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23 November 2018

Mr Warwick Anderson
General Manager, Network Finance and Reporting
Australian Energy Regulator
GPO Box 520
Melbourne Vic 3001

Dear Mr Anderson

Re: Review of regulatory tax approach Discussion Paper

Thank you for the opportunity to comment on the Review of regulatory tax approach published on 2 November 2018. This letter outlines a submission from ATCO Australia (ATCO).

As an owner and operator of energy and logistics infrastructure in Australia for over 55 years, ATCO is proud of its ongoing commitment to supporting the communities in which we operate. ATCO is a long-term investor with a clear vision of delivering customer value through sustainable growth, continuous investment, improvement and innovation.

The disruption of energy markets has highlighted the importance of consistent policy settings, regulatory certainty and appropriate investment signals to ensure that customers continue to receive safe, affordable and reliable energy.

Overarching comments

ATCO considers that the National Gas Objective should be a key driver of the outcomes of this review. It must not be forgotten that the purpose of estimating the building blocks is to determine efficient prices that will then incentivise efficient investment in and efficient use of the network that is in the long term interests of consumers. ATCO is concerned that the outcomes of this review may lead to inefficient pricing outcomes that are not in the long term interests of consumers.

ATCO makes the following overarching comments in relation to the AER's Discussion Paper. The attached submission elaborates on these observations:

- ATCO supports the AER's three findings where changes are not considered necessary: 1) retaining the benchmark approach to calculate the tax building block, 2) maintain the current benchmark for tax at 30% and 3) to insulate consumer from changes in the market valuation of the tax asset base.
- ATCO submits that the AER should carefully consider the incentive effect of any amendments to the regulatory approach as a result of expensing refurbishment capital expenditure for tax purposes before any change is made.
- ATCO does not support the AER's proposed change to mandate the use of the diminishing value method to determine tax depreciation. ATCO submits that the straight-line depreciation method results in more economically-efficient price signals to consumers as it results in a consistent level of tax depreciation.

- ATCO recognises that the tax law allows a cap of 20 years to be adopted for certain gas distribution assets.
- ATCO submits that the interest expense adopted in the tax modelling must reflect the same assumptions used in calculating the rate of return. To do anything else would create inconsistency in the framework and would represent a critical departure from incentive based regulation.

About ATCO

ATCO is a customer-focussed global company that develops, builds, owns and operates a range of energy infrastructure assets, supporting residential, business and commercial consumers. ATCO has been proudly operating in Australia and providing employment opportunities for more than half a century. In Australia, ATCO:

- owns and maintains two non-regulated gas distribution networks in Albany and Kalgoorlie, together with the largest (Mid-West and South-West) gas distribution network in Western Australia, servicing over 750,000 connections through more than 14,000 km of natural gas pipelines and associated infrastructure;
- owns and operates two power generation facilities (a joint-owned facility in Adelaide and a wholly-owned facility in Karratha) with a combined capacity of 266 MW; and
- manufactures and delivers modular building solutions to a diverse group of customers.

ATCO's Australian businesses are part of the worldwide ATCO Group with approximately 7,000 employees and assets of $22 billion. ATCO is engaged in pipelines and liquids (natural gas transmission, distribution and infrastructure development, energy storage, and industrial water solutions); electricity (electricity generation, transmission, and distribution); retail energy; and structures and logistics.

If you have any questions or would like to discuss any of these issues further please contact me or Matthew Cronin, General Manager Strategy & Regulation.

Yours sincerely

[redacted]

J.D Patrick Creaghan
Managing Director & Chief Operating Officer

Attachment 1: ATCO Australia submission

ATTACHMENT 1: ATCO SUBMISSION

REVIEW OF REGULATORY TAX APPROACH

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ATCO

An appropriate citation for this paper is:

Attachment 1: ATCO Submission

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Table of Contents

1. Introduction

1. ATCO welcomes the opportunity to provide a submission on the Australian Energy Regulator's (AER) Review of Regulatory Tax Approach Discussion Paper, which was published on 2 November 2018.

2. ATCO's position on the matters raised in the discussion paper is summarised in the following table:

Table 1.1: Summary of ATCO's position

ISSUE	ACCEPTED BY ATCO	SUMMARY OF ATCO'S POSITION
Not moving to actual tax pass through	✓	ATCO accepts the AER's finding to retain the current benchmark approach to calculate the tax building block
Retaining benchmark entity structure and ownership assumption	✓	ATCO accepts the AER's finding to maintain the current benchmark for tax at 30%
No tax asset base revaluations	✓	ATCO accepts the AER's finding to preserve a consistent regulatory approach that insulates consumers from changes in market valuation on both the RAB and TAB
Expensing of refurbishment capital expenditure	-	ATCO submits that the AER should consider the incentive effect of any amendments to the regulatory approach to expense refurbishment capital expenditure for tax purposes
Application of diminishing value assumption	-	ATCO submits that the straight-line depreciation method results in more economically-efficient price signals to consumers as it results in a consistent level of depreciation and therefore more stable prices
Gas asset lives	✓	ATCO recognises that the tax law allows a cap of 20 years to be adopted for certain gas distribution assets
Interest expense adjustment in tax modelling	-	ATCO submits that the interest expense adopted in the tax modelling must reflect the current benchmark approach to calculate the tax building block.

2. Areas where changes are not proposed by the AER

3. ATCO supports the AER's three findings where changes are not considered necessary.

4. The AER's three findings are as follows:

1. Not moving to actual tax pass through

ATCO supports the retention of the current benchmark approach as it underpins the incentive based regulatory framework adopted in Australia for energy networks.

The AER's initial report had discussed some advantages and disadvantages of a tax pass through, including noting caution around making such a change. The AER have now confirmed its view that it would not be in the long term interests of consumers to adopt a tax pass through approach. The AER concluded that the tax costs passed through to consumers would likely increase over time, as service providers have no incentive to minimise its tax costs.

2. Retaining benchmark entity structure and ownership assumption

ATCO supports the retention of the current benchmark entity structure and ownership assumptions.

The AER have found that different entity structures explain a small portion of the historical tax difference but that it will be less relevant in the future because of changes to the ATO's assessment approach, which includes legislative change that mean certain structural practices no longer have the effect of reducing tax payable.

3. No tax asset base revaluations

ATCO supports the consistent treatment of the RAB and TAB as a result of asset transactions.

The AER found that the effect of asset transactions (mergers, acquisitions and privatisations) can increase (or decrease) the tax cost base recognised by the ATO. The AER concluded that it remains appropriate to preserve a consistent regulatory approach that insulates consumers from changes in market valuation on both the RAB and TAB.

3. Areas where changes are proposed by AER

3.1 Expensing of refurbishment capital expenditure

5. ATCO submits that the AER should consider the incentive effect of any amendments to the regulatory approach that results in expensing refurbishment capital expenditure for tax purposes.

6. The AER's discussion paper proposes an amendment to the regulatory model so that the value of certain capex (such as refurbishment capital expenditure) is immediately expensed in the regulatory model for tax purposes in the year it is incurred.

7. It is important that network businesses continue to be incentivised to adopt the lowest sustainable cost solution to address issues with aging assets. PWC's report makes a similar point:

> *In particular, consideration should be given to whether a change to the regulatory tax forecast to treat amounts such as refurbishment costs as immediately deductible could lead to sub-optimal asset replacement decisions and policies by NSPs. This would be an additional factor that the AER would need to take into account in considering the long term interests of consumers.*[1]

8. The AER's review must ensure that any change doesn't create a perverse incentive to replace assets rather than refurbish them. The potential for this change to create negative capital incentives as noted by the AER.[2] The AER's view that immediate expensing of some capital expenditure is a possible change appears to be centred on analysis around the NPV=0 principle. There is limited discussion of the potential distortions of investment incentives and of the likelihood.

9. Further, the AER only goes so far as to find that this change *could* be in the long term interests of consumers[3], not that it is. The possibility of this approach having a benefit to consumers in the short term (because of a higher tax deduction) and disadvantaging future customers' needs to be considered. The AER notes (in respect of the current approach) that reducing generational inequity encourages efficient use of energy services and is in the long term interests of consumers.[4]

10. ATCO submits that further consideration of the implications of this possible change on the incentive framework and whether it is in fact in the long term interests of consumers should be undertaken before any change is made.

3.2 Application of diminishing value assumption

11. ATCO does not support the AER's proposed change to mandate the use of the diminishing value method to determine tax depreciation.

12. The AER's discussion paper proposes to use the diminishing value method instead of straight-line depreciation for tax purposes. The AER are also considering whether this change should be made prospectively or to existing assets (even though this would not align with the tax law).

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1 PWC, AER Tax Review 2018 Expert Advice, 26 October 2018, Page 20

2 For example, AER Discussion Paper, Review of regulatory tax approach, November 2018, Table 6.1 on page 48 of the Discussion Paper.

3 Ibid at page 62.

4 Ibid at page 61.

13. ATCO submits that the straight-line depreciation method results in more economically-efficient price signals to consumers as it results in a consistent level of depreciation and therefore stable prices. This is similar to the reasons why the AER have adopted the current cost accounting method in the post-tax revenue model (PTRM) for the regulated asset base (RAB), as it results in a more even allocation of the return on and of capital in real terms over time.

Economic Regulation Authority's previous considerations

14. The application of the diminishing value method was considered by the Economic Regulation Authority as part of its draft and final decisions for ATCO's 2014-2019 Access Arrangement. Ultimately, the Economic Regulation Authority accepted ATCO adopting the straight-line tax depreciation method.

15. In the ERA's draft decision, the ERA required ATCO to adopt the diminishing value method for tax depreciation:

> *2166. The Draft Decision required ATCO to apply diminishing value depreciation on new capital expenditure from the fourth access arrangement period to depreciate the TAB, in line with the behaviour of a benchmark efficient entity as outlined in the NGR.*[5]

16. In the ERA's final decision, the ERA accepted the straight line method for tax depreciation:

> *2170. The Authority has reviewed ATCO's response and the Ernst & Young opinion. The Authority has decided to accept ATCO's adoption of the straight line method to depreciate new capital expenditure in its TAB after 1 July 2014 for the following reasons:*
>
> - *The Authority has sought and obtained evidence from ATCO that it has and continues to adopt straight line depreciation in its tax returns. The Authority considers that ATCO has the incentive to select the most efficient tax depreciation method, particularly during the pre-tax regime.*
> - *The Authority now considers that a benchmark efficient entity would seek to minimise its tax liabilities over the lives of the assets, rather than over one access arrangement period only. Such an entity would select the tax depreciation methodology that achieves this, based on its circumstances. In a neutral NPV context, and in line with the National Gas Objective, the benchmark efficient entity would also safeguard the long term interests of consumers through making sure that costs are evenly spread out through the lives of assets.*[6]

17. ATCO submits that the Economic Regulation Authority have previously accepted that the straight-line method is in the long term interests of consumers. There is no reason for this to have changed. The AER's position appears to be premised on its finding that diminishing value depreciation is used for more than 60% of assets owned by private sector networks. As explained further below, this is insufficient to suggest the benchmark efficient approach is to always select diminishing value tax depreciation.

18. For the reasons noted by the ERA and summarised above, ATCO considers that the National Gas Objective and the Revenue and Pricing Principles are best met through the adoption of the straight-line tax depreciation method.

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5 Ibid, Para 2166

6 Ibid, Para 2170

Options are available under the tax law

19. The Income Tax Assessment Act provides for a choice of two methods to determine the decline in value of a depreciation value:

1. Diminishing value method
2. Prime cost method (also referred to as the straight-line method)

20. Once the choice of a depreciation method has been made, it cannot be changed.

21. Ernst and Young summarised this as part of ATCO's response to the ERA's 2014 Draft Decision:[7]

> 13. Under Section 40-65 of the ITAA 97, a taxpayer has a choice of 2 methods to work out the decline in value of a depreciating asset which is the diminishing value method or prime cost method (Note: I use the term "the straight-line method" in this addendum in substitution to "prime cost method" as it is the term used in the Draft Decision).
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> 14. Section 40-130 of the ITAA 97 states that a choice of the tax depreciation methods must be made by the day the taxpayer lodges the income tax return for the income year to which the choice relates or within a further time allowed by the Commissioner of Taxation. Once the choice over the tax depreciation method is made, the taxpayer cannot change it.
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> 15. Improvements or alterations to an existing depreciable asset are treated as being part of that depreciable asset. Costs of such improvements or alterations are added to the cost base of that depreciable asset and depreciated over the remaining effective life of that asset under the depreciation method that has been adopted for that asset.

22. Importantly, once a particular method of depreciation has been adopted for a particular asset, a tax payer must continue with that method over the life of the asset (or for the length of its ownership of the asset) and if similar assets are added in later years, the tax payer must also choose the same depreciation method for those assets.

23. This means that a network business does not have the freedom to change the depreciation method in response to any change in the requirements of the regulatory framework, but must continue to apply the depreciation method already adopted. For businesses that have adopted the straight-line method the mandating of the diminishing value method is inconsistent with the revenue and pricing principles as they will not be provided with a reasonable opportunity to recover at least the efficient costs the service provider incurs in providing reference services and complying with a regulatory obligation or requirement or making a regulatory payment.

24. There are difficulties involved in applying diminishing value method. ATCO notes that PWC have recommended that the AER develop appropriate polices to assist with any change, in relation to:

1. the classification of functional assets
2. the treatment of assets during the transition phase

25. ATCO submits that the added complexity of developing policies or guidelines could be avoided if the straight-line method is retained.

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7 Ernst & Young, Review of regulated tax asset base for regulated revenue purposes - addendum to the report of Vaughan Lindfield, 21 November 2014, Page 3, Available from: https://www.erawa.com.au/cproot/13047/2/20141129%20GDS%20-%20ATCO%20-%20AA4%20-%20Appendix%2012.4%20Review%20of%20regulated%20tax%20asset%20base%20for%20regulated%20revenue%20purposes%20-%20addendum%20to%20the%20report%20of%20Vaughan%20Lindfield,%20Ernst%20_%20Young.PDF

Diminishing value method may not be adopted by the benchmark efficient entity

26. As noted above, ATCO submits that it cannot be reasonably assumed that a benchmark efficient entity will always select the diminishing value tax depreciation method.

27. The AER's analysis demonstrates that the straight-line method is adopted by non-NTER entities for approximately 40% of assets by value.[8] It is reasonable to assume that these entities would seek to minimise tax liabilities to the extent permissible under tax law and in doing so they have adopted the straight-line method.

28. The AER's conclusions appears to presuppose that the diminishing value method will always be the best choice for taxpayers in minimising income tax liabilities. This cannot be correct as non-NTER entities have adopted the diminishing value method in respect of only 60.42% of assets by value.[9] A significant proportion are subject to the straight line tax depreciation method.

29. Ernst and Young made similar observations as part of ATCO's response to the ERA's 2014 Draft Decision:[10]

> c. As the ERA correctly pointed out at Paragraph 1103 of the Draft Decision, the diminishing value method is an option under tax law. If the ERA is correct by arguing that a benchmark efficient entity always adopts the diminishing value method, this leads to an absurd outcome that the choice of the depreciation methods becomes effectively redundant for federal taxpayers as a broad collective. The ERA approach appears to presuppose that the diminishing value method will always be the best choice for federal taxpayers in minimising their income tax liabilities. However, such a presumption is unlikely to be correct in all circumstances. Whilst the diminishing value method provides larger tax depreciation at an early stage of the effective life of a depreciable asset in comparison with the straight-line method, this is not the only factor for federal taxpayers to determine a choice of the tax depreciation methods. There are other relevant factors such as one described at Subparagraph d below.
>
> d. The diminishing value method results in an undeducted amount remaining at the end of the effective life of a depreciable asset whereas there is no such undeducted amount under the straight-line method. Given these characteristics of the depreciation methods and the size of the capital investments, infrastructure taxpayers will generally choose the method that provides the better after tax return based on discontinued cash flows. The assumption that the diminishing value method provides the best outcome in all circumstances is false. This choice can be influenced by many factors including any disparity between the economic life of the asset as compared to the effective life of the asset for tax purposes.

30. There is clear evidence that the benchmark efficient entity will not always adopt the diminishing value method. If it did then ATCO considers that the AER would have found a much higher percentage of firms adopting the diminishing value method. ATCO recognises that the benchmark efficient entity may not be the same for every service provider.

31. It is a highly relevant consideration for the AER to consider the practical difficulties in implementing any change from straight-line method to diminishing value method due to the tax law:

1. not allowing a change to the depreciation method once it has been made

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8 AER, Discussion paper – Review of regulatory tax approach, November 2018, Page 67

9 Ibid.

10 Ernst & Young, Review of regulated tax asset base for regulated revenue purposes - addendum to the report of Vaughan Lindfield, 21 November 2014, Page 4

2. requiring improvements or alterations to an existing depreciable asset to adopt the same depreciation method that has been adopted for that asset.

Straight line method mandated for some asset classes

32. The Income Tax Assessment Act requires that the straight-line method is adopted for certain types of assets. For example, buildings and intangible assets (such as software). This is acknowledged in PWC's report, which states:

> *…except in respect of intangible assets or capital works expenditure captured by Division 43 of the ITAA 1997 that are required to be deducted for tax purposes on a straight line basis…*[11]

33. For these asset classes it would be inconsistent with the tax law to adopt anything other than straight-line tax depreciation.

34. ATCO submits that the added complexity of adopting two different tax depreciation methods in the regulatory models could be avoided if the straight-line method is retained across all asset classes.

Smoothing effect over gas prices

35. It is important that considerations of the depreciation method result in the consumer receiving efficient pricing signals. During our recent Voice of the Customer engagements, participants told us that they value price stability.[12]

36. The AER have illustrated the different profile of tax depreciation under the straight-line and diminishing value methods in Figure 6.5 of its report. This shows that the diminishing value method results in rapid changes in prices.

37. Ernst and Young highlighted that the straight-line method will contribute to a stable pricing path both within an access arrangement period and between access arrangement periods.[13]

> h. The straight-line method produces a relatively constant depreciation amount over the effective life of a depreciable asset. As such, the adopt of the straight-line method should contribute to a "smoothing effect" over the gas pricing (i.e. less volatility in gas pricing) not only within the access arrangement period but also over the different access arrangement periods. The adoption of the diminishing value method for this access period is likely to increase tax costs in future access periods to the extent that the quantum of capital costs included do not remain at the same level (i.e. the starting base for future access periods may be lower as a consequence of adopting the diminishing value in respect of capital expenditure incurred after 1 July 2014).

38. The long term interests of consumers is best served by the tax costs incorporated into tariffs reflecting the tax costs that would be incurred by the benchmark efficient entity adopting the straight-line tax depreciation method. This is to ensure that consumers avoid seeing movements (up or down) in prices as a result of the individual tax circumstances of a firm. This is illustrated by the situation where consumers are receiving services from two firms that are identical in all aspects except its tax arrangements. These consumers should not receive different price signals simply because of the firm's

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[11] PWC, AER Tax Review 2018 Expert Advice, 26 October 2018, Page 20

[12] ATCO, 2020-24 Plan, 31 August 2018, Page 15, Available from: https://www.erawa.com.au/cproot/19448/2/ATCO%20AA5%20Access%20Arrangement%20Information.PDF

[13] Ernst & Young, Review of regulated tax asset base for regulated revenue purposes - addendum to the report of Vaughan Lindfield, 21 November 2014, Page 4

different tax arrangements. This example highlights the importance of the incentive regime to customers (who pay no more than efficient costs) as well as service providers (who are incentivised to act efficiently).

3.3 Gas asset lives

39. ATCO recognises that the tax law allows a cap of 20 years to be adopted for certain gas distribution assets.

40. ATCO notes that for gas distribution networks the 20 year cap applies to the following assets:[14]

- Pipelines
  - Generally
  - PolyvinylChloride (PVC) pipelines
- Regulators (including gate stations, subgate stations, block valve stations, pressure regulating stations and district regulating stations).

41. The 20 year cap does not apply across all asset classes of a gas distribution network, for example buildings tax lives are typically longer than 20 years and are not subject to the 20 year cap.

42. ATCO considers that if the AER were to require the application of the 20 year cap that it should be applied prospectively (to new capital expenditure) to avoid any unintended pricing effects.

[14] ATO, Taxation Ruling TR 2018/4, Page 181

4. Areas where more information is required

4.1 Interest expense adjustment in tax modelling

43. ATCO submits that the interest expense adopted in the tax modelling must reflect the same assumptions used in calculating the rate of return. To do anything else would create inconsistency in the framework and would represent a critical departure from incentive based regulation.

44. The AER are considering the case for adjusting the interest expense so that the regulatory approach to the tax deduction aligns more closely with observed tax management practices. The AER do not yet have all the relevant information and are waiting for further information before proposing any changes.

45. ATCO considers that adopting actual interest expenses would be inconsistent with retention of the current benchmark approach to calculate the tax building block and the revenue and pricing principles as:

- Customers would be exposed to greater risks from firm specific tax and financing choices than they currently bear under a benchmark approach
- Networks would face a material risk that inconsistent treatment for efficient costs and expenses between the tax and return on capital building blocks would lead to allowed revenues less than required to recover efficient costs

46. Adopting actual interest expenses would also be inconsistent with the AER's conclusions that it remains appropriate to insulate consumers from changes in market valuation on both the RAB and TAB. Asset transactions (mergers, acquisitions and privatisations) can increase (or decrease) the interest costs of the business. It would be inconsistent to insulate consumers from changes in market valuation on both the RAB and TAB but then expose consumers to the actual interest expenses that flow from any asset transactions.

47. ATCO notes that the AER's gearing assumption of 60% is consistent with the ATO's threshold for thin capitalisation, providing alignment with interest deductions allowed under the Tax law.

Thin capitalisation

48. Thin capitalisation measures apply to the total debt of the Australian operations of both inbound and outbound investors and aims to prevent excessive gearing of an Australian entity.

49. Broadly, the rules operate to deny deductions for interest expenses and borrowing costs (debt deductions) where an entity's actual debt exceeds the maximum level allowed by the law, in particular the safe harbour debt threshold which is set at 60% for debt funding.