CCP 22 – Tax Review
AER Forum Presentation – 19 July 2018

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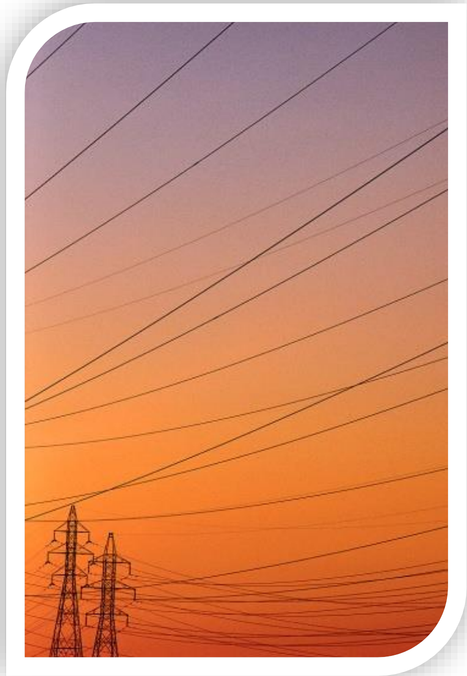

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Consumer Challenge Panel

Outline

1. What do we know now?
2. What do we need to know?
3. What do consumers think?
4. Some suggested principles for this review
5. A suggested way forward
6. Current incentive structures are much greater to reduce tax than opex or capex
7. Preliminary response to Prof Lally's paper
8. Response to AER's specific questions

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What do we know now?

- A high level analysis by the AER and the ATO suggests that:
  - For private sector networks, actual tax payments are lower than the AER allowance
  - For publicly owned networks, actual tax payment are higher then the AER allowance
- There are many potential reasons for these differences but we do not know how material these reasons might be
- Under the AER's incentive based regulatory framework:
  - It is designed to replicate what would occur in a "workably competitive" market
  - "unders and overs" in particular building blocks are a natural part of the framework as networks are incentivised to do better, but may not always do so
  - The description of what a benchmark efficient entity (BEE) means eg capex/opex levels, is not static but will change over time
- Strong grounds for concern – need to know more

What do we need to know?

- What networks, both privately and publicly owned actually pay in tax over time
  - Including coming to a view on the time period that should be examined
- How the actual tax paid compares to the AER allowances
- What are the major drivers of that tax payment
- And what does that mean for collecting RIN data

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What do consumers think -1?

- That they are paying a high price for the failure over the last 10 years of the energy supply chain to achieve the NEO/NGO and see networks costs as the prime cause of this
- Consumers do expect more of networks – there is a social licence to operate a regulated monopoly providing an essential service
- Affordability has been ignored – most recently seen in the ACCC Electricity report, but has been clear in many other reports in recent years
- The high level evidence provided by the AER and ATO suggests further work needs to be done to see if there is a problem and how material it is
  - Consumers do not accept the view "it is simply incentive based regulation working" even if they understood what incentive based regulation actually meant

What do consumers think - 2?

- The so-called “regulatory bargain” between networks, the AER and consumers has largely favoured networks which have faced incentives to overinvest and earned rates of return above that which would be the case in a workably competitive market
  - Consumers have borne most if not all of the regulatory risk
- Key part of the “bargain” is trust and regaining it requires transparency
  - In this case around corporate structures and actual tax paid
  - Disappointed to see some networks either not willing to provide tax data or apparently hiding behind a “too difficult to provide” veil
- Purchasers of network assets need to recognise that they may have to bear regulatory risk different to their assumptions in their bid models

Some suggested principles for this review

- The approach should reflect that networks pursuing tax minimisation is perfectly legitimate activity subject to the community's views of their social licence
- Preference for a sector-wide tax benchmark
- The approach should reflect the rate of taxation that would be levied on a private company operating in a workably competitive market solely to provide the services supplied by the regulated business
  - Consistent with the approach on the cost of debt
- The level of transparency provided by the AER should be sufficient to enable third party verification within the constraints of commercial confidentiality
- The approach should aim to achieve the best estimate of benchmark tax taking into account the benefits to consumers relative to the regulatory costs imposed on businesses and the regulator

A suggested way forward

1. Establish the benchmark entity
   - Possibility: "A network utility in private ownership that adopts commonly implemented, legal strategies to minimise tax payments over time"
2. Establish the extent to which allowed tax typically overstates the actual payments of the benchmark entity
   - This is critical and will require detailed data on the regulated activities of the business
3. Determine the basis of application of the sector-wide benchmark: e.g.
   i. Estimate effective tax payment/rates for the benchmark firm and apply to each firm uniformly, or
   ii. Determine tax minimisation strategies to be applied across NSPs and estimate the taxable income through the application of these strategies.
4. Evaluate and test the application of the proposed approaches

Current incentive structures are much greater to reduce tax than capex or opex

Cost	Approach	Strength of incentives	Economic benefits of efficiency gains
Opex	Benchmarking efficiency testing, if not inefficient revealed costs used to set starting opex	Moderate – NSP retains 30% of value of gains	Strong – reduces real resource costs of supplying energy. Supports NGO/NEO and LTIC
Capex	Forecast capex subject to efficiency testing, actual capex rolled into RAB (generally)	Moderate – NSP retains 30% of value of gains	Strong – reduces real resource costs of supplying energy. Supports NGO/NEO and LTIC
WACC	Benchmark WACC based on efficient financing costs	Very Strong – NSP retains 100% of value of gains	Moderate – Benchmark WACC (if it does not 'aim high') serves LTIC but limited impact on efficient allocation of financial resources
Tax	Benchmark tax, no reference to actual costs	Very strong - NSP retains 100% of value of gains	No efficiency gains from incentive to reduce tax. Benchmark not in LTIC as estimate overstates actual tax expense for most NSPs

Is there a case to make the tax incentives consistent with the incentives on opex and capex?
And is that feasible?

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Preliminary responses to Prof Lally's Paper

First some starting propositions….

1. Incentive to minimise taxes comes from the delinking of the allowance for taxes paid from the actual tax payments not from the level of the tax allowances, i.e. firms seek to maximise profits independently of the regulatory allowances.
   - Implication: a low tax **benchmark** will not necessarily increase tax minimisation
2. NPV=0 also requires that the allowance for tax is an unbiased estimate of the achievable tax payments for the benchmark businesses
   - Implication: evidence suggests the current approach fails NPV=0 test
3. The competitive market benchmark would require that taxes be based on benchmark tax expenses that reflect common practices to minimise tax
4. The NEO/NGO would require that, to be consistent with the long term interest of consumers, the focus should be a better benchmark to ensure customers do not pay more than necessary.

Preliminary response to Prof Lally's recommendations

- Criteria:
  - What are to be the criteria? How are the options to be assessed against the NGO/NEO
  - Should the benchmark be a sector average or company specific?

1. Options:

- Are all the options feasible? Relative strengths and weaknesses of AER allowance is not evaluated.

	Actual	Benchmark ("targeted")	Capped
Company	Feasible	Feasible	Feasible
Sector-wide	?	Feasible	?
Hybrid	?	Feasible	?

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Preliminary response to Prof Lally's recommendations

2. Dismissal of actual
   - Agree there are significant issues, but not clear it is inferior to current approach.
     - Not clear it could yield higher values than current approach.
3. Capping is a blunt instrument and fails the NPV=0 test
   - Agreed. But is it inferior to the current approach?
4. Targeting (i.e. benchmarking) tax minimisation strategies not recommended
   - Disagree. Should not be ruled out at this stage.
   - Arguments misconstrue AER objective and conflate it with ATOs and misinterpret effect of incentives of a benchmarking approach.
5. Targeting gearing for tax purposes not recommended
   - Disagree. Should not be ruled out at this stage.
   - If actual gearing used, effect may be to remove distortion from tax. UK option? – assume benchmark gearing except for companies with high gearing.

Preliminary response to Prof Lally's recommendations

6. Carry-forward of losses should not be included as they arise from unregulated activity or tax minimisation
   - Agree if arise from unregulated activities.
7. Clear case for use of DV depreciation.
   - Agree
8. Merits of using shorter-than-ATO asset lives are weak
   - Agree
9. Modelling of low cost pools can be ignored (trivial effect).
   - Agree
10. Adjustment should be made for uplifts in asset values
    - Deserves further consideration
11. No changes proposed to treatment of Government-owned businesses (except for adoption of DV and adjustment for asset value uplifts)
    - AER should adopt a private-owned business benchmark

Do not dismiss tax pass through (or cap) too soon

- All we know now is what the high level ATO/AER analysis shows for the tax paid vs allowances for privately and publicly owned networks
- We support AER proposition that getting more relevant information will help us better understand the current situation and what is driving it
- We understand the difficulties around pass-through
- However we have yet to see whether the current position is superior to pass through
- So we are disappointed that the AER seems to be dismissing it far too early in the investigation and discovery process from the RIN data

Answers to the AER's Questions

1. *The type of detailed tax information we should seek from energy networks*	• Any information that informs the analysis of what tax was actually paid and the materiality of the drivers for actual tax paid being different from the regulatory allowance over a period of at least 5 years; for example:
	  • Recent tax assessments, ownership structure, level of R&D expenditure, gearing, interest payments and stamp duty paid, % regulated and unregulated revenues/income.
	  • Revenue/income/cost and tax allocation principles.
	  • Actual tax depreciation approach, actual tax asset lives, uplift to tax value of assets.

2. *The list of potential drivers, including the interaction with timing effects arising from different depreciation profiles*	• We support the ATO/AER list of potential drivers. For example • ownership structure, gearing, depreciation, asset lives, prior tax losses, unregulated activities are potential explanations. • Require additional RIN data to assess significance of other factors listed by networks (eg R&D, TAB revaluation, debt costs, refurbishment)

Answers to the AER's Questions

3. The relevance and materiality of potential drivers	• See above. Additional data from RINs required to comment on this, but would note the issue of corporate structures/financing arrangements eg stapled securities & trust structures – important in past, in future given tax rulings and tax law changes?

4. The list of potential changes	• Agree with AER that this is difficult to determine in the absence of RIN data – but reference point for change should be the failure of present approach to achieve NEO/NGO
	• Agree with 'no regrets' actions:
	    • changes to tax depreciation in PTRM/RFM
	    • Expensing/reclassification of refurbishments
	• Additional information required on impact of TAB revaluation (Rule change required?), gearing, ownership structures, self-assessed tax asset lives, low value pools, gearing, 'outside framework' tax expenses.

Answers to the AER's Questions

5. The advantages and disadvantages of a move to a tax pass-through approach, including the expert advice from Dr Lally commissioned by the AER and released with this initial report	• See comments above. • Key question is not whether tax pass through approach is perfect, but whether it provides a better estimate of NSP tax costs - that are funded by consumers - than statutory corporate rate • And what are alternatives to a fairer cost allowance?
6. The implementation of this review to the April 2019 determination drivers	• We support the AER's intention that any changes to regulatory models will apply to the round of network determinations also due for final decision in April 2019.