Australian Gas Infrastructure Group

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L6, 400 King William Street
Adelaide, SA 5000 Australia

PO Box 6468, Halifax Street,
SA 5000 Australia

+61 8 8227 1500

info@australiangasnetworks.com.au

australiangasnetworks.com.au

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Mr Warwick Anderson
General Manager - Network Finance and Reporting
Australian Energy Regulator
GPO Box 3131

CANBERRA ACT 2601

Dear Warwick

Voluntary Provision of Tax Information to the AER Tax Review

I refer to your letter to Craig de Laine dated 17 August 2018 seeking a voluntary provision of information relevant to the Australian Energy Regulator's current regulatory tax review. The Australian Gas Infrastructure Group (AGIG) welcome the opportunity to assist the AER to understand matters that are relevant to this review. The purpose of this letter is to outline the information that accompanies this letter, and to provide the AER with a guide to interpreting that information. The information that accompanies this latter relates to the following regulated entities:

- Australian Gas Networks – South Australia
- Australian Gas Networks – Victoria and Albury, and
- Multinet Gas.

I specifically refer to the three information requests noted in the body of the letter, and have sought to also address the queries as noted in Appendix A.

There are two components to this response; an outline of the information which accompanies this letter to assist the AER and some further, broader comments which may assist in interpreting the information and deriving policy-relevant conclusions from it. The outline of the information, as well as the information itself, are contained in a confidential appendix to this letter.

Comments on the interpretation of the information provided

Tax asset base

The majority of the difference between the tax that is paid in respect of the activities undertaken by regulated businesses and the assumptions adopted in the AER's modelling, relates to differences in the values of assets in the tax fixed asset registers (tax-TAB) compared to those applied in the AER's regulatory tax calculations (the regulatory-TAB). In turn, the majority of this difference in assumed taxation values reflects the effect of transactions in the relevant assets, which cause a resetting of the tax-TAB, but have not led to a resetting of the regulatory-TAB.

Consistent with the arguments that have been advanced to the AER already, caution is required in the conclusions that are drawn given that the value of assets in the tax-TAB are materially higher than those in the regulatory-TAB.

This outcome has arisen as a consequence of the deliberate action of all the Australian regulators that have applied a post-tax approach to revenue determination to ignore any effect that transactions in assets may have for the regulatory-TAB. This policy dates back to the very first decisions after the privatisations of assets in Victoria, when the regulator in question consciously determined a "benchmark" opening regulatory-TAB equal to the opening RAB, ignoring the potential that existed at the time for the privatised businesses to write-off for tax purposes much higher amounts. Since that time, virtually all of the energy network assets have been traded again in some form (save for the assets remaining in public hands or those only recently privatised) and the same principle of carrying-forward the regulatory-TAB as a benchmark unaffected by the transaction has been applied.

Carrying-forward the regulatory-TAB and ignoring the effect of transactions in the assets was, and remains, a key principle that serves the long-term interests of customers. One of the underlying principles of Australian regulation has been the desirability of relying on benchmark rather than actual information – including transactions in assets – when setting regulated prices. This includes ignoring the actual leverage employed by firms when determining the WACC, as well as carrying-forward the RAB independent of subsequent transactions.

Ignoring such decisions shields customers from the consequences of the commercial decisions made – and risks taken – in such transactions. Ignoring the effect of transactions when calculating the regulatory-TAB (and RAB) is just one further outworking of this policy, and reflects a symmetric and consistent treatment of all aspects of regulatory (including financing) decisions. We note that the Australian policy of carrying the regulatory-TAB forward in the same manner as the RAB has since been copied by the New Zealand regulator (the Commerce Commission),[1] which reversed its earlier practice of seeking to apply more closely the tax effects of transactions.[2]

Moreover, if the AER was to attempt to take account of the effect of asset transactions when determining the regulatory tax allowance, then focussing on the potential tax *benefits* of the *acquirer* of the asset will only yield part of the total tax consequence. In many cases, transactions in assets will also give rise to *negative* tax consequences for the seller of the asset, and it is quite plausible that the negative tax implications of the seller will exceed the tax benefits of the acquirer. This potential is most easily illustrated for the case where a physical asset is traded. In this circumstance:

- the tax base of the acquirer will be set at the purchase price of the asset, but
- the seller of the asset will pay tax on the profit on disposal, and
- ordinarily, the tax detriment to the seller will exceed the tax benefit to the buyer, once the time value of money is taken into account.

This outcome is illustrated in the following very simple example.

Figure 1: Simple example of tax consequences for buyer and seller of an asset

Assumptions	
Discount rate	7%
Tax rate	30%
Remaining tax life of asset	10
Sale price of asset	100
Tax value of asset to seller	10

Year	0	1	2	3	4	5	6	7	8	9	10
Seller											
Tax profit on disposal	90.00										
Tax payable	27.00										
Buyer											
Write-up in asset for tax purposes		90.00									
Additional tax depreciation		9.00	9.00	9.00	9.00	9.00	9.00	9.00	9.00	9.00	9.00
Tax effect of additional depreciation		-2.70	-2.70	-2.70	-2.70	-2.70	-2.70	-2.70	-2.70	-2.70	-2.70
NPV of tax savings	-18.96										
Seller and buyer combined											
Total tax effect of transaction (NPV)	8.04										

The actual tax effect on the seller will depend on the precise structure of the sale; however, it would be expected that most of the transactions in assets that have occurred would have created a tax

[1] *Commerce Commission, 2010, Input Methodologies for EDBs and GPBs, paragraphs G2.13-G2.24.*
[2] *Commerce Commission, 2004, Gas Control Inquiry – Final Report, paragraphs 10.25-10.39.*

liability for the seller of the asset (for example, triggering a material capital gain that otherwise may not have occurred for many years).

It is noted that, when the New Zealand Commerce Commission considered whether to follow the tax effects of transactions more closely, the Commission acknowledged that a tax liability would typically be created for sellers of assets, and agreed that those negative consequences should be applied to offset the tax benefit to the acquirer when calculated future regulatory tax allowances.[3] The need to offset the tax detriment of the seller against the tax benefit of the buyer had also been acknowledged earlier by the Commerce Commission's adviser, Dr. Lally.[4]

Accordingly, we submit that the current approach of ignoring the effect of asset transactions on the regulatory-TAB (and RAB) remains good regulatory practice. In addition, the alternative of simply recognising the tax benefits to acquirers of assets would represent an incomplete consideration of the total tax effects of asset transactions. We would welcome the opportunity to assist the AER with any further information in relation to the above, although we would caution that the acquirer of an asset need not be privy to the tax circumstances of the sellers.

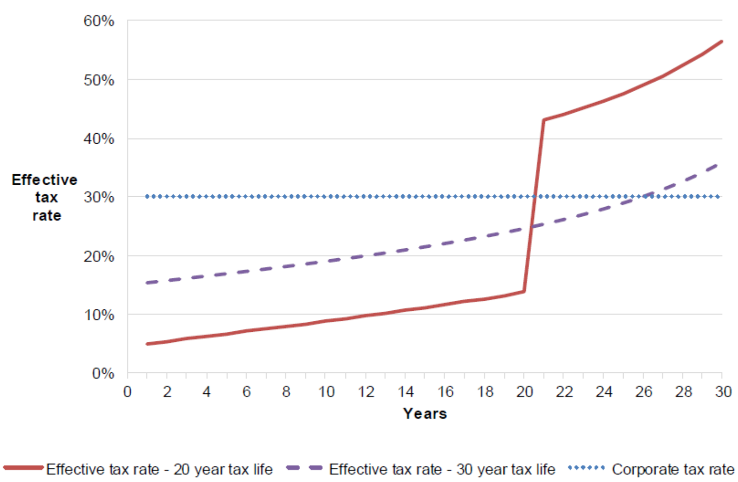
The discussion above relates to the question of what is the most appropriate treatment of asset transactions when deriving regulatory tax allowances on a going-forward basis, and we note our agreement with the comments of the AER's adviser, Dr. Lally that it would be inappropriate to apply changes in approach retrospectively.

Tax outcomes need to be considered over an extended period

There are often differences between the rates of depreciation used in tax returns and those applied in the AER's regulatory modelling, as well as differences in the classification of expenditure between capital and operating (revenue account) between these contexts.

It is important for the AER to take a proportionate response to these differences. Applying a faster deduction for tax purposes merely results in taxation being deferred, it cannot result in tax being avoided altogether. Thus, to the extent that a regulated business obtains faster deductions than the AER assumes, its taxation liabilities will rise above (i.e., as assets become depreciated faster) the tax allowance in the AER's revenue calculations in the future as actual tax deductions are exhausted, but the regulatory model assumes they are not. This was summarised well in the AER's own figure, which we reproduce below.

Figure 2: Effect of tax asset lives of effective tax rates



Source: AER, 2018, Review of Regulatory Tax Approach: Initial report, p16

[3] Commerce Commission, 2010, Input Methodologies for EDBs and GPBs, paragraph G2.20.
[4] Lally, M. (2004), Review of submissions on tax treatment in the Commerce Commission's cost benefit analysis, p.11-16.

In addition, we also think it is important for the AER to consider in its analysis the additional complexity that would be associated with modelling the taxation system with more "accuracy" when doing regulatory calculations, and weigh this against the perceived benefits of such an exercise. Indeed, the work that the AER has undertaken on this matter to date should underscore this concern.

Interest deductions

Where businesses have been acquired for a value higher than their RAB, subsequent tax returns will include a higher amount of interest as a deduction than would be implied by the AER's regulatory tax modelling.

As discussed earlier, the use of benchmark assumptions about all finance-related matters has been one of the underlying principles of Australian regulation, and is one that serves the long term interests of customers. While it is the case that our interest payments (and, behind this, gearing levels and actual TAB values) exceed the amounts implied by the AER's benchmark assumptions, this is affected by recent acquisitions (and is one that brings with it some risk).

Accordingly, we submit that, when analysing information pertaining to interest deductions, the AER should make the relevant adjustments to remove the effect of differences in financing decisions.

A broader view of tax is needed – dividend withholding tax

A fair comparison of a regulatory tax allowance to the actual tax paid by a regulated businesses also requires a broader view of actual taxation, and also include dividend withholding tax within the set of actual taxes.

Where firms pay dividends to foreign residents, a taxation liability arises (dividend withholding tax) unless the dividend is fully franked (in which case the dividend withholding tax is not applicable). Thus, dividend withholding tax operates as a *de facto* minimum amount of company tax in circumstances where the company is not making a tax profit. It should also be noted that withholding tax is essentially additional tax over and above the income tax that is ultimately paid when the company becomes tax paying. Accordingly, this tax liability is directly relevant to the AER's analysis. Moreover, this tax liability is often material.

If you have any further queries in relation to the content of our response to your voluntary information request, please do not hesitate in contacting myself or Craig de Laine ([redacted]).

Yours sincerely

Ben Wilson
Chief Executive Officer