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Warwick Anderson
General Manager Network Finance and Reporting
Australian Energy Regulator
GPO Box 3131
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Dear Warwick,

AER Review of Regulatory Tax Approach: Response to Discussion Paper

AusNet Services is grateful for the opportunity to participate in the consultation process for the AER's review of the regulatory tax approach.

As outlined in our previous submissions to this review, we support periodic assessments of regulatory benchmarks to ensure that they continue to reflect efficient practice. Where there is evidence of a change in efficient tax approaches, the benchmark should be updated to reflect this to ensure customers benefit from continued efficiencies. AusNet Services continues to engage constructively and transparently in this review, including by providing tax information voluntarily and responding to the recent AER Tax RIN.

AusNet Services welcomes many aspects of the AER's Discussion Paper, including its decision not to move to an actual tax cost pass through regime. AusNet Services agrees that this would not be in the long-term interests of customers. It would also be at odds with the principles of incentive-based regulation, which AusNet Services has long supported. For these reasons, the AER should not adopt approaches that are effectively a 'hybrid' of an actual and a benchmark approach (such as use of actual gearing for taxation purposes), as they distort the frameworks' incentive properties and lack any clear rationale.

AusNet Services also agrees with the AER's decision not to reflect any changes in a networks' actual tax asset base, which sit outside the regulatory regime, in the regulatory tax approach. Again, this would have eroded the separation between the 'benchmark' and actual tax approaches.

Indeed, maintaining the principle of incentive-based regulation should be a primary consideration in the AER's decision making in this review. That is, any changes made to the current benchmark approach should result in incentives that encourage networks to act in the long-run interests of consumers. However, some of the potential options raised by the AER (such as incorporating immediately deductible capex in the regulatory tax allowance) do not meet this criterion and would result in poor outcomes for customers over the long-term.

Previously, we submitted that timing differences should not be the focus of the AER's review. While we agree with the AER that there are some timing effects associated with different tax depreciation profiles under due to the regulatory modelling assumptions, the pursuit of these

benefits should be a consideration in the AER's review, but not pursued if there are adverse consequences which outweigh the customer benefits.

Tax is an extremely complex area, and there are lots of reasons why it may be not desirable for a network to solely adopt a single approach (such as declining value depreciation), despite it theoretically leading to a lower NPV cost over an asset's long life.

Applying Changes Prospectively vs Retrospectively

In several parts of its Discussion Paper the AER raises transitional options that would result in retrospective adjustments to the previously approved regulatory treatment of existing assets – for example, applying declining value depreciation across the new and existing TAB – even where a network would be unable to change approaches applied to existing assets under Australian Tax Law.

We are highly concerned that the AER has raised retrospective applications as options in its review – this goes against sound principles of economic regulation, including certainty, stability and predictability. It would be very unusual for the AER to impose an approach on the network that reverses its previous decisions on the regulatory treatment of particular assets, particularly when this change is not consistent with Tax Law and would not be able to be implemented by businesses.

In addition, in some cases, applying retrospective changes in approach could result in severe cash flow shortfalls compared to actual expenses. For example, when AusNet Services' electricity distribution network was purchased in the early-2000s, the diminishing value depreciation approach was applied to all assets. Today, 15 years later, for some asset classes the period of lower tax payments associated with approach is almost at its end, and soon the tax payments for these assets will be higher than allowed under the AER's regulatory tax approach (which uses straight line depreciation). If, for regulatory purposes, all these assets were to be depreciated using a diminishing value approach starting today, the resulting tax allowance would be much lower than the tax expense today of these assets. It could also create cash flow difficulties for the businesses.

While applying retrospective changes may benefit customers in the short-term through lower prices, it will severely reduce investor confidence and will chill investment in the sector. Regulatory stability and predictability is greatly valued by investors, as expressed in the Network Shareholder Group's submission:

> *As providers of long-term capital to support the provision of reliable energy network services to customers, we seek a regulatory regime that provides ongoing confidence to invest efficiently through stable and transparent processes and outcomes, and importantly with confidence and certainty across multiple regulatory periods and resets. This ensures that risk remains consistent with investor expectations, reduces the cost of new capital to NSPs and delivers lower prices to customers.*[1]

[1] Network Shareholder Group, *Submission to the AER's Initial Report Paper on the review of regulatory tax approach*, 26 July 2018.

Eroding the stability and predictability of the regulatory regime should be taken seriously by the AER due to the long-term consequences a lack of quality investment in the sector will have on customers.

Diminishing Value Depreciation

As described in our earlier submissions, AusNet Services applies a mix of prime cost (straight line) and diminishing value depreciation to new assets. This has been our approach for many years and we consider that it is an efficient tax strategy. As a privately owned network, AusNet Services has strong incentives to adopt efficient tax practices and pay no more than the legally required amount of tax.

These efficient practices include adopting prime cost depreciation in some circumstances – which can help smooth the profile of cash tax payments. A smoother cash tax paying profile allows investors to forecast and model the value of franking credits, and factor this into decisions, rather than discount the value of these credits due to tax cash flow volatility.

Indeed, PwC's analysis of businesses' voluntarily provided tax information concludes that up to 40% of assets held by private sector entities have the prime cost method of depreciation applied. If State-owned National Tax Equivalent Regime (NTER) entities are included, this rises to 57%.

PwC and the AER have observed that:

- 60% of assets owned by private sector entities are depreciated using the DV approach; and
- Over a 40 year asset life, DV results in a slightly lower NPV tax cost than the PC approach.

This information has led them to conclude that DV depreciation is **the** benchmark efficient tax practice, and should potentially be applied to 100% of assets in the regulatory allowance.

This conclusion is unreasonable for the following reasons:

- 40% is a material proportion of assets that can't be assumed away as inefficient practice. As private sector entities, operating under strong cost efficiency incentives, continue to apply PC depreciation to 40% of their assets, it cannot be assumed that this is inefficient behaviour. The tax regime is highly complex and there are other reasons why networks continue to use PC depreciation as part of an efficient tax management strategy. For example, it creates cash flow stability where the assets constructed have a material impact on the company's allowable deductions. In this way PC depreciation can smooth prices for customers and, importantly, create cash flow stability for a business.

- In explaining the incentive benchmark approach on pages 21 and 22 of its Discussion Paper, the AER explains that:

  'Consumers also benefit when efficient approaches or costs are revealed and more accurate or efficient benchmark is set in subsequent regulatory periods. Over multiple regulatory periods this cycle of efficiency gains, revealed costs and lower benchmarks benefits both energy networks and consumers.'

The AER's consideration of this issue goes beyond 'revealed cost' – the data **reveals** that 40% of assets are depreciated using PC; not that it is efficient tax practice for 100% of assets to be depreciated using DV.

Indeed, picking a single low-cost approach and applying it as the efficient benchmark, despite it not being comprehensively applied, is at odds with other parts of the building block model that do use revealed cost, being:

- *Cost of debt* – the AER sets the efficient benchmark debt costs based on the average observed credit rating of the 'benchmark' firm. It does not adopt the observed credit rating that will generate the lowest costs overtime as the benchmark.
- *Operating Expenditure* – the AER does not apply an opex forecast based on an aggregation of the lowest cost practices observed across the industry – rather it looks at revealed opex for each firm and (unless materially inefficient) bases the new benchmark on this revealed cost.

If DV were applied to 100% of new assets, in the short term it would materially undercompensate networks continuing to use the PC method. Due to the significant difference in short term cash flows, this approach would strongly encourage networks to apply 100% DV to mirror the regulatory tax allowance, rather than continue to adopt their own efficient tax practices that suit the circumstances of their business.

In establishing a benchmark in relation to depreciation approaches, the AER should consider using the approach 'revealed' by the data and establishing a benchmark that uses both the DV and the PC approaches, to reflect the proportions of the actual use of these approaches.

Immediate Expensing of Refurbishments

Reflecting the immediate expensing of certain capex for tax purposes in the regulatory tax allowance will not result in lower prices for customers. If the AER makes this change, we will amend our regulatory capitalisation policies to treat refurbishment expenditure as opex, so that making efficient decisions to refurbish rather than replace assets will not have a negative short-term impact on cash flow. This will significantly increase prices for customers, which is contrary to the AER's objectives of making this change. There is precedent for networks changing their regulatory capitalisation practices in a similar way, and these changes are not always reflected in the AER's opex benchmarking.

AusNet Services considers that reflecting the practice of immediately expending refurbishment expenditure for regulatory tax purposes, while continuing to treat it as a long-lived capital investment for regulatory revenue purposes, is not consistent with the principles of incentive based regulation and is likely to lead to adverse customer outcomes.

While there may be a timing benefit in incorporating this tax practice in the regulatory tax allowance over the life of the asset, the benefit is relatively small in comparison to the adverse customer outcomes that may be generated.

These include:

- As outlined in the ENA's submission on this matter, incorporating this practice in the regime would result in a short term reduction in a network's revenue when undertaking

refurbishments, compared to replacements. This is because the revenue associated with these long-lived capital investments is recovered over a long period of time. In the short-run, the negative impact on the tax allowance of undertaking refurbishments will be greater than the revenue recovered for these assets. Like many of our business customers, near-term cash flow impacts matter when making investment decisions. The prospect of a short-term reduction in revenues from refurbishing assets would create an incentive to favour asset replacements over refurbishments, even if they were a less efficient option.

- Inter-generational customer equity issues arise. Under the current regulatory framework, revenue recovery is back-ended due to RAB indexation. Introducing this change in setting the regulatory tax allowance will further back end revenues associated with particular assets – that is, today's customers will be paying relatively less for their use of these assets, while future customers will be paying more. The AER needs to have regard to whether this change is in the long-term interests of customer, and not only on the short-term price impacts that may arise.

If the AER were minded to make a change, a benchmark should be applied rather than an approach that reflects a network's actual practice. This approach would be more consistent with a benchmark regime that provides incentives to adopt efficient tax practices. As explained above, a hybrid approach based on both actual practices and benchmarks for various inputs is unnecessarily complex and confusing.

An approach which incorporates the actual practice of the individual network is an example of this hybrid approach which would be very complex to administer, and expose networks and customers to significant risk of forecasting error. The amount of immediately deductible expenditure can be very volatile year-on-year. Requiring networks to forecast this for five years at the time of their revenue determinations could result in cash flow volatility for the business within the regulatory period, if the forecast does not match the actual expenditure.

Neither PwC nor Lally provide compelling reasons as to why reflecting the actual practice of the NSP in the tax allowance is the superior approach to a benchmark in this particular instance, and does not suffer from the same incentive problems as under an actual tax approach.

Notwithstanding the above, AusNet Services re-iterates its strong support for the ENA's submission on this matter, and considers a change would not be in the long-term interests of customers.

20 Years for Gas Distribution Asset Lives

While we recognise that there is a difference between gas distribution asset lives assigned for regulatory tax purposes, and those applied in the actual tax regime (capped at 20 years), the materiality of implementing this change in the long run may not be material.

This is because if a network is in a steady state (i.e. the types of assets and the size of its asset base is relatively constant over time) then the total annual depreciation expense should not vary materially under different asset lives. While an asset with a life of 40 years will have half the annual depreciation expense than an asset of 20 years, there will be double the number of the 40 year life assets remaining in the regulatory Tax Asset Base in any one year, resulting in an equivalent total depreciation expense (absent the positive NPV timing impact of the scenario with shorter lives).

The AER should assess the materiality of the difference between the current scenario (where lives longer than 20 years are assumed in the regulatory tax allowance) and the future scenario (where lives are capped at 20 years for regulatory tax purposes) before deciding whether to implement this change. In AusNet Services' view, the difference may not justify the complexity of transitioning to the new approach.

If the AER concludes a change is warranted, then further detailed consideration must be given to the transition. In particular, any transition path should not result in a lower tax allowance than the end point scenario i.e. where all assets have a 20 year cap applied.

More thought and consultation is required on appropriate transition paths for any changes made in relation to this matter, as it is not clear that the options presented in the AER's paper.

Interest and Gearing

The AER has yet to consider whether a change in the interest expense and gearing assumptions used to set the regulatory tax allowance is desirable.

AusNet Services agrees with the AER's consultants that the same gearing should be adopted for both rate of return and tax calculations. We note this was also the conclusion reached by the Independent Expert Panel on the Rate of Return. The gearing adopted in the regulatory modelling should reflect the efficient gearing level of the benchmark firm. This has been determined by the Rate of Return Guideline review as being equal to 60%. This should be consistently reflected in the building blocks.

If actual gearing is applied for tax purposes, this will result in a tax allowance that is based partially on benchmark inputs and partially on actual inputs. The AER has determined that a move to an actual tax pass through regime is not desirable. A hybrid approach would suffer from many of the shortfalls of an actual pass through approach, with an added element of complexity.

The same logic can be applied to interest expense, which should again be based on the benchmark cost of debt which will shortly be determined by the finalisation of the Rate of Return Guideline.

Please contact Charlotte Eddy, Manager Economic Regulation, on [redacted] with any questions in relation to this submission.

Sincerely,

[redacted]

Tom Hallam
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AusNet Services