT or some other earnings measure) in previous years.[78] It stated that this change to the way the AER calculates the tax allowance could be made immediately and based on tax data presented to date. It also stated that the effect of this change would be a different allowance for Government owned networks compared with privately funded networks.

Setting benchmark allowances

In our discussion paper we identified that applying a 30 per cent tax rate (as one aspect of our overall tax approach) was the most appropriate benchmark. We identified that this would align with other aspects of our incentive benchmark approach, including the rate of return, and provide an appropriate overall revenue recovery package.

Instead, if we were to adopt multiple benchmarks, there are a number of threshold questions to consider. We need to consider the interactions between multiple benchmarks and other components of regulated revenue, including those that are set as a single benchmark (such as the rate of return). We also need to consider, if there are to be multiple benchmarks, whether the proposal from the CCP is the most appropriate one. It might be that more than two benchmarks should be considered.

The CCP suggested that the tax rate can be adjusted to reflect the specific circumstances of a particular NSP, and thus multiple benchmarks would be appropriate. We accept that, when applying a single benchmark, some inputs to a benchmark approach may reflect NSP specific inputs. There are grounds to question whether the tax rate is also an input that can simply be varied, with no risk to the overall revenue recovery package, or if it is an inherent aspect of the benchmark approach. We are concerned to ensure that our tax approach is compatible with the (single) rate of return benchmark. This concern extends to the ECA proposal, which would more substantially alter the tax benchmark in a way that could

78 ECA, *Review of regulatory tax approach 2018*, 30 November 2018, p 3. (LATE SUBMISSION)

potentially introduce inconsistency with the rate of return benchmark. Substantial analysis would be required to ensure that the overall revenue recovery package was appropriate.

We also need to consider the potential for other additions to the primary benchmark. The implicit criteria adopted by the CCP in proposing this second benchmark appears to be that there was an identified material difference between actual and forecast tax costs for non-company structures. Other additional benchmarks could also meet this 'identified material difference' test; and we have not had opportunity to assess those alternatives. Finally, we would need to consider whether having multiple benchmarks would reduce incentives for efficient investment on the energy networks.

The appropriate tax rate given different categories of investors

The CCP also suggested a tax rate of 15 per cent should be applied to all entities held in non-company structures. However, it does not appear to be appropriate to simply apply this tax rate to all the NSPs with a flow-through structure. This is because there are NSPs that have flow through structures, but where the standard corporate rate of 30 per cent would apply to all their upstream investors.

A possible option could be to apply the 15 per cent tax rate to just the NSPs with stapled structures (and apply the existing 30 per cent rate to the two NSPs structured as partnerships). This aligns with the CCP's underlying concern that concessional tax rates will apply to stapled structures for a seven or fifteen year transition period. However, we note that the 15 per cent rate would not be applicable to all investors, particularly foreign investors.

The CCP acknowledged that its suggested rate would be a compromise at this stage that could be reviewed in 4-5 years' time at the next tax review. However, there appears to be no clear basis on which this compromise is to be made, and on what principles we should be establishing multiple benchmarks, and whether additional benchmarks should be adopted for each stapled structure according to the tax profile of its specific investors.

In response to submissions on multiple benchmarks, PwC noted that for stapled structures, whilst some investors in stapled structures may pay 15 per cent (e.g. superannuation funds and foreign investors in MITs), others may pay more or less.[79] PwC identified that one problem with applying a blended rate retrospectively (that is, after the partnership or trust agreement had already commenced) is that if a rate of 15 per cent rate were adopted it would result in investors with lower tax rates benefitting from the regulatory tax costs provided in respect of investors with higher tax rates. It then reported that it is unclear how this could be practically dealt with in light of:

- the commercial arrangements between the relevant entities, and
- that under tax law there is no basis for allowing aggregation of tax between different tax payers as tax is levied on an identified taxpayer.

79 PwC, *AER tax review 2018–Addendum, Expert advice*, 10 December 2018, p. 61.

We also note that one of the NSPs with a stapled structure, TransGrid,[80] made a submission which it considered relevant to our consideration of its tax costs.[81] TransGrid submitted that as part of its sales process, its new owners paid the NSW Government a one-off NTER equivalent payment in 2015. We understand that this payment represented what the NSW Government would have otherwise received from consumers (via TransGrid) over 99 years, had it not be privatised (as a result of the privatisation the NSW Government would no longer be the owner (nor the taxing authority), and hence no longer receive NTER tax equivalents from TransGrid).

Hence, TransGrid indicated that the payment was effectively a pre-payment of tax obligations by its new owners to ensure that NSW taxpayers were better off as a result of the transaction. This suggests that consumers are not currently paying tax costs that are simply not being incurred, rather they have already been incurred by TransGrid's new owners.[82]

We received similar supplementary submissions from Ausgrid and Endeavour Energy indicating that TransGrid's tax situation also applied to their transactions.[83] That is, their new part owners (i.e. new owners other than the NSW Government) have also pre-paid their share (50.4 per cent) of NTER tax equivalents over the life of their leases.

CCP commented on this issue in its submission, and considered that: it was irrelevant; that consumers are not interested in indemnifying TransGrid's new owners from regulatory risk. The fact that government-owned utilities were paying taxes to their owner rather than the ATO may create an impediment to efficient privatisation, but this issue should be resolved by the relevant Government and not by the AER through making decisions that are contrary to the NEO.[84]

It is important to further consider these issues prior to setting a second benchmark that is reflective of these privatised networks. This would include the basis on which the pre-payment of taxes was recognised by the State Government. However, we have not been able to do so in the time available to this review.

What are our findings and recommendations?

In our discussion paper, we did not explore the possible use of multiple benchmark tax rates. Rather, we maintained our current approach of adopting a single benchmark tax rate of 30 per cent.

Whilst CCP's suggestion may have the effect of reducing the face value tax difference in this particular regard, it is unclear whether such an approach would tend to the correct overall

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80 Spark Infrastructure, *Submission on the 'Stapled Structures' Consultation Paper*, 20 April 2017, p. 2.

81 This submission arose from the earlier voluntary information collection phase; but it was not received in time to be considered in our discussion paper. TransGrid, *Supplementary information on tax paid by TransGrid*, 2 November 2018.

82 We note that prior to the privatisation, the NTER payments were made to the NSW Government and not the Federal Government. Therefore, after its privatisation, any federal income taxes paid by TransGrid's new owners are in addition to the one-off prepayment of NTER tax equivalents that it made to the NSW Government in 2015.

83 Ausgrid, *AER tax discussion paper supplementary submission*, 10 December 2018 (LATE SUBMISSION); Endeavour Energy, *AER review of regulatory tax approach 2018*, 11 December 2018 (LATE SUBMISSION).

84 CCP, Submission to the AER review of regulatory tax approach, *Discussion paper*, 25 November 2018, p. 21. (LATE SUBMISSION)

revenue recovery package. This has not been tested nor proven. As noted previously, our aim is not to simply reduce tax differences.

Further, it is unclear what principles should be applied in setting the different tax rates, and whether different applicable tax rates should also be applied to the various owners of the flow-through structures. We note that introducing additional benchmark tax rates can introduce additional complexity to the overall regulatory framework and this should be weighed against its benefits.

In response to the ECA's submission, we note that its recalculated basis for the tax allowance (not just the tax rate) would also raise substantial matters around compatibility with the building block approach and the provision of the correct overall revenue recovery package. The proposed approach has some similarities to a tax pass-through option, where we would be ultimately setting future costs based on actual taxes paid (and we would also need to determine the actual taxes paid for only the regulated activities of the NSP). We are not recommending a tax pass-through option, and discuss our considerations further in section 9.

Given the information currently available:

- We consider that maintaining the single benchmark tax rate would be consistent with our approach to setting the rate of return, and ensures the correct overall revenue recovery package. However, it is not clear if this would be the case under multiple benchmarks or an alternative benchmark construction.
- It is not clear that the proposed second benchmark would be appropriate where owners in flow through structures still pay the standard corporate tax rate, or where joint owners of one entity have different tax rates.

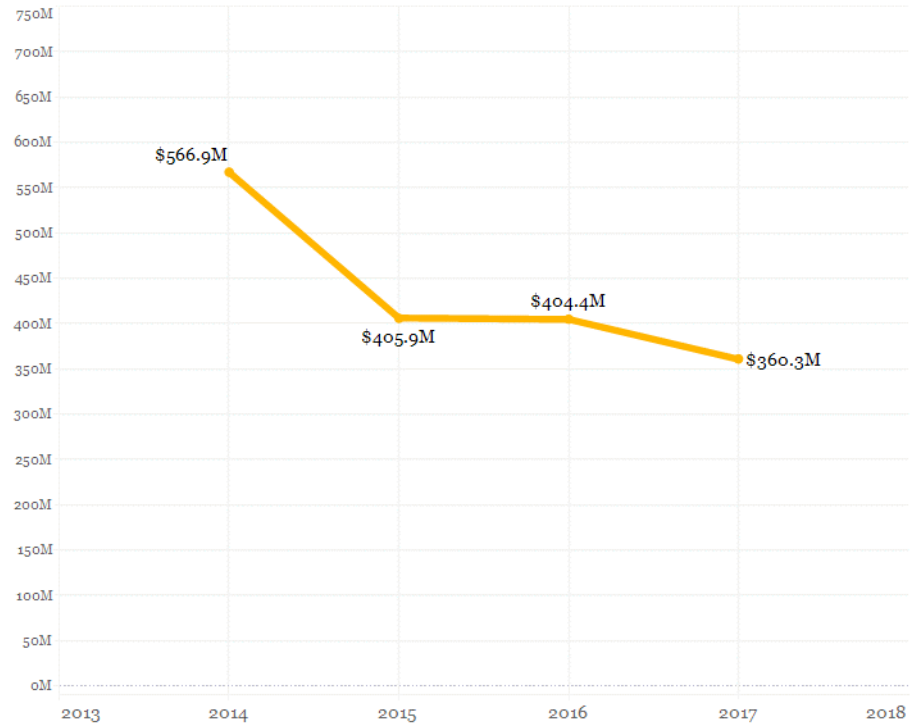
We consider that introducing a second benchmark for the purposes of calculating our regulatory provision for tax costs would be a material departure from the current regulatory framework. In particular, careful consideration and consultation needs to be given to potential consequential impacts in other parts of the regulatory framework and the overall impact on incentives for efficient outcomes. For the purposes of this final report and based on the information before us, we are not recommending the adoption of a second benchmark or an alternative benchmark construction.

5.4 Accrued tax losses

When a business entity records a tax loss in a given year it is able to carry forward that loss to offset against future taxable income. Instead of paying tax on that income, it instead deducts it from the value of carried forward tax losses, until those losses are exhausted. If substantial carried forward tax losses are built up, perhaps over a number of years, it may be that it takes many years of otherwise profitable business activity to use up these losses and return to the point where tax is again paid. In accounting terms, the entity might record a tax expense each year, but this would be offset against the accrued tax loss so no tax payment was made until the accumulated losses were exhausted. Tax losses are therefore one factor explaining the difference between actual tax payments and the regulatory forecast of tax costs from year to year.

Some of the regulated networks had built up large tax losses at the start of the period analysed by the ATO. Below we reproduce the updated figure from the PwC addendum on carried forward tax losses.

Figure 5.6 Tax losses carried forward—from PwC addendum



Source: PwC, *AER tax review 2018–Addendum, Expert advice*, 10 December 2018, p. 42 (figure11).

Notes: This figure shows average tax losses for private sector networks, calculated where yearly data was available.

Figure 5.6 shows the size of average tax losses recorded by the privately held or listed regulated networks, as well as the general decrease in those tax losses during the ATO analysis period. Although we show only average data to preserve confidentiality, we note that the general trend of tax losses being drawn down is stronger when individual networks are considered in isolation. Data availability means some networks are not included in all years of Figure 5.6.

The ATO note was focused on 'cash' tax payments by these networks during that period, but some businesses paid no tax (or less tax) because instead they drew down their pre-existing tax losses. Even if actual taxable revenue, tax expenses and therefore taxable income for each year within the period exactly aligned with AER forecasts, no tax would be paid because of earlier events. Hence, this effect contributes to the face value tax difference but is not of itself a driver of the underlying tax difference relevant to regulated activities.

Treatment of tax losses

It is a requirement in the AER's PTRM that the NSP identify any tax losses associated with its regulated activities when it is first regulated. We have conducted assessments of NSPs in

the past. Where tax losses were identified in relation to the regulated activities, these were exhausted in the first period the NSP was regulated by the AER.[85] Subsequently, the tax loss forecast by the preceding period's regulatory model is the input to the following period's regulatory model. The amount of tax losses reported in the PTRMs has been significantly lower than the data before us suggests at face value.

What caused accumulated tax losses?

We consider that it is relevant whether the historical generation of these tax losses related to regulated activities. There are two broad implications:

If the tax losses arose from taxable expenses not relevant to the regulated activities of the networks, then they are not part of the relevant tax difference. We need to consider the marginal effect of relevant tax outcomes against the background of these unregulated tax losses. In the period of analysis, there appears to have been a drawdown in tax losses as taxable revenue. The ENA submission noted that a drawdown of accrued tax losses was a reduction in an asset of the firm, and therefore an expense to the firm in the same way that it would have been had cash been paid.[86]

However, if the tax losses arose from taxable expenses relevant to the regulated activities of the firm, then they are part of the relevant underlying tax difference. We need to consider why they occurred, why they were not forecast in the AER's regulatory models and whether this indicates deficiencies in the regulatory tax approach.

Disentangling the drivers of observed tax losses is difficult given the various causes of the loss and because of the long time period that has elapsed since these losses were generated. Quantifying any relevant tax losses would be a difficult undertaking, but first we would have to decide which causes of the tax losses should be accounted for under our regulatory framework.

What are our findings and recommendations?

The incentive approach allows variation in revenue and costs around the benchmark, but given the nature of regulated activities we would not expect this would result in an accounting loss in any period. Accordingly, any tax losses are likely to emerge due to timing issues in the realisation of tax expenses. Our review has identified immediate expensing and the DV depreciation approach as significant contributors to front loading tax expenses within the regulatory framework.

Tax losses created by timing issues such as the use of DV depreciation and immediate expensing naturally reverse, so that tax losses built up from such sources will be drawn down in later years (albeit with a lasting NPV effect). As we have demonstrated in other parts of this report, these timing issues are significant and are therefore likely to explain a considerable proportion of any accumulated tax losses related to regulated activities. While we recognise there have been problems with our tax approach in the past in relation to

85 For example, Ergon Energy recognised a tax loss balance of $148 million in 2009–10. This balance was exhausted in the 2010-15 regulatory control period.

86 ENA, *Review of regulatory tax approach, Response to the AER discussion paper*, 23 November 2018, p. 9.

immediate expensing and the DV depreciation approach, we have decided not to apply these approaches retrospectively. For similar reasons we do not advocate customers sharing in the benefits of any tax losses that emerge from these sources. Accordingly, the tax losses that are relevant for regulatory purposes are therefore less than those shown in Figure 5.6, although we have not been able to quantify the amounts.

The DoEE suggested that the AER had dismissed the net present value (NPV) effect arising from the existence of tax losses and the delay in the payment of tax.[87] Our recommendation to adjust the depreciation component of our regulatory approach (with regard to immediate expensing, DV depreciation and gas asset life capping) recognises the NPV effect that arises when taxes losses are incurred.

It is also possible that tax losses may have been generated by non-regulated activities (which are subject to competitive forces) within a tax consolidated group. Customers should not receive tax benefits from tax losses emerging from non-regulated activities. Given these activities are subject to competitive forces, there is a greater risk they contribute to tax losses, compared to regulated activities. As discussed in chapter 7 we do not consider the asset revaluations should be reflected in the TAB as the incremental change in value is not funded by consumers. For similar reasons the impact of revaluations should not be included in the tax loss calculation for regulatory purposes. Separating the impact of revaluations on tax losses is difficult as it acts through increasing the tax depreciation expense rather than being separately observable. Accordingly, we know the tax losses for regulatory purposes should be less than observed tax losses, but do not know by how much. The impact is likely to be significant given that there have been approximately $6 billion added to the NSPs tax assets due to revaluations.[88]

As noted above, it is very difficult to separate regulated and non-regulated activities from the available tax information. However, the PwC addendum attempted to estimate the stand-alone tax position arising only from regulated activities, based on data provided in RIN responses. This analysis indicated that, after isolating taxable revenue and expenses relevant to the efficient operation of the regulated assets, the networks were generating taxable profits.[89]

In conclusion, we consider that our decision to allow immediate expensing of certain capex and the use of the DV approach will reduce the extent of tax losses in future and provide benefit to consumers. Apart from this there do not seem to be obvious ways to further reduce the extent to which tax losses should be excluded for the calculation of tax for regulatory purposes.

87 DoEE, *Submission to the AER's Review of Regulatory Tax Approach*, 23 November 2018, p. 7.
88 PwC, *AER tax review 2018–Addendum, Expert advice*, 10 December 2018, p. 48
89 PwC, *AER tax review 2018–Addendum, Expert advice,* 10 December 2018, p. 45.

6 Depreciation–timing effects

Summary of the issues

Tax depreciation is a non-cash expense and represents the change in the value of an asset for tax purpose. Different depreciation schedules result in different annual tax expenses.[90] All else being equal, a higher depreciation expense in a given year results in a lower tax payable for that year. Given that an asset can only be depreciated once, the total tax depreciation (in nominal terms) over the life of an asset should not be impacted by the method used to depreciate an asset. However, the total depreciation value will be different in NPV terms due to the timing difference under different depreciation schedules.

The RINs we issued to the NSPs queried their current practices around the calculation of the tax depreciation expense. This included the lives and methods used to depreciate assets, and capitalisation policies for claiming immediate expenses. This section discusses three key drivers related to depreciation expense that are timing effects:

- Immediate expensing of capex
- DV approach
- Capping of gas asset lives.

We note that the following two drivers were considered to be immaterial in our discussion paper, and will be discussed briefly at the end of this section:

- Self-assessed asset lives
- Low value pools.

For this final report, we consider that the use of immediate tax deduction for certain capex (such as refurbishment capex) is a material driver of the difference between tax paid and the regulatory provision for tax costs.[91] The potential to immediately expense some capex is not presently recognised in the AER's regulatory models. We are not able to draw a clear conclusion on whether the use of DV method and the use of 20 year capped lives for gas assets are material drivers of the tax difference historically, but we consider that they are likely to be drivers of a difference going forward.[92] At present, the regulatory models use SL tax depreciation (not DV) for all regulated networks but one, and recognise the 20 year gas asset life cap in about half our gas determinations.

These three drivers are relevant to the regulatory tax approach and we recommend making changes relating to each one. Consistent with our discussion paper, we consider that the self-assessed asset lives and the low value pool assets are not material drivers of the tax difference and do not recommend making changes in response to these issues.[93]

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90 The next chapter discusses the scenario where the total amount of depreciation varies (rather than the timing of when depreciation is expensed).

91 PwC, *AER tax review 2018, Expert advice, 26 October 2018*, pp. 64–67.

92 PwC, *AER tax review 2018, Expert advice, 26 October 2018*, pp. 78, 85.

93 AER, *Discussion paper*, 2 November 2018, p. 46.

How does this issue contribute to the tax difference?

Our current approach

Our current approach is to record capex in our regulatory models based on different asset classes, grouping physically similar types of assets. Each asset class has a tax asset life, based on the ATO standard tax asset lives. The initial value for tax purposes is the amount of capex incurred to build the asset. The value of the asset declines in subsequent years as depreciation is deducted. We use SL depreciation for tax purposes, which means that the same amount of tax depreciation is deducted each year of the asset's life (in nominal terms) until its value for tax purposes drops to zero.[94]

In electricity, we use the approved PTRM and RFM for all service providers.[95] This implements our standard depreciation approach as described above, including the use of SL depreciation for all current determinations and almost all previous determinations. The exception is the use of DV tax depreciation for the Victorian distribution networks in the 2011–15 regulatory control period in accordance with the transitional rules.[96]

In gas, there is more scope for NSPs to propose tax depreciation methods other than the SL approach. Nonetheless, the SL approach has been applied in current access arrangement determinations for all gas NSPs regulated by the AER except for Jemena gas networks. However, the AER has accepted the DV method proposed by a numbers of gas NSPs for tax depreciation in previous access arrangement periods.[97] We have applied a 20-year asset life cap to pipeline assets in about half our current gas decisions.

Although the asset classes in the PTRM and RFM are based on the type of assets installed, earlier in the regulatory determination when assessing regulatory proposals we have had regard to different categories of capex by driver. One common category is 'repex', which is that portion of network capex where the primary driver is replacement of existing assets that have reached the end of their life. Repex may include a specific program targeting the refurbishment of existing assets.

6.1 Immediate expensing of capex

In regulatory proposals, service providers generally propose two broad categories of capex based on the asset type—network and non-network (sometimes labelled system and non-system or pipeline and non-pipeline). Network capex is then further divided into a number of categories based on the key driver for that capex, such as: augmentation (augex, sometimes labelled growth capex) or replacement (repex). The replacement capex proposal might

94 There is one exception, where Jemena Gas Networks currently uses the diminishing value approach instead of straight-line.

95 AER, *Post-tax revenue models (transmission and distribution) - January 2015 amendment*, January 2015
AER, *Roll forward model (distribution) - December 2016 amendment*, December 2016
AER, *Roll forward model (transmission) - October 2015 amendment*, December 2016

96 AER, *Final decision, Victorian electricity distribution network service providers Distribution determination 2011–2015*, October 2010, p. 582

97 This includes 2010–15 Jemena Gas Networks access arrangement period, Multinet Gas 2013–17 access arrangement period, Envestra (now Australia Gas Networks) Victoria and Albury 2013–17 access arrangement periods, and AusNet Services (Gas) 2013–17 access arrangement period.

include a specific program that deals with the refurbishment of network assets (refurbishment capex). Capex is differentiated on an 'asset class' basis, where certain similar assets are classed together, and then depreciated at the approved standard life for that asset class. The standard asset life reflects the average effective life of the assets categorised into that asset class.

Service providers include maintenance-type activities as part of their opex allowance, and some of these activities might be labelled as refurbishment. In this case, the cost does not enter the asset base (tax or regulatory), and the service provider instead recovers the expenditure from customers in that year. Accordingly, the value is expensed immediately for tax purposes. However, we understand that generally refurbishments would be capitalised and treated as standard capex for RAB and TAB purposes. For this capex, the value enters the regulatory and tax asset bases at the end of the year it is incurred and is depreciated at the standard life of the associated asset class on a SL basis.

Although these costs are capitalised into the asset bases in the regulatory environment, it may be possible for service providers to immediately deduct these expenses for tax purposes if they meet certain criteria. It has generally been accepted by the ATO that a 'distribution line' in the electricity industry can be regarded as a single ‘functional unit’ of property for tax depreciation purposes. This includes the various components that make up the distribution line (poles, wires, conductors, transformers, insulators, etc.).[98] This definition of a 'functional unit' impacts what may be considered a new depreciating asset for tax purposes. Building a new network line (augex), is generally regarded as a separate depreciating asset for tax purposes, as it can be separately identified or regarded as having a separate function from any existing distribution infrastructure. However, replacing or refurbishing an item (e.g. pole) that forms part of a broader functional asset like an existing network (repex), may not substantially alter the function or life of the asset to which it belongs. This type of capex may therefore give rise to an immediately deductible tax expense that the service provider can claim when lodging their tax returns.[99]

The draft ATO ruling which sets out the ATO position on composite items and identifying the depreciating asset provides some guiding principles and examples of how certain types of capex should be identified for income tax.[100] However, it understandably does not account for every individual capex scenario, leading to different interpretations of the guiding principles by different taxpayers. An NSP taking a risk-averse approach to claiming tax deductions may immediately expense capex that fits clearly in the ATO definition of a deductible repair—such as a like-for-like pole replacement after storm damage. Another taxpayer may interpret this to include replacement of assets that it does not consider to be materially altering the function or life of the overall composite asset of the network. PwC notes the potential for differing views and interpretation of what constitutes a functional asset in its report. It also notes that whether replacement assets are repairs, improvements to an

98 This position was set out in a previous ATO Tax Determination in 2002 (TD 2002/5) and confirmed by a draft Taxation Ruling in 2017 (TR 2017/D1).

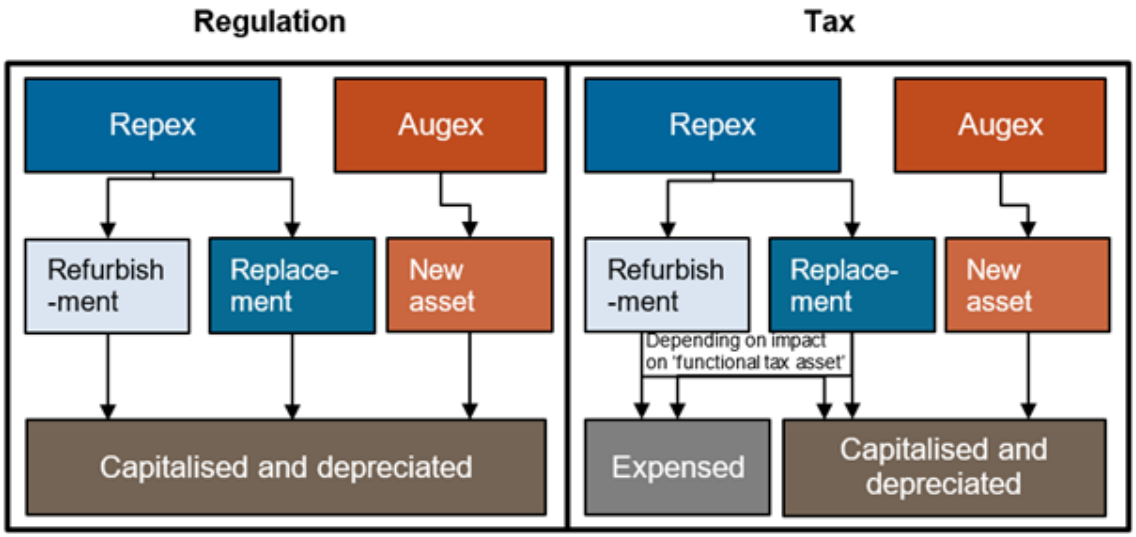
99 See example 2 2 in ATO Tax Determination (Withdrawn) TD 2002/5, and example 9, ATO Tax Ruling (Draft) TR 2017/D1.

100 ATO, Tax Ruling TR 2017/D1.

existing asset or a separate new depreciating asset is a contentious area of law and the appropriate income tax treatment is situation and fact specific.[101]

This difference in treatment of certain types of expenditure, as shown in Figure 6.1, leads to a timing difference between when these costs are assumed to be deducted in the regulatory models (over the life of the asset), and when they are actually deducted (the year of incurrence). In its report, PwC notes that this creates a material difference between tax paid and the regulatory provision for tax costs for some NSPs.[102]

Figure 6.1 Comparison of treatment of refurbishment–regulatory vs tax



Source: AER analysis.

Note: The "Expensed" box represents the source of the timing difference between the actual and regulatory assumptions in when costs are deducted. This is the cause of the windfall gain to NSPs that immediately expense capex.

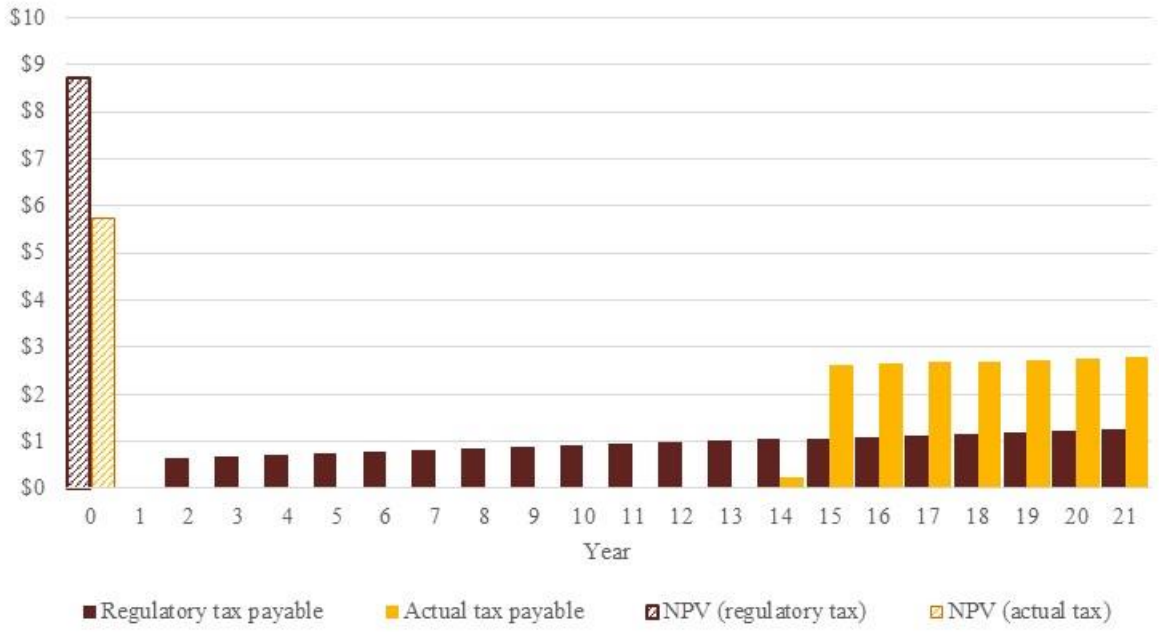
In submissions to our initial report, stakeholders acknowledged this potential for different treatment of refurbishment expenditure for regulatory and tax purposes. However, the ENA recommended that any proposed change in this area should be the subject of a detailed consultation process to avoid any unintended consequences.[103]

Many stakeholders also highlighted that this is simply an issue of the timing of deductions, not the overall value and is therefore revenue neutral over the life of the asset. However, as we discussed in our initial report, due to the lack of compensation for the time value of money in the TAB, the NPV of tax depreciation for a shorter-lived tax asset will be greater than that with a longer tax asset life.[104] This means that service providers generally have an incentive to front load actual depreciation expenses—and write off immediately for tax purposes if possible—but capitalise the costs in the regulatory tax environment.

101 PwC, *AER tax review 2018, Expert advice*, 26 October 2018, pp. 60–63.
102 PwC, *AER tax review 2018, Expert advice*, 26 October 2018, p. 63.
103 ENA, *Submission to initial report*, 26 July 2018, p. 13.
104 AER, *Initial report, Review of regulatory tax approach*, 28 June 2018, pp. 12–16.

This is illustrated in a simplified example shown in Figure 6.2 where a single year of refurbishment capex for an asset with a 20 year life is incurred in year one. In the regulatory modelling of tax costs the expenditure is capitalised and deducted from taxable income over the 20 year life of the asset. Therefore, there is a small relatively stable tax payable amount for the life of the asset (brown bars). However, if that expenditure is expensed in the year in which it occurred for tax purposes (year 1), there is a large tax loss in that year—where the amount deducted for tax outweighs the revenue recovered for this expenditure. For the next 14 years of the asset's life tax payable is zero, as the initial year's tax losses are carried forward and offset future income. For the final 7 years of the asset's life, the tax payable (yellow bars) is larger than that modelled in the regulatory environment. When these tax costs are discounted to NPV terms using the assumed rate of return, the tax payable calculated in the regulatory environment is larger than the actual tax payable. The NPV difference is presented as the cross-hatched bars in year zero in Figure 6.2.

Figure 6.2 Comparison of regulatory tax payable and actual tax payable for refurbishment expenses ($ nominal)



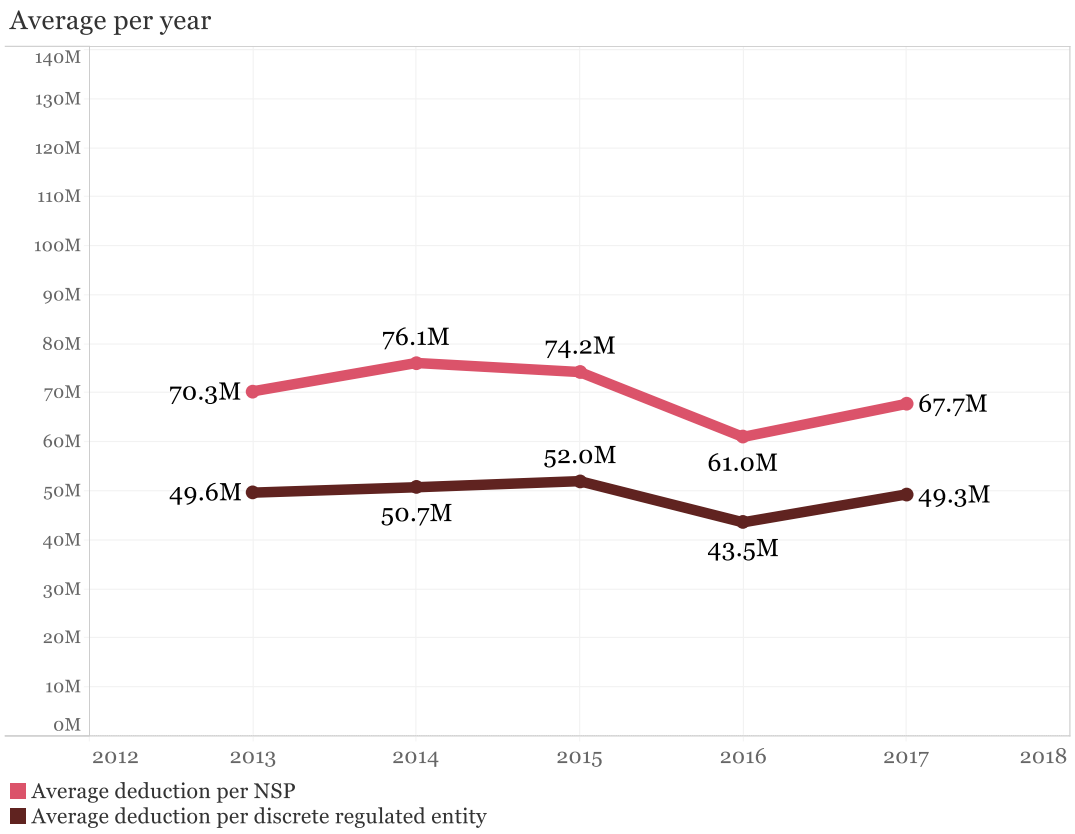
Source: AER analysis. Updated analysis from discussion paper correcting for tax losses carried forward.
Assumptions:
Inflation = 2.50%, Capex = $100 in year 1, RAB life = 20 years, TAB life = 20 years, nominal rate of return = 7.00%.

In the RINs issued to service providers we asked for documented tax capitalisation policies and details of expenditure which was included in the regulatory capex allowance (and hence capitalised into the RAB and TAB), but treated as immediately deductible for income tax purposes.

In the discussion paper we noted that 10 NSPs responded to our voluntary request regarding immediately expensed capex claiming an average of about $80 million per annum of capex included in the TAB was immediately deducted for actual tax purposes. As shown in Figure 6.3, the PwC addendum report has revised the average down to around $50 million

per annum.[105] This updated average reflects information from the RIN responses, which included more responses from NSPs that had not claimed—or only claimed small amounts—of capex as immediate deductions.[106] There is considerable variation between entities, with amounts claimed ranging from about $5 million to greater than $200 million (annually, averaged over the period). While some NSPs were not claiming any immediate deductions for capex, the standard deviation in amounts claimed across the entities was around $75 million.[107] The amount expensed also does not appear to be directly related to the size of the networks, with some relatively smaller networks expensing large amounts, and vice versa.

Figure 6.3 Average amount of capex in the TAB immediately deducted annually for tax purposes—from PwC expert advice



Source: PwC, *AER Tax review 2018–Addendum, Expert advice,* 10 December 2018, p. 50.

The information received in response to the RIN was informative, but still incomplete. Not all of those who responded provided a detailed description of the specific type of capex being

105 PwC, *AER Tax review 2018–Addendum, Expert advice*, 10 December 2018, p. 50.
106 In the discussion paper, w noted that some NSPs that responded to the voluntary request as not claiming deductions were incorrectly described as not responding to the information request.
107 PwC, *AER Tax review 2018–Addendum, Expert advice*, 10 December 2018, p. 50.

treated as immediately deductible. In some cases, it was not purely related to refurbishment expenditure, but also included capitalised labour or overheads.[108]

However, it appears that the different treatment of certain capital related expenditure is causing a material difference between the provision for tax costs in our regulatory models and the actual tax costs of some NSPs. For example, consider an NSP with the following characteristics:

- $5 billion opening asset base (RAB and TAB) with a remaining life of 30 years
- $300 million annual capex program with a standard life of 30 years
- $100 million of capex that is able to be immediately expensed each year
- Nominal allowed rate of return of 7 per cent[109]

In this case, the current approach (which does not recognise immediate expensing of capex) forecasts tax costs for the 5 year period of $86 million ($ nominal). If the capex is recognised as immediately expensed in the regulatory modelling of tax costs the forecast for that period is zero (as the immediate expensing of capex leads to a tax loss that is carried forward over the 5 year period).

What are our findings and recommendations?

As discussed above and highlighted in the PwC report, the information received so far suggests that the treatment of capex that may be immediately deductible for tax purposes is a significant driver of the underlying tax difference for some NSPs. The choice to immediately expense capex (where possible) is an option available to an NSP to reduce the present value of tax costs. Where an NSP chooses this option, it creates a windfall gain for that NSP which does not directly benefit consumers in the form of lower network charges as a result of this reduced tax cost to the NSP.[110] We do not consider that this outcome promotes the long-term interests of consumers to the greatest degree. We consider an approach that reflects the lower tax costs in the revenues recovered from consumers would better promote the NEO and NGO.[111] On this basis, we consider that amending our regulatory models to allow for certain capex to be included in the RAB but expensed immediately for the purposes of determining the regulatory tax costs is desirable. Below we discuss the change required to our regulatory models to account for this treatment of capex. We also discuss our position on the assessment and application of the forecast capex to be treated as immediately deductible.

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108 For example, some responses appeared to only pick up amounts which were booked to tax adjustments in the tax returns, which PwC note could potentially understate the annual amount being deducted immediately. See: PwC*, AER Tax review 2018, Expert advice*, 26 October 2018, p. 66.

109 Return on equity = 10.0%, Return on debt = 5.0%, expected inflation = 2.5%.

110 The 'windfall gain' refers to the NPV difference that NSPs gain from the timing variances resulting from the different treatment of immediately expensed capex for actual tax and regulatory tax purposes.

111 NEL, s. 7; NGL, s. 23.

Change to regulatory models

Currently, all capex is treated equally for tax purposes in our regulatory models (RFM and PTRM)—it is included in the TAB and depreciated at its approved tax standard life. The tax depreciation deductions used to calculate tax payable matches this depreciation profile. In our determinations we do not currently assess whether the proposed capex would be able to be deducted immediately for tax purposes. Our regulatory models currently have no capability to add capex to the RAB—to be depreciated over its economic life—while immediately expensing this capex for tax purposes.[112] Therefore, to address this issue an amendment to our models is required to provide for the immediate expensing treatment of capex.

The discussion paper proposed two separate approaches to address this issue in our regulatory models:

1. Create a separate capex input section to record immediately deductible capex
2. Duplicating each asset class that includes immediately deductible capex and specify this asset class as immediately deductible for tax purposes.

Our final report recommends option 1 as the most appropriate change. This option would create a separate capex input in our regulatory models—similar to the inputs for disposals and customer contributions currently in our regulatory models—where immediately deductible capex can be recorded. The value and calculation of net capex entering the RAB would therefore remain unchanged—gross capex, less disposals, less customer contributions.[113] The value of capex entering the TAB—currently gross capex, less disposals—would be amended to also remove immediately deductible capex. This value of capex would instead be recorded as a tax expense for the year in which it is (or forecast to be) incurred. This change would be required for both the PTRM—for calculating the tax depreciation expense—and the RFM—for rolling forward the TAB for actual capex incurred.

This approach does not exclude the option available to NSPs to propose new asset classes for 'refurbishment' capex that is immediately deductible for tax purposes, but has an effective regulatory asset life that is lower than new replacement capex assumed for other asset classes. The decision on whether to include new asset classes (and their approved lives) is considered at each regulatory determination, with regard to information from the NSP on the type of capex that will be allocated to the asset class. We consider that reviewing the regulatory asset life of 'refurbishment' capex proposed by NSPs will go some way to addressing the major intergenerational equity and cash-flow concerns raised in submissions to the discussion paper. This is discussed further below.

For this final report, recognition of immediate expensing of regulatory capex is one of the three depreciation related changes that we consider can now proceed to implementation through the formal model change process. We will produce an explanatory statement that includes the proposed model changes and the reasons for those changes (based on this

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112 While it is possible to have an asset class with a tax standard life of 1 and a regulatory standard life >1, there is still a one-year lag between when the capex is incurred and when it is expensed for the tax calculation.

113 Note that customer contributions are not a required input for the electricity transmission models.

final report) in late January 2019. This process will provide another opportunity for stakeholder consultation on the changes to be made to the key regulatory models.

Consistent with our initial report and discussion paper, our intention is to apply these model changes to the group of revenue determinations with final reset decisions due in April 2019.[114] However, we consider it necessary to undertake additional consultation on the specific implementation of the model changes, but note that this could be done simultaneously with the general model changes, and as part of the individual revenue determinations. This is discussed further below.

Assessment and application

The proposed amendment to our regulatory models requires a forecast for immediately deductible capex to be included in the tax modelling of forecast revenues. It also requires an amount for actual deductions claimed to be included when rolling forward the TAB for actual capex. Currently, NSPs are not required to provide this information to the AER as part of their regulatory proposals.

In the discussion paper we set out two main options to determine the value of immediately deductible capex to be used when calculating an NSP's tax costs:

1. Apply a 'benchmark approach'—assuming a certain proportion of capex would be immediately expensed by a benchmark firm operating the regulated network.
2. Apply an 'NSP specific approach'—reflecting the NSP's actual values (and forecasts) of immediately deductible capex when determining its tax costs.

Our final report recommends a combination of these two approaches. We consider that an 'actuals informed approach' should be used to determine the amount of capex that is to be treated as immediately deductible capex in our regulatory modelling of tax costs. The 'actuals informed approach' would involve forecasting a certain proportion of capex as immediately deductible. This proportion would be informed by the amount of actual capex that was treated as immediately deductible over a previous period, and the actual use of immediate expensing across the sector.

Submissions from consumer groups and discussions with networks suggested that a benchmark approach that is independent of the NSP's current practice was preferable to one that makes a judgement on whether specific capex forecast could be immediately deducted. However, they noted that further analysis and consultation is required to implement such an approach.[115] Other submissions from networks and investors recommended against a benchmark approach that applied a single assumption across all businesses.[116] We consider that given the available information we are unable to observe a clear sector wide

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114 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.

115 Consumer Challenge Panel, *Submission to the AER on Review of regulatory tax approach - Discussion paper November 2018* , 25 November 2018, pp. 23, 31 (LATE SUBMISSION); Discussions with ENA and SA Power Networks on 22 October 2018 and 6 November 2018.

116 Jemena, *Response to Discussion Paper–Review of regulatory tax approach*, 23 November 2018, p. 3; Network Shareholder Group, *Submission in response to the AER's Discussion Paper on the review of the regulatory tax approach*, 23 November 2018, pp. 4–5.

benchmark. There has also not been sufficient opportunity to consult extensively with stakeholders on the construction of a more granular benchmark approach—or an applicable sharing scheme—for this final report to recommend such a change. Following further consultation and analysis on the matter in the future, it may be possible to establish an industry benchmark of certain categories of capex, or some form of sharing scheme. This may also include the recognition of the tax treatment of certain capex in the Capital Expenditure Sharing Scheme (CESS) to ensure the correct economic gain/loss is being shared between networks and consumers.

We consider that the specific forecasts of immediately deductible capex to be applied to each NSP is best considered as part of the regulatory determination process. This process can more thoroughly consider the particular circumstance of each network, including the ongoing nature of refurbishment capex, and individual capitalisation policies which may impact the applicability of the 'actuals informed approach'. The specific interrelationships between opex and capex and the treatment of immediately deductible capex can be considered in greater detail in that process.

To this end, our recommended ‘actuals informed approach’ requires an NSP to submit the proportion of forecast capex over a regulatory period—informed by past practice—that would be recognised as immediately deductible for tax purposes and treated as such when forecasting the provision for tax costs. When rolling forward the TAB for actual capex incurred, the actual (audited) amount of regulatory capex claimed as immediately expensed would need to be provided to ensure actual capex entering the TAB does not include such capex. The actual amounts provided would inform the proportion of forecast capex to be treated as immediately deducted. This data will also be used to better inform our future assessment. As part of the reset process we will also review and consult on the reasonableness of using the past actual amounts expensed to inform the forecasts. Where an NSP considers the proportion of past capex not to be an appropriate indicator of the future proportion of immediately expensed capex this can be dealt with as part of the reset consultation process.

It appears from the information received as part of this review that the amount of capex that has been claimed as immediate deductible is able to be calculated and provided by most NSPs quite readily. From the responses to our RIN the average amount of capex treated as immediately deductible for tax purposes ranges from zero to over $200 million per year, with the average amount claimed being around $50 million. It also does not appear to be materially influenced by the size of the network or level of overall capex. Recognising this material variance in amounts claimed as immediately deductible for tax purposes across NSPs, the PwC report recommended against applying an industry average when determining the amount of capex to be treated as immediately deductible for tax purposes.[117] In its addendum report, following further information received from the RIN process, PwC did not change its recommendation.[118]

This significant variation between businesses is likely to reflect different interpretations of the ATO rulings, different risk appetites for NSPs in their interpretation of tax law, and the

[117] PwC, AER *Tax review 2018, Expert advice*, 26 October 2018, p. 66.
[118] PwC, AER *Tax review 2018–Addendum, Expert advice*, 10 December 2018, p. 50–51.

various age profiles and functional asset classification of networks. Some networks may have large ageing functional assets—reflecting the point at which their TABs were established. Such networks may require more individual components to be replaced or refurbished, without materially impacting the function of the overall asset. Other networks may be in a time of significant growth, requiring new depreciating assets to be constructed that are less likely to be able to be immediately expensed.

Submissions from stakeholders

Further guidance and consultation required

Submissions from NSPs noted that the AER should engage with the ATO to determine clear guidelines on what capex is clearly able to be immediately expensed to avoid making a judgement on what it thinks the ATO might allow in the future.[119] While the ATO has released a draft guideline that sets out a position on how it considers certain types of capex should be identified for income tax, submissions note that this issue is complex and uncertain and often depends on particular circumstances of each case.[120] We agree that if the AER was to assess what aspects of a forecast capex proposal would be considered eligible for immediate expensing, it would be beneficial for the ATO to provide assurance of this assessment.

The Department's submission to the discussion paper also advised that the AER should work closely with the ATO to fill in information gaps.[121] The submission from the ATO offered its assistance and expertise in informing the AER's decisions.

As a result of these submissions we wrote to the ATO and asked if it was able to provide any public guidance—beyond a public ruling—on the scope for network businesses to apply immediate expensing for certain capex.[122] Prior to completing this final report the ATO had not finalised its response to this request for assistance.

We consider that the 'actuals informed approach' recommended in this final report does not require an assessment of whether specific capex forecasts are able to be immediately expensed. Nevertheless, we would appreciate any further clarification or assistance from the ATO in assessing what capex may be considered immediately deductible to inform AER decisions on this matter going forward.

Inter-generational equity

In its submission to our discussion paper, ENA noted our focus on the 'NPV=0' principle in recommending a change, while not having proper regard to the inter-generational equity and incentive effects of making a change.[123] We consider adherence to NPV=0 is an important

119 Ergon Energy and Energex Limited, *Response to AER Review of Regulatory Tax Approach–Discussion Paper*, 23 November 2018, p. 2; ENA, *Response to the AER Discussion Paper*, 23 November 2018, p. 25.

120 Ergon Energy and Energex Limited, *Response to AER Review of Regulatory Tax Approach–Discussion Paper*, 23 November 2018, p. 2; ENA, *Response to the AER Discussion Paper*, 23 November 2018, pp. 25, 27, 31–32; Jemena, *Response to Discussion Paper–Review of regulatory tax approach*, 23 November 2018, p. 2.

121 DoEE, *Submission to the AER's Review of Regulatory Tax Approach*, 23 November 2018, p. 2.

122 AER, *Letter to the ATO re: Assistance with AER tax review*, 6 December 2018, pp. 5–6.

123 ENA, *Response to the AER Discussion Paper*, 23 November 2018, pp. 26, 27–29.

principle underpinning our decisions. We also note that ENA highlights the importance of this principle in its subsequent submission regarding tax costs for entities held outside a company structures.[124] However, as discussed in section 4.1 we have also had regard to other criteria in making our recommendations as a result of this review.

ENA provided some further modelling of the proposed change to recognise the immediate expensing of capex compared to the current approach. It noted that the proposed change resulted in a short-term benefit to current consumers at the expense of future consumers. Key to this issue appears to be that the current approach generally assumes 'refurbishment' expenditure has the same effective regulatory asset life as new replacement capex. However, as noted in ENA's submission, it is not uncommon for refurbishments to have an effective life much lower than new replacement capex.

ENA modelled a scenario in which an asset has an effective life of 10 years but an assumed regulatory life of 20 years. It noted that under our proposed approach, only 25 per cent of the current value is recovered in the first 5 years after a refurbishment. Under the current approach the NSP recovers 49 per cent in the first 5 years. As the regulatory life is 20 years, it does not seem to us unreasonable that only 25 per cent of the asset value is recovered over 5 years. Where the regulatory life is assumed to be 10 years (consistent with the effective life), 63 per cent of the asset value is recovered in the first 5 years under the 'proposed approach', while 80 per cent is recovered under the current approach. It does not appear to us to be unreasonable for 63 per cent of an asset's value to be recovered in the first half of an asset's expected life. This highlights that inter-generational equity depends as much on the regulatory asset life as actual tax treatment of immediately deductible capex.

CCP noted in its submission to the discussion paper that inter-generational equity is achieved through the depreciation schedule, not the tax allowance.[125] It indicated that overall cash flows under the 'proposed approach' better match those of the service provider. In our view this helps to mitigate any inter-generational equity concerns.

Incentive to refurbish assets

Many stakeholder submissions noted that, by not recognising immediate deductibility of some capex the current approach encourages refurbishment of assets. Refurbishments are often more efficient than full replacement of assets. Therefore, the current approach should be maintained as it is beneficial for NSPs and consumers. NSPs get a cash flow benefit and NPV windfall gain, while consumers are not required to fund more expensive replacement of assets. ENA notes in its submission to our discussion paper that NSPs would have a strong incentive to replace assets rather than refurbishing them if we were to recognise the immediate deductibility of refurbishment expenditure in our regulatory model. This would result in higher costs to consumers.[126] SAPN, et al. submitted that the current approach encourages networks to refurbish assets where it is efficient to do so.[127] ATCO highlighted

124 ENA, *Supplementary Response to the AER Discussion Paper*, 4 December 2018, p. 3.
125 Consumer Challenge Panel, *Submission to the AER on Review of regulatory tax approach–Discussion paper November 2018*, 25 November 2018, p. 4 (LATE SUBMISSION).
126 ENA*, Response to the AER Discussion Paper*, 23 November 2018, pp. 25–26, 28–29.
127 SAPN et al, *Submission to the AER Discussion Paper – Review of regulatory tax approach,* 23 November 2018, p. 2.

the importance that network businesses continue to have incentives for adopting the lowest sustainable cost solution to address issues arising from aging assets.[128]

AusNet Services also submitted that it might amend its regulatory capitalisation policies to treat refurbishment expenditure as opex to avoid the short-term impact of the proposed change on cash flows.[129] NSG likewise submitted that the incentive issues of reflecting the proposed approach can be overcome only if an NSP is able to re-categorise refurbishment expenditures as opex.[130] We note that NSPs are able to propose changes to their capitalisation policies as part of their regulatory proposals. We consider that such a change would be assessed as a 'step change' to opex, and the efficiency of this step change would be assessed as part of the regulatory determination process. An NSP proposing such a 'step change' would be required to justify that this change is efficient and in the long-term interest of consumers, consistent with the NEO and NGO.

ENA's submission noted that there are approaches that maintain the incentive to pursue refurbishments that address the windfall gain received by NSPs that immediately deduct capex for tax purposes. It noted that a sharing scheme, similar to other incentive mechanisms, is an example of such an approach.[131] As noted above we are open to this idea, and consider that the tax treatment of capex may be considered in a future review of the CESS, to ensure the correct economic gain/loss is being shared between networks and consumers. However, we note that further consultation is required about how such a sharing scheme may be constructed. We consider that a review of the current expenditure sharing schemes are the most appropriate avenues for such consultation.

Incentive to engage in immediate expensing

In consultation with stakeholders as part of this review, including in the stakeholder forum held after the discussion paper, there was a divergence in views on whether the AER should provide NSPs with incentives to engage in immediately expensing capex for tax purposes. Some NSPs suggested this is an efficient tax practice, and networks should have incentives to immediately expense capex where possible. They noted that a sector benchmark appeared to be the most appropriate way to do this. However, other NSPs stated that if they do not currently immediately expense capex for tax purposes—taking a conservative approach—they should not be forced to do so.

Some NSPs noted that they were considering immediate expensing of capex for tax purposes—but currently do not. They consider that if the AER was to reflect the tax treatment of the capex it expected to expense in the forecast period, then the businesses would have little incentive to begin to expense expenditure. In this case, they would continue to capitalise capex for tax purposes.

We consider that this may be the case under the 'NSP specific approach' considered in the discussion paper, or if there was a complete true-up for any NPV gain to NSPs. However,

128 ATCO Australia, *Submission to AER – Review of regulatory tax approach discussion paper,* 23 November 2018, p. 3.
129 AusNet Services, *AER Review of Regulatory Tax Approach: Response to Discussion Paper*, 23 November 2018, p.4.
130 Network Shareholder Group, *Submission in response to the AER's Discussion Paper on the review of the regulatory tax approach,* 23 November 2018, pp. 4–5.
131 ENA, *Response to the AER Discussion Paper*, 23 November 2018, p. 25.

we do not consider that the 'actuals informed approach' recommended in this final report completely removes the incentive for NSPs to immediately expense capex for tax purposes. We consider that there is still opportunity for the NSP to benefit from immediately expensing expenditure for tax purposes where the forecast is assumed to be based on its own past practice. The forecasts for future periods will then be informed by the new amounts for immediate expensed capex. The incentive to engage in immediate expensing is reduced (compared to the current treatment), but not entirely eliminated.

Overall, we consider this recommended approach strikes a balance between the importance of eliminating windfall gains and maintaining incentive to immediately expensing capex where it is efficient to do so. Further, this approach provides NSPs the incentive to continue to engage in immediate expensing for tax purposes at least in line with past levels considered efficient given its circumstance.

6.2 Diminishing value method

Our discussion paper identified that a possible change to our tax approach is to use the diminishing value (DV) method instead of straight-line (SL) depreciation for tax purposes. We reached this conclusion based on:

- The analysis of actual tax data which found that the DV method is the dominant depreciation method used by non-NTER entities in actual practice as opposed to the SL tax depreciation method applied by the AER in regulatory models for these entities.
- A scenario analysis based on hypothetical assets with asset lives that reflect lives of typical electricity and gas network assets shows that the application of the DV method results in higher tax depreciation in NPV terms over the life of an asset than continued use of the SL method. This is because depreciation is faster under the DV method.
- The faster and earlier tax depreciation under the DV method means that the regulated entity pays less tax over the life of the asset in NPV terms (after discounting by the cost of capital).

Our discussion paper concluded that an efficient entity would select the DV method for tax depreciation.[132]

Stakeholder submissions on our discussion paper in general accepted our finding that the DV method should be considered to be the new regulatory benchmark.[133] We also received

[132] We note that under some exceptional circumstances an asset owner may prefer a lower asset depreciation under the straight-line approach. These circumstances are discussed in more detail in Dr. Martin Lally, *Review of submissions on the AER's review of its regulatory tax approach*, 25 October 2018, pp. 15–17.

[133] Origin Energy, *Response to Review of regulatory tax approach*, 21 November 2018, p. 2; APA Group (APA), *AER review of regulatory tax approach–APA response to AER discussion paper*, 22 November 2018, pp.8–9; APGA, *Submission to the AER – Discussion Paper: Review of regulatory tax approach*, 23 November, pp. 4–5; Jemena, *Response to Discussion Paper–Review of regulatory tax approach*, 23 November 2018, pp. 2–3; TransGrid, *Response to AER's discussion paper on review of regulatory tax approach*, 23 November 2018, pp. 1–2; Evoenergy, *Response to discussion paper on review of regulatory tax approach*, 23 November 2018, p. 1; Endeavour Energy, *Response to AER Review of Regulatory Tax Approach 2018*, 23 November 2018, pp. 2–4; Ergon Energy and Energex Limited, *Response to AER Review of Regulatory Tax Approach Discussion Paper*, 23 November 2018, pp. 1–2; ENA, *Response to the AER Discussion Paper*, 23 November 2018, pp. 12–16; and AusNet Services, *AER Review of Regulatory Tax Approach: Response to Discussion*

an addendum to its expert consultant report from PwC. The addendum includes updated analysis of information provided by NSPs in response to our formal RINs. The RIN responses provided little new information on this issue because almost all tax fixed asset registers (TFARs) had been provided in the earlier voluntary information collection. The finding in the earlier PwC advice that the DV method is the dominant depreciation method used by non-NTER entities still stands.[134]

After considering the submissions and on the basis of the information available to us, we recommend that the DV method should be adopted in our regulatory tax approach.

What are our findings and recommendations?

We need to determine how the benchmark should be implemented. Our discussion paper set out the following implementation options:

- Apply DV to all new and existing assets.
- Apply DV to (new or existing) assets but only if this is consistent with the NSP's actual depreciation approach.
- Apply DV to new tax assets.

We note that stakeholder submissions provided a wide range of views on which option should be adopted for the new benchmark:

- The CCP submission supports the industry wide application of the DV method as the new regulatory benchmark and for all assets if supported by evidence.[135]
- Origin Energy, APA group (APA), Australian Pipelines and Gas Association (APGA) and Jemena endorsed the DV method as the new regulatory benchmark on the condition that it only applied prospectively to assets identified as a new and separate depreciating asset for the purposes of Division 40 of the Income Tax Assessment Act 1997 (ITAA 1997).[136]
- ENA, TransGrid, ATCO, Evoenergy, Endeavour Energy, the Network Shareholder Group (NSG) and AusNet Services accepted that the DV method should be the new regulatory benchmark. They argued that individual NSPs should be able to select either the new DV method or to continue with the existing SL method based on their own specific circumstances.[137]

Paper, 23 November 2018, pp. 2–4.

134 PwC, *AER Tax Review 2018–Addendum, Expert advice*, 10 December 2018, p. 35.

135 CCP, *Submission to the AER on Review of regulatory tax approach–Discussion paper November 2018*, 25 November 2018, p. 32 (LATE SUBMISSION).

136 Origin Energy, *Response to Review of regulatory tax approach*, 21 November 2018, p. 2; APA, *AER review of regulatory tax approach–APA response to AER discussion paper*, 22 November 2018, pp. 8–9; APGA, *Submission to the AER–Discussion Paper: Review of regulatory tax approach*, 23 November, pp. 4–5; and Jemena, *Response to Discussion Paper–Review of regulatory tax approach*, 23 November 2018, pp. 2–3.

137 TransGrid, *Response to AER's discussion paper on review of regulatory tax approach*, 23 November 2018, pp. 1–2; ATCO Australia, *Submission to AER–Review of regulatory tax approach discussion paper*, 23 November 2018, pp. 3–8; Evoenergy, *Response to discussion paper on review of regulatory tax approach*, 23 November 2018, p 1; Endeavour Energy, *Response to AER Review of Regulatory Tax Approach 2018*, 23 November 2018, pp. 2–4; NSG, *Submission in response to the AER's Discussion Paper on the review of the regulatory tax approach*, 23 November 2018, p. 4; Ergon

Consistent with our discussion paper, we have applied the following assessment criteria for our consideration of the implementation options:

- whether the implementation method reflects efficient practice
- the materiality of the possible changes for the amount that consumers pay over both the short and long term
- the practical difficulties in implementing the change, including the incentive it provides to NSPs, and the NSP's ability to respond to the change, and
- the regulatory and administrative costs it imposes on the AER and the NSPs due to its application.

Having considered the submissions received from stakeholders, as well as new information provided by our consultant, our recommendation is to:

- Maintain the current regulatory tax depreciation method (SL) for existing assets.
- Apply the DV method to all NSPs for tax depreciation of new assets/capex with the exception of assets qualified under section 40.72 of ITAA 1997, (e.g. intangible depreciable assets which must be depreciated using SL method).[138] This includes assets added to the cost base of existing depreciating assets, and new and separate depreciating assets for the purposes of Division 40 of the ITAA 1997.[139]

We recommend this because:

- the implementation method reflects the efficient practice of a benchmark entity
- while the regulatory benchmark is prospective (and does not apply to existing assets), in the long term it will promotes efficient outcomes in the long term interests of consumers
- it provides a reasonable balance between the impact of the change to benefit consumers and the incentive for (and the ability) of NSPs to respond to the benchmark
- it provides a reasonable balance between consistency with the tax law and the practical difficulties in implementing the change.

Table 6.1 sets out a comparison of the actual depreciation methods used by NSPs and the regulatory benchmark for existing and new assets under our recommended implementation option.

Energy and Energex Limited, *Response to AER Review of Regulatory Tax Approach Discussion Paper, 23 November 2018*, pp. 1–2; ENA, *Response to the AER Discussion Paper*, 23 November 2018, pp. 12–16; and AusNet Services, *AER Review of Regulatory Tax Approach: Response to Discussion Paper*, 23 November 2018, pp. 2–4.

138 The NSP will need to identify these assets in a separate asset class(es) as part of its regulatory proposal.

139 New assets treated as immediately deductible for income tax purposes is considered in section 8.1 of this final report.

Table 6.1 Comparison of actual depreciation methods and the regulatory benchmark for existing and new assets

	Current		Recommendation	
	Actual depreciation method	Regulatory benchmark	Actual depreciation method	Regulatory benchmark
Existing assets	DV	SL	DV	SL
	SL	SL	SL	SL
New assets[1]	n/a	n/a	DV	DV[2]
	n/a	n/a	SL	DV[2]

Notes:

(1) This includes, in the context of the tax law, assets added to the cost base of an existing depreciating assets and new and separate depreciating assets for the purposes of Division 40 of the ITAA 1997.

(2) With the exception of assets qualified under section 40.72 of ITAA 1997, e.g. intangible depreciable assets such as software license which must be depreciated using SL under the ITAA 1997.

The detailed reasons for our final report position and consideration of issues raised by stakeholders are set out in more detail below.

Depreciation method for existing assets

We will continue to apply the SL depreciation method for existing assets. This decision reflects the fact that tax law prevents NSPs from changing their tax depreciation method for existing assets. We will continue to apply SL tax depreciation to existing assets for NSPs that use SL depreciation for their tax assessments.

We have decided to continue to use SL depreciation for existing assets for NSPs that use the DV method in respect of their tax assessments. This change is made largely for reasons of simplicity and regulatory predictability but also because we do not consider that this change will make a material difference to the amounts paid by consumers. This assessment is consistent with Dr Lally's advice on this issue at the discussion paper stage.[140]

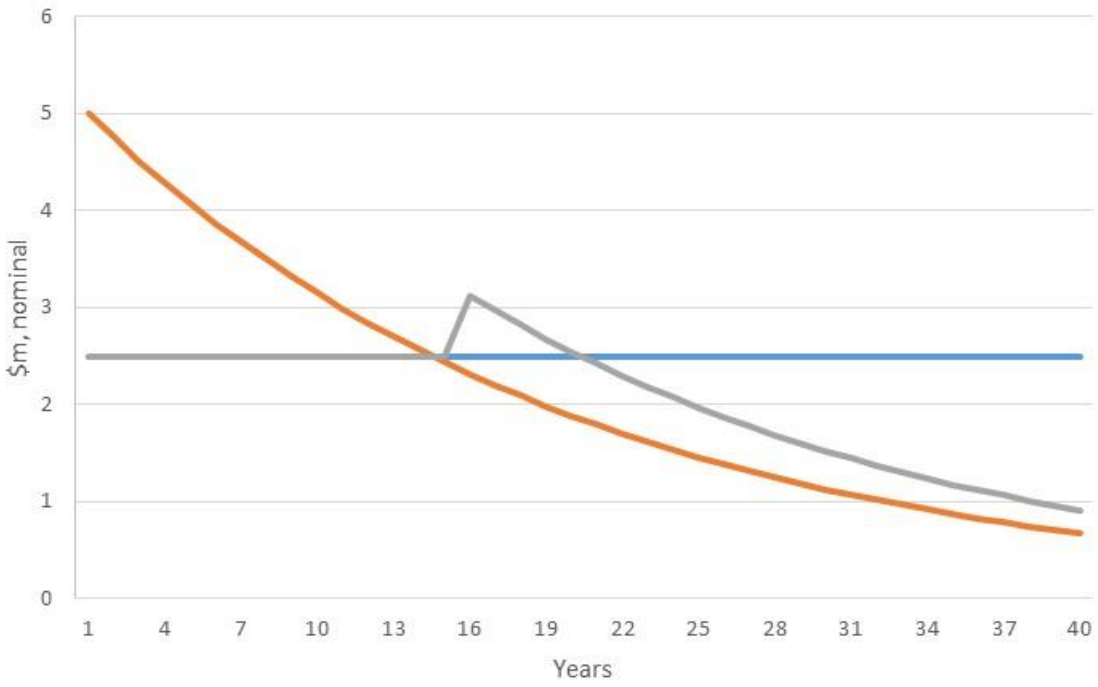
The impact in NPV terms from switching the depreciation method from SL to DV for existing assets is likely to be small given that many existing assets are already well into their useful lives. The DV method gives higher depreciation during the early part of the asset's life compared to SL, but lower depreciation in the latter part of the asset's life. Switching to DV in the later years of the asset's life reduces the impact of the switch.

The typical weighted average standard life of electricity network assets is between 40 to 45 years. For these assets, the cross-over point where the DV method starts to produce a lower annual depreciation amount compared to the SL method occurs at year 15–17 or around 40 per cent through the asset's life. Figure 6.4 shows that the cross over point occurs at year 15 for an asset with starting value of $100 million and standard life of 40 years. After this point a switch in the regulatory benchmark from SL to DV method will not materially narrow in NPV terms the difference between the actual and regulatory tax depreciation over the life of the

140 Dr Martin Lally, *Review of Submission on the AER's review of its regulatory tax approach*, 25 October 2018, pp. 24–25.

asset.[141] For example, if switching occurs at year 16, with a discount rate of 6 per cent, the NPV of depreciation over the life of the asset is $36.1 million. This is lower than both $37.6 million for total depreciation under the SL method, and $45.5 million under the DV method if it is applied over the entire life of the asset. This shows any change to DV should occur early in the asset's life to maximise the tax offset from the DV method. Over the entire asset's life, the difference between DV and SL is material (a 21% difference in this example), so applying DV to new assets is of material benefit over the life of the asset.

Figure 6.4 Depreciation expenses under SL, DV and from a switch in approach



Source: AER analysis.

The CCP submitted that the use of a simple average age profile of assets in the NPV analysis is problematic and the analysis should, instead, be based on a 'value weighted average age'.[142] We agree it is useful to examine the age of the assets weighted by value as part of our NPV analysis. Using the latest tax data from our recent determinations, we found that for most NSPs that adopt DV as the dominant tax depreciation method in practice, the weighted average age profile of the NSP's assets had passed the cross over point where a switch in the depreciation method could produce a materially positive outcome for consumers. For this reason, we consider that a switch of regulatory benchmark from SL to DV for existing assets is unlikely to materially advance the long term interest of consumers.

141 This calculation assumes the same DV percentage is used as at the start of the asset's life.

142 CCP, *Submission to the AER on Review of regulatory tax approach–Discussion paper*, 25 November 2018, p. 38 (LATE SUBMISSION).

However, there were other reasons supporting our recommendations to only apply DV to new assets/capex. The recommended approach allows all networks the opportunity to transition from the old benchmark (SL) to the new benchmark (DV). Maintaining current practice in this area imposes minimal implementation costs. We note that some submissions suggest that, if we were to apply DV to existing assets, we would need to recalculate the opening TAB in our regulatory models to achieve consistency with tax legislation.

Overall, we consider that the continued application of the SL method for existing assets provides a reasonable balance between the following factors:

- efficiency of the benchmark
- consistency with the tax law, where appropriate under the regulatory framework
- regulatory simplicity
- practical difficulties and cost in implementing a potential change.

Depreciation method for new assets

Our recommendation is to apply the DV method as the regulatory benchmark for tax depreciation for all new assets in future regulatory determinations. However, intangible assets qualified under section 40.72 of ITAA 1997 should continue to be depreciated under the SL method. The NSP should identify these assets in separate asset classes.

We reached our conclusion for the following reasons:

- it reflects the practice of a benchmark efficient entity, and will have significant impact in the long run
- it represents a prospective change, which is promotes regulatory predictability
- it achieves a reasonable balance between regulatory simplicity, the effectiveness of the benchmark and broad level consistency with the tax law.

We consider an efficient benchmark entity would select DV as the tax depreciation method. Use of the DV method as the benchmark will enable NSPs to adopt efficient tax depreciation for new assets. The example above shows the differences in tax depreciation can be significant in NPV terms.

Several submissions from NSPs and investors argued that the SL method provides better inter-generational equity and price stability than DV.[143] Under DV customers today are likely to pay relatively less than those in the future. While the majority of the benefits under DV accrue early in an asset's life, all customers will gain in the long run from having the most efficient approach applied to calculation of tax expenses.[144]

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143 APA, *AER review of regulatory tax approach–APA response to AER discussion paper*, 22 November 2018, pp.8–9; APGA, *Submission to the AER – Discussion Paper: Review of regulatory tax approach*, 23 November, pp. 4–5; Jemena, *Response to Discussion Paper–Review of regulatory tax approach*, 23 November 2018, pp. 2–3; Endeavour Energy, *Response to AER Review of Regulatory Tax Approach 2018*, 23 November 2018, pp. 2–4; and ENA*, Response to the AER Discussion Paper*, 23 November 2018, pp. 12–16.

144 As assets are commissioned over the years, the customers at the time of the commissioning benefit the most. Under an ongoing capex program the net difference between consumers across time is minimal.

The CCP submitted that the inter-generational equity issue is most effectively addressed through the regulatory depreciation allowance (that is, depreciation of the RAB) and not by tax depreciation (that is, depreciation of the TAB). We agree with this observation because the RAB regulatory depreciation allowance is more significant than tax depreciation. We have rejected proposals in the past to change to a DV approach for determining the regulatory depreciation allowance because of our assessment that the SL approach promoted smoother prices. The regulatory depreciation allowance is calculated within an 'NPV=0' framework, whereas the tax calculation is not. That is, NSPs can earn more or less than our regulatory provision for tax costs over the life of an asset, but they cannot earn more or less than our regulatory depreciation allowance in NPV terms.

We consider applying the DV method prospectively to new assets for tax purposes will promote regulatory predictability under the incentive framework. It provides incentive for investment and is in the long term interest of consumers. Submissions from NSPs and investors in general argued that any possible changes should be applied prospectively.

Several stakeholders argued that an individual NSP should be able to choose its tax depreciation method because:

- Although 60 per cent of assets owned by the private sector are depreciated using DV, the businesses that own the other 40 per cent are also seeking to minimise tax liabilities.[145]
- Many NSPs are choosing to adopt the prime cost (SL) method in certain circumstances. Imposing DV may provide an incentive to choose a method that may be less efficient in some circumstances. Enabling an NSP to select either DV or SL approach for new assets is the most efficient approach.[146]
- SL depreciation creates cash flow stability for a business. The AER should consider using the approach 'revealed' by data and establishing a benchmark that uses both the DV and SL to reflect the actual proportions of these approaches.[147]

There are a variety of reasons why the SL method may be used by NSPs for tax purposes. The use of the SL method by the AER may have reduced the incentives for NSPs to consider other approaches. However, we consider the change of the benchmark to DV for new assets will address this issue by providing these NSPs the incentive to change their current practice going forward. SL depreciation could also reflect the tax depreciation method used for assets prior to privatisation. Our view is that the SL method should continue to be applied to existing assets.

The tax framework NTER entities operate under is another reason for these entities to adopt the SL method. We consider that the benchmark tax depreciation method should be established based on the actual tax practices of non-NTER entities.

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145 ATCO Australia, *Submission to AER – Review of regulatory tax approach discussion paper,* 23 November 2018, pp. 3–6.

146 Network Shareholder Group, *Submission in response to the AER's Discussion Paper on the review of the regulatory tax approach*, 23 November 2018, pp. 12–16.

147 AusNet Services, *AER Review of Regulatory Tax Approach: Response to Discussion Paper*, 23 November 2018, pp. 2–4.

There are circumstances where it may be financially preferable to apply the SL method. As noted by PwC and Dr Lally, if an entity in a tax loss situation expects to remain so for a sufficiently long period it may select the SL method for tax depreciation as it could provide higher tax deductions.[148] Submissions from ENA suggested that an entity would select the SL method because it prefers to pay tax so as to have imputation credits available to distribute.[149] While we note these scenarios, we do not consider these individual circumstances are useful to informing the approach of a benchmark entity.

We consider allowing the NSPs to have the ability to select either the DV or SL method for regulatory tax purposes would systematically bias the outcomes. This is because NSPs would reasonably choose the option that generated higher forecast regulatory revenues which might not be consistent with their actual practice. The AER would experience great difficulty and incur material costs in establishing the efficient benchmark for each NSP in the long run.

Future capex linked to existing assets

We propose that the DV method should be applied to all new capex for tax depreciation. However, some future capex may be associated with existing assets for the purposes of Division 40 of the ITAA 1997. Tax law would require this capex to inherit the depreciation approach used for those existing assets (which may be SL). We acknowledge that this decision to this extent will reduce the consistency of the regulatory benchmark with tax law as NSPs may not be able to apply the DV method for ATO assessment purposes for some new capex.

However, we consider this is a reasonable trade-off to achieve regulatory simplicity. The alternative of applying separate depreciation methods to different types of new capex adds substantial complexity and cost to the regulatory process. This would require that NSPs prepare two different categorisations of forecast capex for regulatory depreciation and tax depreciation purposes. It would also generate substantial regulatory cost for the AER to assess, verify and enforce compliance. There is also no straight forward method to correctly estimate and claw back any potential differences. Overall, we consider that applying the DV method to all new assets for tax purposes achieves a reasonable balance between regulatory simplicity, the effectiveness of the benchmark and at broad level consistency with the tax law.

6.3 Gas asset life caps

The ATO sets a statutory life cap of 20 years on certain classes of gas transmission and distribution assets.[150] Submissions to our discussion paper noted that the 20 year asset life

148 Dr Martin Lally, *Review of Submission on the AER's review of its regulatory tax approach*, 25 October 2018, pp. 18–19; and PwC, *AER tax review 2018, Expert advice*, 26 October 2018, p 73.

149 ENA, *Response to the AER Discussion Paper,* 23 November 2018, p. 18.

150 ATO, TR2018/4, p. 181. For transmission assets–compressor station assets, Gas pipeline LNG station assets, pipelines–transmission, spur or lateral, regulators and underground gas storage asset. For distribution assets low pressure gas storage holders, pipelines (high, medium and low pressure trunks, primary or secondary mains or services) and regulators.

cap is not compulsory, and that some NSPs elect to apply longer lives for their assets.[151] The ATO confirms this interpretation.[152]

Size of the difference

Currently, we use 20 year tax lives for the relevant asset classes of all gas transmission networks subject to full access arrangement determination by the AER.[153] However, four gas distribution networks subject to full access arrangement determination currently have approved tax asset lives for the asset classes subject to the cap that are greater than 20 years.[154]

PwC noted that the average effective lives for gas assets in the tax asset registers (27.8 years) were significantly lower than the average effective lives in the AER's TAB (35.1 years). PwC suggested that this indicates the 20 year cap for gas transmission and distribution assets is not uniformly applied to the regulated businesses in the AER's determinations.[155]

Figure 6.5 shows that the value of assets with a 20 year life ($2.5 billion) in the tax fixed asset registers (TFARs) of the businesses is greater than the value in the TAB ($1.2 billion) from our regulatory models. On the other hand, the value of assets with tax lives greater than 20 years in the TFARs ($1.6 billion) is less than the value in the TAB ($1.8 billion) from our regulatory models. The differences of values in the TAB and TFAR between assets with 20 year tax lives and assets with longer tax lives suggest that in the TFAR some assets are recorded at 20 year life, while in the TAB from our regulatory models the same assets are recorded at a longer life. We consider this is evidence of longer tax lives being applied under the AER's approach compared to actual gas practices.

151 ENA, *Response to the AER Discussion Paper,* 23 November 2018, pp.17,18, SAPN et al, *Submission to the AER Discussion Paper – Review of regulatory tax approach*, 23 November 2018, pp.1,2, CCP, *Submission to the AER on Review of regulatory tax approach–Discussion paper November 2018*, 25 November 2018, pp. 45-47 (LATE SUBMISSION).

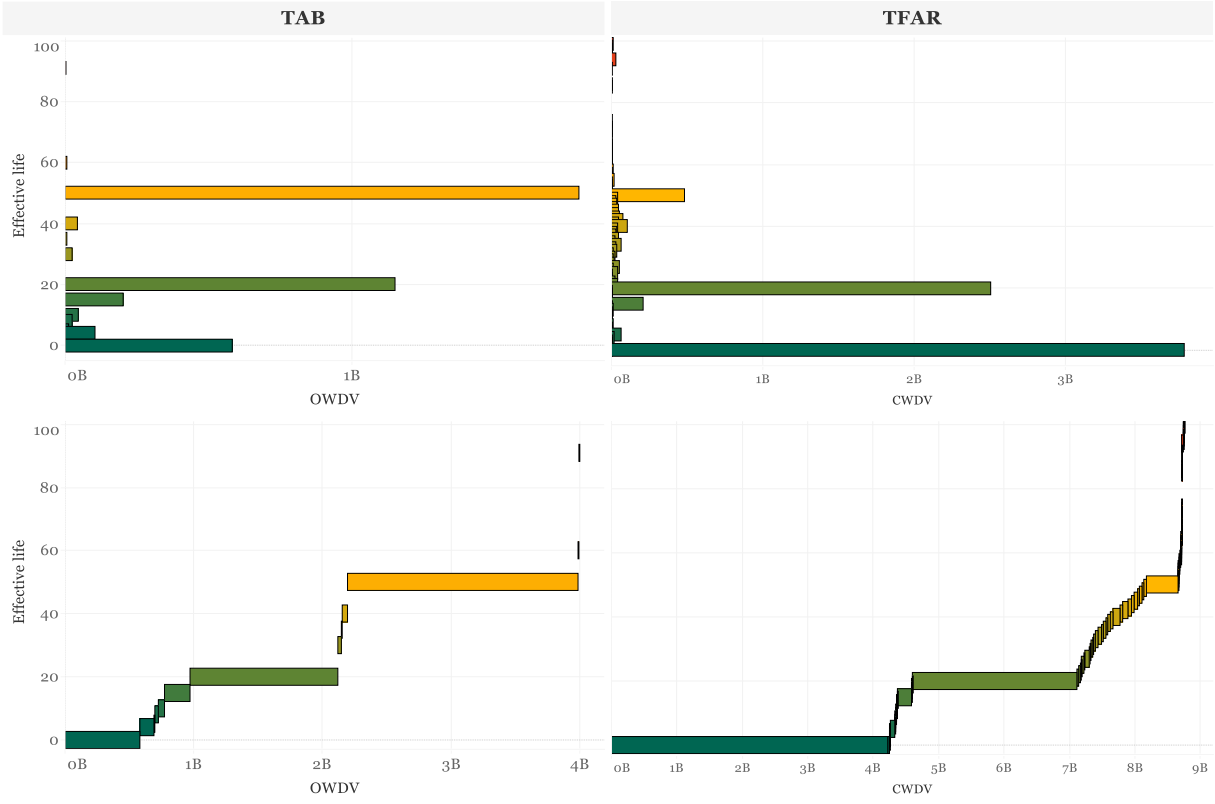
152 ATO, *How do the statutory caps on effective life work?* https://www.ato.gov.au/Business/Depreciation-and-capital-expenses-and-allowances/In-detail/Effective-life/Statutory-cap/Capital-allowances--statutory-caps-on-the-effective-life-of-buses,-light-commercial-vehicles,-minibuses,-trucks-and-truck-trailers/?page=1#How_do_the_statutory_caps_on_effective_life_work_

153 Amadeus (NT), Roma to Brisbane pipeline (Qld) and APA Gasnet (Vic).

154 ActewAGL Distribution (Gas), AusNet Services (Gas), AGN (Victoria and Albury) and MultiNet.

155 PwC, *AER tax review 2018, Expert advice*, 26 October 2018, p. 84.

Figure 6.5 Effective life spread of gas assets, Non-NTER and NTER entities—from PwC Expert advice



TAB opening value (all respondents)	$3.99B	TFAR CWDV (nearest available date as provided)	8.29B
TAB average effective life by value	35.12 years	TFAR average effective life by value	27.83 years

Source: PwC, *AER tax review 2018, Expert advice*, 26 October 2018, p. 84 (figure 27, extract).

Notes: OWDV: Opening Written Down value; CWDV: Closing Written Down Value

What are our findings and recommendations?

Applying shorter asset lives reduces an NSP's tax payable in NPV terms. Other things being equal, it would be expected that applying the 20 year cap would be the most efficient approach for the NSPs to adopt. The gas transmission pipelines' assets apply the 20 year statutory cap.[156] For two gas distribution networks, we have also approved 20 year asset lives.[157] This suggests that, for gas NSPs, the industry efficient benchmark is to adopt the 20 year tax asset life for the relevant asset classes. We therefore consider the 20 year cap should be applied to all gas networks.

156 APA Group, *AER review of regulatory tax approach–APA response to AER discussion paper*, 22 November 2018, p .9, APGA, *Submission to the AER – Discussion Paper: Review of regulatory tax approach*, 23 November, p. 5.

157 AGN (SA) and Jemena Gas Networks.

We acknowledge the ATO allows the self-assessment of asset lives under the tax law,[158] providing a choice:

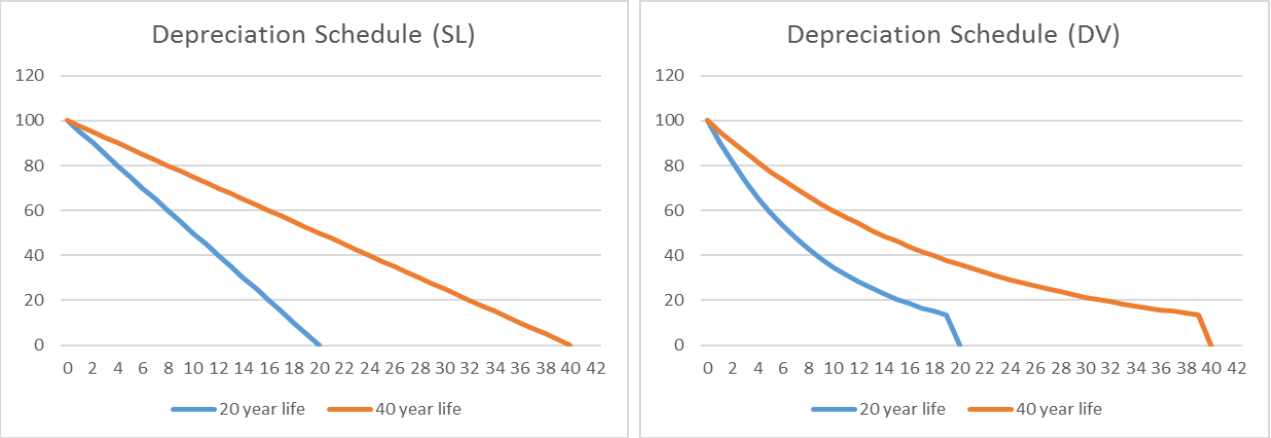
(a) to use an effective life determined by the Commissioner for a depreciating asset under section 40-100, or

(b) to work out the effective life of the asset under section 40-105.

The statutory cap applies to the Commissioner's effective lives. Hence, there is no obligation for an NSP to apply the 20 year cap. ENA submitted that a business may elect to apply asset lives greater than the 20 year cap in order to be able to access and pass on franking credits to shareholders. ENA also suggested that especially since 2005, there is a tendency for businesses to avoid accelerated depreciation due to the uncertainty of whether tax loss would be able to be carried forward in the future.[159] However, the utilisation of tax losses carried forward has been allowed by the Commissioner to date. Also, our benchmark approach does not direct an NSP's choice to allocate its capital deductions through time. Longer lives can still be chosen for the NSP's actual tax approach. The NSP is best placed to choose its actual approach and bear the risk in choosing to deviate from the benchmark.

Where the asset life is capped at 20 years, the shorter tax asset life front loads the depreciation and results in a depreciation deduction with higher NPV to the businesses. Examples are provided in Figure 6.6, assuming a starting asset value of $100 million, inflation rate of 2.5 per cent and a real rate of return of 3.4 per cent. They show that the NPV of the depreciation expenses is greater under a shorter asset life, regardless of the depreciation approach adopted. The NPV under the SL scenario employing the 20 year life is $57.4 million, which is higher (53%) than the NPV of $37.6 million employing the 40 year life. The NPV under the DV scenario employing the 20 year life is $63.4 million, which is higher (38%) than the NPV of $46.1 million employing the 40 year life.

Figure 6.6 Depreciation schedule of 20 year and 40 year assets under different depreciation approaches



Source: AER analysis.

158 *ITAA 1997*, s40-95.

159 ENA, *Response to the AER Discussion Paper,* 23 November 2018, p. 18.

We would expect an NSP acting rationally would choose front loaded depreciation on an NPV basis as this maximises the value of the investment by reducing the costs of taxation. This reflects the method that a benchmark efficient entity would select. PwC states that a benchmark efficient entity would seek to legally minimise its tax position where possible, and would be expected to apply the 20 year statutory capped effective life.[160] Therefore, for this final report we recommend applying the 20 year statutory cap to all applicable new assets.

ENA submitted that the provisions introducing the capped lives in 2002 were intended to provide an incentive to businesses and promote investments in the Australian gas industry while ignoring wider policy implications.[161] We do not consider this a relevant consideration. It is the consistency between our regulatory tax approach and the predominant practice of NSPs that is at issue. That is, the Commissioner in setting the 20 year cap would not do so expecting an inconsistency between regulatory and tax approaches to provide the incentive for businesses to invest. We make no assessment on the reasoning that lead the Commissioner to set a 20 year cap. We consider that given the availability of the 20 year cap, it is the most efficient benchmark for regulatory tax purposes as well, and that this best promotes the long term interest of consumers.

We note that the Commissioner has not reviewed this policy since its introduction, hence the 20 year cap is an accepted asset life from the ATO's perspective. If this provision was to be reviewed and changed, then we would need to reconsider the appropriate benchmark.

ENA and AusNet Services submitted the capping of the gas asset lives may not lead to a materially different outcome when a network is in a steady state. They provide an example where two assets are expected to last 40 years. The analysis assumes the assets are replaced at the end of twenty years resulting in no NPV distortion in both scenarios whether the 40 year life is applied, or the 20 year cap is applied.[162] We consider that the relevance of this example is limited. Although unlikely (given capex fluctuates from year to year), it is possible that capex could be added to the TAB at such a rate that total depreciation remains largely unchanged from year to year. However, this does not mean that the NPV outcomes over the lives of these assets are unchanged depending on the asset life chosen. Adopting a shorter asset life maximises the depreciation expense in NPV terms and therefore minimises the tax liability in the long run.

The CCP supported the capping of the gas asset lives, given that the AER's current approach seem to be inconsistent with tax law.[163] The CCP also submitted that the assumptions used in estimating pre-tax revenue building blocks did not need to match the assumptions for tax. While the regulatory depreciation (that is, depreciation of the RAB, not TAB) aims to meet efficiency and inter-generational equity objectives, the tax depreciation benchmark should reflect the efficient practices for tax and not introduce bias in NPV

160 PwC, *AER tax review 2018–Addendum, Expert advice*, 10 December 2018, p. 65.

161 ENA, *Response to the AER Discussion Paper,* 23 November 2018, p. 17.

162 ENA, *Response to the AER Discussion Paper,* 23 November 2018, p. 18, AusNet Services, *AER Review of Regulatory Tax Approach: Response to Discussion Paper*, 23 November 2018, pp. 5–6.

163 CCP, *Submission to the AER on Review of regulatory tax approach–Discussion paper*, 25 November 2018, p. 46 (LATE SUBMISSION).

terms.[164] As discussed in relation to the DV method, we agree with the CCP that regulatory depreciation (on the RAB) and tax depreciation (on the TAB) may adopt different paths. We consider the application of the 20 year cap is the benchmark for efficient practice for tax. However, for the RAB, longer lives are appropriate to reflect the economic lives (as distinct from the tax lives) of the assets in question.

We recommend that the tax asset life cap should be applied only to new assets. The submissions to the discussion paper suggested that any changes must be made only to new assets.[165] This is a prospective change that allows the affected gas distribution networks to transition to the new benchmark.

The materiality of the change is difficult to evaluate due to the uncertainty of the quantum and the timing of future capex. We consider that the effect of applying the cap, when considered in conjunction with potential changes and application on immediate expensing and the DV method, would align the TAB tax depreciation profile to that of the TFAR reported to the ATO.

We acknowledge that applying the 20 year cap to new assets may not make a significant difference in the initial years of application for some gas distribution networks. This is because the relative magnitude of new capex is likely to be small in proportion to existing assets. Over time the cumulative effect will increase as more assets enter under the 20 year cap. In the long run there are meaningful benefits to customers from applying the cap as the efficient benchmark.

6.4 Self–assessed asset lives

For income tax purposes, NSPs can either adopt the Commissioner's effective lives or alternatively use their own effective life estimate.[166]

Once an effective life has been adopted, a further self-assessment of the effective life is allowed if the circumstances regarding the use or nature of the use of the asset have changed and the effective life is no longer accurate. [167] The first PwC report provides examples of such changes and the circumstances where the taxpayer can recalculate the effective asset life and provides discussion on the circumstances in which a taxpayer must recalculate the effective life.[168, 169]

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164 CCP, *Submission to the AER on Review of regulatory tax approach–Discussion paper*, 25 November 2018, p. 13 (LATE SUBMISSION).

165 Origin Energy, *Response to Review of regulatory tax approach*, 21 November 2018, p.2, ATCO Australia, *Submission to AER–Review of regulatory tax approach discussion paper*, 23 November 2018, p.8, Jemena, *Response to Discussion Paper–Review of regulatory tax approach*, 23 November 2018, p. 3.

166 ITAA 1997, s.40-95.

167 Pursuant to ITAA 1997 subsection 40–110(1).

168 Pursuant to ITAA 1997 subsection 40–110(2).

169 PwC, *AER* tax r*eview 2018, Expert* a*dvice*, 26 October 2018, pp. 80–81.

The ATO note suggests that taxpaying entities often exercise their option to self-assess shorter effective lives[170], while PwC suggests self-assessment would not be a widespread practice based on their knowledge and experience in the industry.[171]

As previously noted, different tax depreciation methods are not NPV neutral, because the time value of money is not compensated for in tax calculations (deductions sooner rather than later would provide a higher NPV). Dr Lally suggested that there may be the incentive to self-assess shorter tax asset lives and this can potentially lead to material differences. However, Dr Lally also commented that the scope for such shortening of effective life may be unclear, and that it would put a significant burden on the AER to replicate these self-assessments for individual assets.[172] We would need to understand which assets were subject to self-assessed lives, as well as what those lives were.

PwC noted that based on the information gathered there seems to be a relatively small difference between the effective lives from the regulatory determinations and from tax asset registers. However, for gas assets specifically, PwC noted that the difference is material – they suggested that it reflects that the 20 year effective life statutory cap was not being uniformly considered in the AER's TAB for these NSPs.[173] This statutory cap is discussed in section 6.3.

Based on the above analysis, PwC did not find any evidence that the existing regulatory approach to forecasting of tax costs should be amended to reflect effective life choices made by electricity industry participants.[174]

Consistent with the findings in our discussion paper, we do not recommend making changes regarding self-assessment of asset lives.

6.5 Low value pools

A tax payer can calculate the depreciation of certain low-cost and low value assets by allocating them to a low value pool and depreciating them at a set annual rate of 37.5 per cent. This is provided that the asset has been depreciated for at least one year using the DV method, and has a written-down value of less than $1,000. Once an asset has been allocated to the pool, it must remain there.[175]

All assets included in the low value pool are depreciated at a fixed rate of 37.5 per cent for tax purposes. This means any difference between the fixed rate and the depreciation rate assumed in our regulatory models for these assets will contribute to the underlying tax difference between actual tax paid and the regulatory provision for tax costs. However, our analysis of available actual data found that only 1.3 per cent of the total assets held by NSPs

170 ATO, *Note to* the *AER*, 10 April 2018, p. 2.
171 PwC, *AER tax review 2018, Expert advice*, 26 October 2018, p. 81.
172 Dr Martin Lally, *Tax payments versus the AER's allowances for regulated businesses*, 16 June 2018, pp. 26–27.
173 PwC, *AER tax review 2018, Expert advice*, 26 October 2018, pp. 81–84.
174 PwC, *AER tax review 2018, Expert advice*, 26 October 2018, p. 85.
175 Further details on the low value pool assets can be found on the ATO website: https://www.ato.gov.au/Business/Depreciation-and-capital-expenses-and-allowances/General-depreciation-rules---capital-allowances/Low-value-assets-(pool)/

are classified as low value assets. Although, there may be reporting issues in relation to these assets, we consider that the relative small percentage of low value pool assets is unlikely to be a key factor in any difference between the forecast tax costs provided for in revenue determinations and actual tax payments.[176] This is consistent with the advice provided by PwC and Dr Lally.[177]

We note that submissions from AusNet Services, APA, APGA and CCP to our initial report also suggested that low value pool assets are unlikely to be a material driver of the differences.[178] In response to our discussion paper, submissions from APGA and CCP supported our position of not making any changes in our regulatory benchmark to reflect the specific tax treatment of low value pool assets.[179]

Consistent with the findings in our discussion paper and without evidence of materiality on this issue received from the RIN responses, we do not recommend making changes to address the use of low value pools.

176 PwC, *AER Tax review 2018, Expert advice*, 26 October 2018, p. 76.

177 Dr Martin Lally, *Review of submissions on the AER's review of its regulatory tax approac*h, 25 October 2018, p. 4. PwC, *AER Tax review 2018, Expert advice*, 26 October 2018, p. 76.

178 APGA, *Submission to Initial Report*, 26 July 2018 p. 3; *AusNet Services, Submission to Initial Report*, 26 July 2018, pp 3–4; CCP, *Submission to Initial Report*, 26 July 2018, p. 27; APA, *Submission to Initial Report*, 26 July 2018, p. 5.

179 APGA, *Submission to the AER – Discussion Paper: Review of regulatory tax approach*, 23 November, p.4; CCP, *Submission to the AER on Review of regulatory tax approach – Discussion paper November 2018,* 25 November 2018, p. 50 (LATE SUBMISSION).

7 Depreciation–value effects

Summary of the issue

When an asset is acquired, that asset's cost or value is available to offset the future income generated from its use. Tax depreciation is a non-cash expense and represents the change in the value of an asset for tax purpose. The total amount of depreciation available (and so the value of this tax expense used to reduce tax payable) may change as a result of various corporate transactions for regulated assets—such as privatisation, mergers or acquisitions (M&A).[180] NSPs may revalue their tax asset base (TAB) to reflect the market value of depreciable assets.

TAB revaluations are not currently reflected in our regulatory modelling of tax costs.[181] If such a revaluation is upward, the actual value of tax assets is higher than the TAB in our models. This in turn leads to future depreciation expenses calculated in our models being lower than the amount actually claimed. As such, our provision for tax costs would be higher than if the revaluation of the TAB was reflected in our modelling.

For this final report, we are not recommending adjustments to the TAB in response to market transactions for regulated assets. We consider that it remains appropriate to preserve a consistent regulatory approach that insulates consumers from changes in market valuations. Where an asset trades at a multiple in excess of its RAB, the incremental value sits outside the regulatory framework. Customers do not pay higher return on capital and return of capital building blocks, but they also do not pay a lower tax building block.

Tax law governs the cost of a depreciable asset in relation to privatisations and M&A market transactions. These transactions can provide for a step up (or step down) in the depreciable cost base of assets. Transactions involving ownership changes can also give rise to costs outside of the regulatory regime such as stamp duty or taxable gains. In certain circumstances a stamp duty cost may be either immediately expensed or included in the depreciable cost of an asset at the time of changing ownership.[182] The immediate expensing of stamp duty costs may result in tax losses that may be carried forward for several years. Where stamp duty costs are capitalised this creates a step up in the depreciable cost base. Consistent with our discussion paper, we do not recommend any changes related to stamp duty.

The recognition of a step up or step down in the TAB could see costs not incurred in providing regulated services included in the regulatory estimated cost of tax. Further, the recognition of costs incurred based on the market value of an asset would transfer the benefit of higher depreciation deductions from the buyer to customers, despite customers having no role in the transaction. This could have implications for future market transactions

[180] The previous chapter discusses scenarios where the timing of when depreciation is received varies (rather than the total amount of depreciation received).

[181] Similarly, the regulatory framework does not provide for revaluation of the RAB, which is used to calculate the return on capital and return of capital building blocks.

[182] This is dependent on whether the change in ownership involves an asset privatisation or merger and acquisition related to a tax consolidated group, asset sale or long-term lease.

that may reduce the long-term efficiency of regulated services.[183] For example, a buyer may pay more than the regulatory value of the assets because they expect to be able to make efficiencies. The benefits to the buyer conducting such a transaction are significantly reduced if customers receive the tax benefits. This may result in the transaction not taking place. Customers in turn, do not receive the benefits of any efficiency enhancements that the buyer was planning to introduce if the transaction no longer occurs.[184]

We are also not recommending changes to our current treatment of research and development (R&D) deductions. Based on the information before us, this type of expenditures is not a material driver in the difference between the regulatory forecast of tax costs and actual tax payments.

7.1 Asset revaluations

Tax legislation includes a number of divisions under which the tax cost base of a depreciable asset is set or reset. This would include how the cost of an individual asset is measured (division 40), asset privatisations (division 58) and resetting the tax cost base of an entity or asset on entering a tax consolidated group (division 700).

How does this issue contribute to the tax difference?

Our current approach to valuing the TAB reflects the historical cost base of tax assets. We do not currently recognise the sale value of assets or transaction costs arising from a change in ownership which fall outside of the regulatory framework, either in the RAB or TAB.

The effect of market transactions (mergers, acquisitions and privatisations) can be to increase (or decrease) the tax cost base recognised by the ATO. Because such changes are not recognised in the TAB in our regulatory models, this allows for higher (or lower) depreciation expense in subsequent years and a reduction (increase) in tax payable relative to the estimate of regulatory tax cost. Where a buyer of an entity or asset is part of a tax consolidated group, the possibility exists of both step ups and step downs in depreciable tax cost base.[185] The cost of acquiring the entity is essentially recognised as the market value for tax purposes.[186] The regulatory approach has not recognised these revaluations because market values can differ from the current cost value.

PwC reports aggregate opening written down values in the TAB of $59.8 billion and those reported in the TFAR of $67.9 billion.[187] This represents a difference of $8.1 billion or 13.5 per cent. PwC cautions against drawing specific inferences about the drivers in these values due to the interaction of the following:

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183 NEL, s.7; NGL, s.23.

184 The buyer (without the tax benefit) may offer a lower price, which the seller may then not accept. This also stalls a possible efficiency enhancing transaction.

185 PwC, *AER tax review 2018, Expert advice*, 26 October 2018, p. 93.

186 The tax consolidation rules determine an "allocable cost amount" for the joining entity which recognises the cost of membership interests and the value of the joining entities liabilities, including other adjustments that affect the entity's value.

187 PwC, *AER tax review 2018, Expert advice*, 26 October 2018, p. 85.

- The treatment of immediately deductible expenses of a capital nature (refurbishments),
- The inclusion of unregulated (or unspecified) assets,
- The choice of depreciation method and asset lives applied (affecting historical depreciation), and
- Step ups in the tax cost of depreciable assets that arise on acquisition of regulated (and unregulated) assets not recognised in the TAB.[188]

The current information set is too limited to quantify the contribution of asset revaluations to the tax difference. PwC's analysis of the information regarding the revaluation of the tax cost base received in our final RINs demonstrated that uplifts contributed approximately $6 billion to the difference in TAB and TFAR.[189] However, we are not able to accurately quantify the drivers of the differences between the TAB and TFAR.

Submissions from stakeholders

APGA submitted that changes to the TAB can have a significant impact on investment decisions and incentives. Any revaluations of the TAB should flow through to the RAB because consumers would receive a benefit without other building blocks reflecting the higher cost this imposes on the business. To reflect the symmetrical treatment of costs the TAB revaluation would need to flow through to the RAB. This would lead to higher RAB related returns and higher costs for consumers.[190]

ENA stated that market transactions can result in the upward revaluation of the tax cost base, increasing the tax depreciation deductions in relation to that asset.[191] The buyer in those transactions factors in the tax benefit from those deductions into its bid price and therefore the owners of the network are the beneficiary of the increase in deductions.[192]

The NSG also commented that revaluations under the ITAA 1997 could not be interpreted to include the revaluation of assets used to provide regulated services. The NSG stated that recognising a revaluation in the TAB would represent a subsidy from competitive (unregulated) services to regulated services.[193]

The CCP considered that asset revaluation would be complex and add risks to both networks and consumers. Costs to consumers of a higher RAB following a positive revaluation might be substantial and continue over remaining life of the asset. The AER should continue its current approach to the treatment of revaluations in the TAB (and RAB) —that is, not recognising changes in market valuations as reflected in sale prices.[194]

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188 PwC, *AER tax review 2018, Expert advice*, 26 October 2018, pp. 85–86.
189 PwC, *Expert advice–Addendum*, 10 December 2018, p. 13.
190 APGA*, Letter in response to AER Review of Regulatory Tax Approach*, 26 July 2018, p. 3.
191 The effect is symmetrical, so a downward revaluation would decrease the tax depreciation deductions
192 ENA, *Review of Regulatory Tax Approach – Response to the AER Initial Report*, 26 July 2018, p. 18.
193 NSG, *Submission to initial report*, 26 July 2018, p. 8.
194 CCP, *Submission to the AER on Review of regulatory tax* approach–*Discussion paper*, 25 November 2018, pp. 5, 47–49. (LATE SUBMISSION)

What are our findings and recommendations?

Consistent with our discussion paper, we are not recommending adjustments to the TAB in response to market transactions for regulated assets. We consider that it remains appropriate to preserve a consistent regulatory approach that insulates consumers from changes in market valuation, on both the RAB and TAB. Where an asset trades at a multiple in excess of its RAB, the incremental value sits outside the regulatory framework. Customers do not pay higher return on capital and return of capital building blocks, but they also do not pay a lower tax building block. Overall, the impacts from the returns on and of capital greatly exceed the tax impact.

Revaluations of the tax cost base for depreciation purposes occur in response to changes of ownership, where the buyer forms or is part of a tax consolidated group.[195] The incentives applied under the regulatory framework are based on efficient costs of operating the network. Therefore, a change in ownership that gives rise to costs unrelated to the efficient operation of the network would not reflect the efficient costs that should be borne by customers.

PwC does not recommend any change to the TAB to recognise revaluations of the tax cost base for the following reasons:

- cost associated with changes in ownership or a step up in the cost base of depreciable assets are not referrable to the efficient operation of the regulatory assets,
- step ups in the tax cost base may be matched by a cost to the seller, such as a capital gain,
- the introduction of integrity risks to the regulatory regime through the incidental allocation of costs unrelated to the regulatory assets,
- tax cost resetting rules can also give rise to step downs in the tax cost of depreciable assets (impairment),
- potential for market value allocation rule to skew value from unregulated business to regulated business and vice versa.[196]

PwC's addendum report stated that the RIN responses show the resetting of tax cost bases under the tax consolidation law is not widespread across the regulated entity. However, in instances where it has occurred, the increase to depreciable tax bases has been significant. Notwithstanding this, PwC did not change its recommendation that any uplifted tax asset values should not be recognised in the regulatory forecast of tax costs.[197]

We agree with PwC's recommendation and consider that recognising the market value of a regulated network in the cost of regulated assets would transfer the buyer's risk (the uncertainty of its assessment of value of the firm) reflected in the bid price to customers. This would be inconsistent with the NEO and NGO as the risk does not emerge from the provision of regulated services.

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195 PwC, *AER tax review 2018, Expert advice*, 26 October 2018, p. 21.
196 PwC, *AER tax review 2018, Expert advice*, 26 October 2018, pp. 93–94.
197 PwC, *AER tax review 2018–Addendum, Expert advice*, 10 December 2018, p. 48.

The buyer valuing an asset on a discounted cash flow basis expects to be able to derive a higher value (and positive cash flow) through management efficiencies and growth opportunities, than what is recognised in the asset's current value. Acquisition prices may also be affected by factors other than the efficient delivery of regulated services (or outperformance of expenditure allowances) such as unregulated revenues potential, control premiums, intangible assets or changes in demand. Therefore, market values are subject to variability in response to economic conditions, whereas regulatory values (RAB and TAB) are set based on efficient costs incurred to provide regulated services.

An efficient sale transaction that results in changes of ownership, occurs where both the seller and buyer expect to derive a benefit. The tax consequence on both sides of the transaction results in costs and benefits incurred by both parties. We acknowledge the incidence of tax on both sides of a sale transaction. Where an asset or entity is traded at a value higher than its current tax cost base, the buyer is able to benefit from the future tax depreciation expenses, and expensing of stamp duty, that reduce its actual cost of tax for a given level of revenue. On the side of the seller it is likely a taxable gain will be earned.

A change of approach to recognise revaluation of the tax cost base in the TAB would reallocate benefits of incremental increase in tax depreciation deductions from buyers to customers. This outcome may discourage future asset sales influencing the long-term efficiency of regulated networks which is not consistent with the NEO and NGO.[198]

Dr Lally considered the tax cost base uplift arising from a change in ownership should remain with the buyer on the grounds of efficiency.[199] He concluded that by altering the valuation through the recognition of a higher tax cost base a rational bidder would lower its prices. This lower value may not coincide with the expected benefit of the seller and may discourage changes of ownership occurring.

We agree with Dr Lally's conclusion that revaluing the TAB in response to an uplift would discourage changes of ownership and that this is not an outcome in the long-term interest of consumers.[200] Transactions involving changes of ownership between rational parties perform an important function in identifying efficiencies as assets are transferred to those who value them most. To recognise the market value of assets and costs outside of the regulatory framework in the TAB is likely to reduce the prospective buyer's offer price. The potential to discourage changes of ownership may prevent the transfer of an asset to owners able to deliver services more efficiently, to the detriment of consumers. For this final report, we do not recommend that TAB revaluations be applied in order to prevent these adverse outcomes. Such outcomes would hinder the promotion of efficient investment and operation of electricity and gas services provided by NSPs in the long-term interests of consumers.

7.2 Stamp duty

Stamp duty is imposed by State and Territory governments on the transfer of property, such as a business, and can vary depending on the jurisdiction.

198 NEL, s.7 National Electricity Objective; NGL, s.23 National Gas Objective.
199 Dr Martin Lally, *Review of submissions on the AER's review of its regulatory tax approach*, 25 October 2018, p. 1.
200 Dr Martin Lally, *Review of submissions on the AER's review of its regulatory tax approach*, 25 October 2018, p. 15.

How does this issue contribute to the tax difference?

We currently do not make any allowance within the regulatory models for stamp duty. Stamp duty is a cost incurred by the purchaser of an asset that does not contribute to the provision of regulated services.[201]

Asset sale transaction costs including stamp duty may either be:[202]

- recognised in the depreciable cost base of an asset,[203] or
- immediately deducted.

In the former case, the capitalisation of stamp duty may be a contributing factor to step ups in the tax cost base of depreciable assets.[204] Our analysis of this driver aligns with the treatment of the revaluation issue above.

In the latter case, the immediate deductibility of stamp duty would reduce the tax payable (relative to the regulatory benchmark) for an entity that had recently been purchased.

What are our findings and recommendations?

Transaction costs such as stamp duty paid on the transfer of an asset are not incurred in the provision of regulated services. These costs fall outside the regulatory framework and do not form part of our assessment of forecast efficient costs under the NEL or NGL.[205] To recognise these costs would transfer the tax benefits of costs incurred by the buyer to customers.[206] However, customers do not pay for these transaction costs in regulated prices, and so they also do not benefit from a lower tax building block.

These costs sit outside of the regulatory regime as they do not contribute to the provision of regulated services. The recent privatisations of NSW electricity distribution and transmission assets were granted under long-term lease arrangements. As noted by PwC, stamp duty paid in respect of a lease is deductible for income tax purposes pursuant to section 25-20 of the ITAA 1997.[207] This is expected to contribute to tax losses for these businesses.[208]

PwC's addendum report stated that while the RIN responses reveal average stamp duty of $595.3 million in regards to the privatisation within the past 5 years, it also indicated that the costs capitalised to depreciable tax costs base of the network assets were considerably lower at $17.5 million on average per NSP. PwC does not recommend any changes to the regulatory model, as these costs are not recoverable to the NSPs under the regulatory framework.[209]

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201 NEL, s.7A(2)(a); NGL, s24(2)(a).
202 PwC, *AER tax review 2018, Expert advice*, 26 October 2018, pp. 36, 106–107.
203 PwC, *AER tax review 2018, Expert advice*, 26 October 2018, p. 106.
204 PwC, *AER tax review 2018, Expert advice*, 26 October 2018, p. 106.
205 NEL, 7A (2)(a) and NGL, 24(2)(a)
206 Dr Martin Lally, *Review of submissions on the AER's review of its regulatory tax approach*, 25 October 2018, p.13.
207 PwC, *AER tax review 2018, Expert advice*, 26 October 2018, p. 107.
208 PwC, *AER tax review 2018, Expert advice*, 26 October 2018, p. 107.
209 PwC, *AER tax review 2018–Addendum, Expert advice*, 10 December 2018, p. 49.

For this final report, we do not recommend any changes related to stamp duty. We will continue with our current approach of excluding these costs from the regulatory framework as they do not contribute to the provision of regulated services.

7.3 Research and development expenditure

According to PwC's report, R&D expenditures by certain entities may access tax incentives in Australia.

How does this issue contribute to the tax difference?

In our initial report, we noted one of the potential drivers that may contribute to the difference between the regulatory provision for tax costs and tax paid was the existence of R&D expenditures. NSPs may reduce their taxable income to reflect expenditure on R&D. This will lead to a taxable income that is lower than in our models and so tax payable is lower. Currently, we do not account for any R&D deductions in our regulatory models.

What are our findings and recommendations?

For this final report, we are not recommending changes to our current treatment of R&D deductions. Based on the information before us, R&D expenditure is not a material driver in the difference between the regulatory forecast of tax costs and actual tax payments.

Submissions from the NSPs to our initial report suggested that much of the R&D expenses sit outside the regulatory regime, and customers should not benefit from the tax deduction in respect of a cost they did not contribute to.[210]

PwC provided its view that it was unlikely any R&D deductions would have resulted in a material difference between actual tax paid and the regulatory forecast of tax costs.[211] In addition, PwC noted that the R&D tax incentive is designed to encourage companies to engage in R&D. Where the R&D expenditure was outside the building block, any R&D tax concessions should in any case be excluded from the calculation of the forecast of tax costs in our regulatory models. It also noted that legislation proposing to amend the R&D tax incentive is currently before Parliament. If passed, it will mean the R&D tax incentive program will be more targeted and harder to access.[212] PwC recommended that the AER's modelling of the regulatory provision for tax costs should not be adjusted for the R&D deductions, as they do not appear to have a material impact on the tax differential.

PwC's addendum report stated that according to the RIN responses, the aggregate R&D tax offsets claimed by the NSPs were less than $5 million in each of the last five years. This confirms its view that R&D tax offsets have not resulted in a material difference between actual tax paid and the regulatory forecast of tax costs.[213]

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210 AusNet, *Response to AER Tax initial report,* 26 July 2018, p. 4; ENA, *Response to AER Review of Regulatory Tax Approach – Initial Report*, 26 July 2018, pp. 8, 16, 20; Energex and Ergon, *Response to Review of Regulatory Tax Approach – Initial Report*, 27 July 2018, pp. 2–3

211 PwC, *AER tax review 2018, Expert advice*, 26 October 2018, p. 109.

212 PwC*, AER tax review 2018–Addendum, Expert advice*, 10 December 2018, p. 51.

213 PwC, *AER tax review 2018–Addendum, Expert advice*, 10 December 2018, p. 52.

We agree that R&D expenditures outside of the building blocks should not be considered as a deduction for tax purposes. Customers may nonetheless benefit from R&D expenditure for inclusion in the building blocks if it creates any spill over benefits to the regulated services.

8 Interest expense

Summary of the issue

In its note to the AER, the ATO identified that one of the material drivers of the face value tax difference was deductions for interest expense. Interest expense related effects contribute to the face value tax difference in three main ways—via interest rates, total asset value and gearing ratio.

In its analysis of the RINs, PwC has confirmed that interest expense is a driver of the face value tax difference. However, after isolating the interest expense relevant to regulated activities, we consider that the difference in interest expense does not indicate that changes to the regulatory tax approach are required. This is because:

- Observed actual interest rates broadly align with the regulatory estimates used to forecast interest expense, noting that this is also affected by:
  - the use of a trailing average portfolio for regulatory purposes;
  - the transition to the trailing average from the previous on-the-day approach;
  - term differences between actual debt and regulatory benchmarks; and
  - currency swaps.
- The recently published rate of return guideline includes changes to the method for estimating the regulated return on debt that will then flow through to future tax calculations, further aligning the regulatory approach with observed tax outcomes.
- Differences arising from the total asset value (where additional debt is incurred because the total asset value exceeds the RAB) do not appear relevant to the regulated activities of the firm. Consumers do not fund the additional interest charges for debt not related to the regulated activities of the firm and do not benefit from the additional interest expense for tax purposes.
- Observed gearing figures broadly align with the regulatory gearing estimates used to forecast interest expense, after adjusting for total asset value, and noting the difference between book value and market value calculations.

We note that due to the timing of the receipt of the RIN responses and our discussion paper, we were previously not able to include analysis of debt information. However, most stakeholders submitted that in principle, we should adopt a consistent gearing ratio between our rate of return assumptions and tax calculations.

The CCP and the DoEE did not necessarily agree. They submitted that we should consider actual tax practices and whether any adjustments need to be made to our interest expense assumptions.[214] The CCP noted our possible changes to tax depreciation—that the AER is

[214] DoEE submitted that we should consider the impact of related party payments that may be deductible for tax purposes. DoEE, *Submission to the AER's Review of Regulatory Tax Approach*, 23 November 2018, p. 8. PwC has confirmed that it incorporated all information received regarding related party financing in its analysis. Further, it stated that it has not

considering applying DV and immediate expensing in its tax calculations, which is different from its approach for regulatory depreciation, where SL depreciation is used and expenditures are not immediately expensed.

However, from PwC's analysis of the RIN information, we have not found that material adjustments are required that would cause us to change our current regulatory approach.

Our current approach

We calculate interest expense for tax purposes by adopting the same assumptions used in calculating our rate of return. That is, we adopt the same benchmark gearing ratio[215] (applied to the same RAB value) and the same cost of debt assumption. Thus, interest expense is calculated as:

$$Interest\ expense = 60\% \times RAB \times cost\ of\ debt$$

If any of the above assumptions differ from either the NSPs' actual practice or how interest expenses are calculated for tax purposes, then these differences would contribute to a tax difference. For example, if an NSP's actual gearing is higher than our benchmark gearing of 60 per cent, then the NSP would have higher interest deductions, resulting in a lower tax liability compared to our calculations.

Actual tax practice

Tax practice is to generally allow expenses made by NSPs on their debt interest to be deductible.

However, there are some exceptions which mainly operate to limit the amount of interest deductions that may be claimed e.g.:

- Thin capitalisation rules – limit the amount of debt that can be used to fund the Australian operations of foreign entities investing into Australia and also Australian entities investing offshore. The rules operate to disallow a tax deduction for a portion of debt financing expenses (e.g. interest payments, loan fees). However, there are tests that businesses can apply in order to avoid any deductions being disallowed. The commonly used test is the safe harbour test. If a business' debt to equity ratio is 60 per cent or less, no debt will be disallowed. Another test is the arms-length debt test. This is the amount an entity could borrow if it were to borrow at arms-length from a third party – if the debt level falls within these amounts then no debt will be disallowed.[216]
- Transfer pricing rules – the ATO would typically examine the terms of financing arrangements, including the interest rate charged and in many cases would include the

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evidenced any other related party dealings (Section A of the International Dealings Schedules provided in response to the RINs that it would consider material for the purpose of this review). PwC, *AER tax review 2018–Addendum, Expert advice*, 10 December 2018, p. 61.

215 Gearing ratio = debt/(debt + equity).

216 There is also the worldwide gearing debt amount that allows the Australian operations of an entity, in certain circumstances, to be geared up to 100% of the gearing of the Australian entity's worldwide group. https://www.ato.gov.au/business/thin-capitalisation/non-adi-general-outward-investor/step-3--calculate-the-worldwide-gearing-debt-amount/ accessed 4 December 2018.

potential application of transfer pricing rules (this would be particularly relevant to related party loans). The main focus is to examine whether the interest rates charged are on an arms-length basis.

Further detail is provided in the PwC addendum report (section 3.1.4).[217]

How does this issue contribute to the tax difference?

In our discussion paper, we indicated that there may be four potential reasons why the actual interest expense for NSPs may differ from what we have applied in our tax calculations:

- Actual cost of debt may be different from our benchmark cost of debt,
- Actual debt levels may be different from the level of debt we have deemed in its RAB (calculated as 60% x RAB) - reflective of differences in market value and RAB value,[218]
- Actual gearing may be different from our benchmark 60 per cent gearing,[219] and
- There may be hybrid securities which we have treated as equity in our return on capital assumption, but the payments made under them are deductible for tax purposes.

Consistent with the ATO note, PwC found that actual interest expense was larger than what we provided for in our tax calculations (albeit, PwC examined interest expense information for 2018 only). It found that (in 2018) total actual interest expense was about $4,137 million, which was $543 million higher than the regulatory interest expense amount of about $3,594 million.[220]

We discuss in the section below, each of the above items which may contribute to the interest expense difference, including stakeholder submissions to our discussion paper, PwC's analysis of the information received in response to the RINs, and our findings.

8.1 Cost of debt

In calculating the interest expense, we apply the same return on debt assumption as in our rate of return—which we consider to be the efficient debt costs. If an NSP has higher actual debt costs than our benchmark return on debt assumption, then the NSP bears the additional cost—customers do not provide a higher return. This encourages NSPs to pursue efficient debt costs.

Since our discussion paper, we have commissioned a second report from PwC regarding the new information received in the RINs that was not considered in the discussion paper.[221] In this report, PwC analysed the discrepancies between actual interest rates of the NSPs and

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217 PwC, *AER tax review 2018*–Addendum*, Expert advice*, 10 December 2018, pp. 27-33.

218 For example a network may have a RAB value of $10 billion, but a market value of $15 billion. 60% of the market value would by $9 billion. Comparing this to the RAB value implies a gearing ratio of 90%.

219 The benchmark gearing applied is an observed average across the industry, so some variation around this average is to be expected by individual NSPs.

220 PwC, *AER tax review 2018*–Addendum*, Expert advice*, 10 December 2018, p 19.

221 PwC, *AER tax review 2018*–Addendum*, Expert advice*, 10 December 2018.

the return on debt determined for the regulatory forecast of tax costs. We consider the cost of debt results of this report below.

Stakeholder submissions

In response to our discussion paper, NSP stakeholders and their representatives submitted that we should adopt a consistent cost of debt assumption between the rate of return and tax calculations.[222] Representatives of consumers, however, were open to changing these assumptions as part of their submissions on interest expense. These were focused on the potential to change gearing and not the cost of debt.[223]

PwC's analysis of RIN information

PwC finds that regulated entities have recently been issuing debt at materially lower interest rates than the rates included in regulatory determinations. In the case of private entities the difference is in the order of 150 basis points.

What are our findings and recommendations?

We have undertaken analysis on more detailed data from issuances in 2017 and estimate:

- Around a third of the differential observed by PwC is a timing impact. Regulatory decisions are made at a point in time based on interest rates at the time. These old interest rates are then locked into regulatory determinations. Over recent years, interest rates have been decreasing so that current interest rates are lower than the rates that were used when making the regulatory determination. When recent debt issuances are compared to the current benchmark the differential narrows. The entities we regulate are currently transitioning to a trailing average cost of debt. As this transition progresses, interest rates for the purpose of our regulatory determinations will be updated annually for 1/10th of the debt portfolio rather than locking in a point in time interest rate for 5 years for the whole debt portfolio. The chosen transition path will further align the regulated return on debt and actual interest rates over time, reducing this source of tax difference. There is also an important interaction between the transition to a trailing average and recent asset transactions (mergers, acquisitions or privatisations) where entities refinance their entire debt portfolio at current rates, which are below the transitional rate. This cause of the interest rate difference will also diminish over time, without any further changes to the tax approach.

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222 ENA, AER review of regulatory tax approach, November 2018, pp. 22–23; Origin, *response to Review of regulatory tax approach,* 21 November 2018, p. 3; APA Group, *APA response to AER discussion paper*, 22 November 2018, pp. 6–7; TransGrid, response to AER's discussion paper on review of regulatory tax approach, 23 November 2018, p. 1; APGA, *Submission to the AER Discussion Paper: Review of regulatory tax approach*, 23 November 2018, p. 4; ATCO Australia, *submission to the AER–Review of regulatory tax approach Discussion* Paper, 23 November 2018, pp. 1, 9; EvoEnergy, *AER discussion paper on review of regulatory tax approach,* 23 November 2018, p. 1; Jemena, *response to Discussion Paper - Review of regulatory tax approach*, 23 November 2018, pp 4-5; Endeavour Energy, *response to AER Review of Regulatory Tax Approach 2018*, 23 November 2018, p. 5; Network Shareholder Group, *Submission in response to the AER's Discussion Paper on the review of the regulatory tax approach*, 23 November 2018, pp. 5–6; AusNet, *AER Review of Regulatory Tax Approach: Response to Discussion Paper*, 23 November 2018, p. 6.

223 CCP, *Submission to the AER on Review of regulatory tax approach - Discussion paper November 2018,* 25 November 2018, pp. 4, 6, 50-51 (LATE SUBMISSION); ECA, *Review of regulatory tax approach 2018*, 30 November 2018, p. 2 (LATE SUBMISSION)

- Around a third of the differential observed by PwC is because some debt was issued in overseas currencies. The unconverted interest rate of debt in overseas currencies tends to be lower than local currency debt. However, once the debt is converted into local rates the actual interest rate faced by borrowers is approximately the same as local debt.
- Around a quarter of the differential observed by PwC is because a portion of recent debt has been issued at terms that are shorter than 10 years. Short term debt is typically cheaper than long term debt. This effect may be related to the chosen transition path to the trailing average portfolio approach. We considered the benchmark term in our rate of return guidelines review in some detail.
- Just under a tenth of the differential observed by PwC is because its comparison has been undertaken against the current broad BBB benchmark credit rating. In the rate of return guideline review, we have decided to amend our benchmark to more closely match a BBB+ benchmark credit rating. This change to our method for setting the regulated return on debt will automatically flow through to future forecasts of tax costs.

Once each of these factors has been adjusted we find that recent interest rates achieved by regulated entities more closely align with their current benchmark cost of debt. Therefore, we find that no changes are warranted to our current approach of applying a consistent return on debt assumption in our tax calculations.

8.2 Market value of network service provider

The interest expense is calculated by multiplying the cost of debt assumption by 60 per cent of the RAB. Therefore, we are implicitly deeming 60 per cent of an NSP's RAB to be its debt level.

A potential source of difference in interest expense may be due to the market value of an NSP being higher than the value of RAB used in our regulatory processes. Therefore, even if an NSP were to adopt a 60 per cent gearing ratio (based on market values) its level of debt would be higher than our assumed level of debt in the RAB.

Evidence of the market value of NSPs being higher than RAB values can be seen from RAB multiples for acquisitions/transactions. In recent transactions of NSW NSPs they have been around 1.4x to 1.6x.[224] Thus, the actual value of some NSP's debt is likely to be higher than what we have applied in our calculations (60% x RAB).[225] This means that the NSP's actual interest expense would be higher than the interest expense applied in our tax calculations, resulting in lower actual taxes paid by the NSP than calculated in our models.

We note that in our rate of return calculations, we do not adjust either the weighted average cost of capital (WACC) or the RAB value to account for potential differences between the acquisition price (or market value) of an NSP and its RAB value. This is because we consider that the NSP's RAB represents the appropriate economic value of the assets for which it should earn a rate of return. We do not consider the RAB to represent the acquisition price (or the market value) of the NSP which may be affected by factors other

224 AER, *Discussion paper, Financial performance measures*, February 2018, pp. 14-15.

225 For example a network may have a RAB value of $10 billion, but a market value of $15 billion. 60% of the market value would by $9 billion. Comparing this to the RAB value implies a gearing ratio of 90%.

than the efficient delivery of regulated services (e.g. unregulated revenues, control premium, outperformance of expenditure allowances, intangibles).[226]

Stakeholder submissions

In response to our discussion paper, stakeholders submitted that we should not make adjustments to our interest expense calculations to reflect differences between the RAB value and any market value. They agreed that any differences sit outside the regulatory framework i.e., RAB values are not revised to reflect changes in market value, hence there are no changes to the return on or of capital assumptions.

In addition to the above, ENA also submitted that we would need confirmation from the ATO on allowable interest deductions, if we were to increase the gearing beyond 60 per cent, to reflect debt that sits outside the RAB for tax purposes. This is because NSPs that are subject to thin capitalisation rules must satisfy either the safe harbour gearing amount of 60% or the arms-length debt test. Therefore, there is no guarantee that the ATO would allow interest deductions on gearing in excess of these amounts and there is increasing focus by the ATO on the amount of interest deductions made by NSPs.

PwC's analysis of RIN information

PwC found that M&A activity and unregulated assets contributed to the difference in interest expense. It found that in the 2018 income year:[227]

- Total actual interest deductions for all NSPs was about $4,137 million, which was $543 million higher than the regulatory interest expense amount of about $3,594 million.
- However, once differences due to M&A activity and unregulated assets were removed,[228] total actual interest deductions for all NSPs was about $3,266 million, which was $328 million lower than the regulatory interest expense of about $3,594 million.

PwC recommended no change to our regulatory tax calculations due to M&A activity and unregulated assets. This was because it considered that these factors were outside the regulatory ring-fence and therefore a justified difference, as the additional interest costs relating to these activities are not recoverable for regulatory purposes.

What are our findings and recommendations?

We consider that no adjustments to our interest expense calculations should be made to reflect differences between RAB values and market values which do not appear relevant to the regulated activities of the firm. Consumers do not fund the additional interest charges for

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226 If we were to increase the RAB value to reflect unregulated revenues, then the NSP would earn a rate of return for assets that are not involved in the delivery of regulated services. Also, if we were to increase the RAB to reflect potential outperformance of expenditure allowances, then the NSP would be rewarded twice - when it actually outperforms on its allowances, e.g. through lower actual opex, and again through a higher return on and of capital, through the larger RAB.

227 PwC, *AER tax review 2018–Addendum, Expert advice*, 10 December 2018, pp. 19–22.

228 PwC adjusted for differences due to M&A activity and unregulated activities by multiplying the observed actual interest costs and gearing to the RAB for each of the NSPs, and compared the resulting figures with the regulatory interest expense for each of the NSPs.

debt not related to the regulated activities of the firm and do not benefit from the additional interest expense for tax purposes.

We consider that the owners of the NSPs should bear the risk of any differences between their acquisition price and the RAB value. For example, if the owners of an NSP pay for a higher acquisition price (compared to the RAB), they bear the risk of doing so. Given that the owners bear this risk and not customers, it is appropriate for the owners to retain any benefits or detriments that arise (e.g., higher debt levels may result in higher interest expenses and hence lower tax liabilities compared with our assumptions).[229]

This is also consistent with our discussion in Chapter 7 about not adjusting the TAB in response to market transactions for regulated assets. As discussed, where an asset trades at a multiple in excess of its RAB, the incremental value sits outside the regulatory framework. Customers do not pay for higher return on capital and return of capital building blocks, but they also do not pay a lower tax building block

8.3 Actual gearing

In its note, the ATO stated that *some* listed or privately owned entities it reviewed had an average gearing level above the AER's assumed gearing level of 60 per cent. It then noted that this would lead to higher tax deductions being claimed for interest expenditure compared to the AER's calculations.[230]

Our understanding is that the ATO based its preliminary analysis primarily on the tax information submitted by the NSPs. As such, the gearing levels calculated by the ATO would be based on book values (i.e. financial statements) for the NSPs examined.

The results of ATO's preliminary analysis are consistent with our empirical analysis undertaken for our recent rate of return guideline. We found that gearing based on book values for listed NSPs[231] examined in our comparator set was 69 per cent to 70 per cent based on 5-year and 10-year historical averages, respectively.[232]

We note that in our empirical analysis for our recent rate of return guideline, gearing based on market values for the same listed NSPs examined in our comparator set, was 54 per cent to 60 per cent based on a five-year and 10-year historical averages, respectively.

However, despite the difference in measurement basis, NSPs may choose to adopt a higher gearing ratio than our benchmark (based on market value) if they consider it optimal to do so. Thus, a higher gearing ratio may lead to a higher interest expense, hence lower tax liabilities compared with our tax calculations.

In conjunction with our Initial report we published a report prepared by Dr Martin Lally (June 2018) which included discussion on NSPs adopting gearing levels higher than used by the

229 For example, having higher interest expenses, and hence lower actual taxes.
230 ATO, *Note to the AER,* 10 April 2018, p.2.
231 These listed businesses are APA Group, Spark Infrastructure, DUET Group, AusNet and Envestra.
232 AER, *Rate of return instrument–Explanatory Statement*, December 2018, Chapter 4 gearing.

AER.[233] Dr Lally advised against a change to gearing for tax purposes, as it would potentially discourage optimal behaviour if the advantages of higher interest deductions are removed from the businesses, but the disadvantages are not (e.g. higher bankruptcy risk).

We also note that in its review of our recent draft explanatory statement for the current rate of return guideline review, the Independent Panel stated the following in relation to gearing:

> The only significant interaction of the gearing ratio with other building blocks is with the taxation component. Because interest costs are tax deductible, consistency requires the same gearing ratio to be used in the rate of return and taxation building blocks.[234]

Stakeholder submissions

In response to our discussion paper, most stakeholders submitted that we should adopt a consistent gearing ratio between our rate of return assumptions and our tax calculations i.e., 60 per cent.[235]

However, the CCP did not agree and submitted that gearing does not need to be consistent.[236] CCP noted that the estimation of depreciation was a good example:

- Part of the allowed pre-tax revenue is the provision for depreciation. This provision matches the recovery of the amount spent on an asset to the services it provides in order to meet efficiency and inter-generational equity objectives.
- But this may be different to how the costs are allowed for tax purposes.

PwC's analysis of RIN information

Consistent with the ATO note, PwC found that for 2018, gearing was on average higher than our benchmark ratio of 60 per cent:[237]

- overall, average gearing was 69 per cent,
- for private entities it was 65 per cent, and
- for NTER entities it was 76 per cent.

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233 Dr Martin Lally, *Tax payments versus the AER's allowances for regulated businesses*, 16 June 2018, pp. 4-5.

234 Independent Panel, *Review of the Australian Energy Regulator's rate of return draft guidelines*, September 2018, p. 35.

235 Origin, *Response to Review of regulatory tax approach*, 21 November 2018, p. 3; APA, *AER review of regulatory tax approach–APA response to AER discussion paper*, 22 November 2018, p. 7; TransGrid, *response to AER's discussion paper on review of regulatory tax approach*, 23 November 2018, p.1; APGA, *Submission to the AER – Discussion Paper: Review of regulatory tax approach,* 23 November, p. 4; ATCO Australia, *Submission to AER – Review of regulatory tax approach discussion paper,* 23 November 2018, p. 9; Evoenergy, *Response to discussion paper on review of regulatory tax approach, 23 November 2018*, p.1; Jemena, *Response to Discussion Paper–Review of regulatory tax approach*, 23 November 2018, p. 5; Endeavour, *Response to AER Review of Regulatory Tax Approach 2018*, 23 November 2018, p. 5, NSG p.5; Ergon and Energex, *Response to AER Review of Regulatory Tax Approach Discussion Paper*, 23 November 2018, p. 2, ENA, *Response to the AER Discussion Paper*, 23 November 2018, p.21; AusNet, *AER Review of Regulatory Tax Approach: Response to Discussion Paper*, 23 November 2018, p.6

236 CCP, *Submission to the AER on review of regulatory tax approach-discussion paper November 2018*, 25 November 2018, pp. 50–51 (LATE SUBMISSION).

237 PwC, *AER tax review 2018–Addendum, Expert advice*, 10 December 2018, p. 23.

However, PwC noted that the gearing ratios from the RIN information, and used for tax purposes, was based on financial statements (i.e. book values) which is a different basis from the way the AER calculates its gearing ratio (based on market value).[238]

Given the differences in gearing ratios (compared with our benchmark ratio), PwC recommended that the AER consider whether it was appropriate to adopt a different gearing ratio for tax purposes,[239] noting that the AER would have to consider consistency between the forecast of tax costs in the regulatory models and the rate of return building block. It also recommended consideration of Ofgem's ex-post claw-back mechanism in its regulatory modelling when actual gearing is higher than regulatory assumptions.[240]

What are our findings and recommendations?

We note that PwC's finding that gearing (based on book value) being higher than our benchmark ratio of 60 per cent (based on market value) is consistent with our empirical analysis undertaken in our recent rate of return guideline review.

However, our benchmark gearing of 60 per cent is primarily based on market values rather than book values. Using market values promotes consistency between our benchmark gearing ratio and other rate of return parameters that are typically informed by market data. We consider this is important given the relationship between leverage risk and equity beta, and the estimation of equity beta from returns data of listed equity.[241]

For the above reasons, we also do not consider it appropriate to apply Ofgem's ex-post claw-back mechanism which is triggered when gearing is higher than regulatory assumptions (although, we note that actual interest costs also need to be higher than regulatory assumptions for adjustments to be made).

The CCP submitted that we should consider whether any tax law adjustments should be made to our interest expense calculations. However, based on PwC's analysis of the RIN information, we have not found material adjustments that are required that would cause us to change our current regulatory approach.

Our finding is that no changes are warranted to our current approach of adopting a gearing ratio of 60 per cent for tax purposes

8.4 Hybrid securities

Hybrid securities are securities that have characteristics of both debt and equity (e.g., stapled shareholder loan notes or convertible notes).

A possible cause of higher interest expenses could be due to differences in treatment of hybrid securities between the AER and the ATO. That is, we may treat certain hybrid

238 PwC, *AER tax review 2018–Addendum, Expert advice*, 10 December 2018, p. 26.

239 This also included consideration of the impact of thin capitalisation restrictions. That is, in situations where gearing exceeds debt levels which are allowed under Australia's thin capitalisation rules, only the amount allowed under the thin capitalisation rules should be allowed in regulatory tax calculations.

240 PwC, *AER tax review 2018–Addendum, Expert advice*, 10 December 2018, p. 34.

241 AER, *Rate of return instrument–-Explanatory Statement*, December 2018, Chapter 4 gearing.

securities as equity, in both the rate of return and the tax calculations. However, for actual tax purposes, payments made under these securities may be treated as deductible interest expenses. This issue was raised by the CCP in its response to our initial report.[242]

In our rate of return instrument we maintained our existing approach for these hybrid securities as summarised in Table 8.1.

Table 8.1 Rate of return instrument—treatment of hybrid securities

Hybrid security	Treatment – rate of return instrument
Stapled shareholder loan notes	Treated as equity - we noted the following characteristics: • Stapled to each share, with no separate existence without the share (that is, they cannot be traded independently) • Subordinate to all other creditors • Returns on the notes were not guaranteed and only payable to the extent to which there is available cash.
Non-convertible subordinated notes	Treated as debt - was applicable to AusNet Services; we noted that given the relative size of AusNet Services' current level of debt and hybrid securities, adjusting for these hybrid securities was unlikely to have a material impact on the overall gearing estimates, and that these particular notes are not stapled to its shares.

Note: Stapled loan notes were a consideration in the calculation of gearing for Spark Infrastructure in recent years and was treated as equity when calculating gearing on both market and book values.

Source: AER, *Rate of return instrument–Explanatory Statement*, December 2018, Chapter 4 gearing.

We have treated stapled shareholder loan notes as if they were equity and was mainly relevant to the calculation of one of the five listed NSPs' gearing in our comparator set.[243] It is possible that for tax purposes, the payments made under these loan notes may be deductible expenses. Hence, it may contribute to the tax difference, although this may not be a material driver because it only applies to a small proportion of the available comparator set. We are also cognisant of the difficulty in separating the loan notes from its stapled shares in order to calculate a different gearing for tax purposes, given that they cannot be traded separately and, as such, have no separate existence from the share (the share price would encompass the value of the loan note).[244]

Stakeholder submissions

The ENA submitted that it considers hybrid securities to be a side issue that is completely irrelevant to the vast majority of NSPs. It raised a number of issues, including[245]:

- If any changes were to be made it would risk the AER creating an incentive to 'race to the bottom' as identified by Dr Lally

242 CCP, *Submission to the AER on review of regulatory tax approach-initial report*, June 2018, p. 19.
243 Stapled shareholder loan notes applied to Spark Infrastructure over the historical period examined, but only up until 2008 for Envestra.
244 AER, 2018 *Rate of Return Guideline review, Discussion Paper Gearing*, February 2018, p. 25.
245 ENA, *AER review of regulatory tax approach*, 23 November 2018, pp. 23–24.

- Shareholder loan notes cannot be traded separate from the underlying share and so there is no obvious basis for determining the proportion of value that pertains to the note versus the underlying share
- Deductibility of interest paid on the loan notes may be capped by thin capitalisation rules
- Shareholder loan notes are typically issued by NSPs with foreign investors, and so if any changes were made, the corresponding impact on gamma would need to be considered – it would be inconsistent to reflect tax deductibility of an instrument that is used by foreign investors, but then assume that the same instrument is held by the usual proportion of domestic investors.

PwC's analysis of RIN information

PwC noted the limitation in obtaining financing information (e.g., shareholder loans) for upstream investors. It also examined whether there were any finance staples in use, and found that this was not the case (for the information supplied as at 30 June 2018).[246]

PwC also examined recent tax law changes that will impact interest expenses (related to shareholder debt) going forward and noted the following:[247]

- Debt pricing – related party loans has been an area of increasing focus for the ATO. Following the Chevron case in April 2017, the ATO published its Practical Compliance Guideline PCG 2017/4 which deals with related party debt financing. PwC notes that it is not a public ruling but rather provides guidance on where the ATO will allocate compliance resources to test the tax outcomes of related party financing arrangements. As a result of these developments, it is expected that interest rates applicable to shareholder loans (and thus interest deductions) obtained by some NSPs may be lower in future compared with historic rates.
- Unitholder debt and double gearing – legislation is currently before Parliament to amend the thin capitalisation rules to prevent foreign investors from double gearing their investments and claiming additional interest deductions. PwC noted that there will be no grandfathering or transitional arrangements, and the potential change would affect investors with an interest of 10 per cent or more, which applies to all current investors in NSPs with flow-through structures.

Further details are presented in the PwC report in section 3.1.4.[248]

What are our findings and recommendations?

Given that hybrid securities are not applicable to most of the NSPs, and PwC in its analysis of the RIN information did not find any material concerns to warrant adjustments to our tax calculations in this regard, we find that no changes are required to our current approach.

246 PwC, *AER tax review 2018–Addendum, Expert advice*, 10 December 2018, p. 33.
247 PwC, *AER tax review 2018–Addendum, Expert advice*, 10 December 2018, pp. 27–34.
248 PwC, *AER tax review 2018–Addendum, Expert advice*, 10 December 2018, pp. 27–34.

9 Actual tax pass through

Summary of the issue

In our initial report and discussion paper, we proposed maintaining a benchmark approach to provide businesses with the incentive to continue to adopt efficient tax practices, in the long term interests of consumers. The most fundamental change to our current approach would be to instead use a 'tax pass through' approach, where the regulatory provision for tax costs is based on actual tax paid by each energy network. There were several variants of tax pass through approaches identified.

Several stakeholders proposed that a pass through of the actual tax paid by a regulated business would remove the tax difference—that is, the difference between the AER's provision for tax costs that is recovered from customers and actual tax paid to the ATO (or NTER equivalent). We did not consider that this was sufficient justification for such a change. While a pass through of tax approach might have the initial attraction of reducing the size of the tax difference, this is not by itself demonstrative that it is in the long-term interests of consumers. In some instances the actual tax paid is significantly above the AER's provision for tax costs. In other cases it is lower, but in our view, over the longer term the actual tax costs passed through to consumers would likely increase over time, as service providers would have no incentive to minimise their tax payments. In contemplating such a fundamental change to the current incentive based regime, we need to consider how service providers will respond under a change of approach as this will influence consumer outcomes.

We canvassed tax pass through options in our initial report. After considering submissions and our consultants' expert advice (PwC and Dr Lally), we addressed it again in our discussion paper. We expressed caution over adopting an actual tax pass through approach for the following reasons:

- The relevant differences between the benchmark and actual tax paid are not as significant as they first appear.
- The differences are likely to narrow over time, because of further changes to the benchmarking approach and changes to tax legislation (including recent court rulings favourable to the ATO).
- Costs to consumers may increase in the long run, as there is no incentive for a network to minimise its tax costs.
- Costs to consumers may also increase in the short run, where depreciation had been brought forward in advance of the regulatory benchmark.
- There would be an incentive to shift tax obligations from unregulated activities into the regulated framework, and higher associated monitoring/enforcement costs in preventing this.
- Increases in administrative costs and regulatory compliance costs for NSPs will further reduce the effectiveness of using an actual tax pass through as a means of lowering costs for consumers.

- Some businesses (especially government owned businesses) pay more tax than the benchmark suggest they should.

In addition, we noted alternative means of addressing the perceived shortcomings of the current regime, such as more regular reviews of the regulatory tax approach coupled with adjustments to tax modelling to address changes in efficient tax practice observed by the AER.

Submissions to our initial report and discussion paper generally supported our position of not moving to an actual tax pass through approach.[249] However, in response to the discussion paper the DoEE strongly supported an actual tax pass through.[250]

A move to a tax pass through of actual tax represents a significant departure from the incentive framework. Our decisions are guided by the promotion of the NEO and NGO. That is, a change to our approach must be considered to promote the delivery of these objectives to the greatest degree.

This chapter looks at the current treatment of tax in the overarching incentive based regime; then reviews the proposed actual tax pass through approach against our criteria. We use the criteria set out in the discussion paper (efficient costs, materiality, achievable in practice, and broader tax issues) to assess the likely impact of applying a cost pass through regime to actual tax payments.

In considering whether there should be a move to a pass through, we have relied on both publicly available information and information we have received through our compulsory information gathering powers (which we also consulted on). There has not been additional material and reasoning that would support a change in approach that has been provided to us for consideration for this final report. As such, for the purposes of this final report we maintain our conclusion that an incentive approach to tax allowances is appropriate and should continue.

What is our current approach?

We use a building block approach to determine the efficient costs which includes a tax building block for the cost of corporate taxation. The operation of the current approach is described in chapter 3.

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249 Origin, *Response to Review of regulatory tax approach*, 21 November 2018, p.3; APGA, *Submission to the AER – Discussion Paper: Review of regulatory tax approach*, 23 November, p. 2; ATCO, *Submission to AER – Review of regulatory tax approach discussion paper*, 23 November 2018, p. 2; Jemena, *Response to Discussion Paper–Review of regulatory tax approach*, 23 November 2018, p. 1; NSG, *Submission in response to the AER's Discussion Paper on the review of the regulatory tax approach,* 23 November 2018, p. 1; ENA, *Response to the AER Discussion Paper*, 23 November 2018, p. 5–6; AusNet, *AER Review of Regulatory Tax Approach: Response to Discussion Paper*, 23 November 2018, p. 1; CCP *Submission to the AER on Review of regulatory tax approach – Discussion paper November 2018, 25* November 2018, pp. 5, 13 (LATE SUBMISSION); ENA, Review of Regulatory Tax Approach Supplementary Response, 4 December 2018, pp. 2–3 (LATE SUBMISSION)

250 DoEE, *Submission to the AER's review of regulatory tax approach*, 23 November 2018, pp. 5–6.

We forecast tax costs using a 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 described our tax calculation in detail in our initial report.[251]

In the discussion paper, we noted that a difference between actual tax payments and the AER's forecast of tax costs can arise if any of our regulatory estimates (e.g. estimates of taxable revenue, tax expenses and the statutory corporate income tax rate) vary from businesses' actual practice. We described three effects in detail:

- cost variations,
- revenue variation, and
- smoothing effects.

A key point was that a tax difference between forecast tax costs and actual tax payments is to be expected under a benchmark approach as the circumstances and performance of each NSP are not separately considered.[252] That is, some NSPs may outperform our benchmark in either the short run and/or long run where others will not.

Submissions were generally supportive of our existing incentive approach, with exceptions of the CCP and DoEE.[253]

What is the case for a tax pass through?

This tax review was initiated in response to evidence suggesting actual tax payments by regulated businesses were below the AER's forecasts and customers might be paying more than the efficient cost of providing electricity and gas services. A pass through of the actual tax paid by a regulated business was proposed to address the difference between the AER's provision for tax costs that is recovered from customers and actual tax paid. There were several variants of tax pass through approaches identified in submissions, including a pass through with or without a cap (set at the current benchmark level) or combined with a sharing mechanism.

These pass through options address the perceived shortcoming in the flow through of tax benefits to consumers when a business paid less tax under the current incentive approach. For some costs, like capex or opex, the benefits to consumers of the incentive approach are readily observed. Regulated businesses have an incentive to reduce expenditures to efficient levels, and retain the benefit where actual costs are below forecast in the short term.

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251 AER, *Initial report, Review of regulatory tax approach*, June 2018, pp. 7–11.

252 AER, *Discussion paper, Review of regulatory tax approach*, November 2018, pp. 100–101.

253 Origin, *Response to Review of regulatory tax approach*, 21 November 2018, p. 3; APGA, *Submission to the AER – Discussion Paper: Review of regulatory tax approach*, 23 November, p. 2; ATCO, *Submission to AER – Review of regulatory tax approach discussion paper*, 23 November 2018, p. 2; Jemena, *Response to Discussion Paper–Review of regulatory tax approach*, 23 November 2018, p. 1; NSG, *Submission in response to the AER's Discussion Paper on the review of the regulatory tax approach*, 23 November 2018, p. 1; ENA, *Response to the AER Discussion Paper*, 23 November 2018, p. 5–6; AusNet, *AER Review of Regulatory Tax Approach: Response to Discussion Paper*, 23 November 2018, p. 1; CCP, *Submission to the AER on Review of regulatory tax approach – Discussion paper November 2018*, 25 November 2018, pp. 5, 13 (LATE SUBMISSION); ENA, *Review of Regulatory Tax Approach Supplementary Response*, 4 December 2018, pp. 2–3 (LATE SUBMISSION).

Then, the revealed efficient level of costs is reflected in future revenue determination processes and the benefit flows through to consumers in the medium to the longer term.

The process is different for tax because the benchmark tax approach is not automatically reset to reflect past tax practices each time we undertake a revenue determination. Under the current framework it is necessary for the AER to observe the tax management practices of the networks and alter its benchmark tax approach in order to pass any observed efficiencies through to consumers.

In earlier submissions, the CCP had submitted that a change to a tax pass through should not be taken off the table unless improvements could be made to the benchmark incentive approach.[254] The CCP noted that, absent the AER amending its benchmark tax approach, no benefits pass through to consumers for differences between actual tax paid and the benchmark allowance in the long term. In its submission to the discussion paper, the CCP appeared to accept that progress had been made towards a better benchmark, where it noted the AER's commitment to undertake regular tax reviews, and proposed the adoption of multiple benchmarks instead of a change to a tax pass through.[255]

The key advocate for a move to tax pass through is the DoEE. The DoEE's submission supported a shift away from the incentive framework, and stated that the long term interests of consumers would be better served by an approach where network businesses were only compensated to the extent they needed to meet their statutory obligation.[256] The DoEE submitted that incentive based regulation makes sense for calculating operating and capital expenditures, but not for tax as networks do not share any reduction in their calculated tax liabilities with consumers, nor is the outcome used to inform the calculation of tax in future revenue determinations.[257]

The DoEE's support for a tax pass through appears to stem from its position on the first finding of this review—how to define the relevant tax difference.[258] The DoEE's submission appears to consider that the face value tax difference is the relevant measure. From this basis, it observes that certain network businesses have paid no tax and the current model is 'clearly enriching networks at the cost to consumers'.[259] This then leads the DoEE to suggest that a fundamental change to the regulatory regime is required.

In contrast, the AER distinguishes the face value tax difference from the relevant underlying tax difference. We consider that it is necessary to isolate the tax outcomes relevant to the efficient operation of regulated assets from broader tax outcomes. Customers should not receive the benefit or detriment from taxable revenue and expenses arising outside of this framework. Our initial report and discussion paper explained in most cases the difference between our forecast of tax costs and the tax actually paid is arising from factors not relevant

254 CCP, *Submission to the AER on Review of regulatory tax approach – Initial report June 2018*, 26 July 2018, p. 23.
255 CCP, *Submission to the AER on Review of regulatory tax approach - Discussion Paper*, 25 November 2018, pp. 5, 14. (LATE SUBMISSION)
256 DoEE, *Submission to the AER's Review of Regulatory Tax Approach*, 23 November 2018, p. 3.
257 DoEE, *Submission to the AER's Review of Regulatory Tax Approach*, 23 November 2018, p. 3.
258 DoEE, *Submission to the AER's Review of Regulatory Tax Approach*, 23 November 2018, p. 3.
259 DoEE, Cover Letter for submission to AER tax review 23 November 2018, p. 1.

to the efficient operation of regulated assets.[260] Our review has identified changes to the tax approach to reduce the difference between actual tax paid and the regulatory provision for tax costs. The Australian Government and ATO have also implemented new rules and approaches meaning that the tax difference is likely to be smaller in the future.

The DoEE's submission focused on the nature of tax as a statutory obligation, and considered that this type of cost was not appropriate for inclusion in an incentive regime.[261]

We note that costs incurred as a result of statutory obligations are prevalent throughout all building blocks used to determine regulated revenue, not just the tax building block. Examples include reliability obligations, environmental obligations, occupational health and safety obligations, and connection obligations. We consider that it is appropriate to address statutory obligations under a benchmark incentive approach. The service provider is responsible for meeting these obligations, but is afforded the autonomy to determine how it meets those obligations and rewarded for improved efficiency when it does so, noting that this then often benefits consumers in the long run.

Incentive effects and the potential for costs to rise

Our discussion paper noted that a cost pass through approach would provide no incentive to reduce tax costs. In response, the DoEE submitted that, had a tax cost pass through been applied across the last five years, consumers would have been better off, because in its view the face value difference identified by the ATO would have been passed through to consumers.[262]

We do not consider this to be a reasonable counterfactual. If an actual tax pass through had applied in the past, the NSPs may have adopted different tax management practices, since they would have been insulated from any increase in the amount of tax payable. ENA submitted that networks would have responded to such a change in the regulatory framework.[263]

ENA submitted that moving to pass through of tax that reflects deduction for costs incurred outside the regulatory business would transfer the benefit of those tax deductions to consumers.[264] It submitted that this was not appropriate since consumers had made no contribution to these costs initially. We agree in so far as it is the efficient provision of regulated services that is at issue. It would be inappropriate for non-regulated services to either increase or decrease the tax obligations that ultimately fall on the consumers of services provided by regulated businesses.

Whilst a tax pass through approach might reduce the size of the tax difference, a reduction in the tax difference is not necessarily the objective of this review. Our aim is to ensure that customers pay no more than the efficient costs (including tax costs) of operating regulated

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260 We describe three major drivers in chapter 5– the chain of ownership, aggregation of regulated and unregulated outcomes, and accrued tax losses.

261 DoEE, *Submission to the AER's Review of Regulatory Tax Approach*, 23 November 2018, p. 3.

262 DoEE, *Submission to the AER's Review of Regulatory Tax Approach*, 23 November 2018, p. 5.

263 ENA, *Review of Regulatory Tax Approach – Supplementary response*, 4 December 2018, p. 5.

264 ENA, *Review of Regulatory Tax Approach – Supplementary response*, 4 December 2018, p. 4.

energy networks. Under a tax pass through, the actual tax costs passed through to consumers could rise above efficient cost level over time. This is because service providers face no incentive to minimise costs they are not exposed to, and so no incentive to pursue efficient tax practices.

This is a pervasive problem under any form of cost-plus regulation and is likely to lead to higher consumer prices over the longer term compared to a benchmark incentive approach. The long term interests of consumers are not served simply by eliminating the gap between forecast of tax costs and actual tax costs—they are served by ensuring the efficiency of the total revenue allowance of which tax is a component.

The DoEE's submission stated that the AER had considered that tax costs could increase over time under a tax pass through 'without any attempt to ascertain whether this would in fact be the case, either from a qualitative or quantitative perspective'. In the DoEE's view, there was no prospect of a tax pass through leading to consumers paying more than the current benchmark—but even if it did, this could be managed via a cap.[265]

We consider that the discussion paper did engage, qualitatively and quantitatively, with this question. The discussion paper quantified the extent to which NTER (State government owned) entities currently pay equivalent tax above the benchmark. The NTER calculation mirrors the standard ATO tax calculation, and many of the observed behaviours of the NTER entities are options that privately owned networks could adopt. NTER entities have been reported as paying tax in excess of our estimate of the regulatory provision for tax costs.[266]

Our review has confirmed NTER entities pay more tax equivalent payments on average per annum than the regulatory estimate.[267] State governments are indifferent to whether the profits from its regulated networks are reported as tax or received as dividends.

Our discussion paper also qualitatively and quantitatively examined the effect of different depreciation methods. In particular, we considered whether depreciation claimed in excess of that estimated in the regulatory model could lead to higher actual tax costs in the future. The key consideration is that networks may have depreciated regulated assets for ATO tax purposes in excess of the AER's tax depreciation benchmark. If a benchmark approach was maintained, the natural reversal of this timing effect would mean that these networks would be required to pay more actual tax than the benchmark amount in the future (all else equal). However, consumers would be protected from the higher actual tax payments because they would continue to pay costs at the benchmark level. A switch to a tax pass through near the change over point would mean that consumers would suffer the worst outcome under both regimes. They would pay benchmark tax costs when these are higher than actual tax costs, and then switch to pay actual tax costs when these are higher than benchmark tax costs.

Consistent with our discussion paper, we consider that these depreciation related effects could lead to higher consumer costs in the short term, if a tax pass through approach was adopted.

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265 DoEE, *Submission to the AER's Review of Regulatory Tax Approach*, 23 November 2018, p. 6.
266 ATO, *Note to the AER*, 10 April 2018.
267 PwC, *AER tax review 2018, Expert advice*, 26 October 2018, pp. 31–35.

PwC's addendum report stated the actual tax is likely to increase in response to a change to a cost pass through. The NSP's incentive to efficiently manage its tax affairs would cease to exist because an actual tax pass through would inappropriately allocate the risk associated with the NSPs' management of their tax affairs to consumers. The NSP would avoid incurring administrative costs in investigating and implementing tax practices that might result in lower tax payable, since all the benefits would accrue to consumers.[268]

A capped tax pass through

The DoEE submitted that any potential increase in tax payable (in either the short or long term) could be managed via a cap, where the amount passed through is the lower of actual tax payments and the benchmark currently forecast by the AER.[269]

We do not consider that a cap will resolve the problems associated with a move to a tax pass through. A capped pass through may not allow networks reasonable opportunity to recover their efficient costs. It also introduces other disadvantages, including where the regulator would have to assess the justification for tax reductions and the allocation of tax between regulated and unregulated activities—two questions that the tax pass through approach was intended to avoid.

To illustrate the point, assume that the AER's forecast of tax costs is an unbiased estimate of tax payable, and this sets the benchmark tax costs to be used in the cap. There would inevitably be variation in actual tax payments around this forecast from period to period. This means actual tax costs are equally likely to be above the forecast as below the forecast. However, under a cap, the network is allowed to recover only the lower of the AER's forecast and actual tax costs each period. This systematically undercompensates networks across multiple periods, even where their incurred tax costs are exactly in line with the AER's forecast on average. Under such a cap, the NPV=0 principle would not be met. This problem with capped pass throughs is described in more detail in the expert advice from Dr Lally, commissioned for our initial report.[270]

Dr Lally further discussed other disadvantages under the capped approach:

- It would implicitly (and wrongly) attributes all shortfalls between taxes paid and those allowed by the regulator under the current regime to tax minimisation behaviour by firms.
- It would still provide an incentive for service providers to shift costs between regulated and unregulated activities—and it is not clear to what extent ring-fencing/monitoring could prevent this
- It is inconsistent with incentive regulation being applied to the other building block components.

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268 PwC, *AER tax review 2018–Addendum, Expert Advice*, 10 December 2018, pp. 54–55.
269 DoEE, *Submission to the AER's Review of Regulatory Tax Approach*, 23 November 2018, p. 6.
270 Dr Martin Lally, *Tax payments versus the AER's allowances for regulated businesses*, 16 June 2018, p. 4.

Dr Lally also responded to submissions in advice commissioned for our discussion paper, and found that this did not change his advice with regard to tax pass throughs (either complete or capped). [271]

Existing pass through mechanisms

The DoEE noted that the AER already allows for a pass through for other sector or State based charges and questioned why the same mechanism was not appropriate for income tax.[272]

We understand that the DoEE's submission was referencing two separate mechanisms currently used in conjunction with our standard building block determination of regulated revenues—pass through events and jurisdictional charges.

The NER allows the definition of 'pass through events' that allows revenues to be adjusted for specific events that will impact on the efficient costs of the regulated networks. Suitable pass through events are generally:

- beyond the control of the service provider (exogenous to the network)
- unforeseen (and so not suitable for inclusion in the normal building blocks).

The trigger for each pass through event is defined in advance. After the fact, the NSP makes an application to the AER for assessment of the costs of the pass through, and the AER adjusts the NSP's revenues in subsequent years (with an NPV true-up) with regard to the approved efficient costs of the pass through event. The adjustment process is usually symmetrical, in that pass through events can have a positive or negative effect on allowed revenues.[273]

Jurisdictional charges differ in that they are costs included at the annual pricing stage (after we have determined regulated revenues for the network, but before we determine consumer charges) so that the service provider collects State based taxes or levies and then provides this revenue to the relevant government agency. Like pass throughs, these are exogenous costs in that the service provider has little to no ability to influence the charges. Generally, these are ongoing costs with a lagged true-up (forecasts against actuals) where the value of the jurisdictional charge is clearly known (albeit after a lag).

As is clear from the above characteristics, corporate income tax differs from the type of costs currently addressed via pass through events or jurisdictional charges. Corporate income tax is intrinsic to the operation of the building block model, not exogenous, and is dependent on the service provider's decisions in each of the non-tax building blocks. Corporate income tax is not an unforeseen event, such as would normally trigger a cost pass through. However, it also differs from jurisdictional charges because of uncertainty around the amount of tax that is relevant to regulated activities.

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271 Dr Martin Lally, *Review of submissions on the AER's review of its regulatory tax approach*, 25 October 2018, p. 6.
272 DoEE, *Submission to the AER's Review of Regulatory Tax Approach*, 23 November 2018, p. 3.
273 The NGR also allows for cost pass through mechanism to be used to vary reference tariffs.

Implementation issues

PwC identified difficulties in determining the actual tax costs in respect of regulated assets for the following reasons:

- Isolating actual tax costs of regulated assets operating within an integrated or consolidated commercial group
- Identifying actual tax paid by upstream investors
- The ability to true-up actual tax payments with respect to transactions relating to consolidated groups and M&A activity
- The amendment of prior year tax positions can be made by the taxpayer or the ATO, sometimes reflecting changes in the application or interpretation of historical tax law altering the timing incidence of tax paid.[274]

This last item could risk price shocks or inter-generational issues, because in some instances it may be that a large number of prior years' tax positions are jointly altered as a result of an ATO assessment, which would mean that current consumers would be liable for tax outcomes referable to many earlier years.

The ATO may be better placed than the AER to address the complex issues affecting the determination of tax outcomes relevant to regulated activities under a tax pass through regime. We would expect that this could involve:

- Increased regulatory oversight by the ATO.
- Increased compliance costs to identify tax payable at the regulated business level.
- New requirements to assess claimable deductions to ensure they are based on an appropriate allocation approach that prevents cross-subsidisation, consistent with the regulatory framework.
- Requiring the ATO to verify the actual tax payments made each year.

The increased regulatory oversight and compliance associated with new information requirements will increase the costs of administering the regime. This will directly impact consumers where it affects the efficient operating costs of the regulated businesses, and indirectly impact consumers where regulatory agencies require more funding to undertake their tasks.

Under our current approach the verification and oversight required to estimate the cost of tax is based on the forecast of efficient costs. The benchmark incentive approach recognises the NSP is best placed to bear the risk for its decisions affecting the costs it incurs relative to our forecasts. As such, the incremental costs of administering the incentive regime are minimal.

Consistent with our discussion paper, for the purposes of this final report, we are not recommending a change to an actual tax pass through approach.

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274 PwC, *AER tax review 2018–Addendum, Expert Advice*, 10 December 2018, pp. 53–54.

Glossary

Term	Meaning
Addendum to PwC Expert advice	Refers to the addendum to the PwC Expert advice. (10 December 2018)
AER discussion paper	Discussion paper released by the AER on 2 November 2018 entitled "Review of regulatory tax approach".
AER initial report	Initial report released by the AER on 28 June 2018 entitled "Review of regulatory tax approach".
Asset	A resource controlled by an entity as a result of past events from which future economic benefits are expected to flow to the entity. For example: electricity poles and wires, gas pipelines and compressors, motor vehicles or buildings.
Asset revaluations	Adjustment (up or down) to the tax cost base of a depreciable asset arising as a consequence of a change in ownership.
ATO Note	ATO's note to the AER received on 10 April 2018, setting out its findings of the potential discrepancies between actual tax payments and the forecast regulatory tax costs for regulated electricity distribution network services provider from 2013-16.
Australian resident investor	An investor considered as an Australian resident for tax purposes.
Australian superannuation fund	An Australian superannuation fund is superannuation fund which satisfies the definition as set out under in subsection 295-95(2) of the Income Tax Assessment Act 1997.
Capitalisation policy	The basis on which the NSP classifies costs as either capitalised expenditure or an immediately deductible expense.
Chain of ownership	Entities or subsidiaries under common control by the ultimate owners of the business.
Confidentiality guideline	The AER's, 'Better Regulation: Confidentiality Guideline', 29 November 2013 as updated or amended by the AER from time to time.
Corporation	A separate legal entity often used to conduct business in Australia. Registered with the Australian Securities & Investments Commission.
Debt-to-equity ratio	A financial ratio indicating the relevant proportion of equity and debt used to finance a company's assets.
Diminishing value	A depreciation method allowed under section 40.72 of the Income Tax Assessment Act 1997. Diminishing value method depreciates an asset's remaining value by a given percentage each year based on the asset's effective life.
Dr Lally report	Expert report by Dr Martin Lally, Capital Financial Consultants Ltd.
Effective corporate tax rate	The effective corporate tax rate is the rate (or %) that is actually paid by the corporate.
Effective life	Is a defined term under section 995.1 under ITAA 1997. The effective life of a depreciable asset is based on how long the asset can be used to produce income. The effective life is a key input used to calculate the annual tax depreciation amount of a depreciating asset.
Energy networks	Electricity networks and gas pipelines regulated by the AER
Face value difference	The difference between the actual tax payment by the regulated entity, inclusive of any tax debit or credit associated with unregulated activities or other taxable expenses/deductions outside of the regulatory framework, and the forecast regulatory tax cost.
Flow through vehicle	An entity that does not in itself have an applicable tax rate. In these structures, income is distributed up the chain to owners who are themselves liable to pay tax depending on their

	particular circumstances.
Gamma	Assumed benefit which will be received by shareholders following distribution of franking credits to those investors.
Government business enterprise	A Government business enterprise is a commercially focused government owned business that operates as a separate legal entity that has been delegated financial and operational authority to carry on a business.
Imputation credit	Some or all of the tax paid by a company is attributed, or imputed, to the shareholders by way of a tax credit to reduce the income tax payable on a dividend distribution.
Low-value pool	A low value pool of assets that cost or have a written down value of less than $1,000. This pool of assets can be depreciated at an annual rate of 37.5%.
Managed Investment Trust	A trust in which members of the public collectively invest in passive income activities such as shares, property or fixed interest assets. It has the meaning given in s275-10 of the ITAA 1997. The withholding tax rate for foreign investors in jurisdictions with which Australia has an exchange of information agreement under the Managed Investment Trust regime is 15%.
Market value	An amount for which an asset should be exchanged for in an open market between a knowledgeable, willing, but not anxious buyer and seller.
Maximum allowable debt	Level of deductible debt permitted under the thin capitalisation rules as set out in Division 820 of ITAA 1997.
McGrathNicol report	Expert report by McGrathNicol on how the various corporate ownership structures of the gas and electricity businesses that the AER regulates may impact on the actual tax paid by the regulated entities.
Membership interest	Any interest or right held by a member of an entity as defined in s960.135 of ITAA 1997.
Minister's media release	Media release issued on 15 May 2018 by the Minister for the Environment and Energy stating that, following a request by the Turnbull Government, the AER would undertake "an investigation into whether electricity networks and regulated gas pipelines are gouging consumers to cover their corporate tax liabilities"
National Tax Equivalent Regime (NTER)	An administrative arrangement under which the relevant taxation laws are notionally applied to certain State and Territory businesses as if they were subject to those laws.
Net present value (NPV)	Net present value is a measurement of dollar value of future cash flows over a certain period in today's dollar terms by applying a discount rate to future cash flows.
Net profit before tax	The profit of entity after deducting the costs directly or indirectly incurred by the entity when producing revenue through ordinary activities. This does not include income tax expenditure.
Network Service Provider	Has the meaning given by Part 1 Section 2 of the NEL and in this notice refers to
Partnership	An association of persons carrying on a business or in receipt of income jointly.
Pre-investor level tax	The tax paid by the entity carrying on the regulated activities, as distinct from any tax payable further up the chain by the owner(s) of the entity.
Prime cost method	A depreciation method allowed under section 40.75 of the Income Tax Assessment Act 1997. Prime cost method depreciates an asset's remaining value by a uniform amount each year based on the asset's effective life. It is also often refers to as the Straight-line method.
PwC Expert advice	Refers to the expert advice report by PricewaterhouseCoopers. (26 October 2018)
RAB multiple	A ratio between the value of the regulatory asset base for regulatory purposes and the sale value of the assets (e.g. As a result of an ownership change).
Regulated assets	Refers to assets that form part of the regulatory asset base as prescribed in the NER.
Revenue	The gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increases in equity, other the increases

	relating to contributions from equity participants.
RIN	Regulatory information notice.
RIN (Electricity)	Regulatory information notices. An instrument under the NEL which allows the AER to gather information from regulated network service providers for the performance or exercise of a function or power conferred on it under the NEL or the National Electricity Rules (NER).
RIN (Gas)	Regulatory information notices. An instrument under the NGL which allows the AER to gather information from regulated scheme pipeline service providers for the performance or exercise of a function or power conferred on it under the NGL or the National Gas Rules (NGR).
Single entity rule	Taxable income of the consolidated group is calculated on a combined basis and included in one income tax return (refer s.701-1 ITAA 1997).
Sovereign wealth fund	A sovereign wealth fund is a state-owned investment fund.
Stamp duty	Stamp duty is a tax on certain transactions and it is imposed by state and territory governments. For example a purchaser of public owned network asset from privatisation process may be liable to pay stamp duty to the relevant state and territory governments.
Standard (statutory) corporate rate	The relevant income tax rate applicable to the corporate entity.
Stapled structure	A stapled structure is an arrangement where an asset entity and an operating entity are bound together, such that they cannot be bought or sold separately.
State owned enterprises	Corporate vehicles established under State law which hold assets owned by the public sector.
Step up/down	Readjustment of the value of an asset for tax purposes - often occurs during acquisition of a business or consolidation.
Tax consolidated group	Companies (and certain trusts and partnerships) that are owned within a group are treated as a single taxpayer for income tax purposes.
Tax liabilities	The amount of tax payment owed by an entity and is responsible for paying to the taxing authority.
Tax loss and accrued tax losses	A tax loss occurs when the total deductions a tax payer can claim for an income year exceed their income for the year. If a taxpayer make a tax loss in an income year they can carry it forward (accrued) and deduct it in future years against income for tax purposes.
Tax pass through	An approach where the regulated tax costs is based on actual tax paid by each energy network.
Tax payments	A tax payment paid to the taxing authority (ATO) by an entity.
Timing effect	Bringing forward a deduction now (e.g. higher depreciation claim) and foregoing an amount of deduction in future years.
Trailing average portfolio	A regulatory estimate of interest rate based on the moving average of past observed rates of interest
Trust	A trust is an obligation imposed on a person - a trustee - to hold property or assets (such as business assets) for the benefit of others, known as beneficiaries.
Underlying difference	The difference between the actual tax payment by regulated entity and the forecast regulatory tax cost within the regulatory framework
Upstream equity participants	Any entities that have a direct or indirect equity interest in the NSP of greater than 10 per cent. This would include a total participation interest as defined in section 960-180 of the Income Tax Assessment Act 1997, but only to the extent that the participation interest is greater than 10 per cent.

Appendix A: Summary of submissions

This appendix summarises the submissions we received in response to the discussion paper.

Summary

APA Group

Any assessment of the reasonableness of the regulatory tax allowance should be conducted in the context of the regulatory regime to preserve the internal integrity of the regulatory regime.

A consistent benchmark should be applied in calculating allowed revenue and tax allowance based on that revenue, otherwise it could reduce both consumer and investor confidence.

The tax regime has no regard to the incentive features of the regulated regime, as it is driven by its own suite of incentives.

The comparison of tax payable and tax allowance must consider revenue impacts of both formal and informal incentive mechanisms. This applies especially to pipeline industry under price cap.

There is a range of corporate structures under which investment in network businesses are held. Some of these structures reflect foreign ownership interests, trust structures, etc. The actual form of the corporate structure has some scope to be fluid as either assets are traded in the international marketplace or tax laws change to favour a particular structure. Hence, it would be difficult to apply a corporate structure in any of the building blocks. The Australian corporate benchmark entity structure should be retained.

Consumers should have confidence that prices will not be increased by upward asset revaluations. Therefore, the regulatory tax allowance, regulatory tax depreciation or regulatory tax deduction for interest expense should not be adjusted to reflect business acquisitions.

As a multi-asset holder, APA raises capital at the corporate level, so does not allocate debt to a particular operating business. It is impossible to determine actual cost of debt applicable to any particular pipeline. AER has recently estimated the cost of debt through Rate of Return Guideline. This should also be used for tax interest expense purposes. Should the AER conclude the actual debt costs has a role in the regulatory framework, it must be examined through broader consultation and analysis process.

Immediate expensing of refurbishment for tax purposes may lead to a timing difference between tax and regulatory regimes. From a regulatory perspective there must be consistency between return on and of capital and the tax allowance. Estimates of refurbishment expenditure should be a business specific forecast or the subject of an industry benchmark.

A move to diminishing balance depreciation may result in an improvement in the regulatory framework in the long term interests of consumers, but this should be approached with caution due to the modelling complexity and resultant reduction in transparency and understandability of the framework. Any such change must be prospective.

For 20 year gas capping, there is no change required to the transmission sector where 20 year depreciable life is already in place.

ATCO Australia

National Gas Objective should be a key driver of the outcomes of this review. The purpose of building blocks is to determine efficient prices that incentivise efficient investment and use of network that is in the long term interest of customers. ATCO is concerned this review may lead to inefficient pricing outcomes.

The regulatory tax framework should:

- not move to actual tax pass through (i.e. retain the benchmark approach to calculating the tax building block);
- maintain the current benchmark entity structure and ownership assumption, with a tax rate of 30%;
- preserve a consistent regulatory approach that insulate customers from changes in market valuation on both the regulatory and tax asset base.

The incentive effect of any amendments to the regulatory approach as a result of expensing refurbishment capex for tax purpose should be carefully considered before any change is made. Any change shouldn't create a perverse incentive to replace assets rather than refurbish them.

Straight line depreciation provides a more economically efficient price signal to consumers as it results in a consistent levels of tax depreciation, relative to diminishing value depreciation. Economic Regulation Authority accepted the straight line tax depreciation method over diminishing value depreciation in ATCO's 2014-19 access arrangement. The National

Gas Objective and the Revenue and Pricing Principles are best met through the adoption of the straight-line tax depreciation method.

The Income Tax Assessment Act allows both diminishing value and prime cost (straight-line) depreciation methods, but once a choice has been made it cannot be changed. A benchmark efficient entity will not always adopt the diminishing value method. Further, for some assets ITAA mandates straight line method.

The long term interest of consumers is best served by incorporating straight line depreciation tax costs into tariffs. This avoids movements in prices as a result of the individual tax circumstances of a firm.

If a 20 year asset life cap is to be adopted, it should be applied prospectively and only for certain assets.

Interest expense adopted in the tax modelling should reflect the same assumptions in rate of return, otherwise it will lead to inconsistency in the framework and depart from incentive based regulation.

Ausgrid

The condensed three-week timeframe for consultation, coinciding with Ausgrid's revised regulatory proposal 2019-24, limited its ability to consider the Tax Discussion paper in detail.

Ausgrid raises a point of clarification. While the discussion paper asserts that all 10 NSPs that responded to the voluntary information request were claiming immediate tax deductions for the regulatory capex allowance, this doesn't align with Ausgrid's response. Ausgrid does not have a tax capitalisation policy separate to its accounting capitalisation policy and that the tax capitalisation policy broadly follows the accounting capitalisation policy. Further, Ausgrid did not disclose any expenditure that had been included in the regulatory fixed asset register and treated as tax deductible for tax purposes.

Ausgrid – supplementary submission

NSW government required a retention value hurdle to be met as part of the transaction of Ausgrid, to ensure the NSW public were better off.

For transaction proceeds to compensate the NSW government for value of tax that would have been paid as a State-owned corporation, the net present value of future tax obligations have been pre-paid to the NSW government as part of the sale price, and the proposed tax pass through approach must be rejected.

AusNet Services

The decision not to maintain the current benchmark approach to tax is welcomed. A move to an actual tax cost pass through regime would not be in the long term interests of consumers and would be at odds with the principles of incentive based regulation. Similarly approaches which are effectively a hybrid of an actual and benchmarking approach should not be adopted.

Maintaining the principle of incentive-based regulation should be a primary consideration of the review. Some of the options raised in the review (such as incorporating immediately deductible capex in the regulatory tax allowance) would result in poor outcomes for customers over the long-term.

Transitional options that would result in retrospective adjustments to previously regulatory approved treatments of existing assets, such as declining value depreciation across new and existing TAB, go against sound principles of economic regulation, including certainty, stability and predictability. These would not be consistent with tax law and would not be able to be implemented by the businesses. While these retrospective changes in approach may benefit customers in the short-term through lower prices, it could result in severe cash flow shortfalls and severely reduce investor confidence.

Applying diminishing value depreciation to 100% of assets in the regulatory allowance is unreasonable. Private sector entities continue to use prime cost depreciation for 40% of their assets – this can't be assumed away as inefficient practice. Prime cost depreciation creates cash flow stability for a business and can smooth prices for customers.

Reflecting the immediate expensing of certain capex for tax purposes in the regulatory tax allowance is not consistent with the principles of incentive based regulation and will not result in lower prices for customers. If this were to be introduced, AusNet would amend its regulatory capitalisation policies to treat refurbishment expenditure as opex, resulting in increased price for consumers. This change would also create an incentive to favour replacements over refurbishments, even if they were a less efficient option. Under the current regulatory framework, revenue recovery is back-ended due to RAB indexation. Introducing this change will further back end revenues and lead to intergenerational inequity.

The materiality of implementing change for gas asset lives in the long run may not be material. If a network is in a steady state then the total annual depreciation expense should not vary materially under different asset lives. The difference may not justify the complexity of transitioning to the new approach. Any transition path should not result in a lower tax allowance.

Consistent with the conclusion reached by the Independent Expert Panel on the Rate of Return, the same gearing (60%) should be adopted for both rate of return and tax calculations.

Australian Pipelines and Gas Association (APGA)

Regulatory and tax frameworks differ significantly, with different objectives and inherent incentives. To simply compare tax allowance against cash tax payable fails to recognise these differences in the framework, objectives and incentives.

The tax pass-through approach should not be adopted.

It is difficult for the regulatory framework to factor in the actual corporate structure of the entities, as it can change within and between regulatory periods. The Australian corporate benchmark entity structure should be retained.

The approach to asset valuation is a key area of difference between the regulatory and tax frameworks. The tax framework has always used original historical cost asset valuation, while the regulatory asset base has been reformed and indexed. These different approaches underpin many of the discrepancies between the tax allowance and the tax paid.

Consumers should not be impacted by asset revaluations occurring on changes of ownership. Regulated asset values are not adjusted on acquisition. Similarly, the regulatory tax allowance should not be affected by the value reflected in a business acquisition.

Given the AER has just undertaken an intensive process to determine the appropriate cost of debt through Rate of Return Guideline Review, this estimate should also be used for the cost of debt for tax interest expense purposes.

The information provided as part of the tax information RIN will not be helpful in determining the reasonableness of the regulatory tax allowance, where the debt outstanding is not adjusted for asset revaluations and the interest rate is based on the Rate of Return Guideline.

Immediately deductible expenditures may lead to a timing difference between tax and regulatory regimes. However, there must be consistency between return on and of capital and tax allowance, and there is a question whether estimates of refurbishment expenditure should be a business specific forecast or the subject of an industry benchmark. These issues require broader consideration and analysis in order to avoid unintended consequences.

The tax information RIN should indicate the extent to which businesses currently apply straight line or diminishing value depreciation for tax purposes, to enable assessment of the impact of any change to the assumed method of depreciation.

A move to diminishing value depreciation would result in the improvement of regulatory framework in the long term interests of consumers. However, businesses are not allowed to change tax methodologies midway and hence changes should be made prospectively.

Regulated gas transmission businesses already depreciate their pipelines over 20 year for tax purposes, therefore the proposed amendment is not required for the gas transmission sector.

Australian Tax Office

The ATO offered its assistance in the consideration of alternative design and administration methods that would take into account the AER's role in serving the long term interests of consumers, as set out in the National Electricity Objective and National Gas Objective.

Consumer Challenge Panel

Tax expense must be estimated in the context of the NEO/NGO and the overall framework of incentive-based regulation.

The primary objective is to obtain unbiased and achievable estimate of the tax paid by the benchmark entity, consistent with the NPV=0 principle. This requires that the assumptions reflect the tax treatment of debt, capex and opex in each of their various forms, and the tax strategies commonly used by networks.

The assumptions used in estimating tax need not be the same as those in estimating the pre-tax revenue building blocks.

Networks should have an incentive to reduce tax paid, with consumers sharing the benefits of any reductions in tax paid.

The current regime uses a benchmark that is unrelated to the actual tax payments and does not change according to the utility's actual tax management strategies. Hence, there are strong incentives for utilities to minimise their tax under the current regime.

Where there is a high level of uncertainty in tax liabilities, a pass-through mechanism can reduce risks and better match tax allowed to the tax obligations. However, it reduces the incentive to reduce taxes. Subject to progress towards a benchmark that reflects the tax position of benchmark entities, a move to tax pass through is not supported.

Actual tax paid is substantially below the allowed tax for privately-owned networks. There has been no path of correction or any benefits passed through to consumers. The dynamic adjustment of the tax benchmark can be an effective mechanism for achieving this.

While the AER currently has a single benchmark for tax it does not follow that this is essential. US regulators have different tax rates depending on ownership and Ofgem includes adjustments for tax benefits for highly geared utilities.

On AER's criteria: The centrality of efficient cost criterion are met under the NPV=0 principle, with any reduction in the level of efficient costs in the long term interests of consumers. Quantitative measures on materiality are needed as an indication of a $ value would assist customers. What is "achievable tax practice" should be contextual and that will depend

on factors such as who the owners are.

Entity structure and ownership: A two tier approach to benchmark tax rates should be considered, for networks involving a company structure (30%) and networks with alternative structures (15%).

Expensing of refurbishment capex: Incorporating immediate expensing of a proportion of the expenditures, in accordance with industry practice, would be in the long term interest of consumers. New refurbishment capex should be immediately expensed. Further work is required to operationalise this approach. Setting a benchmark of proportion of capex to be immediately expensed may not provide a sound benchmark for an individual NSP, but the advantage of the benchmark approach is that it retains the incentives to reduce tax within acceptable limits.

Depreciation approaches: Diminishing value depreciation should be applied for all new capital investments. Subject to the updated RIN data, where a network has used straight-line depreciation for the purposes of tax depreciation of its existing assets, it should continue to apply straight-line depreciation. This is consistent with tax law which does not allow the tax payer to change the depreciation approach either retrospectively or prospectively. For existing assets where the network has applied diminishing value depreciation, but the regulatory approach has applied straight-line depreciation, consideration should be given to the reset of the TAB. The Rules say little about TAB depreciation, while they have specific requirements in RAB depreciation. If diminishing value depreciation is applied to the TAB, it should not modify depreciation schedule in the RAB. Before a decision is made, better understanding of the risks and benefits of amending the network's current TAB is required.

AER should apply the 20-year cap to all new and existing assets at the earliest opportunity. The relevant tax law was introduced in 2002 and all the gas businesses should now have implemented that approach.

Asset revaluation would be complex and add risks to both networks and consumers. There are limitations of the current data on this issue, and extensive analysis is required. Costs to consumers of a higher RAB following a positive revaluation might be substantial and continue over remaining life of the asset. The AER should continue its current approach to the treatment of revaluations in the TAB (and RAB), not recognising changes in market valuations as reflected in sale prices.

The AER should continue with its current proposed approach with respect to self-assessed asset lives and low value pools.

For interest expense, there is a difference in the "above the line" regulatory revenue determination, and a "below the line" calculation of tax allowance. There is no basis for the view that the tax calculation should simply apply the 60/40 debt equity ratio in the draft AER Rate of Return Guideline. Definition of debt and equity for regulatory and tax purposes are not the same.

Implementation: AER should implement any changes that can be achieved with the model prior to the April 2019 decisions. Changes that require a rule change will take longer. These latter changes should be completed prior to the next round of AER revenue decisions in April 2020.

Consumer Challenge Panel – supplementary submission

There should be a clear distinction between the taxable income and the taxation rate. Both contribute to the taxation gap, and taxable income can depend on a network's interpretation of tax rulings.

Having two benchmark tax rates should not impact on the willingness to invest in the sector. Long term investors look to long term returns driven by the fundamental nature of the sector, and the businesses will retain the benefit of a lower tax rate relative to the corporate 30% tax rate.

Special consideration for superannuation companies means consumers continue to pay a higher network charge to subsidise the Government's retirement income objective. This is not consistent with the NEO/NGO.

The Department's submission appears to be dismissive of timing factors as having significant importance relative to the tax rate issues. Dr Lally indicated that there is a NPV benefit and this 'timing' difference matters with respect to the estimation of taxable income.

Ofwat uses the firm's actual gearing and this has not been controversial and is fairer to consumers. While this requires allocation of debt between the businesses in the entity, this has not been seen as overly contentious or difficult. Oftwat also operates a claw-back mechanism for changes in gearing during a regulatory period, but uses the WACC determination rate rather than actual interest rates. There is merit in further examining this approach and its relevance to the Australian regulatory context. The AER should proceed on the basis of 'reasonable' assumptions using publicly available information, ATO advice and current tax law.

US regulators have used blended tax rates that reflect different statutory tax rates of the respective owners where a 'pass-through' structure is used.

Department of the Environment and Energy (included cover letter)

The Department of the Environment and Energy questioned three key aspects of the AER's process in undertaking its Review: the ATO was not closely consulted in the preparation of the Discussion Paper; only a limited subset of publically available information or voluntarily provided material has been relied on in developing the Discussion paper; and, the

timing of the final report if postponed will mean that changes to the AER's regulatory tax calculation model will not be incorporated in time for the April 2019 revenue determinations.

Under the incentive-based model consumers are effectively compensating NSPs for company tax, even where they have no statutory obligation to pay it, and where an NSP pays less company tax than the AER has modelled, consumers do not receive a benefit. Consumers would be better served by an approach where network businesses are only compensated to the extent they need to meet their statutory obligations.

The incentive-based regulatory approach with a common benchmark does not work for tax, as networks do not share any reduction in their calculated tax liabilities with consumers, nor is it used to inform tax in future revenue determinations.

The use of the Australian company tax rate as a common benchmark for setting the tax allowance is inappropriate given only 7 of the 17 NSPs are taxed as an Australian company and no NSP is majority owned by Australian-resident companies whose shareholders are majority Australian. Partnerships, trusts and superannuation funds do not pay Australian company tax and foreign entities who are the beneficiary of a trust or partnership, or have related party transactions with an Australian company, may not be paying tax at the Australian company tax rate.

If the tax rate actually applied to a business is accounted for in setting revenue, saving in the cost of tax could be passed onto consumers. The Final Report should demonstrate that the benchmark approach is that an efficient tax practice, with the benefits passed onto consumers.

Had a cost pass-through approach been applied to historical tax payments, any cost saving from the previous discrepancy would have been passed through to consumers. Even if NSPs were to increase their current tax payments by restructuring to an Australian company, they would be subject to company tax. Consumers would be no worse off, and in addition receive a welfare benefit as revenue previously retained by investors will now be paid as tax.

While the benchmark approach assumes each NSP is a benchmark efficient entity that pays tax at the Australian company tax rate, less than a third of businesses operate under this structure. Where a NSP is a flow-through entity, the NSP does not pay company tax and its actual cost of debt and equity may be lower when compared to a company. In this case, assuming the NSP is a company provides a rate of return above its cost of debt and equity and provides a tax allowance above its actual tax payable. These NSPs are being compensated twice for a single efficiency - the non-payment of company tax. Further exploration is needed on whether it is appropriate for stapled structures to receive any tax allowance.

No evidence has been provided to suggest that unregulated business reduce actual tax paid by the entity group. The presence of an unregulated business could increase the tax paid, as they typically have large values of depreciating assets for tax purposes and the uncertainty of cash-flow may lead to lower levels of gearing.

The provision of an upfront allowance for company tax provides a NPV benefit that may or may not occur until many years' time. Current practice over-compensates for the real cost of tax liabilities.

Other related party dealings, which can operate to reduce tax paid by entities regardless of the type of structure they adopt, may also be a driver in the difference observed.

Even if the Treasury Laws Amendment Bill 2018 passes, there will be many situations (particularly during the transition period) where NSPs will not pay the company rate of tax.

Although the AER does not have access to the tax records of upstream investors and cannot compel this information through its RINs, these upstream investors are well known and tax information relevant to them could be attained through their publically available financial reports.

Department of the Environment and Energy – supplementary submission

Noted that the AER's consultation process include opportunity for ATO comment on multiple occasions.

Endeavour Energy

Incentive based regulation provides long term benefit to consumers and should be maintained. Changing from using a benchmark tax allowance based on the prevailing corporate income tax rate are not warranted. Significant practical difficulties and poor incentive outcomes would arise in departing from current practices.

No change is warranted to amend the tax asset base used for regulatory purposes as a result of a sale of the regulated network. If a transaction price exceeds the current regulatory asset value, these additional costs are paid by the new acquirer and not passed on to customers.

There may be a case for change to the current regulatory regime to adopt diminishing value depreciation, but Endeavour question whether it should be applied to all businesses and whether the choice of depreciation methods should be consistent in setting both the return of capital and tax building blocks. The inherent NPV value of each form of depreciation, intergenerational equity and price path should be considered before a decision is made to apply one form of depreciation over another. If diminishing value is adopted, ATO rules do not allow it to be applied to all assets.

The treatment of refurbishment expenditure should be determined on an asset-by-asset or expenditure-by-expenditure

basis, not on a broad-based benchmark. Otherwise it may distort the current aligned incentives of customers and the network to favour replacement over refurbishment and potentially lead to large intergenerational discrepancies.

In determining interest expense for income tax purposes, there should be alignment of assumptions for gearing and value of debt for the purposes of the rate of return and for income tax calculations.

A capital value of actual debt and equity that differs to that of the total capital value used for regulatory purposes creates a risk that should be borne by the shareholders, not consumers. Otherwise it would break ring fencing rules against cross subsidising unregulated activities.

Endeavour Energy – supplementary submissions

NSW government required the NSW public being better off as a result of the transaction of Endeavour Energy, and in the sale process the future income tax were pre-paid to the NSW government as part of the transaction price in order to allow for this retention value hurdle.

This effective prepayment of future tax obligations needs to be taken into account in the current tax review.

Energy Consumers Australia

There has been on-going real price increases for energy services over the past decade, suggesting the incentive based model for energy network regulation is not working as intended.

Within the regulatory framework and building block model used to determine revenue, the tax allowance provided to networks is generally in excess of actual tax payments. If the regime were changed to making the tax allowance simply a recovery of tax paid, that the lack of incentive would result in privately owned firms simply reducing effort in (lawful) tax minimisation.

The regulatory challenge is how to ensure that energy network businesses are not overcompensated for their tax liabilities without reducing the incentives for efficient cost management.

There is uniform agreement (both consumers and industry) to maintain the benchmark approach and not move to an actual tax pass through. Similarly on entity structure (maintain the 30% Australian corporate tax rate), asset valuations (maintain the current approach) and depreciation (move to a diminishing value depreciation approach for new assets).

The issue of interest expense is problematic. If interest expense is higher than is systematically allowed for in the Benchmark Efficient Entity, it suggests that the gearing ratio is too low.

In principle, the immediate expensing of refurbishments should be applied, but refinement of the benchmarking approach should be further explored. The capping of gas asset lives at 20 years should also be applied.

With the tax allowance currently set at the highest level that a firm could pay, there are questions as to whether the incentive on tax management is too high. Unlike capex and opex incentives, the network business keeps the entire underspend on tax allowance.

Profitability analysis demonstrate that the allowed rate of return is a baseline while the actual return is always higher. This is inconsistent with Capital Asset Pricing Model, which assumes the actual returns will be normally distributed around the expected return. The way the tax allowance currently operates only provides upside risk.

The alternative is to structure the incentives so that businesses are just as likely to be penalised for inefficiency (failure to minimise tax) as they are to be rewarded.

Rather than setting the allowance by modelling, it could be set based on a proxy measure as the average of tax actually paid by networks as a percentage of revenue.

The AER should move swiftly to allow consumers to share the benefits of the network providers existing tax minimisation strategies and to apply any changes to the April 2019 revenue determination decisions.

Energy Networks Australia

Efficient benchmark approach should be maintained within the incentive-based regulatory framework. This is consistent with the entire economic regulation framework, which encourages NSPs to operate efficiently, reveals efficient behaviour and avoids inter-generational equity issues.

The standard approach of using the statutory corporate tax rate (currently 30%) should be maintained as few entities seem to face a different rate and there is no obvious alternative. Individual circumstances are irrelevant in determining a benchmark. There is also an interaction between ownership structure and tax carry forwards. Ownership structures do not appear to be a material driver of the tax difference.

Tax asset base should not be adjusted at the time of a corporate transaction, as such a change would lead to customers paying charges depending on corporate transactions. Consumers do not contribute to purchase price above the RAB, and hence should not receive tax benefit from it.

It can be efficient for networks to adopt DV depreciation for some assets but evidence shows there is no basis for

assuming that diminishing value tax depreciation should be applied to all assets in all networks. The guiding principle should be that diminishing value is used in circumstances where a benchmark efficient operator would adopt it. This requires a case by case consideration of the circumstances in which the network is operating. Any change should be prospective, applying to new assets only, to align with the tax law which does not allow changes to depreciation methods mid-stream. There is more work to be done to determine how to implement this change.

Regulatory tax depreciation should mirror the benchmark efficient approach to tax depreciation. There are intergenerational equity concerns, as consumers gain greater benefit in the earlier stage of an asset life, while many assets are less reliable and require higher maintenance costs in later stages of the life. If the economic value of an asset follows a DV it should be used for the regulatory allowance for economic depreciation. Also, there is an internal consistency issue where the AER has applied changes prospective only for trailing average.

It is not efficient for gas networks to adopt a 20-year tax life for some gas pipeline assets given current tax provisions. While the Discussion Paper appears to assume that tax law currently requires the use of the 20 year statutory capped effective life for gas assets, this cap is not compulsory. Entities should continue to be entitled to choose to self-assess the effective life of gas assets based on their own circumstances.

AER Rate of Return Guideline Independent Panel has highlighted that internal consistency requires that the same approach to gearing and the return on debt must be used when determining the allowed return and the corporate tax allowance. No change to the current approach is warranted. Only if actual gearing differs from the AER's benchmark 60 per cent gearing across NSPs, benchmark gearing assumption should be changed. Debt that sits outside the RAB is irrelevant to the regulatory allowance. Hybrid securities are a side issue, irrelevant to the majority of NSPs.

While immediate deduction for refurbishment expenditure creates a positive net present value (NPV) outcome under the current regulatory approach. There are a number of ways of addressing the positive NPV, but it must be addressed in a way that does not cause adverse consequences, such as incentive for more costly option of replacement rather than refurbishment of assets, intergenerational inequity, and expensing rather than capitalising expenditure to reduce corporate tax payments. The next stage of this process should involve the AER producing a number of specific options for addressing this issue and engaging in a round of consultation with stakeholders. Any changes should not speculate ATO decisions or cause NSPs to move to inefficient methods.

Energy Networks Australia – Supplementary Response

The ENA supplementary submission addresses a number of claims in the Department of Energy and the Environment submission.

In claiming the difference between the regulatory allowance and tax paid is enriching the networks at the cost of consumers, the Department fails to fully consider the drivers of the difference, which is largely due to payments outside the regulatory models and allowances.

The basis of the claim that a pass through approach has not been tested is unclear. This was a direct focus of the stakeholder consultation and discussions throughout the review. The pass-through approach was broadly rejected by expert advisers, and a wider range of stakeholders (including the CCP), with the reasons detailed in a number of AER and expert reports.

The claim that no taxation allowance should be provided where a company structure is not present is inconsistent with a regulatory revenue setting approach.

The proposition that the entire benefit of tax deductions not recovered in regulated revenue allowances should be transferred to energy consumers would represent a fundamental movement away from the benchmark-based approach that applies across Australian infrastructure regulation.

The claim that adoption of a company benchmark is inappropriate because only 7 of 17 NSPs are taxed as an Australian company ignores the more relevant metric — the tax asset base, with 72.3% of regulated asset owners (by TAB value) currently adopt a structure subject to the corporate tax rate.

The claim that consumer would have benefitted if a cost-pass through approach had been adopted in the past ignores a critical point that networks would face an economic incentives for networks to immediately restructure as companies.

The claim that cost savings can only arise through movement to an actual tax pass through approach is incorrect. Similar cost savings can be passed through to consumers through changes in the benchmark efficient level.

It is incorrect to assume information relating to upstream investors can be easily obtained through publically available financial reports.

The claim that consumers would be 'no worse off' were NSPs to restructure and increase their current tax payments in response to a tax pass-through system being adopted, suggests that the AER should change its test to whether consumers would be 'worse off', rather than consider the impact of any proposed change in approach to the long-term interests of consumers in price, quality, reliability and security of supply.

The claim that the ATO is ideally placed to fill in information gaps should be followed up by the AER.

Ergon Energy and Energex Limited

While there are variances between the regulatory tax allowance set by the AER and the actual tax paid to the ATO, which are expected under the incentive based regulatory framework, this does not warrant moving away from the incentive-based regulatory framework and benchmark approach.

The review could blur the line between tax law and regulatory policy. The AER should not seek to undermine tax policies.

The proposed change in the depreciation method from straight line to diminishing value, and the immediate tax deduction of certain types of capex such as refurbishments must be in accordance with tax law, so should be applied prospectively to new assets only.

Applying diminishing value depreciation, while bringing tax depreciation forward, is likely to result in lumpy deductions with current customers benefiting over future customers. Due to the nature of long asset lives, smoothed impact is more equitable to our customers. Implementing the proposed change from straight-line to diminishing value depreciation will be complex, as many assets will remain straight line for a significant time and systems will need to be capable of reporting of multiple methodologies within a same asset class.

The tax benchmark should reflect that certain capitalised costs are immediately deducted. However such assumptions should be made on a basis of consistent treatment across all DNSP, and should clearly state which works are to be so treated, with appropriate endorsement from the ATO. NSPs should not be put in a position to pursue uncertain or aggressive tax positions in order to meet the benchmark. Clear guidelines should be developed on the extent of allowable capitalised refurbishment/repair/overhead costs.

The same estimate of benchmark efficient gearing should be used consistently throughout the regulatory process.

Deductible interest expenses are a matter of tax policy. If tax laws are breached and excessive interest expenses are being claimed, it is the matter for the ATO. If the full interest is legitimately tax deductible, then the proposed reduction in the tax wedge should include a corresponding increase in the gearing ratio.

The compressed timeframes has not given sufficient time to inform a well-considered determination, which may undermine the quality of the AER's findings and any proposal to implement changes, which is not consistent with the national electricity objective.

Any changes to the framework must be prospective. Business decisions and tax payments made in the past are as a result of the tax policy/legislation in place at that time and may no longer be seen as efficient if any changes were made retrospectively.

Evoenergy

The efficient benchmark approach should be maintained within the incentive based framework.

Statutory tax rate should be retained as few entities face different tax rates and there is no obvious alternative.

Diminishing value depreciation may be appropriate, where it would be adopted by benchmark efficient firm in the relevant circumstances. It should not be assumed to be applied to all assets. Any changes should be applied prospectively to new assets only.

Internal consistency requires the same approach be used for gearing and return on debt when determining allowed rate of return and corporate tax allowance.

No change should be made to the treatment of refurbishments without proper consultation and analysis.

Evoenergy expect to be adequately consulted on any proposed changes that may affect its 2019-24 determination. It is concerned about the potential treatment of large mandated Commonwealth Government project, which will be undertaken during the upcoming regulatory period, as tax implications are significant given the mismatch between the timing of revenues and costs recognised for tax purpose.

Jemena

Tax pass through is not warranted. The current incentive framework with regulatory tax allowances based on a benchmark efficient entity provides best outcomes for consumers and efficient investment.

The 30% corporate tax rate should continue to be used as the benchmark tax rate, as it is consistent with the principle of a single benchmark entity in the incentive regulatory framework.

Proposed changes to reflect immediate expensing (tax deductibility) of refurbishment expenditure is contrary to ATO guidance. It will incentivise and reward businesses for immediately deducting. Deductibility of capex should be assessed on specific facts, having regard to the circumstances of the business. If the AER resolve to change the treatment of capex in the regulatory framework, the changes must be prospective and only apply to new expenditure.

Proposed changes to incorporate diminishing value depreciation, while closing the gap on the time value of money gain being achieved by businesses who use diminishing value, would result in intergenerational inequity, if applied to existing

assets that use straight-line depreciation, as it would change the profile of benefits to customers. As the tax rules do not allow businesses to change the basis of tax depreciation after the initial choice has been made, businesses cannot respond to this change in the regulatory framework. Therefore, diminishing value depreciation should only be implemented prospectively.

Similarly, the proposed changes to asset lives for gas pipelines to 20 years should be applied on a prospective basis and only to new assets.

No change to the regulatory framework with respect to TAB revaluations is warranted. Where a business is not compensated for a higher return on and of capital building block, it should not be impacted by a lower tax building block.

With regards to the treatment of interest expense, the four implementation options identified in the discussion paper would create an asymmetry between what is compensated within and outside the regulatory framework. Differentiating interest paid for tax purposes from benchmark debt cost in rate of return would over- (or under-) compensate consumers.

The intention of the review is to better measure the efficient tax costs in the context of long term interests of consumers. Simply aiming to bridge the gap between allowance and actual tax paid would lead to sub-optimal outcomes.

Joint businesses (SAPN, Citipower, Powercor, AGIG, United Energy)

Current tax laws give gas network businesses a choice to adopt longer than 20 year asset lives. It should be accepted that the benchmark efficient practice could encompass either the 20 year lives or self-assessed lives, as allowed for by tax legislation since 2002.

While some networks may claim tax deductions (for example, due to differences in gearing) which differ from the regulatory debt allowance, this is consistent with the incentive framework and is not an indication that a change needs to be made. Debt that is outside of the regulatory asset base is irrelevant to the regulatory allowance.

Treating refurbishments and replacements consistently in the tax framework, encourages networks to refurbish assets where it is efficient to do so. A change to provide for immediate expensing of some categories of capital expenditure, such as refurbishments will incentivise networks to replace rather than refurbish. This is not in the long term interest of consumers and will not contribute to the achievement of the national electricity and national gas objectives. While the NPV=0 condition is important, it is only one factor in assessing whether any change in approach is required. The possibility that immediate expensing may have a benefit to consumers in the short term but disadvantage future customers is not adequately addressed.

Josephine Doueihi

The comparison of the tax payable per the corporate tax returns to the regulatory tax allowance was not a comparison of like-for-like. The AER may want to consider performing the comparisons by splitting tax return into regulated and unregulated activities, and/or comparing the tax allowance to actual income and expenses in the tax return. If the discrepancy in the tax payable and the regulatory allowance is not due to unregulated activities, it may be the difference between actual and forecast regulated activities.

The gearing for tax allowance should not be adjusted, as this would be inconsistent with building block framework.

AER should decide what tax structure a benchmark efficient firm should have and apply it to all regulated entities, rather than applying multiple benchmarks. Consumers should not be disadvantaged based on differences in tax structure or benchmark.

AER may consider using actual capex expenses and actual depreciation, reducing the gap between forecast and actual.

Tax laws do not allow switching between straight-line and diminishing value depreciation. Switching to diminishing value depreciation will disadvantage entities currently using straight-line depreciation.

The proposed reduction in tax asset lives for gas pipeline assets should be applied, but to ease implementation it should only apply to new assets.

Costs associated with privatisation, M&A and stamp duty should not be part of tax allowance as they are not costs in regulated services.

Network Shareholders' Group

Tax cost pass through is not in the long term interest of consumers, as its benefits are unclear, difficult and costly to assess, and could have adverse outcomes.

Changes to the regulatory approach to estimating tax are not required. The current regulatory tax approach (including the regulatory treatment of capital expenditure, depreciation and the rate of return) ensures consistency within and across the regulatory system. Changes which seek to reflect common practice may not be efficient or provide incentives for efficiency.

Many of the concurrent reviews underway in the energy sector focus on single-issues, without adequately considering the inter-relationships and how each review, decision and change delivers positive outcomes in the long-term interests of consumers.

Retaining an incentive-based approach to a benchmark efficient entity is in the long-term interests of consumers. The incentive-based approach ensures customers pay no more than the efficient costs, encourages NSPs to achieve efficiencies and apply tax practices that are efficient, and minimises the cost of administering the regulatory framework. Estimating the efficient costs of complying with tax liabilities by reference to a benchmark efficient entity insulates customers from volatility of tax payments and changes in ownership, maintains consistency with regulatory benchmarks for the regulated rate of return and enables benchmark assumptions to be reviewed from time to time.

It is appropriate that a benchmark efficient entity be subject to the 30% corporate tax rate because more than 70% of NSPs are taxed as a company, the applicable rate for flow through structures may be greater than 30%, proposed legislative changes will limit the availability of concessional tax rates in respect of stapled structures going forward, and it does not distort decisions regarding ownership and structure. Applying an alternate structure would penalise Australian companies, make some NSPs unable to replicate the benchmark, and increase cost to customers due to loss of imputation credits. Using blended tax rate from multiple structures is complex, inconsistent with tax legislative framework, and creates winners and losers. There are current reviews on stapled structures and vehicles for offshore investors, which are expected to reduce the use of these structures and vehicles.

The proposed change to a diminishing value depreciation approach will have a significant impact. Tax law does not allow for the depreciation method of an existing asset to change. Imposing diminishing value for all NSPs may provide an incentive to choose a method that may be less efficient. Enabling an NSP to elect diminishing value or straight-line approach for new assets reflect the most efficient approach. Prior to making any changes, the AER should fully consider the limitations of the data available.

Immediate expensing (deductibility) of some capital expenditure categories may not be common or efficient. This change is likely to be subject to significant implementation and transition issues. General application of the approach has potential to create perverse outcomes, as there are situations where it is less efficient and it incentivises replacement rather than refurbishment of assets. The immediately expensing of capital items for tax purposes could lead to sub-optimal asset replacement decision and policies.

Interest expense must remain part of the incentive based framework and be consistently determined with the regulatory estimates of the efficient cost of debt for a benchmark efficient entity. A cost pass through of interest expense would not be in the long-term interests of consumers. Adopting a different benchmark cost of debt for tax purposes is inconsistent, as it would require the AER to determine that there is a different efficient asset value, gearing and cost of debt to be applied for tax purposes than for revenue purposes.

Estimating the efficient cost of complying with tax obligations must be based on the RAB and TAB and not re-valuations or acquisition prices. To do so would conflate the value and service ascribed to unregulated services and activities, distorting markets and potentially leading to customers of regulated services subsidising or being subsidised by unregulated services.

Origin Energy

A change to the method of calculating benchmark regulatory tax is not warranted.

Continued application of an incentive based method is consistent with the intent of the national electricity and gas objectives.

Current entity ownership structure has little effect on tax difference, therefore changing the standard corporate rate is not warranted.

A fuller understanding of the nature of tax losses carried forward will have a material bearing the treatment of other elements such as depreciation.

Where practicable, there should be consistency with the ATO's treatment of tax expenses and the regulatory treatment. If the AER allows certain capex included in the RAB to be immediately expensed for tax purposes, then network determinations should include a forecast of immediately deductible capex.

DV depreciation is a more appropriate depreciation method, but changing to this method for existing assets is problematic, so only new assets should change to DV.

The statutory cap of 20 years for the effective lives of gas transmission and distribution assets should be applied to new capex, but not to existing assets, to remove the prospect of any permanent uplift in the TAB.

Until further information is available, the TAB should not be adjusted in response to market transactions for regulated assets, thereby preserving a consistent regulatory approach to insulate consumers from changes in market valuations, both on the RAB and the TAB.

In determining interest expense, to ensure consistency between the different building block components, the AER benchmark gearing ratio of 60% and benchmark cost of debt should be adopted for both regulatory and tax calculations.

The tax pass-through method may achieve short-term reductions in the tax component of the networks' revenue allowance, but is unlikely to deliver long-term efficient tax management. Therefore, it is inconsistent with the principles of

incentive regulation, risking internal inconsistency and perverse outcomes.

TransGrid

An efficient benchmark entity approach and the standard approach of using statutory corporate tax rate (currently 30%) within the incentive-based framework when estimating the efficient cost of complying with tax obligations should be maintained.

The tax asset base should not be adjusted at the time of a corporate transaction.

The calculation of interest expense should align with the gearing and the return on debt used for the benchmark rate of return. This is consistent with the incentive-based framework allowing businesses to take the risk to depart from the benchmark.

The current approach should remain for the treatment of refurbishment costs as this option encourages businesses to maintain their networks at significantly lower cost than replacing assets.

Businesses should have the option to select whether to adopt straight-line or diminishing value approach according to the individual circumstances. Any changes should be made on a prospective basis only, aligning with the tax rules which do not allow for switching depreciation methods.

Further consultation is required on the proposed adoption of diminishing value method, as it cannot be applied on some of the asset classes under the income tax rules.

The cumulative effect of other policy and regulatory interventions should be considered, as they have the potential to undermine efficient investment and the benefits it brings to consumers.

Appendix B: Historical overview of tax review process

In our tax review we investigated the nature of the identified difference between the regulatory forecast of tax costs and actual tax payments. We examined the drivers of any tax difference and considered whether changes to our regulatory tax approach are required. We sought to identify whether an alternative regulatory treatment will better measure efficient tax costs. We considered how recently introduced or imminent tax legislation changes will impact any difference between our estimate of tax and what the businesses pay.

An overview of our historical approach to tax allowances and the process we followed in this review is set out below.

AER's approach to tax allowances prior to this review

Tax-related (gamma) component of our revenue determinations

- Since 2009, we repeatedly sought to reduce tax allowances based on the available evidence when making our regulatory determinations, leading to many appeals under the limited merits review regime.
- The first time our tax allowance (and specifically the gamma parameter) was appealed was in 2010 by three electricity networks in Queensland and South Australia.[275] By the time the Australian Competition Tribunal reached its decision in that case, there were appeals by another six networks.[276]
- In 2011, the Tribunal overturned our position and increased tax allowances for the first three networks. This Tribunal decision flowed through to all outstanding appeals and increasing consumer bills by around $925 million ($nominal). However, the Queensland government directed its electricity DNSPs not to recover $490 million of this increased revenue.
- In 2012, the AEMC made a series of rule changes, which paved the way for our Better Regulation reforms in 2013. With these reforms in place, we amended our benchmark approach to reduce the tax allowance (through a higher gamma), starting with decisions in 2015.
- In 2015, five NSW/ACT energy networks appealed against the size of the tax allowance set under our new approach.[277] They were successful on this issue before the Australian Competition Tribunal, but the Full Federal Court upheld the AER position on appeal. We subsequently successfully defended our position at a second Full Federal Court hearing (over the SA Power Networks determination).

275 Energex, Ergon Energy and ETSA Utilities (now SA Power Networks)

276 Jemena Gas Networks in NSW, and five Victorian electricity distribution networks (United Energy, SPI AusNet (AusNet Services), CitiPower, Powercor and Jemena Electricity Networks)

277 Ausgrid, Essential Energy, Endeavour Energy, and ActewAGL (now Evoenergy)—electricity; plus Jemena Gas Networks.

- Our success at the second Full Federal Court caused four other networks businesses to drop outstanding appeal proceedings; two other networks persisted with their Tribunal appeals but were unsuccessful.[278] The direct revenue impact in these matters under appeal was $500 million (an avoided increase in customer bills).
- This key aspect of our tax approach is now settled.

Concerns raised by consumer stakeholders over the AER's tax allowance

- Consumer representatives stated that our tax allowance was too high in a number of submissions. In most of these submissions the focus was on gamma. We pursued this issue through the appeal processes described above.
- Consumer submissions in 2017 and early 2018 asked the AER to examine whether our forecast of tax costs materially differed from the actual tax payments made by regulated networks.[279] Consumers were concerned that tax payments were below the AER's forecasts and so they might be paying more than the efficient cost of providing electricity and gas services.
- In May 2017, as a result of the first tranche of these consumer submissions, we commenced internal work on this issue. We also commissioned an external report on ownership structures and tax implications of those ownership structures.
- In late July 2017, staff level discussions commenced with the ATO, DoEE and the Commonwealth Treasury.
- On 10 August 2017, a staff level inter-agency working group comprising members of the AER, ATO, DoEE & Treasury met for the first time. This working group sought to coordinate an examination of both forecast of tax costs and tax payments.
- From August 2017 to April 2018 the working group met periodically focusing on the ATO verifying the amount paid in tax by regulated networks.

Commencement of the AER's current tax review

- On 10 April 2018, we received a note from the ATO with qualitative (not quantitative) findings on the tax difference and potential drivers causing an apparent material difference between the provision for tax costs in AER determinations and the actual tax payments made to the ATO by the regulated networks.[280]
- On 3 May 2018, the Minister for the Environment and Energy requested that we investigate this issue and produce a final report with recommendations by December 2018.[281]

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278 CitiPower, Powercor, United Energy and AusNet Services dropped their gamma appeals; ActewAGL (gas) and Jemena Electricity Networks proceeded with their appeals but were unsuccessful.

279 For example, see Consumer Challenge Panel (CCP) 9, *Submission to the AER, Response to TransGrid for a revenue reset for 2018-19 to 2022-23*, 12 May 2017, pp. 36–38, 80–83; Consumer Challenge Panel (CCP) 9, *Submission to the AER, Response to draft decision and revised proposal for revenue reset for Murraylink for 2018-23*, 29 January 2018, p. 36.

280 ATO, *Note to the AER*, 10 April 2018.

281 The Hon Josh Frydenberg, Minister for the Environment and Energy, *Letter to the AER re: tax allowances*, 3 May 2018.

- On 15 May 2018, we publicly initiated the review, publishing an issues paper, the ATO note and the Minister's letter. The issues paper outlined the proposed scope of the review, and assessed the publicly available information on the regulatory provision for tax costs and tax payments.

Review timeline and milestones

An overview of the review's timeline and milestones is set out below.

Table B.1 Review timeline and milestones

Date	Milestone
3 May 2018	Minister for the Environment and Energy requests that the AER investigate and produce a final report with recommendations by December 2018
15 May 2018	AER publically initiates the review by releasing an issues paper
31 May 2018	Submissions on the issues paper received
28 June 2018	Initial report published
18 July 2018	Public forum held
26 July 2018	Submissions on initial report received
August-September 2018	Stakeholder engagement on RINs to be issued to regulated networks
17 August 2018	Voluntary information requests issued to regulated networks
31 August 2018	Issuing of draft RINs to regulated networks
Late August/Early September 2018	Voluntary information responses received from regulated networks
28 September 2018	Submissions on draft RINs received from regulated networks
9 October 2018	Issuing of final RINs to regulated networks
26 October 2018	Final RIN responses received from regulated networks
2 November 2018	Discussion paper published along with two expert reports from PricewaterhouseCoopers and Dr Martin Lally
7 November 2018	Public forum held
23 November 2018	Submissions on discussion paper received
17 December 2018	Final report and recommendations published along with addendum report from PricewaterhouseCoopers

Stakeholder engagement during the review

We recognise that effective and meaningful engagement with stakeholders across all our functions is essential to fulfilling our role, and it provides stakeholders with an opportunity to inform and influence what we do. It helps us to make better decisions, enhances the

transparency and predictability of our regulatory activities and processes. This builds stakeholders' trust and confidence in the regulatory regime.

We actively engaged with stakeholders throughout the tax review process. Our engagement included seeking written submissions on papers published by the AER (issues paper, initial report and discussion paper), holding public forums, consulting informally and formally with the regulated networks throughout the RIN development process, and engaging with individual stakeholders in bilateral discussions and meetings.

An overview of our engagement with all our key stakeholders is set out below. A list of the written submissions we received is included at the end of this appendix. All of the written submissions we received throughout the review are available at our website: https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/review-of-regulatory-tax-approach-2018.

Government agencies (ATO, DoEE and Commonwealth Treasury)

After the review commenced we provided periodic formal updates to the inter-agency working group. These updates were timed around each significant review milestone.

Throughout the review we engaged in extensive staff level contact with both the ATO and the DoEE. We also provided Treasury staff updates on the progress of the review. Regular meetings took place between us and the ATO and DoEE to discuss relevant issues and the progress of the review. For example, we consulted with the ATO on how to best frame the questions requesting tax information and sought feedback on our proposed draft questions for the RINs.[282] Representatives of the ATO and DoEE also attended the two public forums we organised and we also received written submissions from both agencies on our November discussion paper.

Regulated networks

Regulated networks engaged with us during the review process in a variety of ways. For example, regulated networks were well represented at both public forums and a number of them provided written submissions at different stages of the review process.

Further, we undertook extensive consultation with the regulated networks in relation to our requests for tax information. Following the publication of our initial report we conducted a dozen bilateral meetings with regulated networks to discuss our proposed information requests. As a result, in August and September 2018 most of the regulated networks voluntarily provided core tax information to us.

We were also able to use our formal information gathering powers under section 28F of the NEL and section 48 of the NGL by developing RINs to collect more detailed tax information.[283] We issued draft RINs at the end of August 2018, and consulted on these

282 No comments were received.

283 The RINs we issued to the regulated networks asked more detailed questions in several areas and included all the information requested in the voluntary phase; where regulated networks had already provided this information voluntarily they were simply able to state ‘already provided’ in response. Regulated networks who had not provided core tax information voluntarily were required to do so by the RINs.

throughout September 2018 in accordance with NEL and NGL requirements. Final RINs were served on the regulated networks on 9 October 2018, with responses received by the end of October 2018.

Consumer groups

The Consumer Challenge Panel (CCP) actively engaged with us throughout the review by providing written submissions on our review papers, and attending and presenting at our public forums. We also had a number of discussions with CCP members about relevant topics during the review.

The ECA provided us with written submissions on our review papers and attended the public forums. The MEU also provided us with written submission on our review papers.

Networks associations/Investors group

Networks associations and investors group (such as the ENA, APGA and NSG) participated in the review's consultation process by providing written submissions on our review papers, and attending and presenting at our public forums. We also had a number of individual discussions with these groups primarily around our proposed information requests.

Other issues relevant to the review process

A number of issues affected the way we conducted our review. These issues are discussed below.

Information gathering constraints

The issues paper we released at the commencement of the review identified gaps in the tax information we were able to use in our analysis. We 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.[284] Given this, in our initial report we proposed using our information gathering powers under the NEL and NGL to issue RINs to obtain detailed tax information from the regulated networks. [285]

At the July 2018 public forum we provided an overview of the potential questions that could be included in the RINs. It was evident that stakeholders were concerned the potential questions could not reasonably be answered in the time available. Stakeholders noted that the AER would have to consider the costs of the regulated networks complying with the RIN and submitted that these would outweigh the benefits. We subsequently undertook an intensive engagement phase where we met with individual regulated networks to discuss the tax information we were intending to collect through the RINs. During this process we also proposed requesting certain information be provided to us on a voluntary basis. This would allow us to gather any readily available information earlier than available under the legislated

284 AER, *Review of regulatory tax approach – Initial Report*, 28 June 2018, p. 2.
285 *AER, Review of regulatory tax approach – Initial Report*, 28 *June 2018*, p. 2.

RIN process, thereby providing us with more time for the analysis of the information, and reducing the burden on the regulated networks to provide a significant amount of information at once.

The timeframes associated with the exercise of our formal RIN powers did not facilitate the inclusion of the full analysis of the material in our November 2018 discussion paper. Our discussion paper was based on the first tranche of tax information voluntarily provided by the regulated networks. Our consideration of the information provided in response to the RINs has informed our findings in this final report.

Information sharing constraints

Both the AER and the ATO are restricted in what specific tax information they can share with Government agencies and other stakeholders.

The ATO acknowledged this limitation in its note to the AER in April 2018, which stated:

> We are only able to provide limited information to you as information that is 'protected', that is, disclosed or obtained under or for the purposes of a taxation law, that relates to the affairs of an entity and that identifies, or is reasonably capable of identifying the entity cannot be divulged by the ATO to the AER.[286]

Generally, tax information obtained under tax law is treated as confidential and there is a strict regime around accessing and disclosing that information. We understand the ATO is primarily permitted to disclose tax information only for law enforcement reasons.[287]

As a result of these restrictions, the ATO was only able to provide us information of a general nature or in aggregated form. This is reflected in the ATO's note which only contained broad, qualitative statements on the tax difference and likely drivers. It also meant that we had to commence our own investigations to obtain the relevant tax information we required for our analysis.

We are also limited in the tax information we can share with the ATO and other stakeholders. During the course of our review, we received information provided voluntarily by the regulated networks in response to the AER's information requests. Confidentiality was claimed over this information and the regulated networks made it clear that they would be unlikely to provide information in response to the voluntary request for information if the AER did not maintain the confidentiality of the information. This would have significantly impacted the review's progress. We also obtained detailed tax information from regulated networks using our compulsory information gathering powers.[288] Confidentiality was also claimed over this information.

Under s.44AAF of the *Competition and Consumer Act 2010* (CCA) the AER is required to take all reasonable measures to protect from unauthorised disclosure information that is given to it in confidence; or that is obtained by the exercise of its compulsory information gathering power. Section 44AAF(3) of the CCA authorises us to disclose information given to us in confidence or obtained by compulsion. However, this authority only allows us to share

286 ATO, *Note to the AER*, 10 April 2018.

287 See Division 355 of Schedule 1 of the Tax Administration Act 1953.

288 NEL Section 28F, NGL section 48.

the information with a limited number of entities.[289] The listed entities do not include any of the government agencies involved in this review. We note the facilitation of information sharing arrangements with these government agencies would require legislative change.

Expert tax advice

Throughout the review we sought to augment our knowledge and expertise on tax matters by seeking the advice of experts. As noted above, we actively engaged with the ATO as we considered they were ideally placed throughout the review process to comment on tax matters, and particularly the process of assessing tax from a government perspective.

In addition, we retained PwC as our primary expert tax advisors. The particular advantage of a private sector advisor was its familiarity with tax management practices from the perspective of regulated network businesses. We also engaged as an expert advisor a recently retired senior level ATO staff member. This ex-ATO staff member was previously the lead ATO staff member assigned to the inter-agency working group on the tax difference.

289 These entities are: the Australian Competition and Consumer Commission, the Australian Energy Market Commission, the Australian Energy Market Operator, the Clean Energy Regulator and the Climate Change Authority.

List of submissions received throughout the review

Table B.2 List of submissions received throughout the review

Review Stage	Number of submissions	Submission by	
Issues paper	16	APA Group	Jemena
		AusNet Services	Joint submission by Ausgrid, AustralianSuper & IFM
		Australian Pipelines and Gas Association	Joint submission by SA Power Networks, Australian Gas Infrastructure Group, Citipower, United Energy & Powercor
		Business SA	Josephine Doueihi
		Consumer Challenge Panel 22	Major Energy Users
		Energy Networks Australia	Network Shareholders' Group
		EnergyAustralia	TransGrid
		Ergon Energy & Energex	
		Infrastructure Partnerships Australia	
Initial report	15	APA Group	Infrastructure Partnerships Australia
		AusNet Services	Joint submission by SA Power Networks, Australian Gas Infrastructure Group, Citipower, United Energy & Powercor
		Australian Pipelines and Gas Association	Josephine Doueihi
		Consumer Challenge Panel 22	Major Energy Users
		Endeavour Energy	Network Shareholder's Group
		Energy Consumers Australia	Power and Water Corporation
		Energy Networks Australia	TransGrid
		Ergon Energy & Energex	
Discussion paper	24	APA Group	Endeavour Energy supplementary submission
		ATCO Australia	Energy Consumers Australia
		Ausgrid	Energy Networks Australia
		Ausgrid supplementary submission	Energy Networks Australia supplementary submission
		AusNet Services	Ergon Energy & Energex
		Australian Pipelines and Gas Association	Evoenergy
		Australian Tax Office	Jemena
		Consumer Challenge Panel 22	Joint submission by SA Power Networks, Australian Gas Infrastructure Group, Citipower, United Energy & Powercor
		Consumer Challenge Panel 22 supplementary submission	Josephine Doueihi
		Department of the Environment and Energy	Network Shareholder's Group
		Department of the Environment and Energy supplementary submission	Origin Energy
		Endeavour Energy	TransGrid