Submission to the AER

Discussion Paper: Review of regulatory tax approach

23/11/2018

APGA Submission to the AER Review of Regulatory Tax Approach – Discussion Paper

Introduction

The Australian Pipelines and Gas Association (APGA) welcomes the opportunity to make a submission on the AER's Review of regulatory tax approach discussion paper. APGA is the peak body representing the owners and operators of Australasia's gas pipeline infrastructure. Our member businesses deliver all of the gas used in Australia.

The economic regulatory framework which governs gas transmission pipelines is critical to maintaining the attractiveness of the pipeline sector as a destination for investment. Regulatory rates of return influence the way gas pipeline businesses invest in their assets, their ability to attract investors to the Australian market, and ultimately the services they can provide customers. Successful pipeline businesses also support, in turn, a thriving industry sector.

Key Issues

- APGA supports the process of ongoing improvement to the Australian regulatory framework and the analysis questioning whether the current framework remains robust and whether refinements are required.
- It is important that the analysis is conducted in the appropriate context. As APGA outlined at the AER public forum on 7 November this year, the regulatory framework and the tax regime differ significantly; each with their own objectives and inherent incentives. To simply compare the AER tax allowance against the cash tax payable by the businesses fails to recognise these differences in framework, objectives and incentives.
- APGA therefore supports the AER's decision not to move to a tax pass-through approach.
- APGA applauds the work the AER has done in arriving at the positions it has outlined in the discussion paper. Our submission focuses on the issues on which the AER has not yet reached a conclusion.

Benchmark Corporate Structure

The PWC report identified that there is a range of corporate structures under which investments in network businesses are held. Some of these structures reflect foreign ownership interests, trust structures, etc.

APGA considers that it would be difficult for the AER's regulatory framework to accommodate the actual corporate structure of the entity holding network assets. As we have seen in recent years, the actual form of the corporate structure holding the network assets has changed for some assets. This has occurred through privatisations of formerly government-owned assets, through global trading in companies holding network assets, or through restructures of the businesses holding network assets.

It would be difficult for a stable regulatory regime to both remain current and accommodate an actual corporate structure in the calculation of its building blocks. The actual corporate structure could well change, either within or between regulatory periods. Accordingly, it is better for the

regulatory framework to use a stable benchmark as its basis, rather than an actual corporate structure.

In terms of the impact on the regulatory tax allowance, the PWC analysis (Figure 1) indicated that over 70% of regulated asset holders pay tax at a 30% tax rate. Any corporate structure featuring the same tax rate would therefore serve as a reasonable benchmark.

APGA supports the AER's decision to retain the Australian corporate benchmark entity structure.

Asset Valuation and Revaluation

One of the key areas of difference between the regulatory and tax frameworks is the approach to asset valuation. While the regulatory framework valued assets as part of the Hilmer reforms, the tax framework has always used original historical cost. Moreover, the regulatory framework indexes the asset base for inflation, whereas the tax framework has never adopted an indexation approach.

This different approach to asset valuation is fundamental to the different objectives and incentives inherent in the two regimes – neither is correct or incorrect in its own right. But this different approach to asset valuation underpins many of the "discrepancies" between the AER's tax allowance and the amount of cash tax paid.

We must therefore be very careful to acknowledge the central role asset valuation plays in the integrity of the regulatory framework in any discussion of the treatment of any asset revaluation.

As we have observed in recent years, there is a global trade in regulated network assets. From the perspective of consumers, it is important to have confidence that prices will not increase by virtue of any upward asset valuation caused by the purchase of assets over time. The fact that regulated asset values are not adjusted on acquisition is an important feature underpinning the stability and predictability of the regulatory regime.

APGA therefore supports the AER's position that the regulatory tax allowance should not be affected by the value reflected in any acquisition of the business.

However, some stakeholders have expressed a view that:

1) tax depreciation applied in the calculation of the regulatory tax allowance should be adjusted to reflect any upward asset revaluations; and
2) interest expense applied in the calculation of the regulatory tax allowance should reflect the amount of debt financing held by the parent following an acquisition of a network business where the actual interest expense is greater than the regulatory cost of debt.[1]

APGA considers that either of these positions is fundamentally inconsistent with the principle that consumers should not be impacted by asset revaluations occurring on changes of ownership. We therefore support the AER's position to refrain from adjusting the regulatory tax depreciation or the regulatory tax deduction for interest expense to reflect the impact of any business acquisitions.

[1] Actual interest expense might be greater than the regulatory cost of debt where the parent either: 1) financed an acquisition at a gearing level higher than the AER's benchmark; 2) acquired an asset for a value greater than the regulated RAB; or 3) both.

Actual vs Benchmark Cost of Debt

The other component in calculating the interest expense deduction is the cost of debt applied to the outstanding amount.

APGA notes that the AER has just undertaken an intensive process to determine the appropriate cost of debt through its 2018 Review of the Rate of Return Guideline. It would be difficult to imagine a more relevant estimate of the cost of debt for tax interest expense purposes than that just determined by the AER itself.

APGA notes that the AER requested information on actual debt issues and the related cost of debt for each issue, as part of its tax information RIN. Where the amount of debt outstanding is not adjusted for asset revaluations, and the interest rate is based on the AER's recent Rate of Return Guideline analysis, APGA considers that this information will not be helpful in answering the question of the reasonableness of the regulatory tax allowance.

Depreciation

There are three issues discussed surrounding depreciation:

Immediate expensing of refurbishment

Generally speaking, where a business undertakes expenditure which is immediately deductible for tax purposes, prudent tax management practices would suggest that the expenditure would be claimed as an immediate tax deduction. Where this expenditure is capitalised and depreciated over a longer time horizon for regulatory tax allowance purposes, a timing difference is created between the tax and regulatory regimes.

From a regulatory perspective, the issues are twofold:

1. seeking to maintain consistency between the return on and of capital building blocks and the regulatory tax allowance; and
2. estimating the proportion of expenditure that is refurbishment, rather than capital, in nature – whether such an estimate should be a business-specific forecast, considering the scope for volatility in annual refurbishment expenditure, or the subject of an industry benchmark (and how such a benchmark would be developed).

These are difficult questions, that require broader consideration and analysis, to ensure that other unintended consequences (and opportunities for gaming) are not created.

While the AER will consider the magnitude of the issue by reference to the RIN information provided, APGA considers that this is one area in which a change to the regulatory tax approach should be approached with great caution.

As a starting point, APGA notes the PWC (p.85) and Lally ("fourthly") analysis indicating that the Low Value Pool is not a significant driver of discrepancies between the tax allowance and tax payable, and supports the AER's decision not to adjust the tax allowance to reflect the immediate deductibility of Low Value Pool expenditure.

Move to declining balance tax depreciation

The AER's Post Tax Revenue Model applies straight line depreciation of the Tax Asset Base for the purposes of calculating the regulatory tax allowance.

The tax information RIN should provide the AER with detailed information on the extent to which businesses currently apply prime cost (i.e. straight line) or diminishing value depreciation for tax purposes.

With this information in hand, the AER should be in a position to assess the magnitude of any change to the assumed method of depreciation for tax purposes. However, the early information indicates that neither method is unanimously applied by all businesses.

To the extent the AER finds that a move to diminishing balance depreciation would result in an improvement in the regulatory framework in the long-term interests of consumers (acknowledging any intergeneration equity impacts), APGA is generally accepting. However, APGA is concerned to ensure that that any such change should be made prospectively, noting that businesses are not allowed to change methodologies for tax purposes once a particular approach is embarked upon.

Aligning gas tax asset lives

Table 6.3 of the AER's Discussion Paper addresses a concern that the gas network businesses are allowed to depreciate their pipeline assets over 20 years for tax purposes while the regulatory tax allowance is based on a longer assumed tax life. This, in the AER's view, is giving rise to a discrepancy between the tax allowance and the amount of cash tax paid.

As outlined by APGA at the AER public forum in November, all the AER's regulated gas transmission assets feature a 20-year depreciable life for the Tax Asset Base for pipeline assets. This proposed amendment is therefore not required for the gas transmission sector.