Ausgrid Submission

AER Profitability measures: return on equity and allocations of interest and tax expenses

August 2019

22 August 2019

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

Ausgrid

24-28 Campbell St
Sydney NSW 2000
All mail to
GPO Box 4009
Sydney NSW 2001
T +61 2 131 525
ausgrid.com.au

Lodged online

Dear Warwick,

Ausgrid welcomes the opportunity to comment on the proposed methods of allocating tax and interest for the purposes of calculating regulatory return on equity, outlined in the PwC report Australian Energy Regulator: Profitability measures review – Advice on the allocation of interest and tax expense – 28 June 2019.

While we have provided feedback on the specific options proposed, our overall view is consistent with previous submissions made by Energy Networks Australia (ENA) and other Network Service Providers (NSPs) regarding the potential for misinterpretation of some of the ratios, particularly those using Net Profit after Interest and Tax (NPAT). The tax and interest position of the NSPs are key elements of the capital structure of any entity, and the NPAT metric is influenced by many factors and could be low or high in any given year due to one-off events. It will be critical to ensure associated commentary is appropriate to facilitate proper understanding of the ratios.

In summary, our views are:

- Tax allocation should be 30% for all NSPs; and
- NSPs should be able to select the most appropriate interest allocation from the three suggested methods.

Ausgrid also believes that these changes need to be considered together with the measure of Regulated Equity so that an accurate calculation of the Regulatory Return on Equity is made. Ausgrid's statutory equity includes goodwill that was paid on privatisation on 1 December 2016. At that time, the non-regulated component of Ausgrid was immaterial – Ausgrid purchased Active Stream from AGL on 30 November 2017 which is now a ringfenced entity within the Ausgrid group. Ausgrid believes that Regulated Equity should be calculated based on the Statutory Equity minus the equity associated with the ringfenced entity PLUS ES. The proposed approach by the AER to calculate regulated equity by applying the benchmark gearing ratio to the regulated asset base (RAB) would significantly overstate the Regulatory Return on Equity.

Please refer to our submission below for further details. If you have any queries in respect of this submission, please contact [redacted]

Yours sincerely

[redacted]

Iftekhar Omar
Head of Regulation

Submission

General observations

Ausgrid notes that complying with additional reporting requirements to facilitate reporting of profitability measures will impose additional effort and cost on NSPs (e.g. internal resources and external audit costs for the additional data required for the profit measures), a point that has been put forward in previous submissions and acknowledged by the AER. We encourage the AER to consider this when deciding on methods to allocate tax and interest for calculating regulatory NPAT.

The income template published in the AER's draft position and associated explanation requires two regulatory columns to be completed, the "service provider" and "core regulated services". This implies that two allocations will need to be made, one for standard control services (SCS) only and one which includes SCS and alternative control services (ACS). We request the AER clarify whether this is the case.

Tax allocations

Ausgrid's view is that all NSPs should apply a 30% tax rate to calculate Regulatory NPAT. In the 2018 tax review, the AER identified that assuming different tax rates for NSPs based on their current ownership structures under a pass-through approach for determining tax allowances may not be in the long-term interests of customers.[1] This is because, under such an approach, businesses may be driven to simply incur high tax costs as they could simply pass these through to customers. In the context of the AER's profitability measures, we believe that applying some blended tax rate below 30% as suggested by PwC for flow-through structures may unfairly overstate the profit position of some NSPs relative to others. This could expose businesses to greater or less regulatory or political scrutiny due to a perception of profitability driven simply by a particular ownership structure. A further inefficient consequence could be that businesses are driven to prefer a corporate structure (even if the ultimate investors remain the same) because this would shield them from such inequitable treatment.

Our concern can be illustrated through the following examples:

1. An NSP that is a corporate entity derives a before tax profit of $100, pays 30% tax and then distributes a fully franked dividend of $70 to its sole and ultimate owner, an Australian superfund. The Australian superfund's legislated tax rate is 15% and through the franking credit system, the superfund is entitled to a refund up to $15 of the tax paid by the NSP on the $100 profit. Thus, the tax paid on profit by the Australian superfund could be as low as 15%.

[1] AER, *Tax Review Final Report*, December 2018, p. 6.

2. An NSP that operates under a flow through structure derives a before tax profit of $100 and pays this to its sole and ultimate owner, an Australian superfund. This superfund is then required to pay tax at its legislated tax rate of 15%.

Under PwC's proposed approach, the NSP's owner in the first example would be assumed to only receive an equity return of $70 (even though it is entitled to receive a further $15 through franking credit rebates). In the second example, the NSP's owner would be assumed to earn a much higher return of around $80.5 (at PwC's example "blended rate" of 19.5%), even though in the two examples above, the ultimate investor is an Australian superfund, obliged to pay 15% tax and therefore entitled to earn a return of $85 at the superfund level.

Our concern is that there will be a misleading perception that certain NSPs are more, or less, profitable due to the economic regulatory treatment of these NSPs by the AER, when the results are simply a reflection of the tax treatment of these entities under tax legislation.

The Australian tax framework is premised on ensuring that the tax paid by ultimate owner is agnostic to whether the capital structure is a flow-through or not. Therefore, the actual after-tax profitability of the NSP is at the owner level and not at the NSP. Given the myriad tax profiles of ultimate investors in NSPs, which are often not known by the NSPs, nor the AER, Ausgrid submits that a 30% tax rate should be applied across all NSPs. This ensures a fair and consistent approach across NSPs.

Another example of how applying the differential rates of tax to NSPs when calculating regulatory NPAT could be misleading is borne out when considering state government owned entities that operate under the National Tax Equivalent Regime (NTER). The PwC recommendation states that the AER should consider the tax rate applicable to flow-through structures held by state owners which are not subject to the NTER[2]. This implies that the AER might consider applying something other than 30% for the state-owned proportion of NSPs that operate under a flow through structure, which are not part of the NTER. However, a NSP that is wholly state government owned and subject to the NTER that derives a profit of $100, which is fully distributed, would pay a $70 dividend and $30 as a tax payment that would accrue to the state government shareholder. Under PwC's proposed approach to assume 30% tax for this NSP, the return to equity would be assumed to be $70, even though the full return to the ultimate shareholder is $100..

[2] PwC, *Australian Energy Regulator: Profitability Measures Review – Advice on the allocation of interest and tax review*, June 2019, p26.

Ultimately, whether a payment is made to a state government owner as a “tax” payment under the NTER or otherwise, as a dividend distribution, is irrelevant, as the state government owner will receive tax paid under the NTER as a cash distribution. On this basis, Ausgrid believes the fairest outcome is that all entities have a 30% tax rate applied, regardless of NTER status.

The above examples illustrate how PwC’s proposed approach could lead to misleading perceptions of profitability across NSPs, which appear to be particularly unfavourable to NSPs held under a flow-through structure.

Ausgrid is also concerned that the recommendation for allocating tax expenses for flow-through structures causes another level of complexity and difficulty with no discernible benefit. For example, Ausgrid is held by various investors that hold their interests through feeder funds, and Ausgrid is not privy to any change in upstream investors or their tax arrangements.

In summary, Ausgrid does not support PwC’s proposal to apply a self-assessed rate for flow-through entities only, because other ownership structures may well incur tax rates different to 30%. We submit that the AER adopt a consistent approach of applying a 30% tax rate to estimated regulatory net profit before tax to estimate Regulatory NPAT, which would result in fair treatment across DNSPs.

Adjustments

With respect to the tax effect of RAB depreciation attributable to inflation and other adjustments, Ausgrid welcomes the opportunity to work with the AER to determine the most effective way forward.

Interest allocation

Ausgrid supports businesses being able to choose which method they use to allocate interest to the regulated component of their business. NSPs have differing approaches to tracking interest costs internally, and therefore information that is readily available to allocate interest costs to the regulated component of their business will differ by NSP. For this reason, each NSP should be given the flexibility to choose which method it uses to allocate interest costs, considering both accuracy and administrative simplicity.

Of the three options identified by PwC, Ausgrid prefers method 1 (regulatory earnings before interest and tax (EBIT)/Statutory EBIT). The simplicity and ease of application means that it will cause the least administrative burden to the businesses. Further, most NSPs track EBIT across different lines of business so the information will be more readily available.

With respect to method 2, Ausgrid is concerned that one-off events, for example revaluations or impairments of the statutory assets, may produce an unreasonable interest allocation. As noted in the PwC report, these adjustments are unrelated to the value of the assets at the time they were debt funded[3], and would incorrectly skew the ratio. Another issue that arises is the application of different accounting standards which affects the carrying values of assets, further limiting the comparability of results across NSPs.

Further, all else being equal, i.e. no new additions, the RAB would depreciate slower than statutory assets due to indexation which would lead to the proportion being allocated to regulated assets increasing over time even though there has been no change to debt or interest. We note that this disadvantage was highlighted by PwC and it was observed that the ratio could be greater than 1.[4] A ratio prone to illogical outcomes such as this does not seem to be robust for this purpose.

Method 3 is reasonable if a business has the resources to readily calculate a bespoke ratio and feels that it would best represent the allocation of interest.

[3] PwC, *Australian Energy Regulator: Profitability Measures Review – Advice on the allocation of interest and tax review*, June 2019, p31.
[4] PwC, *Australian Energy Regulator: Profitability Measures Review – Advice on the allocation of interest and tax review*, June 2019, p31


Thank you
Ausgrid