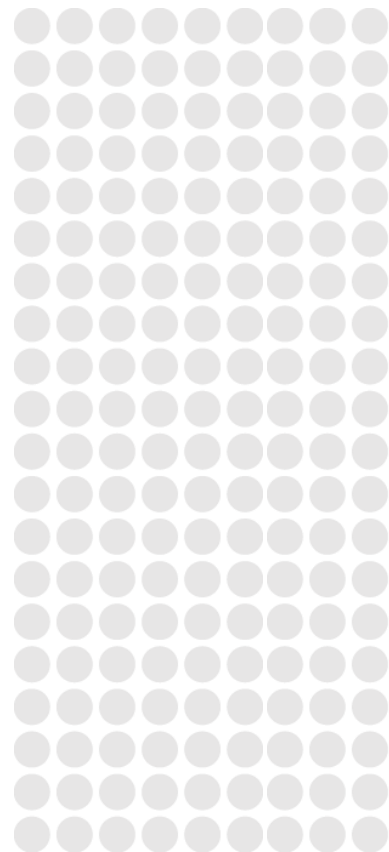




May 2018

AER review of regulatory tax approach

APA response to issues paper



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1 summary

APA considers that differences between estimated tax liability and cash tax paid are normal occurrences in the economy, driven by a number of factors discussed in this submission, and do not signal a problem in either the regulatory or tax regimes.

However, there is apparently a perception of a problem, and APA accepts that there may be benefit in understanding this perception.

In APA's view, the small relative size of the potential benefits to be achieved from changing the approach to estimating tax liability are far outweighed by the administrative and "framework damage" costs associated with introducing the extensive complexity necessary to modify the regulatory framework to more closely track cash tax payable.

To do so would undermine the integrity of the regulatory regime, as discussed more fully in this submission.

In summary, APA considers that the AER should acknowledge the widely accepted reasons for the differences between the regulatory tax allowance and the amount of (cash) tax paid, and confirm the regulatory regime's approach to estimating tax liability that stands today.

1.1 responses to AER questions

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

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

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

APA submits that, despite the best will in the world, it is not able to provide relevant and reliable information to the AER to satisfy its analysis, for two key reasons:

- APA raises capital at the corporate level. As every one of its assets has unique features, it is not possible to meaningfully allocate debt or equity among the individual regulated businesses in the group. Moreover, APA does not attribute any particular debt issue to any particular regulated asset. Any resulting allocation of debt or interest expense would be arbitrary at best.
- APA lodges its tax returns as a consolidated group. As discussed further in this submission, the amount of tax payable attributable to a particular business within the APA Group would be infected by the arbitrary allocation of debt interest expense.

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

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

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

It is important for the AER to be able to understand the causes of any differences between the tax allowances for regulatory purposes and the (cash) tax paid by the entity.

Once those differences are understood, the AER can proceed with confidence in the integrity of the regulatory regime.

The summary in Table 5.1 of the Issues Paper does a good job of outlining the effect of the differences, but makes no value judgement as to whether the difference is the result of any non-compliance on the part of the regulated businesses, or simply an out-turning of the appropriate application of Australian tax rules. APA assures the AER that it is fully compliant with its regulatory determinations and with the Australian Taxation Law.

Moreover, APA considers that there is an important dichotomy to settle, which will guide the analysis: is it the case that the AER's allowance for tax is greater than the amount of cash tax due to be paid at any given time, or is it the case that the amount of cash tax required to be paid is less than the allowance? While these may sound equivalent, they are not:

- if it is found that the "difference" is caused by the AER's tax allowance being "too high" relative to the operation of the regulatory framework

in a stable tax regime, then there may be opportunities to fine tune the relevant regulatory settings.

- we must consider, however, that the perceived “difference” is caused by the amount of tax required to be paid being “too low”. In this respect the AER must consider:
 - the extent to which the level of corporate tax payable has been impacted by the “bulge” of carry over of losses incurred during the Global Financial Crisis, and whether those losses have finished washing through the tax system;
 - the incentives promulgated by the government through the tax regime, by allowing targeted tax offsets and accelerated depreciation on qualifying assets;
 - the government’s current initiatives to increase the amount of cash tax paid, for example by increasing the amount of Australian tax paid by multinational firms on Australian source revenue, and the scope for disallowance of interest deductibility for particular types of convertible securities.

These are matters to be addressed by the government, in its role as the taxation authority, not by the utility regulator.

In the context of incentive regulation, a principle tenet is that the regulator confines its interventions to a high level, in order to encourage the creativity and skills of management in delivering more efficient outcomes. It is in this context that the AER’s regulatory framework adopts a “vanilla” tax structure assumption consistent with this high level approach to incentive regulation.

APA considers that it would be outside the philosophy of the AER’s regulatory framework to guess at, or mandate, particular financing or tax structures that may be used by different entities.

APA considers that once the AER understands the causes of the perceived “gap” between the regulatory tax allowance and the amount of cash tax paid in any given year, it can proceed with confidence in its application of the current regulatory regime.

As discussed further in this submission, there are many valid reasons for this gap, including accelerated tax depreciation, tax offsets and loss carry overs.

2 the regulatory estimate of tax liability

The AER calculates its tax allowance using a model which is founded on a set of regulatory measures. A key example is the regulatory Tax Asset Base (TAB). For some businesses, this was based on the RAB rather than actual acquisition or construction costs.

APA notes that the AER has assessed and approved the businesses' TABs and these are now part of the regulatory framework.

The Australian tax rules allow accelerated depreciation on certain types of assets that would vary the actual tax paid relative to the regulatory tax estimate. This however is a timing difference only – ultimately, particularly for assets constructed post the establishment of the TAB, the amount of tax paid will equal the tax allowance.

2.1 straight line vs accelerated tax depreciation

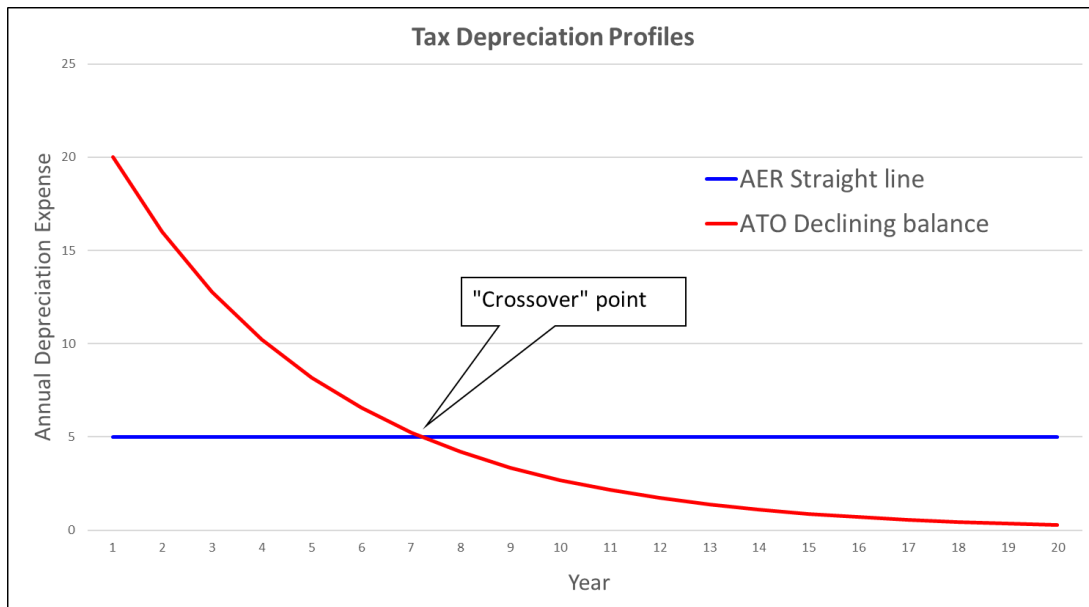
One reason is differences in the assumed profile of tax depreciation assumed in the AER tax calculation (straight line) and the assumed profile of tax depreciation allowed by the Australian tax rules for completion of the company tax return (which may be an accelerated methodology). Ultimately the amount of tax depreciation under the two methods will be the same over the life of the asset - this is simply a timing difference.

The AER analysed this matter in its decision to move from a pre-tax to post-tax framework in 2009¹ (as did IPART in 2011²) and acknowledged (and accepted) this timing difference. Both were clear that accelerated tax depreciation caused the allowed tax depreciation attributable to a particular asset to be higher than the straight line rate in the early years of an asset's life, but after a few years (after "crossover") the allowed tax

¹ AER, *Issues Paper - Electricity Distribution Network Service Providers - Transition of energy businesses from pre-tax to post-tax regulation*, June 2007. Appendix A to AER, *Matters Relevant to Distribution Determinations for ACT and NSW DNSPs for 2009-2014: Preliminary Positions*, November 2007.

² IPART, *The incorporation of company tax in pricing determinations - Other Industries — Final Decision*, December 2011.

depreciation attributable to the accelerated depreciated asset is lower than the straight line case:



- prior to “crossover”, the ATO tax depreciation allowance will be greater than the AER straight line allowance, and the tax paid will be lower than the tax allowed;
- post “crossover”, the ATO tax depreciation allowance will be less than the AER straight line allowance, and the tax paid will be greater than the tax allowed;
- over the life of the asset, the tax paid will equal the tax allowed.

Were the AER to change methodologies, from a “tax allowance” to a “tax payable” methodology, part way through an asset’s life, it would need to be prepared for tariffs to rise to recover the higher tax payable in the later years of an asset’s life arising from the lower depreciation allowance. The AER’s current approach appropriately deals with the tax liability while allowing prices to remain stable over time.

Of course a network business does not consist of a single asset as conceptualised in the diagram above - it is comprised of a portfolio of assets of different ages, and at different points along the depreciation profile curve.

To the extent that the opening RAB (and hence opening TAB) make up a significant proportion of the service provider's assets, and considering both the number of years the regulatory framework has been in place and the tax life of these assets, there would be expected to be a bulk of assets approaching the "crossover point" in the diagram above.

That is, we would expect that:

- the cash tax payable on this bulk of assets would soon exceed the regulatory tax allowance;
- the average rate of cash tax payable would increase; and
- the "gap" between the regulatory tax allowance and the cash tax payable would narrow (or possibly reverse).

Where a business has undertaken significant levels of capex in recent years, its composite effective tax rate may well be lower (and would be expected to be lower) than the statutory rate.

In either case, where the perceived difference between the regulatory tax allowance and cash tax paid is driven by the use of accelerated tax depreciation in the past, this relationship will ultimately reverse or stabilise without regulatory intervention.

2.2 tax losses and tax loss carryovers

The nature of the regulatory framework is such that it would be unusual for the regulated framework to ever forecast a regulatory tax loss – a regulatory tax loss would signal that the difference between the forecast regulatory depreciation building block and the allowed regulatory tax depreciation was greater than the allowed return on equity. This would be an unusual situation indeed.

Nonetheless, the AER and IPART have already examined the question of tax loss carryovers, and any applicable tax loss carryovers are already reflected in the PTRM.

Consistent with the commentary in the ATO Note related to the activities of government-owned businesses,³ this means that any tax losses must arise from other factors: perhaps R&D expenditure undertaken as part of unregulated activity, or special tax incentives given to activities that are not undertaken by the regulated business.

As the regulatory framework seeks to measure the tax liability for the regulated business, the regulated business should not bear the cost of taxes associated with unregulated activities and similarly should not benefit from tax reductions driven by losses in those unregulated businesses.

In the context of the current Australian federal budget, Treasury has noted that it is expecting a significant increase in revenue from corporate taxes, as the tax losses incurred during and after the Global Financial Crisis have now largely washed through the tax system. That is, observed corporate taxes payable have been reduced in recent years as a result of these tax loss carry overs, and Treasury is expecting the amount of corporate taxes to increase going forward. The “gap” between the regulatory tax allowance and the cash tax payable will narrow as the amount of cash tax payable increases.

2.3 businesses file their tax returns on a consolidated basis

The use of consolidated group tax returns is important in interpreting the ATO Note to the AER. The ATO Note's caveats make it clear that the ATO cannot reliably advise the AER on the amount of cash tax paid by individual regulated businesses – the ATO simply does not measure that.

It is therefore not ascertainable from the information available whether the regulated business is paying more or less cash tax than the AER allowance.

APA considers that it is not possible to unscramble the company tax returns to determine the amount of tax payable attributable to any particular member of the consolidated group without making arbitrary assumptions about the allocation of joint and common costs, debt and interest expense, or the use of tax loss carryovers from other entities within the group. This is consistent with the caveats in the ATO Note to the AER.

³ The ATO presumes that government-owned businesses pay relatively more tax because they do not undertake research and development activities.

APA considers that this fact should inform the AER decision on the exercise of its information gathering powers - any attempt to measure the cash tax payable by any particular member of a consolidated group will require extensive arbitrary, and inevitably incorrect, allocations to re-cast this information into mock tax returns for each individual service provider.

2.4 an internally consistent regulatory framework

The AER currently applies a rigorous and internally consistent regulatory model which captures the effect of tax in a manner consistent with the other components of the regulatory framework.

Before embarking on a process of more closely tracking the tax regime in the regulatory framework (especially those aspects relating to timing differences) it should consider the administrative burden it would be introducing (on both itself and regulated businesses), and the reduction in the stability and "predictability" of the regulatory regime. Noting that tax represents only about 4% of total revenue, APA submits that the increased administrative burden (the costs of which will be ultimately borne by end use consumers) and resulting reduction in confidence in the regulatory regime clearly indicates that changes to the current approach to tax are neither warranted nor prudent.

In summary, APA considers that the AER's current approach addresses tax in an internally consistent way. Changes to this treatment would undermine the integrity of the broader regulatory regime.

3 the ATO estimate of tax liability

3.1 interaction with the regulatory regime

To the extent the regulatory regime attempts to align the initiatives put in place by the tax regime as a way of aligning the regulatory estimate of tax liabilities and the amount of cash tax to be paid, it risks undermining the policy incentives the government is seeking to promote through the tax system.

For example, suppose the government sought to increase pipeline development, and to that end allowed a faster depreciation profile⁴ for new pipeline expenditure as a method of stimulating pipeline investment. The pipeline business can receive and act on that incentive, towards achieving the government's policy objective.

However, if the AER then calculates the tax allowance replicating the accelerated tax depreciation, reducing the regulatory tax allowance and passing the benefit on to customers, the business will not benefit from the government's targeted incentive, and the government's policy objective is thwarted.

APA considers that the AER's current approach, using a straight line tax depreciation profile, allows the benefit of such economy-stimulating tax initiatives to be received, and acted upon, by the business to deliver the government's policy objectives.

3.2 mooted changes to the tax regime

In the context of the question of whether the current amount of tax payable is "too low", APA notes that some significant reforms to the tax regime have recently been signposted, including:

⁴ Resulting in a deferral of tax payments, but not a reduction in the total tax payable.

- increasing the amount of Australian tax paid on Australian source income by multinational corporations;⁵
- restriction of interest deductibility on debt due to changes in thin capitalisation rules; and
- changes to the tax treatment associated with some stapled securities.

It is possible that some of these structures may form part of the reason for the “difference” between the AER allowance and the amount of cash tax paid by regulated businesses. The Australian Government has flagged initiatives to reel in these tax structures, which would cause the amount of tax paid to increase and close the perceived “gap”.

Were the AER to amend its approach to calculating the tax allowance by negating the impact of these (currently allowed) tax structures, it would then need to reverse that amended approach when these structures are discontinued.

This would put the AER in the position of having to constantly monitor the tax regime, and consider how the tax allowance calculation would need to be modified for each and every business for each and every change in tax law.

This would add considerable complexity and a high degree of intervention to the AER regulatory function, particularly considering the small (4%) impact of the tax allowance on overall allowed revenue. This is not in the spirit of the regulatory framework.

⁵ Noting that APA does not fall into this category.

4 The ATO analysis and advice

The ATO is clear that its analysis relies heavily on assumptions.

The ATO acknowledges that it is not possible to see the tax paid by a particular regulated business when tax returns are lodged as part of a consolidated group – the ATO's analysis must therefore not be taken as an indication that the regulated business' tax allowances are out of step relative to the contribution of the regulated business to the amount of tax ultimately paid by the corporate entity.

4.1 Entity structures

The ATO Note observes that service providers employ a range of corporate structures, including stapled securities (featuring a trust structure), corporations and partnerships. The ATO also notes that trusts and partnerships in particular do not pay tax directly; rather, income is taxed in the hands of the owners of the stapled security or the partners, as the case may be. Moreover, the recipients of the income may be subject to concessional tax treatment. Nevertheless, tax is paid at the rates applicable to the ultimate owner under Australian tax rules.

It will not be possible, then, to observe the amount of tax payable by the service provider. This is one of the key reasons for the ATO's caveats in its Note to the AER.

The ATO note makes no suggestion that the way entities are structured is in any way in contravention of the tax legislation. It simply observes that the variety of structures employed makes it difficult to draw conclusions about the amount of cash tax paid relative to the income of the service provider.

APA considers that it would be very difficult for the AER to regulate all the service providers under the AER's jurisdiction according to their individual corporate structure – whether stapled security, trust, partnership or multinational subsidiary. APA also considers that the ATO accurately adjudicates tax payable based on the relevant corporate structure. Ultimately, the Australian tax system holds the payer accountable for the payment of the tax calculated appropriately under the tax rules, on penalty of fine for wrong disclosure or non-payment.

The current regulatory framework reasonably makes a common assumption about corporate structure across all service providers, and the appropriate treatment of all service providers by the ATO contributes to the internal integrity of the regulatory framework.

4.2 Interest expense

Consistent with the comments on corporate structure and the lodgement of consolidated tax returns, it is not possible to accurately ascertain how much interest expense is relatable to the activities of the service provider relative to the activities of other members of the corporate group. In APA's case, neither debt nor interest is assigned to any particular regulated pipeline.

In the regulatory framework, the regulatory tax deduction for interest expense is set to be equal to the AER-determined value of the RAB, and the AER-determined cost of debt on the proportion of the RAB determined to be debt financed. That determination is a function of the AER's determination of the appropriate capital structure for the business, which in turn impacts the relative cost of debt and equity.

These inter-relationships are critical to the internal integrity of the regulatory framework. APA considers that it is important to retain these relationships in order to retain that internal consistency. To make other assumptions regarding interest deductibility for tax purposes would, in APA's view, undermine the internal integrity of the regime.

4.3 Tax depreciation

The AER's tax calculation applies straight line depreciation to the Tax Asset Base (TAB). It should be noted that the AER calculates regulatory tax depreciation using a non-indexed regulatory tax asset base, so difference between "book depreciation" and "tax depreciation" only apply to the extent the original determinations of the RAB and TAB differ.

APA notes that the AER undertook a significant process in having the TAB valued for the purposes of the regulatory regime, and had this information reviewed by competent auditors.

The service provider may use some form of accelerated tax depreciation, such as a declining balance method. Any such method would be subject to the normal tax rules applicable to tax depreciation.

APA considers that it would be very difficult for the AER's PTRM to duplicate the myriad approaches to tax depreciation as are allowed under the tax rules. This would need to be balanced against the small benefit to be gained, considering the tax allowance accounts for only 4% of total revenue.

5 in conclusion

In conclusion, APA acknowledges that there will be differences between the AER's tax allowance and the amount of tax paid to the ATO in any given year.

While some of these years will see cash tax paid amounts less than the AER's allowance, the existing scheme is symmetrical – there will equally be years in which the cash tax paid will be greater than the AER's tax allowance. This is primarily driven by differences in timing of deductions, particularly tax depreciation patterns.

Also, when tax payable for a regulated service provider is reported within a broader corporate tax paying group, its liability may be offset or reduced by the tax liabilities of others within that corporate group.

The causes of the differences between the regulatory tax allowance and the amounts of cash tax paid are well understood.

APA considers that attempts to change these factors (for example, gearing and the AER's assessment of the cost of debt) for tax liability estimation purposes risk undermining the broader integrity of the regulatory regime.