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

Dear Warwick,

AusNet Services welcomes the opportunity to make a submission in response to the Australian Energy Regulator's (**AER**) Initial Report on the Review of Regulatory Tax Approach (**Review**). AusNet Services recognises that it is appropriate to look at the benchmark approach to deriving the tax allowance from time to time, to ensure it remains fit for purpose and to share the benefits of any changes in the benchmark approach with customers.

AusNet Services acknowledges the aggressive timeframes the AER has to undertake this highly complex review compared to other, often less complex, AER reviews. Despite this, it is important that any changes the AER intends are founded on sound principles and evidence. At this stage in the review, no case for a substantial change to the current benchmark approach to setting the tax allowance has been advanced. Rather, the current approach is benefiting customers by smoothing prices over the long-term.

We will work closely with the AER and its advisors to assist in the development of the RINs and the scope of information requested, to ensure they reflect useful evidence that cab be gathered within the tight timeframes.

AusNet Services remains circumspect about the possible changes presented in the Initial Report, and recognises the AER's caution as well. Changes to the existing approach will only be appropriate where they both better reflect the efficient behaviour of regulated network service providers, and are consistent with incentive regulation. To assess whether this is the case, we recommend that the AER generates some sound principles against which it can assess potential changes. This can occur in parallel with gathering evidence via the RINs, so as not to extend the tight timeframes.

The AER also needs to comply with the Revenue and Pricing Principles, which require compensation to reflect a network's efficient costs. It remains unclear how some of the approaches discussed in the Initial Report, such as a capped cost pass through approach, would be consistent with these Principles.

The Attachment discusses the relevance of the potential drivers of the perceived difference between tax paid and the regulatory allowance. Please contact Charlotte Eddy, Manager Economic Regulation on [redacted] with any questions in relation to this submission.

Regards

Tom Hallam
General Manager – Regulation and Network Strategy

Attachment – AusNet Services' submission to the AER's Review of the Regulatory Tax Approach

This Attachment outlines the relevance to the review of the potential drivers of differences between the benchmark tax allowance and actual tax paid.

Ownership Structure

The AER's paper states that its Review will 'consider the ownership structure that would be adopted by a benchmark firm.'[1] AusNet Services would be concerned if there were a single 'benchmark efficient structure' adopted for determining the regulatory tax allowance that was a departure from an Australian corporate structure. In this respect, AusNet Services agrees with Dr Lally's advice that the AER should not adjust the regulatory taxation allowance for non-corporate ownership structures.

The fact that some regulated NSPs have different ownership structures other than incorporated structures does not constitute a reason for changing the current benchmark. NSPs may have different ownership structures due to many different and complex considerations. Different structures may be efficient for different businesses in different circumstances, so it is not possible to conclude that a single structure is "benchmark efficient". AusNet Services was previously structured as a triple stapled security, and now has a corporate structure. AusNet Services considers its current structure is efficient and its tax payments reflect its efficient costs.

To conclude, it would not be possible, efficient or desirable for AusNet Services to change its ownership structure to revert to a stapled structure. If the benchmark efficient structure was changed to reflect a stapled or trust ownership structure, AusNet Services would be unable to replicate this. If this led to a lower regulated tax allowance, then AusNet Services would be unable to fund its efficient costs, which would breach the Revenue and Pricing Principles.

Possible Changes to Reflect Timing Differences

As set out in our previous submission, the main reasons why AusNet Services' tax paid is different than its regulatory tax allowance reflect differences in timing assumptions underpinning the two, and not systematic differences between AusNet Services' tax liability and the regulatory tax allowance. That is, over the life of a particular asset, the regulatory tax allowance received will closely match the tax paid; however, these may not match in any one year.

These timing differences should not be the focus of this review. The current benchmark approach produces a smoother profile of tax paid over time, than is the case in reality, which ultimately benefits customers through smoother prices.

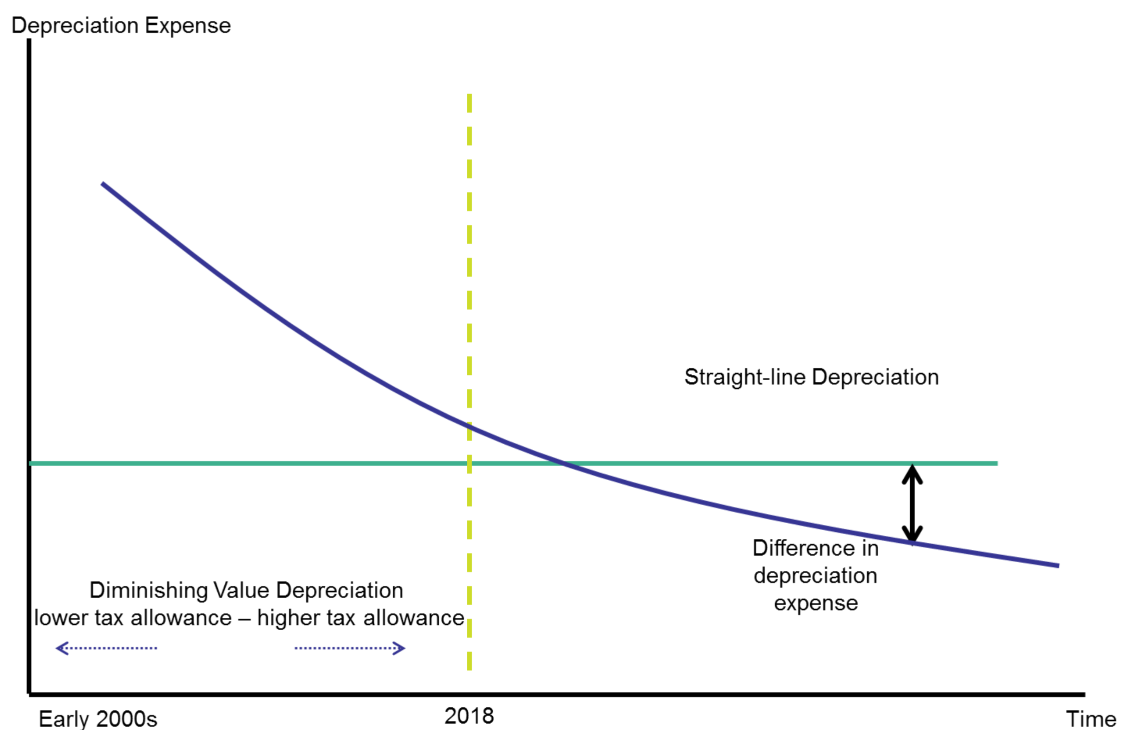
An important example of where timing differences can arise between tax paid and the regulatory tax allowance relates to the depreciation methodology chosen. There are lots of complex reasons as to why NSPs would choose to adopt various depreciation profiles for tax purposes. Two approaches most commonly used in practice are diminishing value and straight line. When an asset is established, a choice is made about its depreciation profile for tax purposes; this is then fixed over its life.

[1] AER, *Initial Report, Review of Regulatory Tax Approach,* p. 35

AusNet Services' electricity distribution network uses a mix of these approaches for new assets. However, at the time of purchase in the early 2000s, the diminishing value method was chosen to depreciate all existing assets.

AusNet Services has already realised most of the tax benefit of this decision; in the later years of these asset lives, the depreciation expenses will have a smaller impact on AusNet Services' actual tax paid than if the straight line approach had initially been chosen. Under the current benchmark approach to setting the tax allowance, it is customers that will benefit in the later years of the assets lives as, all else equal; AusNet Services' actual tax liability will be higher than its regulatory tax allowance. This effect can be seen in Figure 1 below.

Figure 1: Differences in Depreciation Methods



AusNet Services' gas distribution and electricity transmission networks predominantly use straight line depreciation for tax purposes for new assets.

The AER's paper raises the potential use of diminishing value depreciation for regulatory purposes. However, AusNet Services does not consider that applying diminishing value depreciation to new assets for tax purposes reflects the benchmark efficient practice (but it may be efficient for some businesses). That is, AusNet Services does not consider its existing practices in relation to depreciation for tax purposes are sub-optimal or inefficient. Rather, all else equal, the use of straight line depreciation smooths tax payable over time and, where reflected in the regulatory tax allowance, smooths customer prices.

In relation to low value pools, AusNet Services agrees with Lally that the addition of low-value pools into AER modelling will result in wasted effort for little to no benefit as NSPs will generally not use them. The ATO has determined that low-cost assets and low-value assets can be allocated into a low-value pool, defining a low-cost asset as one that costs less than $1,000

after deducting any GST credits, and a low-value asset as an asset which has been depreciated and now has a written-down value of less than $1,000, provided the diminishing value method was used. AusNet Services generally does not use low-value pools, as; firstly, very few of the assets owned and operated by any NSP will have a value lower than $1,000, even in the later years of an asset's useful life, and secondly, as straight line depreciation is applied to new assets we are unable to utilise a low-value pool in relation to these assets.

Introducing the immediate expensing of refurbishment into AER modelling will impact the balance of incentives between refurbishment and replacement expenditures if the two are treated differently in the revenue setting for RAB and TAB purposes.

To conclude, none of the options above affects the value of tax paid by the efficient firm but rather its timing. The current regulatory approach smooths the timing of tax payments and therefore, smooths customers' prices. To make ex-post changes to these arrangement raises a substantial risk that over or under compensation will occur to the detriment either of customers or investors.

Possible Changes to Other Drivers and Actuals

As set out above, any changes to how the regulatory tax allowance is set must be based on both sound principles and supported by evidence. As yet, no principles have been established nor has evidence been gathered about benchmark efficient tax practices. Many of the potential changes included in Tables 6.2 and 6.3 of the Initial Report incorporate some elements of actual tax practice (e.g. TAB revaluations, gearing used for tax purposes, actual depreciation expense), and retain some elements of the benchmark approach.

Generally, it is problematic to 'pick and choose' particular components from each of the two regimes. These approaches seem to reflect a move away from incentive-based regulation and also risks undercompensating networks for costs associated with their regulated activities. This would occur if, for example, tax deductions on costs sitting outside the regulatory regime, including some R&D expenditure and stamp duty payments, were also deducted from the regulatory tax allowance.

A move to actuals could also have perverse impacts on prices. As set out above, the broad application of diminishing value depreciation to AusNet Services' assets in the early 2000s has resulted in lower tax paid compared to the regulatory allowance, all else equal. Going forward, tax costs would be expected to rise above the benchmark approach. Moving to an actual or cost pass through approach at this time risks increasing prices compared to the current benchmark approach to setting the regulatory tax allowance.

In relation to gearing, an internally consistent benchmark gearing assumption should apply to both the calculation of tax and the calculation of the WACC. This benchmark gearing should be 60%, which has been determined by the AER in the Rate of Return Review as the gearing for a benchmark efficient entity. Adoption of a different gearing in the calculation of regulated tax payable would not be internally consistent and in this case, it would not be clear how a benchmark efficient entity was defined.

We do not support the development of an incentive scheme to enable over/ underspends to be shared between networks and customers. Such a scheme would not seem consistent with the philosophy of tax practice, would be problematic given the volatility of tax payments, and perversely would weaken the current incentive to pay no more than the legally required amount of tax under the regulatory framework.

As set out in its submission to the Issues Paper, AusNet Services' tax paid since 2013 has been volatile, which is not unusual. This does highlight a potential problem with moving to an actual tax approach, as this volatility would be reflected in prices faced by customers. This would also be a fundamental departure from incentive-based regulation, which AusNet Services continues to strongly support.