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Mr Warwick Anderson
General Manager, Network Finance and Reporting
Australian Energy Regulator
GPO Box 3131 Canberra ACT 2601

Via email TaxReview2018@aer.gov.au

Dear Mr Anderson

AER Review of Regulatory Tax Approach

The Australian Pipelines and Gas Association (APGA) is the peak body representing the providers of Australia's gas transmission pipeline infrastructure. Our members build, own and operate the transmission pipelines connecting gas supply basins and demand centers across Australia, offering a wide range of services to gas producers, retailers and individual users of large volumes of natural gas. We appreciate the opportunity to respond to your recent initial report on Review of Regulatory Tax Approach. We have also reviewed the expert report from Dr Martin Lally on this issue and participated in the AER public forum on this matter on 18 July 2018. There are four key matters on which the AER has requested inputs from stakeholders in order to set efficient tax allowances:

1. Information required from network service providers (NSPs) to understand differences in actual tax paid and regulatory tax allowances.
2. Options for changes to regulatory models to allow for alignment with actual tax practices.
3. Potential for a pass-through approach.
4. Potential drivers for these differences.

Information requirements and Draft RINs

In respect of the information requirement from the NSPs we note that the following should be taken into account:

- The tax paid by private businesses is at the corporate entity level (or group level) and is representative of, among others: the other unregulated activities of the group; the level of gearing at group level; tax losses; and the interest costs at group level (based on acquisition costs). Separating out these issues will be complex.

- Adoption of group level information for regulated entities will be inconsistent with efficient benchmark definition adopted for setting the allowed rate of return and gamma

We would urge the AER to take these complexities into account, particularly given the very short timeframe requested by the Minister and would suggest that the AER balance the costs of complying with the benefits associated with the relevant information and the benefits associated with any changes made based upon the information the AER collects. This may lead the AER to a more targeted approach to information collection, and where taking a more targeted view may assist the AER in getting a better set of information we would encourage the AER to do this. For example, in cases where firms have recently changed hands or undergone some other material change, past data are likely to be irrelevant to the future tax situation.

In addition, since the timeframe given for the AER to both collect the data and analyze it is very short, we question how much meaningful analysis the AER might reasonably expect to be able to do under these circumstances. While we accept that there may be merits in taking a staged approach, with information that is easily available, we would not want the AER to make a decision which changes the framework one way based on early, incomplete information, only to need to change it in a different way once it had sufficient time to analyze the information in more detail.

Regulatory models

With respect to changing regulatory models to align with evolving efficient tax practice, we believe that this is reasonable, although there are some principles that we believe the AER should consider before undertaking any extensive consultation on the changes. These include:

1. **Prospectivity –** whatever change is made should be made only in a forward-looking sense. Therefore, if changes are to be made to depreciation schedules, for example, this should only be for new assets. To do otherwise sometimes contravenes what we (or indeed any business) can legally do under the tax legislation, which means it cannot be consistent with the actions of a benchmark efficient entity and is likely to result in a windfall gain or loss due to change in practice mid-way.
2. **Materiality –** If the change is made, the AER should consider the impact on complexity of models against the revenue impact of change in approach.
3. **Symmetry –** if a proposal is made to change some aspect of the regulatory tax treatment of costs, then that same change should be made for setting regulatory revenue allowance for internal consistency in the models. For example, if an item is expensed in the tax section of the PTRM, it should also be expensed in the allowed revenue section.

To understand further what we mean by these principles, consider the two changes proposed by the AER's expert, Dr Lally. The first of these is a move to a declining

balance depreciation schedule for tax purposes. Such a move should be informed by the AER's forthcoming examination of actual tax practices, but we can see that it may have merits if this is common practice among industry and therefore representative of what the BEE should reflect. Provided the approach affects only new assets, then the first principle is passed.

The next two principles present more of a challenge; to the extent that it is material, and therefore has an impact on revenues, the need to consider symmetry becomes more pressing. That is, the more that the use of a declining balance method for depreciating new assets is favored in the tax treatment, the stronger the case becomes for treating depreciation in the RAB symmetrically. Otherwise, current consumers obtain a benefit (lower tax allowances) at the expense of future consumers, who will need to pay a higher tax allowance and still pay the same depreciation building block in the PTRM. However, conversely, once symmetry is invoked and changes to the RAB depreciation building block are made, the materiality of the net revenue impacts declines. This highlights the complexity of making even "low hanging fruit" changes to the taxation regime.

Dr Lally's second proposed change, changing the tax asset base likewise can (and should, otherwise it would have a major impact on investment incentives were changes to be made retrospectively) be made prospective. However, it runs into similar problems in respect of the second and third principles where the TAB changes due to a purchase of a business by another business for a RAB multiple greater than one. If the TAB is changed to reflect the new actual or statutory tax asset base, then the impact on the tax building block is material. However, to reflect the symmetry requirement, this revaluation would need to flow through to the RAB; otherwise consumers would be getting a benefit (a lower tax building block payment because of higher interest deductions associated with the higher TAB) without other building blocks reflecting the higher cost this imposes on business. Once symmetry is imposed however, the net effect on revenues is likely to be much smaller, and it may be immaterial. Moreover, making the TAB and RAB reflect actual purchase decisions would have a fundamental impact on the incentive nature of the regulatory regime, leading to higher RAB multiples, and higher costs for consumers.

Pass-through treatment

Use of pass-through costs shifts the risk to customers and is not, we submit, in the long-term interests of consumers. General arguments to this effect have been made by Dr Lally and others, and the ENA has made the case in respect of electricity, which operates under a revenue cap. However, APGA members are under price cap which means that any additional tax as a result of higher than forecasted volumes (and higher revenue) will be borne by customers under a pass-through regime. Dr Lally has pointed out in a general sense that the pass-through approach will not reflect the

efficient regulatory outcome and not satisfy the NPV=0 condition, and we would suggest that it is even more problematic where price caps are used.

Drivers
With respect to drivers, the last of the issues the AER has asked for comment upon, we do not think it appropriate to comment on an industry-wide basis at the present time, when relevant data have not yet been collected or analysed. We think that some drivers, such as low value pools, are unlikely to be relevant, but that any further consideration of drivers should be evidence, not submission based.

We look forward to the opportunity of working with you as this review continues. Should you have any queries in relation to the content of this submission, please feel free to contact me.

Yours sincerely

STEVE DAVIES
Chief Executive Officer