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31 May 2018

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

Dear Warwick,

AER Review of Regulatory Tax Approach – Issues Paper

AusNet Services welcomes the opportunity to respond to the AER's Issues Paper. We recognise that customers have an interest in ensuring that the prices they pay for network services are set at a level that does not over-compensate network businesses over the longer term and will engage constructively and transparently.

The taxation of capital intensive infrastructure businesses is an extremely complex area. The benchmark approach to setting the tax allowance has been applied for many years, having been adopted for sound conceptual reasons, including because the use of actual tax costs was acknowledged to be inconsistent with setting revenues independent of ownership decisions. In addition, the use of the benchmark approach has also been beneficial in smoothing prices for customers as tax timing assumptions often differ under the actual and regulatory tax approaches.

This submission compares the actual tax paid by AusNet Services Ltd and the regulatory tax allowance across its three regulated networks. The reasons for the difference are explained below, and all relate to timing differences, rather than any systematic reasons that would render the benchmark inappropriate over the long term. The benchmark allowance is smoother over time than actual tax paid.

AusNet Services' Tax Paid vs Regulatory Allowance

To provide stakeholders with full transparency, AusNet Services' tax paid against the regulated benchmark is below.

Table: Tax Paid vs Regulatory Tax Allowance (year end 31 March)

$m, nominal	**2013**	**2014**	**2015**	**2016**	**2017**	**Total**
Actual tax paid (per corporate accounts)	40.8	35.4	54.5	141.7	49.4	**321.8**
Regulatory tax allowance	54.3	55.0	46.7	55.0	77.2	**288.2**
Revenue (tax allowance net gamma)	30.4	32.1	24.1	28.8	40.7	**156.2**

Note –Includes tax paid in relation to unregulated and non-core regulated services.

All information is publically available in AusNet Services' corporate accounts and regulatory determinations.

Difference between Actual Tax Paid and Regulatory Tax Allowance

The ATO's note outlines four potential drivers of differences between actual tax paid and the regulatory tax allowance. The relevance of these factors for AusNet Services is explained below.

1. Entity Structure

Entity structure is not a driver of the difference between actual tax paid and allowance for AusNet Services.

The ATO highlights that entity structures where tax is payable at an investor level, not the entity level, as a reason for disparity between the benchmark allowance and actual tax paid. AusNet Services simplified its corporate structure in June 2015, from a triple stapled security, to a structure with a single head company (AusNet Services Ltd). From June 2015 profits generated are taxed at the corporate tax rate at the entity level, and are not passed through to investors and taxed at their marginal rates.

As part of this restructure, the Tax Asset Base for AusNet Services' electricity distribution and gas businesses were revalued and increased by approximately $1 billion. However, this was offset by the cancellation of tax losses worth approximately $1 billion.

Since this restructure, AusNet Services' debt is exclusively third party, arm's length debt and deductions for interest expenses reflect competitive rates.

2. Deductions for Interest Expenses

As per the ATO note, deductions for interest expenses would drive outperformance of the tax benchmark if RAB gearing (total debt/ RAB), was materially higher than the AER's benchmark gearing of 60% (based on total debt/ market value). This explains some of the difference for AusNet Services.

When an entity's market value is higher than its RAB, and its capital structure reflects the AER's benchmark gearing (60% of market value), then the total value of debt will be exceed 60% of the RAB. All else equal, this would result in higher interest expense deductions for actual tax purposes than under the regulatory tax approach.

As this additional interest expense is not funded through regulated revenues, these additional deductions sit outside the regulatory framework when considering the regulatory benchmark tax allowance.

3. Tax Loss Carry Forwards

As at 2018, AusNet Services has no remaining carry forward tax losses so this will no longer drive differences between tax paid and the regulatory allowance going forward.

4. Deductions for Depreciation

Differences in the treatment of fixed assets for regulatory and actual tax are the main driver of the difference between AusNet Services' regulatory tax allowance and the amount of tax paid.

The AER's Issues Paper recognises that networks may treat some replacement capex as an expense for tax purposes. This can include the replacement of cross arm, poles, and conductors. This tax treatment is a long standing industry practice that is accepted by the ATO. Particularly for electricity distribution networks, this can be a material cause of the difference between the benchmark tax allowance and actual tax.

This difference is only a timing difference and will not result in sustained outperformance of the benchmark tax allowance over the longer term – indeed, in future AusNet Services will need to pay significantly more tax than is provided for in regulated revenues, as the benchmark approach will continue to deduct tax depreciation for these assets while actual tax will not. In this way, the benchmark approach smooths price outcomes over time, compared to actual tax paid.

AusNet Services Ltd lodges a single income tax return that combines the income and expenditure of its three regulated networks and its unregulated transactions. As a result of having a single tax consolidated tax group, accelerated tax deductions for certain assets in one regulated business are able to be offset against the taxable profits in another regulated business or unregulated transactions. If AusNet Services Ltd was a single regulated network, these deductions would be carried forward as losses so, as per the above, this consolidation only impacts timing, and is not a systematic difference in tax paid.

In the electricity distribution business, the diminishing value method of depreciation is predominantly used, and contributes to some of the difference between the benchmark and actual tax allowance for AusNet Services – again, this is only a timing difference. The gas distribution and electricity transmission businesses predominantly use the straight line method of depreciation.

The ATO note also referred to the low-value pool mechanism to shorten the life of low value assets. This is not a material driver of the difference between the benchmark and actual tax allowance for AusNet Services.

Additional Reasons Identified by the AER

Of the additional reasons suggested by the AER, the following have been addressed above:

- Cost of debt
- Tax Asset Base revaluation
- Immediate expensing of refurbishment

R&D deductions are not a material driver of the difference for AusNet Services.

Tax disputes with the ATO can also drive significant differences between actual tax paid and the regulatory allowance.

An additional factor that may explain some of the difference is the treatment of provision movements. The movement in provisions such as employee entitlements is deductible for tax purposes when actually paid, whereas the regulatory treatment is to treat as deductible when it is accrued.

Please contact Charlotte Eddy, Manager Economic Regulation on 03 9695 6309 with any questions in relation to this submission.

Sincerely,

Tom Hallam
General Manager Regulation and Network Strategy
AusNet Services