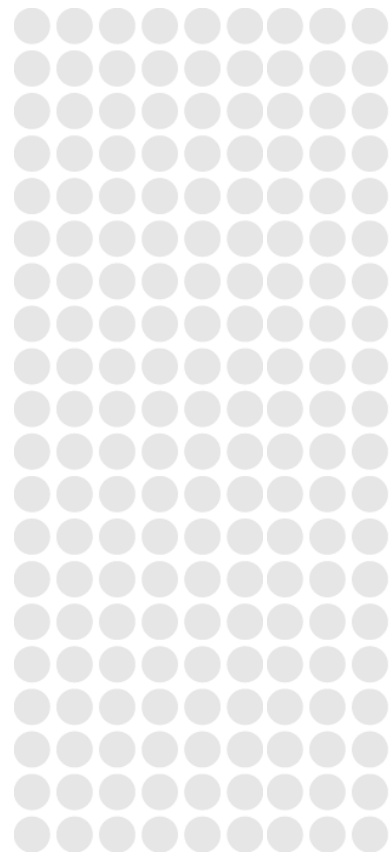




July 2018

# AER review of regulatory tax approach

## APA response to Initial report





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## summary

APA supports the ongoing refinement of the Australian regulatory model, and supports the AER in this continuous improvement endeavour. Such an endeavour must be conducted with an aim to retaining the internal integrity of the existing regulatory model.

There is broad acceptance, from both the submissions to the Issues Paper and commentary at the public forum, that there are expected to be differences (“discrepancies”) between the tax allowed by the AER through its price determinations, and the amount of cash tax paid to the ATO. Again APA advises against placing excess weight on the ATO note, as it has clearly stated that it cannot report on the tax payments made by a Service Provider reporting as part of a consolidated group.

The question then is whether there is anything inappropriate causing these differences, and whether the presence of these differences indicates that the regulatory framework needs to be amended to promote the long term interests of consumers.

The AER having decided to use its information gathering powers, it will conduct its own analysis and reach its own conclusions on these matters. APA looks forward to working with the AER and its tax advisors to develop a suite of information that is relevant to the task at hand, and to create a fit-for-purpose information request to which the businesses can reasonably respond.

The AER has set a challenging task to be able to gather and analyse all the information it has flagged as requesting – particularly the very short period between the final RINs being issued, information being provided to the AER in response, and the release of the AER’s draft position. APA requests that the AER focus on quality of analysis (to which end APA is keen to assist) over speed of deliverable.

## responses to AER questions

The AER Initial Report invited submissions on:

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

The AER's objective in gathering this information is clear: "to identify key drivers of the apparent discrepancy between actual tax payments and the current provision for tax costs"<sup>1</sup> – that is, to assist the AER in ascertaining the cause and materiality of the tax discrepancies. This could reasonably inform the AER regarding areas for more detailed investigation, or where changes may be made to the regulatory model to promote the long term interests of consumers.

APA supports this initiative but is concerned that the exercise of the AER's information gathering powers to collect detailed tax accounting information will not achieve that objective. There are several reasons for this:

- the Service Providers in the APA Group are not tax paying entities. That is, the Service Provider entities do not lodge separate tax returns, and therefore do not maintain separate tax accounts;
- while Service Providers in the APA Group could be expected to pay notional tax on a stand-alone basis, the tax profiles of other un-regulated businesses in the APA Group (when aggregated with the notional tax payments of the Service Providers) have historically resulted in the APA Group consolidated tax payments being lower than AER tax allowances.
- APA issues debt at the corporate level. This means that any attempt to measure the tax payable at the Service Provider level will be affected by arbitrary allocations of debt and interest expense;
- APA does not report corporate costs at the Service Provider level – only at the consolidated level. Any estimate of tax payable by the Service Provider will entail an arbitrary allocation of corporate costs to the Service Provider entity.

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<sup>1</sup> Initial report, pp26-27.

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APA considers that the proposed exercise of the AER's information gathering powers will not serve to provide the information the AER has identified it needs.

As an alternative, the AER could ask the business to analyse its own data and advise the AER on the drivers and relative magnitudes of the differences between the AER's tax allowance and the notional estimate of tax payable for the Service Provider on a stand-alone basis. APA considers that this would be equally informative, and faster. Such an analysis would be conducted leveraging the business' understanding of its own data - this avoids the AER second-guessing the information it may (or may not) require in its proposed RIN and taking too broad an information gathering approach as a result.

A report by the regulated business would of course be equally impacted by all the same arbitrary allocations of debt, interest and corporate costs as described above. But as the stated purpose is to identify causes and relative magnitudes of the differences, such an analysis could well be sufficient to meet the AER's needs.

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

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

APA accepts the list of potential drivers identified in s5.1 and 5.2 as being reasonably complete.

In the context of relevance and materiality, APA is concerned with the nature of some of the items on the list (for example, corporate structure, actual cost of debt), and questions what action the AER might take if it found this to be a material cause of the discrepancy between the AER's tax allowance and the amount paid to the ATO, and what unintended consequences might result.

*A note on TAB revaluation*

APA notes that the AER undertook an extensive review process to establish the regulatory TAB on the move from a pre-tax to post-tax model (including an independent auditor review), and that this TAB has been rolled forward in the AER's Roll Forward Model since. The regulatory TAB has never been indexed or revalued.

APA accepts that this may be a valid item for analysis if the increase in the TAB value resulted from some sort of windfall gain. However, it is difficult to imagine a circumstance in which the ATO would allow an upward revaluation to the TAB without some form of underlying value-based transaction (i.e. the increase in value has been paid for, not created out of thin air). APA is strongly of the view that, to the extent the business' tax asset base has been revalued (say, as a result of an acquisition), it is inappropriate to consider revaluing the regulatory TAB unless the increases in asset values giving rise to the increased tax asset base are equally reflected in the RAB.

So while an increase in the value of the tax asset base on acquisition may give rise to a difference between regulatory tax estimates and actual tax paid, the response should not be asymmetrical regulatory confiscation.

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

APA considers that changes to the regulatory framework must be made with due consideration of the costs and benefits of undertaking that change.

For example, if the business does not classify any expenditure into low-value pools, creating a new asset class with a tracking and reporting mechanism creates costs but no benefits. Matters such as these could be addressed in a report to the AER.

Moreover, APA considers that any changes to the regulatory framework must clearly promote the NGO better than the current approach. Unsubstantiated change risks the stability of the regulatory framework and creates risks, the costs of which are ultimately borne by service providers and customers alike.

One area for discussion in this context is a prospective change to using a declining value approach to tax depreciation. While APA accepts that this may be a valid refinement to the PTRM, it must be conducted in the context of the benefits to be passed through to customers from lower prices, and the additional modelling complexity introduced and the reduction in transparency and consumer's ease of understanding. We look forward to discussing a cost-benefit balance with the AER.

APA is particularly concerned with the AER's commentary around ownership structure. It is not clear how the AER proposes to amend the regulatory

framework to reflect a benchmark structure, and it is very difficult to divine the types of unintended consequences that may arise as a result.

APA urges extreme caution in this area.

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

APA made two key points in its first submission on this review:

1. That the analysis of tax allowance and tax paid must acknowledge the incentives inherent in the regulatory regime (ie, beyond the EBSS, STPIS and CESS); and
2. That the Gas Access Regime is, at its heart, a price cap regime, which encourages the gas businesses to increase revenues by increasing the volume of services provided (the benefits of which flow to customers in the form of a higher load forecast over which to calculate tariffs in the subsequent period).

In the event that a gas transmission or distribution business is successful in responding to the incentives in the regime, it will earn higher revenues, and presumably pay more tax as a result. A pass through of tax payments would therefore require consumers to pay the tax on the company's success. This would not appear to be in the long term interests of consumers.

There was one area of Dr Lally's report that APA found concerning from a policy perspective - his Final Recommendation that, as Government-owned businesses appear to be paying more than the required amount in taxes, no change to the regulatory regime was required to be applied to Government-owned businesses. Of course this recommendation has no bearing on APA-owned businesses, but it fails the Competitive Neutrality policy provisions inherent in the regulatory regime.