

Submission to the Australian Energy Regulator (AER)

Consumer Challenge Panel

**Submission to the AER on Review of regulatory tax
approach – Discussion Paper November 2018**

Sub-Panel 22

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1. Introduction and Summary

The AER established the Consumer Challenge Panel (CCP) in July 2013 as part of its Better Regulation reforms. These reforms aimed to deliver an improved regulatory framework focused on the long-term interests of consumers.

The CCP assists the AER in making better regulatory determinations by providing input on issues of importance to consumers. The expert members of the CCP bring consumer perspectives to the attention of the AER to better balance the range of views considered as part of the AER's decisions.¹

This submission provides CCP22's comments on the Discussion Paper (or "Paper") released by the AER on 1st November 2018 "Discussion paper Review of regulatory tax approach November 2018"². The very tight timetable for this review has meant that we have not had the opportunity to fully consider all the matters raised in the AER Discussion Paper, the PwC Experts advice nor Dr Laly's report.

We look forward to the further report to be published by the AER in December incorporating the information obtained as part of the RiN notices, particularly as it relates to interest expense. We strongly support having a submissions process on the Final Report and Recommendations paper to enable stakeholders to fully consider the package of reforms the AER would be proposing in the context of the information that will then be available.

Networks operate a monopoly asset delivering an essential service. They are regulated under laws that have the National Electricity Objective (NEO) and the National Gas Objective (NGO) of the long term interests of consumers at the core. The centrality of the NEO and NGO provide the framework for this submission as it did our earlier submission on this matter. As the AER comments (p.2):

"...our focus remains on making decisions in relation to revenue proposals that are in the long term interest of consumers as required under the NEO and NGO. We are identifying possible changes to our tax approach that might reduce the tax difference, but only where to do so helps ensure customers pay only efficient costs over the long term."

Monopoly networks are regulated to enable consumers to gain the benefits of what would be the outcome in a workably competitive market. Consumers enter into the so-called "regulatory bargain" with networks and the AER on the basis that we will pay an efficient price for networks to provide an efficient network that meets the NEO/NGO.

¹ Detailed information on the CCP is available on the AER website at <https://www.aer.gov.au/about-us/consumer-challenge-panel>

² AER "Discussion paper Review of regulatory tax approach November 2018" <https://www.aer.gov.au/system/files/AER%20-%20Tax%20review%202018%20-%20Discussion%20paper%20-%20201%20November%202018.pdf>

However, as we noted in our July submission on this matter, consumers see this bargain as being one sided. The disproportionate level of risk on consumers was recognised by the AER Draft Rate of Return Guideline published in July in its reduction in the equity risk premium to better reflect the risks that network owners bear³.

The ACCC in its recent report⁴ highlighted the significant rise in electricity prices over the last decade and pointed to networks being the major contributor. Hence it is not surprising that various aspects of the AER regulatory framework – rate of return, expected inflation and now tax allowance - have been subject to review to ensure that it does achieve the NEO/NGO.

At the forum on this matter in early November, the ENA referred to a recent Australian Infrastructure Investment Report that noted this uncertainty is increasing asset owners interest in unregulated assets. The other comment consumers hear is that these reviews have the risk of private network owners (~49% of network assets) reducing their willingness to invest and that this would not be in the long term interests of consumers. We expect that, given consumers generally feel that capex investment has been well over the efficient level in the past, that this may reflect an imbalance in the regulatory regime. Hence it is reasonable consumers consider some correction is required.

In the context of the tax allowance debate, the Discussion Paper has provided important additional information that confirms the previously expressed concerns raised by consumers that the actual tax payments were considerably below the AER's tax allowance for these networks. The Paper and accompanying PwC report, also confirmed that this gap is concentrated in the privately owned networks. The data provides a good basis to better inform the debate on options to improve the efficiency of the regulatory outcome for consumers who are looking for:

- A significant narrowing of the gap between allowance and actual tax paid
- Ongoing data gathering and analysis of remaining issues
- Commitment to regular tax benchmark reviews completed well prior to the next rate of return review

The Paper makes a range of proposals for change which we agree with and one major proposal for no change that we disagree with.

We look forward to the AER's forthcoming December report that will contain further analysis of the issues based on the RIN data. This will be particularly important in the case of the debt servicing costs. We do not accept the networks case that this issue has been resolved in the Rate of Return review. The decision on the debt equity ratio in that matter has no carryover to the calculation of the tax allowance.

³ Eg see Section 1.5 in the AER's "Draft Rate of Return Explanatory Guidelines" July 2018
https://www.aer.gov.au/system/files/AER%20-%20Draft%20rate%20of%20return%20guidelines-%20explanatory%20statement%20-%20%2010%20July%202018_0.pdf

⁴ ACCC "Restoring electricity affordability and Australia's competitive advantage - Retail Electricity Pricing Inquiry - Final Report" June 2018 p.iv
<https://www.accc.gov.au/system/files/Retail%20Electricity%20Pricing%20Inquiry%E2%80%94Final%20Report%20June%202018.pdf>

Section 2 gives the consumer perspective. The data presented in the PwC report confirms the large gap between pre-gamma allowance and actual payment for privately owned networks. We suggest that this would not pass the “pub test” for consumers as they seek to understand why their energy costs are so high and look to their political representatives for action. We hope that this data will convince those networks that have previously argued for no change, that consideration of change is understandable and justified.

Section 3 discusses principles we have adopted in our submission – the primacy of the NPV=0 principle, networks should have an incentive to reduce the tax paid and consumers should share the benefits of this reduction from regular (4-5 year) reviews to reset the benchmark if required, the estimation of tax should be neutral between capex and opex, capex and opex efficiency is set though the AER propose response model (with no role for the tax allowance), and intergenerational equity is achieved through the depreciation schedule, not the tax allowance.

Section 4 discusses our views on the four evaluation criteria used by the AER – efficient costs, materiality, achievable tax practice and broader tax issues. We are in general agreement with them conceptually, but discuss a number of issues where we believe an alternative interpretation is justified. We then apply that interpretation in our analysis of the Paper’s options for consideration.

Section 5 examines a core AER option that there be no change to the current one benchmark of a corporate equity structure. We argue for two benchmarks – “corporate” and “any other structure” on the basis that the costs of not doing so are material to consumers and contrary of the NEO/NGO.

Section 6 looks at the arguments advanced by networks against the AER’s recommendation of immediate expensing of refurbishment capex. Our modelling results show the benefit received by networks in the current tax allowance creates a distortion that disadvantages consumers and does not meet the NPV=0 objective. However, the proposed change does meet the NPV=0 objective. It is also consistent with our principle of that intergenerational equity issues are most efficiently met through the regulatory depreciation ad not the tax allowance.

Section 7 covers the arguments around the depreciation method. It supports the AER’s proposal to have all new capex depreciated using the diminishing value method, irrespective of whether the network is currently using that approach or straight line. We make an additional recommendation that, where a network has historically used diminishing value for its tax purposes, the AER further investigate the adoption of DV for all existing assets in the TAB calculation. We recognise this change is more problematic for networks that currently use straight line depreciation and that this deserves further investigation by the AER.

Section 8 examines other AER options for consideration – agreeing with AER options on the capping of the age of gas assets at 20 years, exclusion of asset revaluation and self-assessed asset lives and low value pools. We await further information on the stamp duty issue.

Section 9 examines the argument advanced by networks that data on actual interest expenses is irrelevant to the current discussion.

Section 10 discusses some implementation issues. We support implementing as many findings as possible to the April 2019 AER determinations, which we believe are those that can be implemented through model changes. As such we look forward to more specific guidance in the December report

around whether specific changes can be achieved through model changes or whether they require a more formal rule change. We also recognising that there could be considerable work around the changes that can be implemented by model changes eg expensing and depreciation schedules.

In summary:

AER changes for consideration	CCP 22 Comment
No change to the current corporate entity structure	Disagree – AER should consider two benchmarks: <ol style="list-style-type: none"> 1. For those networks with a company structure - current statutory rate of 30% 2. For those networks a structure other than a company structure – a rate of 15%
Recognising immediate expensing of refurbishment capex	Agree – with a preference for using a benchmark proportion of investment to be immediately expensed, but recognise that further work is required to operationalise this approach
Using diminishing value approach for tax purposes	Agree with using the DV approach to calculating depreciation for tax purposes for all new capital investments in the TAB. In addition: <ul style="list-style-type: none"> • For existing assets, where the network has adopted a DV approach to tax depreciation, serious consideration be given to the reset of the TAB on the basis of DV approach and to continue that DV approach over the life of the assets • Subject to some further analysis using the updated RIN data, where a network has used SL for the purposes of tax depreciation of its existing assets, the AER should accept this as the approach to treatment of these existing assets in the future (i.e. excluding new assets).
Reducing tax asset lives for gas	Agree - apply the 20 year cap to all new and existing assets at the earliest opportunity. We make no recommendations at this stage on the detailed implementation of this cap.
Not moving to a tax pass through	Agree - subject to progress towards a benchmark that better reflects the tax position of the benchmark entities.
No adjustment of TAB for market transactions	Agree - AER continues its current approach to the treatment of revaluations in the TAB (and RAB), namely to not recognise changes in market valuations as reflected in sale prices etc.
No change in treatment of self assessed asset lives and low value pools	Agree - AER continue its current proposed approach with respect to self-assessed asset lives and low value pools.
Treatment of stamp duty	Await further information in the December report

Interest expense	No basis for the view that the tax calculation should simply apply the 60/40 debt equity ratio in the draft AER Rate of Return Guideline.
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A final suggestion for debate

As a final note we would put the suggestion that a left field approach could be to simply exclude networks from the tax system. They would pay no tax and there would be no tax allowance in the build block revenue determination.

We think consumers would be very happy to consider this option in more detail. It immediately removes the concern of a difference between tax allowance and tax paid.

We also think it might be attractive to network owners. This may be perceived to distort investment incentives, but, given the lower levels of tax actually paid at present, this may be more apparent than real.

2. What do consumers think?

In our earlier submissions on this matter⁵, we highlighted the need for the regulatory framework within which electricity and gas networks operate to reflect, at all times, best regulatory practice that is in the long term interests of consumers. We give more detail on this in the next section. But generally, consumers do not give much thought to the regulatory structure. They simply focus on price.

In our July submission we highlighted the findings from the ACCC Final Report on the electricity market that concluded⁶:

“Australia is facing its most challenging time in electricity markets. High prices and bills have placed enormous strain on household budgets and business viability. The current situation is unacceptable and unsustainable.

The approach to policy, regulatory design and promotion of competition in this sector has not worked well for consumers. Indeed, the National Energy Market (NEM) needs to be reset, and this report sets out a plan for doing this.”

We provided data from the ACCC report that showed over the 10 years to 2017/18 that more than a third of the 56% real price increase in delivered residential prices was caused by network costs⁷. Across the CCP’s extensive experience with networks’ consumer engagement, one issue dominates consumers’ minds – affordability. Consumers of all sizes – retail to large C&I – are generally satisfied with their level of reliability and do not wish to pay more for increased reliability. More than anything else they want to pay less for the existing level of reliability.

We noted that the initial evidence of the difference between tax allowances and actual tax paid may be a source of the “affordability problem” and looked forward to the additional evidence from the AER’s information gathering. Consumers do not accept the view that “it is simply incentive based regulation working” even if they knew what incentive based regulation actually was.

The evidence of the voluntary information gathering gives some additional information to inform discussion of this affordability problem. It is summarised in the following two graphs from the PwC report⁸. Consumers are not aware of the finer points of the AER’s regulatory framework, but they do know how to complain to their political representatives when they feel that something is “not right”.

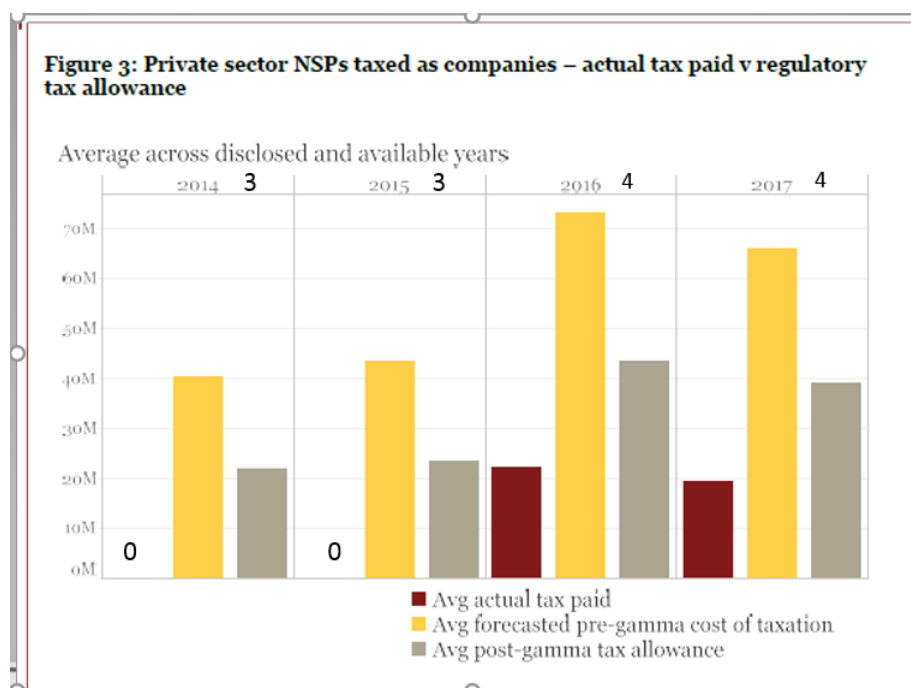
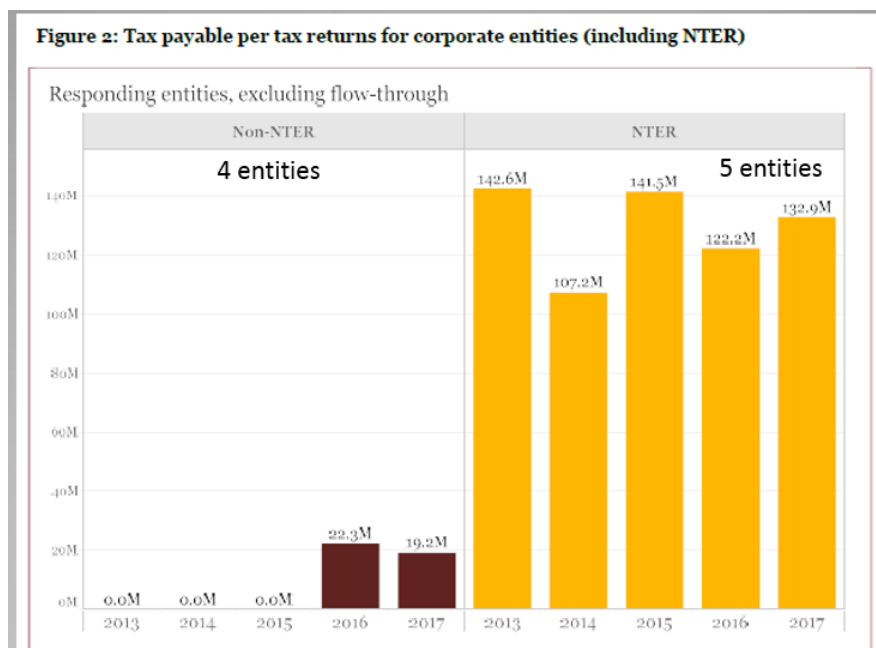
⁵ CCP sub-panel 22 “Submission to the AER on Review of regulatory tax approach Issues paper” 31 May 2018 <https://www.aer.gov.au/system/files/Consumer%20Challenge%20Panel%20subpanel%2022-%20Submission%20to%20Issues%20Paper%20-%2031%20May%202018%20-%20PUBLIC.pdf> and “Submission to the AER on Review of regulatory tax approach - Initial Report June 2018” <https://www.aer.gov.au/system/files/Consumer%20Challenge%20Panel%20subpanel%2022%20-%20Submission%20to%20Initial%20Report%20-%2026%20July%202018%20-%20PUBLIC.pdf>

⁶ ACCC “Restoring electricity affordability and Australia’s competitive advantage - Retail Electricity Pricing Inquiry - Final Report” June 2018, p. iv <https://www.accc.gov.au/system/files/Retail%20Electricity%20Pricing%20Inquiry%E2%80%94Final%20Report%20June%202018.pdf>

⁷ *ibid* p.vi

⁸ PwC “AER Tas Review 2018 – Expert Advice” https://www.aer.gov.au/system/files/PwC%20-%20AER%20tax%20review%202018%20expert%20advice%20-%2026%20October%202018_0.pdf pp28-29

So we suggest applying the well known “pub test” to these two figures – the numbers refer to sample sizes.



The first figure shows that for the four networks for which voluntary data was provided, the actual tax paid for the period 2013-2017 was an average of \$10.4m vs \$119.3m for NTER, publicly owned entities. The second figure looks at just the privately owned networks and for the sample size indicated, the actual tax paid over the same period was under 20% of the pre-gamma tax allowance (the focus of this review). We well recognise there are a range of legitimate reasons for a difference, but consumers are looking to the AER to:

- better understand that difference – and we welcome the analysis in this paper based on voluntary data and look forward to the December report using the RiN data,
- address the reasons for that difference to the extent that they are simply a reflection of the benchmark for the actual tax practices that are being used by networks, and
- making the appropriate adjustments in the tax allowance calculation to reflect this revised benchmark.

We hope that this information has led to a recognition by networks such as Jemena⁹:

“...the issues raised by the ATO do not warrant changes to the current regulatory structure”

and APA¹⁰:

“...[it] considers that differences between estimated tax liability and cash tax paid are normal occurrences in the economy...and do not signal a problem in either the regulatory or tax regime.

earlier in this process, that change is understandable and justified.

⁹ Jemena “Response to Issues Paper” 31 May 2018 <https://www.aer.gov.au/system/files/Jemena%20-%20Submission%20to%20Issues%20Paper%20-%2031%20May%202018%20-%20PUBLIC.pdf>

¹⁰ APA AER review of regulatory tax approach – APA response to issues paper” p. 2
<https://www.aer.gov.au/system/files/APA%20Group%20-%20Submission%20to%20Issues%20Paper%20-%204%20June%202018.pdf>

3. Principles we apply to our analysis

3.1 Principles for estimation of tax expense

The principles for the estimation of tax expense need to be developed in the context of the NEO/NGO and the overall framework of incentive-based regulation. This helps clarify the primary objective in the estimation of tax and role of the estimation of tax and that of other instruments within the regulatory framework. In this context, the long-standing ‘Tinbergen principle’ on the assignment of instruments and objectives is directly relevant. It is best to have a one-to-one assignment of instruments and objectives. Assignment of multiple objectives to a single instrument can create ambiguity and unintended consequences.

This leads CCP22 to conclude that:

1. The primary objective in estimating the tax allowance is to obtain the best unbiased and practically achievable estimate of the tax paid by the benchmark entity. This is consistent with the NPV=0 principle that underpins the AER’s approach to regulation.
2. The networks should have an incentive to reduce tax paid, as other businesses in competitive market do, while continuing to comply with tax laws and the ATO’s tax rulings. While this may raise debate about whether it is in the interest of the welfare of the community as a whole, it is consistent with principles of competitive neutrality and the long term interest of the consumers which should guide the AER’s regulation.
3. Consumers should share in the benefits of further reductions in tax paid due to the incentives under (2). In the absence of schemes equivalent to the EBSS and CESS, this requires regular review of tax practice and resetting of the benchmark to reflect this. We suggest every 4-5 years.
4. The estimation of tax should be, as far as possible, neutral between capex and opex choices (including choices between different capex options), subject to the primary objective. In setting the tax allowance, the AER should not have the objective of offsetting distortions created by the tax system, although this may be a consequence of better matching tax allowed to tax paid.
5. The primary instruments for promoting opex and capex efficiency are the AER’s approach to estimating efficient opex and capex and de-linking the allowed revenues from actual opex and capex for a fixed period (including through the EBSS and CESS). The estimation of tax should not be used to add to or confound these incentives. Attempts to modify these incentives through the allowance for tax are likely to, on balance, hinder rather than help achieve the efficiency objectives and conflict with the primary objective. This is consistent with the primary objective in (1).
6. The primary instrument for achieving intergenerational equity is the choice of depreciation profiles for outlays that contribute to the provision of services over more than one year in estimating the allowed pre-tax revenues. In setting the tax allowance the AER should seek to reflect the pattern over time of the tax paid by the benchmark entity rather than impose a different pattern in pursuit of intergenerational equity. This is consistent with the primary objective.

3.2 NEO/NGO and the regulatory framework

The NEO is “to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to:

- price, quality, safety and reliability and security of supply of electricity
- the reliability, safety and security of the national electricity system.”

The NGO is similarly defined. The AEMC has provided guidance on the interpretation of this objective and, while some may argue that the AEMC has adopted an unduly narrow interpretation, it remains the dominant interpretation¹¹. AEMC has emphasised that, although consumers are also members of the broader community, the focus is on the interests of consumers as consumers of energy. While the AEMC may provide advice on the broader impacts, the criteria for its decision-making is the NEO/NGO and the LTIC.

Translating this to the current inquiry and the role of the AER, the AER’s estimation of tax should reflect the current tax law and rules as reflected in current practice. All tax systems create distortions and inequities, but it is not the role of the AER to seek to adjust or correct for these. In this context, the tax estimates should reflect the current laws, not changes either foreshadowed or legislated but due to take effect in later periods. A further implication is that protection of the tax revenue base is a function of the ATO, not the AER. The current regime uses a benchmark that is unrelated to the actual tax payments and does not change for a utility in response to the utility’s actual tax management strategies. Hence, there are strong incentives for utilities to minimise their tax under the current regime. We do not necessarily accept the argument that merely lowering this benchmark will alter incentives to minimise tax, but if it did that is not a matter to be considered under the current interpretation of the NEO/NGO.

3.3 Promoting efficiency through the regulatory framework

In simple terms, the regulatory objective is to:

1. promote improvement in the efficiency of service delivery
2. ensure an efficient business can expect to earn a commercially sustainable return that will ensure the commercial viability of future investment
3. ensure customers pay no more than efficient costs over the long term.

Within the framework of incentive-based regulation, this is achieved by:

1. de-linking the revenue allowance from actual costs to provide an incentive for utilities to pursue efficiency gains
2. setting a benchmark for costs that is a reasonable, achievable, forward-looking estimate of efficient costs
3. providing a mechanism passing through efficiency gains to customers through prices in future periods. This is essential if the mechanism is to be in the LTIC.

¹¹ AEMC “Applying the energy objectives A guide for Stakeholders” December 2016
<https://www.aemc.gov.au/sites/default/files/content/Applying-the-energy-market-objectives-for-publication.pdf>

The second requirement is important to provide confidence to the utilities that a commercial return is practically achievable and confidence to customers that they will pay no more than necessary. More formally it is necessary for the NPV=0 condition to be satisfied.

A key feature of incentive-based regulation is the de-linking of revenues from actual costs. That is, once the revenue is set:

1. allowed revenues do not change if costs change (with the possible exception of changes beyond the control or influence of the utility)
2. as a consequence of (1), the benefit to the utility from efficiency gains (i.e. reductions in costs within its control) is independent of the allowed revenue (i.e. the cost benchmarks used to establish the allowed revenue).

To use a practical example, suppose a utility's expected annual opex is \$400m but negotiation of a new enterprise agreement that allows reduced staffing levels could reduce opex to \$350m. The annual gain to the utility from the new enterprise agreement is \$50m and this is independent of whether the regulator's assumed opex in the revenue allowance is \$425m or \$375m. The regulator's assumed opex affects the starting level of profitability, not the change in profitability from the implementation of the enterprise agreement. To assume that the level of the benchmark cost incorporated in the revenue allowed will affect the decision whether to pursue the \$50m efficiency gain, requires an assumption that the utility does not wish to maximise profits but adopt a more 'satisficing' approach that targets particular profit or cost levels, such as matching the cost assumptions of the regulator.

An important component of this approach is that at each regulatory period the allowed costs are rebased to reflect revealed costs or revised estimates of efficient costs. It is this process that provides assurance to the consumers that they will share in the increased efficiency during the prior regulatory period.

3.4 Implications for tax benchmark and cost estimate

Tax is simply one of the costs of the businesses and the starting point should be that these principles also apply to the provision for tax in the regulatory determination. This has a number of implications for the estimation of tax and the benchmark.

- (i) Firstly, the objective is to establish the best unbiased and practically achievable estimate of the tax paid by the benchmark entity

This requires that the assumptions reflect:

- the tax treatment of debt, capex and opex in each of their various forms; and
- the tax strategies commonly used by networks, subject to the community's expectation that networks have obligations associated with their social licence to operate.

To be clear, we recognise that tax minimisation is a legitimate activity subject to the community's views of their social licence. We also recognise that as a business adopts more aggressive tax planning strategies there is a greater risk of costs through tax audits and damage to corporate reputation. Hence there is not an objective single tax strategy: the choice made by a network will

depend on its interpretation and attachment to the social licence to operate and its assessment of the risks and return.

The AER will need to observe tax practice and determine an appropriate benchmark. We understand that it may err on the conservative side (i.e. a benchmark well-within the tax planning frontier). But we emphasize this is a matter of observing practice not interpreting its legality. The AER would not be trying to stand in the shoes of the ATO.

Importantly, the assumptions used in estimating tax need not be the same as those in estimating the pre-tax revenue building blocks. The estimation of depreciation provides a good example. Part of the allowed pre-tax revenue is the provision for depreciation. This provision matches the recovery of the amount spent on an asset to the services it provides in order to meet efficiency and inter-generational equity objectives. But this may be different to how the costs are allowed for tax purposes.

Suppose the tax rules allowed all expenditures (whether classified as opex or capex for accounting purposes) to be expensed in the year incurred. It would be difficult to argue that it would be desirable to expense all costs immediately in building up the allowed pre-tax revenue. To do so would conflict with inter-generational equity - current consumers would be paying the full costs of assets that service the needs of future consumers – and result in highly volatile prices. But if the assumptions used for the calculation of the revenues were used for the calculation of tax it would introduce a permanent systematic bias (in NPV terms) between allowed and actual tax. This would mean that if the utility matched every other cost assumption exactly it would earn a higher return than the allowed WACC. In simple terms it would provide a windfall gain for the network.

In its Discussion Paper the AER noted that the “overall compensation package we determine ... is based on private sector ownership for competitive neutrality reasons.” It further noted that there are clear differences in the incentives for Government-owned businesses paying taxes under the National Tax Equivalent Regime (NTER). CCP22 agrees with the AER that the benchmark should be based on a network in private ownership.

(ii) Secondly, once the benchmark tax allowance is determined the allowed tax should be independent of future actions of the utility during the regulatory period

That is the allowance may be calculated on the assumption of a certain level of capex and expensing of capex, but if outcomes are different during the regulatory period, the allowed tax would not change. This is in line with the incentive-based approach for other costs.

Where there is change clearly beyond the control or management of the utility the cost impact of this can be passed through without damaging incentives. The NER (Section 6.6.1) provides for the pass-through of tax changes that are defined broadly to include "the application or official interpretation of a relevant tax" (definition of a tax change event).

The more difficult position is where there is a high level of uncertainty in the estimation of tax liabilities. In this case a pass-through mechanism can reduce risks and better match tax allowed to the tax obligations of the benchmark entity on an ex post basis. But it reduces the incentive to reduce taxes in the LTIC. This creates a difficult trade-off for the AER but one that must be faced.

The current approach reduces this risk by overestimating tax obligations, which is contrary to the LTIC.

(iii) Thirdly, the benchmark needs to be dynamic

Good regulatory practice requires regular review of key aspects to ensure that they are meeting the NEO/NGO. Consistent with the rate of return review, we believe that this tax review should focus on the actual tax practices of networks now and over the next 5 years with implementation as soon as possible following completion of the review. Regular reviews should be undertaken every 4-5 years to assess what changes would need to be made in the revenue reset cycle. Benchmarks will change over time as tax law and practice changes.

(iv) Fourthly, there must be a credible mechanism for passing the benefit of tax practices that lower tax rates through to consumers in the long term

This is the fundamental problem with the current approach. Not only is actual tax paid systematically and substantially below the allowed tax for privately-owned networks, there has been no path by which consumers could expect this to be corrected and benefits passed through to consumers in the long-term. The dynamic adjustment of the tax benchmark can be an effective mechanism for achieving this.

(v) Fifthly, this does not mean there needs to be a single benchmark

While the AER currently has a single benchmark for tax it does not follow that this is essential. US regulators have different tax rates depending on ownership and Ofgem includes adjustments for tax benefits for highly geared utilities. AER uses models and analysis to create utility-specific opex and capex benchmarks. A benchmark that varies with objective characteristics of the utility can reduce errors in the estimation of tax, which should be in the interest of both the utilities and consumers. But in considering multiple benchmarks it is important to consider:

- the additional cost/complexity relative to the improved accuracy of the tax estimates
- the scope for 'gaming'.

Benchmarks based on objective factors beyond the control of the utility (such as whether existing assets use diminishing value or straight-line depreciation for tax purposes) are not subject to risk of 'gaming'. But where the benchmarks depend on decisions of the utility, there may be scope for gaming. The AER has recognised this in the case of opex and capex and carefully scrutinises forecast opex and capex. A benchmark for expensing that depended on the utility's forecasts of the level of expensing would necessitate careful scrutiny of those forecasts. In this case the utility would have an incentive to forecast a level of expensing below its 'true' expected level.

(vi) Finally, the benchmark for the estimation of the tax allowance should be neutral between opex and capex and different forms of opex and capex

This requires that not only should the approach satisfy the NPV=0 principle in aggregate, it should also satisfy the NPV=0 principle for different types of expenditure. If so the internal rate of return will be common across all the options and the estimation of tax allowance should not distort

expenditure choices or confuse the efficiency incentives created by the AER's approach to setting allowances for efficient opex and capex and rewarding efficiency gains.

4. AER criteria for evaluation of change

The AER has proposed four criteria and we comment on each in turn.

(i) Efficient costs

We support the centrality of this criterion. As long as the NPV=0 principal (prices are set so that the net cash flows are equal to the initial investment) then any reduction in the level of efficient costs will be in the long term interests of consumers. The networks can also be assured that the regulatory regime will provide for the recovery of efficient costs and can expect to achieve the allowed rate of return, or, if they can do better than the assumed efficient costs, an even higher rate of return.

(ii) Materiality

The Paper (p. 29) proposes "two reasonable yardsticks" for assessing materiality:

- (i) the proportional impact on the tax allowance (the tax building block) over the long term (multiple regulatory periods).
- (ii) The absolute dollar value impact on tax costs, again over a longer term

The AER goes on to note that the costs to implement change would also be a factor in considering the materiality of a change eg the regulatory burden and the added complexity.

The Paper makes a number of conclusions on which issues are "material" but does not provide any quantitative measures. The changes proposed in relation to immediate expensing of capex, using diminishing value and reducing tax asset lives for gas are all based on a judgement about materiality without any data to give an indication of how that "materiality" has been measured. We would assume that it would be in terms of the NPV rather than percentage of the tax allowance in any regulatory period. Having clearer data would greatly assist consumers in understanding this criterion better if there was an indication of a \$ value required for a "materiality threshold".

(iii) Achievable tax practice

The AER's discussion of this criteria begins with the assumption that there will be only one benchmark across all networks (p.29):

"Firms that seek to adopt the benchmark efficient approach should be able to do so. Certain practices may be considered efficient for certain situations, but for legal or practical reasons may be unachievable by all networks. This includes an assessment of the validity of such a practice under current tax legislation.

- We consider that tax management practices assumed by the benchmark regulatory tax approach should be able to be adopted by NSPs."

and then notes in the later discussion on entity structure (p.42):

“Under our achievability criteria, we have also considered whether it would be possible for regulated networks to align with a benchmark tax approach based on non-corporate owners. Overseas sovereign wealth funds currently benefit from the lowest tax rates. If we were to change the benchmark to this level, it would not be possible for the current owners of regulated networks to align with the new benchmark as they cannot change to become overseas sovereign wealth funds. Meeting the benchmark would require a sale transaction where the pool of buyers was relatively small. This would likely impose windfall losses on existing owners and reduce long term investment in the Australian regulated networks. While this is the most extreme example, risks of this nature would also occur if the benchmark was shifted to be a foreign-held managed investment trust or an Australian superannuation fund.”

This approach sets up a straw man defence that seems to miss the point. We certainly do not propose having a single benchmark based on an overseas sovereign wealth fund. We do not expect company structures in Australia to be forced to sell to a limited pool of overseas sovereign wealth funds.

Equally we do not expect that sovereign wealth funds will set up a company structure when they can keep their structure and pay less tax. As we argued above, we consider that having more than one benchmark is reasonable within the regulatory framework. What is “achievable tax practice” should be contextual and that will depend on factors such as who the owners are (eg private individual or Governments, where they live (Australia or overseas) etc.

We simply argue that consumers should not have to pay a windfall gain to those investors who have an “achievable tax practice” that results in a lower rate of tax payable than a company structure.

(iv) Broader tax issues

Here the AER says:

“This review engages with some issues that reflect broader tax considerations across the economy, rather than specific to the treatment of regulated networks. Our fourth criterion is whether the scope of and impact of the issue means it can best be dealt with by ATO action or government changes to tax legislation, rather than by the AER. In this case we would not seek to change the efficient tax practices assumed by the benchmark tax approach.”

The AER assumption appears to be that “if the ATO is taking action to review the tax regime for entities other than a corporate structure, then that is a reason for the AER to propose that consideration of these structures is out of scope”. We contest this proposition in the next section.

5. Entity structure and ownership

Recommendation:

That the AER should consider two benchmark tax rates reflecting two entity structures:

1. For those networks with a company structure - current statutory rate of 30%
2. For those networks a structure other than a company structure – a rate of 15%

5.1 The AER's option for consideration

As the Discussion Paper notes (p.32), while the AER's regulatory tax approach assumes a benchmark entity is an Australian company using the current statutory tax rate of 30%, in practice networks are held in a variety of structures, with a variety of ultimate owners both here and overseas. These differences:

“...contribute in several ways to the face value tax difference”

The Paper then goes on to argue for no change to the current benchmark of a corporate structure paying 30% tax:

“However, the overall effect arising from these [structure] drivers (both historical and forward-looking) appears to be minimal. Our assessment of these factors aligns with the expert advice we received from PwC and Dr Lally.

We propose to maintain the current approach where our regulatory tax allowance is based on the standard corporate tax rate. This reflects the most commonly observed tax profile of regulated networks. It also appears to be the relevant basis for assessing tax in the future, particularly with regard to legislative changes affecting the tax treatment of structures and certain classes of owners.

The PwC report concludes (p.56):

“...given the majority of NSPs are held via companies, the assumption that the benchmark efficient entity is a company is reasonable.”

And this is supported by the conclusion that (AER p. 42):

“It is also relevant to our materiality criteria that there are only a small proportion of networks currently paying tax rates below 30 per cent.”

Finally, consistent with the “broader tax issues” assessment criteria, the ATO has addressed the lower tax paid by these other structures in recent legislation.

We challenge this reasoning – we think that the impact of not taking into account those entities paying less than 30% tax is material on consumers and a failure to seek to account for this is inconsistent with the NEO/NGO.

5.2 Why we think the difference is material

Our assessment, like that of the AER in assessing its preferred changes in the Discussion Paper, is qualitative and based on judgement. We encourage the AER to provide some indicative estimates and suggest some parameters below. The basis for our conclusion is:

- We think it is useful to exclude publicly owned networks (categories 1 and 4 in the following table), which make up ~51% of the TAB, from the discussion. This means that ~34% of privately owned network TAB that is not in a company structure, currently pay a tax rate of 0-30% as shown in categories 4, 5, 6 and 7.
- This actual tax rate for this 34% varies by category as shown in the following table

Table 2.1 Tax profile of regulated asset holders tracing flow-through vehicles—from PwC expert advice

Investor tax profile	% of TAB	Expected tax rate
1. NTER entity	40.00%	30%
2. Australian company	29.98%	30%
3. Australian States or Territories (tax exempt, non-NTER) ^a	11.10%	N/A ^a
4. Australian managed investment fund	7.86%	15%-30%
5. Australian superannuation funds	3.79%	15%
6. Foreign sovereign wealth funds	2.90%	0%–30%
7. Foreign pension funds	2.07%	15%–30%
8. Foreign companies	2.30%	30%

Source: PwC, *AER tax review 2018, Expert advice*, 26 October 2018, p. 17 (figure 1).

- TAB in categories 5, 6 and 7 (8.76% of TAB) “...are expected to attract tax rates below 30% on any profits distributed” (PwC p.55)
- The “Treasury Laws Amendment (Making Sure Foreign Investors Pay Their Fair Share of Tax in Australia and Other Measures)” Bill introduced into Federal Parliament last September increases the tax rate paid by categories 5 (except superannuation funds), 6 and 7 but only after a long grandfathering period – post 2026 or 2034.

Tax law change	Timetable
1. Restrict the ability of networks to engage in double gearing	<ul style="list-style-type: none"> • The changes to the thin capitalisation rules started on 1 July 2018 (PwC report p.48) that will. However, it does not completely remove the ability to double gear. The 'associate entity' threshold is reduced from 50% or more, to 10% or more, so there still could be double gearing.
2. Applying the corporate tax rate to the 'passive income' of stapled trusts	<ul style="list-style-type: none"> • Those networks that currently have a stapled structure (which was approved prior to 27th March 2018) can continue to enjoy that benefit until 30 June 2034, so long as they do not display any of the “high risk” characteristics in para 2.3.16 and hence be covered by Part IVA • A State or Territory Government can apply to the Commonwealth Treasurer for a future network privatisation to gain the same stapled structure advantages provided it meets the “significant infrastructure” exemption ie intends to spend at least an additional \$500m which would be satisfied by an AER capex allowance as part of a regulatory determination; however only the

	income related to the additional capital improvements would qualify for the concessional tax rate
3. Applying a 30 per cent withholding tax on income flowing to foreign pension and sovereign wealth funds.	<ul style="list-style-type: none"> The 30% withholding tax will apply after 2034 to income distributions to foreign investors from the asset trust (ie trust distributions, not interest or dividend payments) - PwC report p.48 Foreign pension funds are currently exempt from withholding tax in respect of dividends and interest payments (as distinct from trust distributions); this will change from 1 July 2019 for foreign pension fund investors holding more than 10% interest in the business, unless the investment is in existence at 27 March 2018 in which case they have a 7 year transition period (PwC report p. 49). The withholding tax on interest and dividends post this transition is likely to be 10% or 15%, not the 30% rate proposed for income distributions from the asset trust Sovereign immunity for sovereign wealth funds will no longer be available from 1 July 2019 unless their holding is passive and less than 10% of the business. There is also a 7 year transition period for investments in existence at 27 March 2018 (refer bottom of page 49 of PwC report). Hard to say what impact this will have – it is our understanding that many sovereign wealth funds hold less than 10% interest, while some hold up to 19.9%.

- For category 4, the 7.86% of TAB “...we would expect in many cases a concessional tax rate of 15% would apply.” (PwC p.56) until 2034

So, in summary, the current “concessional” tax rates applying to 34% of private sector RAB are expected to continue for at least the next regulatory period for all privately owned networks and in the case of those with a managed investment fund structure, the next three regulatory periods.

	% of TAB	Current tax rate and tax rate until 30 June 2026	Tax rate post 30 June 2026	Tax rate post 30 June 2034
4. Australian managed investment funds	7.86%	15-30% (but more likely to be closer to 15% eg super funds and foreign MITs)	15-30% (but more likely to be closer to 15% eg if super foreign + fund)	15-30% (but closer to 30% with foreign MITs now paying 30%)
5. Australian superannuation funds	3.79%	15%	15%	15%
6. Foreign sovereign wealth funds ^a	2.90%	0%	0-15% ^b	30% ^b
7. Foreign pension funds ^a	2.07%	15% ^c	15%	30%

a. investing via a MIT prior to 27 March 2018; b. assumes fund holds >10% equity – if <10% then tax rate is zero; c- these investors are exempt from interest and dividend WHT

We would recommend that the AER undertake some indicative modelling to show the value of these concessionary rates according to the “two reasonable yardsticks” of materiality discussed above. A

relatively simple approach could be to measure the different in pre-gamma tax allowance for privately owned networks using the current TAB based on two cases:

- (i) 30% rate for all TAB, and
- (ii) 30% rate for 66% TAB and 15% rate for 34% TAB

Consumers have to have confidence in the regulatory framework is working to achieve the NEO/NGO and modelling like this will inform consumers views.

5.3 Conclusion

We do not believe that the AER in putting forward the option for no change in the equity structure has made the case that consumers should pay a tax allowance on the basis of what will happen in 7-15 years – and give those networks that do not have a corporate structure a large windfall gain. Tax allowances should be based on the expected tax position over the next 4-5 years until the next regular review of the tax allowance when changes in the tax law for the next 4-5 year period can be incorporated.

We see this approach as consistent with the AER’s “broader tax issues” criteria. Yes, the ATO does administer tax law, but the AER runs the tax allowance calculation and this should reflect what is actually happening, not what will happen in 7-15 years’ time.

CCP22 believes that the AER should consider two benchmark tax rates reflecting two entity structures:

Benchmark	Investor tax profile categories in Table 2.1
Company structure – 30% rate	1, 2 and 8
Any structure other than a company structure – 15% rate	4, 5, 6, 7

In suggesting two benchmarks we are making a judgement about the trade-off in consumer benefit versus administrative and implementation complexity. Consumers are looking for a narrowing of the gap between allowance and actual. While in theory more benchmarks might narrow the gap further given that some entity structures result in tax obligation rates lower than 15% (see above table), we think that two benchmarks are a reasonable compromise at this stage. This can be reviewed in 4-5 years’ time at the next tax allowance review.

Networks would have the ability to choose which entity structure they adopt with their choice no doubt influenced by the proposed regular reviews of the tax allowance calculation and the 2026/2034 ATO trigger dates.

5.4 Transgrid’s position

Transgrid wrote to the AER in November 2018 to note the process used by the NSW Government during the sale process in 2015¹². Bidders for Transgrid were required to make a pre-payment to the NSW Government based on the bidder’s assessment of the NPV of future tax liability for the life of the asset lease that would have been paid to the NSW Government under the National Tax Equivalent Regime (NTER) regime had the network remained in public ownership.

¹² Transgrid Letter to Paula Conboy 2 November 2018 <https://www.aer.gov.au/system/files/TransGrid%20-%20Supplementary%20Information%20on%20Tax%20Paid%20-%202002%20November%202018.pdf>

Transgrid concludes:

“TransGrid’s investors have effectively pre-paid future tax obligations on a net present value basis for the life of the asset lease. These payments need to be taken into account in the current tax review. The NSW Government received a one-off NTER equivalent payment in 2015 that must be recognised in the assessment of the tax paid by TransGrid.”

CCP22’s view is that this payment is irrelevant to the AER’s considerations in the tax review. We accept that:

- Prior to privatisation the NSW Government received tax equivalent payments from Transgrid
- For its (the NSW Government’s) purposes it required bidders to partition their bid price and identify a component attributable to the NPV value of these tax payments over the life of the lease.
- In separating out this component all bidders had to make a professional judgement of the NPV of the difference between their estimates of the expected allowed tax expense and the actual tax the purchasers expected to pay.
- This gap between tax allowed and tax expected to be paid was an important factor in the bids and helps explain the high RAB multiple paid by the successful bidder consortium.

However, we also consider that:

- Bidders would have valued the business as a whole based on expected cash flows. The subsequent segmentation of the total bid may reflect the bidders view of the expectations of the government for that component rather than the value implicit in the overall bid price.
- A pre-existing rent should not be preserved simply because it was factored into the bid price; bidders familiar with regulated industries would have understood that regulatory arrangements are subject to change and that this is more likely where the regulatory approach is imbalanced and favours one party of the other.
- No doubt the successful bidders would have taken professional advice on the regulatory risk around the tax allowance calculation; what their forecast of actual tax allowance might have been is irrelevant to the AER in this current process.
- Consumers are not interested in indemnifying Transgrid’s owners from regulatory risk; to do so would open a whole new “moral hazard” challenge to the regulatory process as new owners would be rewarded for taking high risk positions by what is effectively a ‘consumer guarantee’.
- That it was a State Government selling the assets rather than a privately-owned company is also irrelevant; to do otherwise would be inconsistent with the competitive neutrality principles of the NCP. Who benefits from the sale and the purpose to which the sale proceeds were put is not relevant to the AER’s considerations.
- It is not the AER’s role to regulate so as to promote or facilitate privatisations; the fact that government-owned utilities pay taxes to their owner rather than the ATO can create an impediment to efficient privatisation; but that should be resolved by the relevant Government, not by AER through its making decisions that are contrary to the NEO.

A final argument that may be advanced – that the additional revenue to the NSW Government from inclusion of the tax NPV means that consumers have already seen the benefit of the difference – is also irrelevant to the current considerations. This “tax” revenue simply went into consolidated revenue and is being spent in many areas (stadiums?) that have no relation to electricity prices. Further, the experience of Transgrid should not drive the outcome for electricity consumers across

NSW and outside NSW. Again, recognising this argument creates a slippery slope where consumers become the ultimate guarantors of commercial decisions.

6. Expensing of refurbishment capex

Recommendation:

That new refurbishment capex is immediately expensed for the purpose of calculating the tax allowance with a preference for using a benchmark proportion of capex (which may vary for different categories of capex) to be immediately expensed, but recognise that further work is required to operationalise this approach

The AER's Discussion Paper has identified that a significant proportion of the expenditure treated as capex for both:

- the purpose of the construction of pre-tax allowed revenues, and
- the estimation of taxable income by the AER

is immediately expensed for the purposes of calculating tax liabilities by the networks. This provides an immediate tax advantage and reduces the NPV of tax payments for the network.

We agree with the AER conclusion¹³:

“... a possible change to reflect the efficient tax costs of a benchmark firm by incorporating immediate expensing in our regulatory forecast [of tax] could be in the long term interest of consumers”.

The AER has proposed two options for implementation of this change:

1. Use of a benchmark proportion of investment to be immediately expensed, or
2. A network-specific benchmark based on the network's forecast of the proportion of capex to be immediately expensed.

CCP22 prefers the first approach in principle but recognises further work is required to operationalise this approach and that the sophistication and accuracy of the benchmark may improve over time. One option may be to use different benchmarks, based on observed behaviour, for different categories of capex. If the use of a benchmark proves not to be feasible the second option would be superior to the continuation of the current AER approach which manifestly overestimates tax payments relatively to the actual tax payments.

6.1 AER's Current Approach

The AER undertakes a detailed review of the network's proposed capex programs. This includes testing the quality of the asset management planning, the options considered for the maintenance and enhancement of the service potential of the assets, and the efficiency of the proposed program of expenditure. The efficient capex program determined by the AER is included in the forecast RAB and the recovery of the costs incurred is matched to the provision of services to consumers through the depreciation provisions. This is the primary means of ensuring intergenerational equity.

¹³ AER, p 62

The depreciation and return on the capex forms part of the annual allowed revenue (AAR) for the network. Once the AAR is set the network has an incentive to further improve its efficiency and reduce opex and/or capex. The EBSS and CESS ensures that the utility retains 30% of any efficiencies, with 70% being passed through to consumers through prices in subsequent regulatory periods. This is the primary means of encouraging the network to choose the most efficient options and reduce costs.

The AER calculates the tax allowance on the assumption that all capex is capitalised and depreciated rather than immediately expensed.

6.2 The Issue

The tax laws allow the immediate expensing of some expenditures that are capitalised in the AER's tax calculations. This alters the time profile of taxation and reduces the NPV of tax payments over the life of the asset. The resulting mismatch between the actual tax treatment and the AER's assumed tax treatment of these expenditures can introduce a distortion in the choice of expenditure options. This is because the internal rate of return (IRR) on an outlay that is expensed exceeds the allowed WACC and the IRR on outlays that are capitalised. In short, the current approach to estimating tax does not satisfy the NPV=0 principle underlying our primary objective.

Each of the networks that responded immediately expensed an annual average of \$108.7m in their tax returns¹⁴. PwC also noted that there was substantial variation between the proportion of capex immediately expensed. This could reflect network-specific factors, such as the age and composition of the network's assets and the network's assessment of the risk and return from more aggressive expensing strategies.

Decisions on expensing of outlays fall into various categories:

- (i) Outlays that can be expensed or capitalised within the discretion provided to the network under the current rules (pole replacement is an example of this);
- (ii) Outlays that can be expensed but where the alternatives cannot be expensed, or
- (iii) Outlays where the proposed outlay and the alternatives can both be expensed or capitalised within the discretion provide to the network under the current rules.

While there may be an assumption that a change in the approach to estimating tax will affect these choices, it is not necessarily so.

If the allowance is based on an 'arm's length benchmark' that is not affected by the network's own decisions those decisions may be independent of the benchmark set. In this case the level of the benchmark does not affect the incremental effect on profits of the choices under (1)-(3) above. The incentives created are a function of the operation of the tax system not the AER's estimation of the benchmark tax payments¹⁵. If the network seeks to maximise profits¹⁶, rather than 'satisficing' or targeting costs and returns determined by the regulator, its decisions should not change.

¹⁴ PwC, p65

¹⁵ That is the incremental impact of a choice between expensing and capitalising an outlay is the same irrespective of the actual benchmark level of expensing assumed by the AER. The assumed benchmark affects

However, if the expensing assumption is based on the network's forecasts and there is a true-up for the actual level of expensing the AER's approach to calculating tax may affect the network's choices.

6.3 The Networks' Response

The network submissions opposed AER's proposals to include a level of immediate expensing of outlays that would better match the typical practice in the sector. The networks noted that the approach would reduce the revenues of the networks and, and the ENA commented¹⁷:

"No network can ignore the fact that this form of expenditure would result in a reduction in allowed revenues....(and that this) is likely to drive the network towards solutions that involve replacement CAPEX in relation to a new asset (where the tax deduction would occur over a longer tax asset life) or an OPEX solution (where the full expenditure would enter allowed revenues immediately)."

The ENA argued that, despite acknowledging that the suggested change meets the NPV=0 principle, this would not be in the long term interest of the consumers as it would create inter-generational inequities.

6.4 CCP22's Assessment

We support the AER's conclusion that incorporating immediate expensing of a proportion of the expenditures in accordance with industry practice would be in the long term interest of consumers.

This approach better achieves the primary objective in calculating tax allowances – to achieve the best, unbiased estimate of the tax payable by the benchmark entity practically achievable. This objective is comparable, if not identical to, the objectives in determining allowances for efficient opex and capex¹⁸. As such it satisfies the NPV=0 principle that has correctly underpinned the implementation of incentive-based regulation by the AER and other regulators.

The desirable efficiency properties of incentive-based regulation assumes that the regulated businesses seek to maximise profits. Once the allowed costs/revenues are de-linked from actual costs the businesses have strong incentives to pursue cost efficiencies and these incentives are independent of the specific level of costs. This conclusion is softened by a behaviouralist interpretation the responses of business¹⁹, but we are sceptical that a change in the benchmark could lead to a 'race to the bottom' and further reduction in tax payments from the already very low levels for the privately-owned networks. Furthermore, as we noted above, consideration of the broader impacts of 'a race to the bottom' (beyond its impact on the LTIC) is outside the scope of the NEO/NGO.

the starting point (the absolute level of profits) before consideration of the alternative options, not the incremental change in post-tax profits.

¹⁶ Taking into account both the returns and risks from alternative tax strategies.

¹⁷ ENA Submission, p17.

¹⁸ For example, the previous sentence could be rewritten substituting opex or capex for tax and it would be equally valid.

¹⁹ This may include an assumption that the regulator's assumed costs provide a reference point that the business may target or that the responses to gains or losses are asymmetric and non-linear.

The networks analysis of the potential impacts of the proposed change appears to assume that the calculation of the tax allowance will be based on the specific behaviour of the network. We have undertaken an analysis of several case studies to test the conclusion of the networks on the potential impacts of the change in approach. In doing this we have also assumed that the calculation of the tax allowance is specific to the decisions of the network. However, as noted below, our preference is to use a benchmark that is independent of the specific behaviour of the network.

It also appears that the networks' conclusions focus only on the tax calculation component and do not consider this in the context of the overall regulatory scheme, such as the strong incentives outside the tax calculation for the pursuit of the most efficient options.

6.5 Case Studies

We have used a model originally developed by the ENA to test three case studies:

1. Two alternatives (replacement and refurbishment) where refurbishment is clearly the more efficient; comparative outlays are \$100m and \$30m, respectively, for the same assumed service levels
2. Alternative treatment (capitalisation and expensing) for the same outlay
3. Two alternatives (replacement and refurbishment) where replacement is marginally the more efficient; comparative outlays are \$100m and \$102m, respectively, (in present value terms) for the same assumed service levels.

In each case study the results are examined where the outlay is capitalised for tax purposes, the outlay is expensed for tax but the tax allowance assumes it is capitalised (current approach), and the outlay is expensed for tax purposes and the tax allowance assumes it is expensed (proposed approach). The outcomes are evaluated against

1. Internal rate of return and compliance with NPV=0
2. Efficiency incentives objectives
3. Intergenerational Equity objectives.

We are undertaking further analysis and testing of the model so the results below are preliminary. The models will be presented in full in a supplementary submission.

Case study 1: Two alternatives (replacement and refurbishment); refurbishment more efficient.

Two projects modelled: one replaces an asset for \$100m and the other refurbishes the asset at cost of \$30m and has the same asset life. Since both provide services over multiple years, the expenditure is recovered from customers through depreciation over the service life. The example assumes both options have the same life and the refurbishment option is clearly the more efficient.

(i) Excess returns

The current tax approach provides an excess return on refurbishment, potentially distorting the utility's investment decision. The proposed approach removes this distortion.

For the replacement option the NPV of the future after tax cash flows equals the original expenditure (i.e NPV=\$100m). This satisfies the NPV=0 principle and the return on original expenditure equals the AER-determined WACC.

For the refurbishment option the NPV of the future after tax cash flows equals the original expenditure (i.e NPV=\$30m) under the proposed tax estimation. This satisfies the NPV=0 principle and the return on original expenditure exceed the AER-determined WACC.

In contrast, under the current tax estimation the NPV of the future after tax cash flows for the refurbishment option exceeds the original expenditure (i.e NPV=\$33.84m). This means that the network earns an excess return of \$3.84m or 12.8% and the rate of return on the original expenditure is 7.7% which exceeds the AER-determined WACC of 6.0%

(ii) Intergenerational equity

The instrument for achieving intergenerational equity is the depreciation allowance in the revenue building blocks. In all three cases the initial expenditure is recovered over the service life of the assets through the depreciation allowance. Thus refurbishment costs are recovered through the return of and return on assets which is \$3.3m in year 1 and drops to \$1.59m in the last year.

The change in the estimation of tax affects the pattern of tax allowances and revenues. Under the proposed approach the revenues are lower in the seven years (initially \$0.77m lower falling to \$0.45m lower in year 7) as the tax losses are used up and then higher in the remaining years. While this introduces a step change in revenues for these assets in the middle of the period the overall cash flows better match those of the utility and the excess return under the current approach is avoided. Furthermore, it should be noted that refurbishment is only part of the capex in any year and the aggregate RAB comprises assets of various ages. Hence the practical effect on the pattern of overall revenues and prices over time is likely to be small.

(iii) Efficiency incentives

The primary mechanism for encouraging efficiency under incentive regulation is the delinking of revenues and costs for a fixed period (5 years) together with the operation of the CESS and EBSS. These mechanisms are designed so that the utility retains 30% (in NPV terms) of any efficiency gains made during the period.

In this case the projects are alternative options for providing the same services. If the AER were to conclude that the replacement option were the most efficient, the allowed revenues for the utility would be set on basis of the costs of the replacement option. In this example, the utility can achieve a \$70m efficiency gain from pursuing the refurbishment option. The utility would retain 30% of this (i.e \$21m). The mismatch between allowed and actual tax marginally increases this incentive (i.e. it adds \$3.84m so that the total gain to the utility). In this case, it adds marginally to the incentives to pursue the most efficient option but in other cases it may encourage the pursuit of a less efficient option.

However, it is more likely that the AER would determine that the refurbishment option was the most efficient and the allowed revenues would be based on that option. The powerful disincentive for

replacement option because it is a much less efficient option remains. Whether the current or proposed approach is used in estimating the tax would not alter this.

This highlights that the incentive framework for setting the allowed revenues based on the opex and asset building blocks is the fundamental mechanism for promoting efficiency. Mismatches in the calculation of the allowed tax may in some cases promote more efficient options but could just as easily promote less efficient options

Case study 2: Alternative treatment (capitalisation and expensing) for the same outlay

This example examines the case of an outlay on a program, such as pole replacement, that can either be expensed or capitalised for tax purposes at the discretion of the utility. Since the program provides ongoing services the expenditure is capitalised and depreciated for the 'above the line' revenue building blocks. The assumed expenditure is \$100m with a service life of 20 years.

(i) Excess returns

The current tax approach provides an excess return if the utility chose to expense the outlay for tax purposes. The proposed approach removes this excess return.

If the utility capitalises the expenditure for tax purposes the NPV of the future after tax cash flows equals the original expenditure (i.e. NPV=\$100m). This satisfies the NPV=0 principle and the return on original expenditure equals the AER-determined WACC.

Under the AER's current approach to estimating tax (which assumes the expenditure is capitalised) the utility earns an excess return if it chooses to expense the outlay for tax purposes. In this case, the network earns an excess return of \$12.8m or 12.8% and the rate of return on the original expenditure is 8.6% which exceeds the AER-determined WACC of 6.0% .

If the AER estimates the tax on the assumption that the utility expenses the outlay (proposed approach), the NPV of the future after tax cash flows equals the original expenditure (i.e. NPV=100). This satisfies the NPV=0 principle and the return on original expenditure equals the AER-determined WACC.

(ii) Intergenerational equity

The instrument for achieving intergenerational equity is the depreciation allowance in the revenue building blocks. In all three cases the initial expenditure is recovered over the service life of the assets through the depreciation allowance. This is constant across all three examples.

Under the current approach the allowed revenues and prices do not change if the utility chooses to expense rather than capitalise the outlays. Whereas, under the proposed approach the revenues are lower in the seven years (initially \$2.57m lower falling to \$1.5m lower in year 7) as the tax losses are used up and then higher in the remaining years. While this introduces a step change in revenues for these assets in the middle of the period the overall cash flows better match those of the utility and the excess return under the current approach is avoided. Furthermore, it should be noted these outlays are only part of the capex in any year and the aggregate RAB comprises assets of various

ages. Hence the practical effect on the pattern of overall revenues and prices over time is likely to be small.

(iii) Efficiency incentives

This case study examines the impact of different choices of tax treatment for a single expenditure rather than the choice between different expenditure options for providing the service. Hence, the relevant efficiency incentive is the incentive to adopt options that minimise tax within the constraints of the tax law and its interpretation by the ATO and the financial and reputational risk of adverse tax rulings.

Under the current approach the outlays are assumed to be capitalised and there is a strong incentive for the network to expense the outlay for tax rather than capitalise it (see discussion of excess return above). However, unless the benchmark is adjusted to reflect the revealed practices that reduce tax payments the consumer does not benefit from this at any point. The benefits are retained in full by the utility, in contrast to the 70/30 sharing of efficiency gains in opex and capex. Adoption of an approach that better reflects common practice and is periodically updated is more consistent with the revealed cost approach on opex and capex and provide a sharing of the benefits with customers.

Provided the benchmark allowance is not automatically adjusted to reflect ex post the actual decisions of the network, the network retains an incentive to search for opportunities within existing tax laws to minimise tax payments.

Case study 3: Two alternatives (replacement and refurbishment); replacement is more efficient

This case study examines two options of refurbishment or replacement and factors in the shorter life of refurbishment. It assumes refurbishment has a service life of 10 years and that the same refurbishment can be repeated. In this case the replacement option requires initial expenditure of \$100m and refurbishment requires an initial expenditure of \$65.45m and further expenditure of \$65.45m in year 10. The NPV of the refurbishment expenditure (\$102m) is slightly higher than that of replacement. Hence refurbishment is the less efficient option.

(i) Excess returns

The current tax approach provides an excess return if the utility chooses the option where outlays can be immediately expensed for tax purposes. The proposed approach removes this excess return.

Under the replacement option the future after-tax cash flows equal the original expenditure (i.e. NPV=\$100m). This satisfies the NPV=0 principle and the internal rate of return equals the AER-determined WACC.

Under the AER's current approach to estimating tax (which assumes the expenditure is capitalised) the utility earns an excess return under the refurbishment option. In this case, the NPV of the post-tax cash flows is \$110.8m (cf NPV of costs of \$102m); i.e. an excess return of \$8.8m. The rate of return on the original expenditure is 7.2% which exceeds the AER-determined WACC of 6.0% .

Under the AERs proposed approach, if the utility undertakes the refurbishment option the NPV of the future post-tax cash flows equals the original expenditure (i.e NPV=\$102m). This satisfies the NPV=0 principle and the return on original expenditure equals the AER-determined WACC.

(ii) Intergenerational equity

The instrument for achieving intergenerational equity is the depreciation allowance in the revenue building blocks. In all three cases the initial expenditure is recovered over the service life of the assets through the depreciation allowance for the purposes of estimating the pre-tax revenue allowance. The depreciation assumption is the primary means of achieving intergenerational equity by matching the recovery of capital costs to the services provided. Thus refurbishment costs are recovered through the return of and return on assets which is \$3.3m in year 1 and drops to \$1.59m in the last year.

The change in the estimation of tax affects the pattern of tax allowances and revenues. Under the proposed approach the revenues are lower in the four years of the life of the refurbishment (compared to the current approach) as the tax losses are used up, and then higher in the remaining years. While this introduces a step change in revenues for these assets in the middle of the life of the overall cash flows better match those of the utility and the excess return under the current approach is avoided. Furthermore, refurbishment is only part of the capex in any year and the aggregate RAB comprises assets of various ages. Hence the practical effect on the pattern of overall revenues and prices over time is likely to be small.

(iii) Efficiency incentives

The primary mechanism for encouraging efficiency under incentive regulation is the delinking of revenues and costs for a fixed period (5 years) together with the operation of the CESS and EBSS. These mechanisms are designed so that the utility retains 30% (in NPV terms) of any efficiency gains made during the period.

In this case the projects are alternative options for providing the same services. If the AER were to conclude that the replacement option were the most efficient, the allowed revenues for the utility would be set on basis of that option. However, under the current approach to estimating tax the utility would be better off choosing the less efficient refurbishment. This is because the tax advantages of immediate expensing more than offset the additional costs under this option. This tax-induced distortion is removed under the AER's preferred approach to tax estimation for refurbishments. Hence, the incentives created through the setting of the allowed capex and operation of the CESS should guide the utility to choosing the most efficient option.

This highlights that the incentive framework for setting the allowed revenues based on the opex and asset building blocks is the fundamental mechanism for promoting efficiency. Mismatches in the calculation of the allowed tax may in some cases promote more efficient options but could just as easily promote less efficient options.

6.6 Specification of the benchmark

The AER's discussion paper sets out two main options to determine the value of immediately deductible capex to be used in calculating tax:

1. Apply a benchmark approach by assuming a certain proportion of capex would be immediately expensed by a benchmark entity
2. Apply a network specific approach reflecting the network's actual values for deductible expenditures.

PwC supports the second option: setting of a network-specific proportion to be immediately expensed. As the AER recognises the concerns with this approach are that:

1. It is more difficult for the AER to implement due to the information requirements
2. It creates an incentive for utilities to game the forecasts; as a consequence a true-up mechanism may be required
3. It reduces/removes the incentive to seek out other opportunities to increase expensing and reduce tax payments and may see networks reduce the level of expensing if there is a significant risk of future audits due to the current level of expensing.

The key concerns with the first approach is the variation between the networks in the rate at which capex is expensed. This makes a single benchmark more problematic. While the approach may work well on average, it may not provide a sound benchmark at the level of the individual network. PwC has also highlighted that we do not yet have a full understanding of the reasons for these variations. This makes it more difficult to model and predict the benchmark level of expensing that properly reflects the circumstances of the individual network.

However, the advantage of the benchmark approach is that it retains the incentives to reduce tax within acceptable limits. We consider that further analysis of the reasons for the variations in the expensing rate is desirable. For example, it may be possible to model the expensing rates at the individual asset category level as a function of key parameters for the network. CCP22 recommends that the AER investigates this further. However, if this is not possible in the short to medium term, the option of the network-specific factor based on the network forecasts with a true-up mechanism could be adopted.

As a collar to this, CCP22 continues to encourage the AER to develop its capex models that will better enable the NSPs' plans for expensing in the ex-ante revenue determination process. This will assist both the near term analyses and the longer term assessment of an efficient benchmark.

7. Depreciation approaches in the assessment of TAB and tax allowance

Recommendations:

The AER apply the DV approach to calculating depreciation for tax purposes for all new capital investments in the TAB²⁰.

For existing assets, where the network has adopted a DV approach to tax depreciation, serious consideration be given to the reset of the TAB on the basis of DV approach and to continue that DV approach over the life of the assets.

Subject to some further analysis using the updated RIN data, where a network has used SL for the purposes of tax depreciation of its existing assets, the AER should accept this as the approach to treatment of these existing assets in the future (i.e. excluding new assets).

7.1 *We start with two basis questions*

There are two basic questions to consider before proceeding with a more detailed examination of the issues around the approach to tax depreciation methodology that best meets the regulatory objectives. They are:

- Whether the network's choice of a tax depreciation method and the associated impact on taxable income and tax payments, affects the NPV of the cash flows (i.e. whether the approach passes or fails the NPV=0 principle)?
- Whether it is necessary to have a consistent approach for both the regulatory depreciation method and the tax depreciation method?

(i) *Does the network's selection of tax depreciation methodologies impact on the NPV of the cash flows?*

The ATO allows a business to depreciate its assets for tax purposes using either the DV or the SL ('prime cost') approach. However, once an asset is depreciated using DV or the SL, the tax payer cannot change this approach²¹. This applies to both the original assets and any improvements or alterations to these assets²².

Based on the voluntary data provided, PwC concluded that DV is the dominant depreciation approach for tax purposes by private sector utility owners, being some 60% of assets by value²³.

²⁰ CCP22 notes the AER's comments (p 68) regarding intangible depreciable assets, which under the current tax law cannot be depreciated using the DV methodology. At this stage, this appears a relatively minor issue and should not undermine the basic principle.

²¹ PwC states that in limited circumstances, a business is allowed to change the effective life applicable to the asset. However, PwC also states that the evidence provided to date by the networks indicates that there has been no reassessment of effective life for the purposes of determining the estimated cost of tax in the regulatory building block. See PwC, October 2018, op. cit., p.p. 80-81. As a result, this issue is not a relevant consideration in the current discussion.

²² PwC, October 2018, op cit., p. 74.

²³ Ibid, Figure 23, p 76.

PwC also considers that this is a conservative estimate and may “understate” the true percentage for private sector networks. PwC states²⁴:

“We note that the percentage may be understated given it is based on the written down value of assets for tax purposes at a point in time and typically the depreciation profile associated with diminishing value method outpaces the prime cost [SL] method until the later years of an assets life.”

PwC then suggests that a truer figure may be around 65%²⁵ and concludes that²⁶:

“In our view, this supports the objective conclusion that a benchmark efficient entity would prima facie adopt the diminishing value method.”

One view is that the selection of SL or DV merely changes the timing of the deductions rather than the total deductions and is therefore revenue neutral over the life of the assets. If this was the case, it could then be argued that differences between the AER’s approach to tax depreciation and the networks’ approach are not material over the life of the assets, and therefore do not justify a change in the AER’s current approach.

However, in their analyses of the impact of depreciation schedules on the ‘tax gap’, the AER and Lally both make the important observation that adopting tax depreciation schedules that differ from the AER’s approach, do not deliver NPV neutral revenue outcomes. Lally provides an example of this point illustrating that using DV rather than SL depreciation for the purposes of the tax allowance would raise the PV of the depreciation deductions by 17%, and thereby reduces the PV of the tax allowance by 30%²⁷.

This difference arises because (unlike the regulatory depreciation) there is no compensation for the time value of money in the TAB. As a result, Lally demonstrates that the NPV will be positive for a network when the actual tax depreciation schedule brings forward the depreciation of the assets relative to the AER’s assumption of straight-line tax depreciation schedule over the life of the assets.

Practices that bring forward the tax depreciation costs, such as the immediate expensing of capex (e.g. refurbishment capex - see above), and also the use of DV rather than the AER’s SL approach to tax depreciation will all result in a positive NPV for the network relative to the AER’s approach. Conversely, the consumer will be worse off in NPV terms over the life of the assets.

Similarly, PwC states²⁸:

²⁴ Ibid, p. 77. CCP22 notes that this comment is similar to our subsequent critique of Lally’s assessment, as Lally uses a technical average age of the asset stock rather than the value-weighted age.

²⁵ Ibid, p. 78. The revised figure is based on removing unspecified data and low value data. CCP22 considers this is likely to better represent the true percentage of tax depreciation based on DV, although final figures will need to reflect the final RIN data. It also appears that the revised figure does not include the impact of the depreciation profile that was also recognised by PwC on p. 77 (see also the quote above from PwC).

²⁶ Ibid, p. 78.

²⁷ Cited by Lally, October 2018, op. cit, p. 16, based on Lally’s previous report to the AER in June 2018.

²⁸ PwC, October 2018, p. 74.

“However, we would generally expect that the predominant method (once the availability of tax losses referred to above is ignored) chosen by Federal tax payers would be the diminishing value method. The timing benefits associated with diminishing value method would typically have a positive net present value benefit on a project compared to the straight line method in respect of long life infrastructure assets.”

CCP22 therefore concludes that the AER should adopt the approach that best removes the intrinsic distortions arising from differences in approach to tax depreciation between the network and the AER. However, in making this conclusion, we are not suggesting some sort of pass-through arrangement (at this stage). Our preference is for the AER to adopt a reasonable benchmark(s) that is representative of efficient tax practices of a privately owned network and is based on its assessment of commonly adopted efficient tax practices.

We also recognise, however, that there are a number of implementation issues that require further consideration by the AER, particularly with respect to the treatment of existing assets as discussed below.

(ii) *Is it necessary to have a consistent approach for both regulatory and tax depreciation schedules?*

An argument presented by various networks is that if the AER amends the tax cost allowance by changing the tax depreciation schedule from SL to DV, then the AER should also amend the depreciation schedule in the depreciation of the assets for the purposes of the pre-tax revenue and the RAB.

In our view, this is a false claim. In fact, the Rules say very little about tax depreciation in the estimation of the TAB, while they have specific requirements in relation to depreciation of the RAB²⁹. In addition, both Lally and the AER reject any requirement for consistency in the approach to depreciation. Lally, for instance, demonstrates that while different regulatory depreciation approaches have no impact on the NPV of the pre tax cash flows, the different tax depreciation approaches do have an impact on the NPV of the tax cost allowances. Fundamental to Lally’s argument is that the pre-tax revenue allowance incorporates inflation and the cost of capital. While the tax allowance does not adjust for either of these factors. For instance, Lally states³⁰:

“However, the regulator’s choice of the regulatory depreciation method has no impact on the NPV of the businesses’ net cash flows (because it is offset by the revenue allowance for the cost of capital), whilst the choice for the tax depreciation method does affect the NPV of the net cash flows. Thus the latter (DV) should be chosen to satisfy the NPV =0 principle and this has no implications for the former.”

²⁹ This is in contrast to the requirements in the Rules regarding the treatment of gamma, which must be consistent with the estimation of the allowed rate of return. See NER, r 6.5.2(d)(2), which states that the allowed rate of return for a regulatory year must be “determined on a nominal vanilla basis that is consistent with the estimate of the value of imputation credits...”.

³⁰ Lally, October 2018, op. cit., p. 11.

Lally also responds in a similar vein to the issues raised by the ENA and others regarding the immediate expensing of capital investment discussed above. For example, Lally responds to the ENA's argument that, for tax cost purposes, any switch from the gradual deduction of a capital expenditure to immediate deduction is "undesirable" as it will reduce the NSP's revenues, as follows³¹:

"However, if the expenditure is immediately deductible and the AER instead acts as if the expenditure is gradually deductible [as per current practice], the [network's] revenues will be set above the NPV=0 level. Accordingly, reducing the revenues to recognise the true tax situation will satisfy the NPV=0 principle and this is desirable rather than undesirable."

While this quote from Lally relates to the issue of immediate expensing, the same principle is relevant to the tax depreciation. The AER summarises these results as follows³²:

"All else being equal, a higher depreciation expense in a given year results in a lower tax payable in that year. However, given that an asset can only be depreciated once, the total tax depreciation (in nominal terms) over the life of an asset should not be impacted by the method used to depreciate an asset. *However, the total depreciation value will be different in net present value terms due to the timing difference under the depreciation schedules.*" (emphasis added)

More specifically, Lally demonstrates that if the network uses a DV depreciation approach for tax purposes while the AER continues to use SL approach, the outcome will be NPV positive for the network after accounting for the cost of cost of capital³³. Such an outcome does not represent efficient regulatory practice which should target the core NPV = 0 principle.

CCP22 therefore concludes that the long-term interests of consumers are best served when the AER's approach to tax depreciation matches the actual efficient practices of the networks, as demonstrated in their tax returns.

However, the objective of achieving NPV neutrality over the life of the assets is not a simple task, given the existing practices for the treatment of tax depreciation, and the operation of the tax law. The next section reviews the options for implementing the NPV=0 objective. It is considered in terms of the tax depreciation treatment of:

- future capital investments; and
- existing capital investments.

As explained below, CCP22 considers the answer to the first question is *relatively* clear and uncontroversial. The answer to the second question – which covers by far the larger segment of capital investment captured in the RAB and the TAB - is considerably more challenging. In the latter

³¹ Ibid, p. 12.

³² AER, November 2018, op. cit., p 46.

³³ There is no inflation or time value of money adjustments for tax depreciation or for the TAB. However, as noted in the AER's Discussion Paper, (p. 65), an efficient entity would consider both inflation and time value of money when selecting a depreciation approach to apply to long-lived assets.

case, we are seeking to balance the reasonable expectations of consumers with the complexity of the AER's task, and with the respective benefits and risks to stakeholders and the networks.

7.2 How should the policy objective be best implemented?

The PwC report demonstrates that for private sector businesses, the most common form of depreciation used by the networks in their actual tax returns is DV. However, as noted, the AER's PTRM adopts a SL depreciation approach to assessing the taxable income and the TAB.

Therefore, for the first 15 years (of a typical 40 year asset life)³⁴, the tax depreciation using DV will be higher and the taxable costs derived from that asset will be lower than the AER's allowance. In nominal terms, in the later years, the situation will reverse. However, as demonstrated by Lally and by the AER, the NPV of applying the DV approach to tax depreciation over the life of the asset will always be positive relative to the AER's SL approach given the dominance of these long-lived assets in the TAB.

The discussion below considers the two broad categories listed above, namely the treatment of depreciation for future capital investment and the treatment of depreciation for existing capital investment. To reiterate previous comments, CCP22 also stresses that the analysis of the implementation approach should be based around the observed tax practices and outcomes for private sector ("non-NTER") entities because the tax equivalent arrangements for NTER entities are driven by multiple factors not related to efficient tax practices. The AER comes to the same conclusions, stating that: "...we consider the benchmark tax depreciation method should be established based on the actual tax practice of non-NTER entities."³⁵

(i) Future capital investments

CCP22 supports the proposal by Lally and PwC that the AER adopt the DV approach as the 'efficient benchmark' for the purposes of assessing the taxable income and the TAB for all future capital investments³⁶.

This efficient benchmark should apply to the AER's ex-ante assessment of the taxable income and TAB for both the privately and publicly owned networks, irrespective of their current practices.

As highlighted by the AER, the initial benefits of adopting DV approach for the tax depreciation of all future capital investments will be relatively small and there may be some questions raised about whether the change is worth the costs of implementation. However, as the AER also concludes, over

³⁴ The AER's example (based on the work of Lally) of an asset with a starting value of \$100m, the NPV of the tax depreciation over the life of the asset using DV approach was \$44.9m, the NPV under the SL approach was \$37.6m (assuming inflation of 2.5% and real WACC of 3.4%). AER, November, op. cit., p.p. 65-66.

³⁵ AER, November 2018, op. cit., p. 67.

³⁶ Where the capital outlays that are recognised in the pre-tax revenue allowance, are commonly expensed by the networks immediately for tax purposes rather than being capitalised and depreciated, this should be reflected in the benchmark for the calculation of the tax allowance.

time the cumulative impact of this change will be material, and ultimately the benefits will well outweigh the implementation costs³⁷.

CCP22 agrees with the AER's conclusions on the long-term benefits of adopting DV tax depreciation for new assets. We also strongly encourage the implementation of this change as soon as possible and for it to take effect from the AER's April 2018 revenue decisions.

(ii) Existing capital investments

The AER's treatment of existing capital investments raises more complex issues of equity between consumers and networks and compliance with taxation law. With respect to taxation law, the dominant consideration is that a business currently applying a SL approach to tax depreciation cannot change that approach either retrospectively or prospectively.

As a result of the tax law restrictions, our discussion of the tax depreciation approach to existing capital investment considers the two cases where a network has historically adopted DV or SL. We recognise this is a simplification of the real world, and there are a number of possible, and more complex configurations particularly in the context of the various changes in ownership and historical changes in tax depreciation approaches by the businesses and by the regulator. However, we believe that the discussion below is a useful starting point in the absence of the final RIN data set, and one that refines the principles on which the AER should make its decision on the treatment of existing assets.

It is also important to emphasise that existing assets are by far the largest component of the calculation of the tax depreciation of the networks. An 'error' in the AER's modelling of taxable income, such as the current distortion caused by using SL tax depreciation in the PTRM, has more immediate impacts on the removal of a bias and the outcomes for consumers.

The network has used DV for tax depreciation of existing assets

Given the PwC data shows that the majority of the networks (at least some 65% by value) have already adopted a DV approach, the networks have been able to take advantage of the tax depreciation discrepancy in the past in order to improve the overall return on their existing assets relative to the AER's SL tax depreciation approach.

Therefore, if the AER continues with the current practice of applying the SL depreciation methodology for existing assets (irrespective of its approach to future assets), then there will continue to be a systematic mismatch between the allowed tax and the actual tax paid.

The point has already been made that for younger assets the tax allowance will exceed tax paid and for older assets that tax allowance will be below the actual tax paid albeit overall in NPV terms, the outcome is NPV positive for the network over the life of the asset.

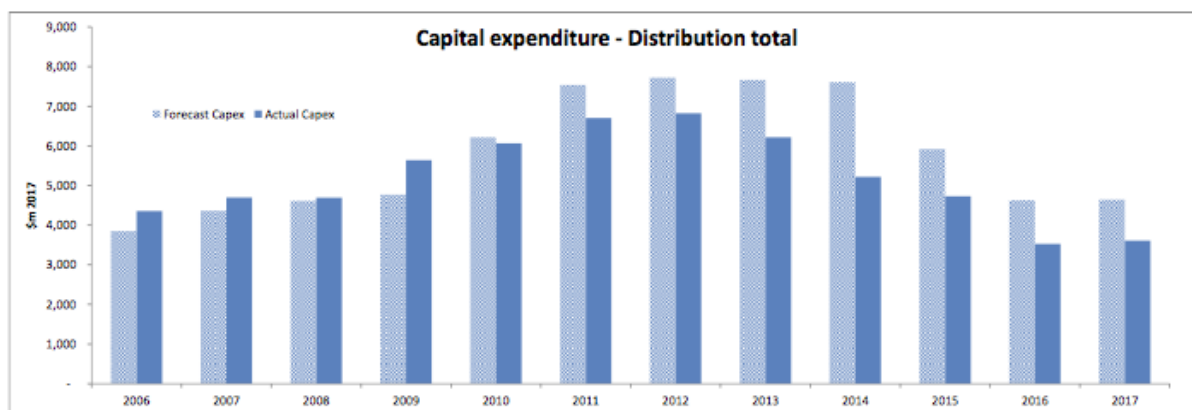
³⁷ See AER, November 2018, op. cit., Table 6.2, p. 49.

When assessing the net benefits of the AER adopting DV for the tax depreciation of existing assets (when the network has used DV for tax depreciation), an important question that has not been adequately considered by the AER and its advisor is the impact of the age profile of the existing assets. In particular, it is important to recognise the following factors that will influence the differences in NPV terms between the AER's SL approach and the networks' DV approach:

- There has been a significant growth in capital spending since 2006 for electricity NSPs. For example, for the electricity distribution businesses, total capex from 2007 to 2017 was close to \$70B (\$2017) resulting in a growth of some 76% in the real dollar value of the electricity distribution RAB (\$2017) across the NEM³⁸ (see also figure below). Similar changes occurred in the electricity transmission sector;³⁹
- For these newer assets (less than 15 years of age), the current tax depreciation costs under DV will be relatively high compared to the SL approach; and
- Newer assets will have a higher acquisition cost relative to older assets in the tax depreciation schedule, particularly given that tax depreciation is calculated on historical costs, not indexed costs.

For these reasons, it is very problematic to assess the benefits or otherwise of adopting a DV for tax depreciation for existing assets (where the NSP uses DV) that is based the use of a simple average age profile is problematic. CCP22 considers that the NPV analysis should, instead, be based on a 'value weighted average age'⁴⁰ that takes proper account of the matters raised above.⁴¹

Capital expenditure



Capital expenditure (capex) is a measure of investment in the distribution networks. This includes augmentation of the network, replacement of assets, improving network performance and non-network investments (for example, buildings). Capex is reported on an as-incurred basis.

³⁸ AER, *Electricity Distribution Network Service Provider Performance Data*, November 2018.

https://www.aer.gov.au/system/files/Networks%20dms%20-%20reports%20-%20electricity%20distribution%20data%20report%20-%20Nov%2018%20-%20For%20Publication_0.pdf

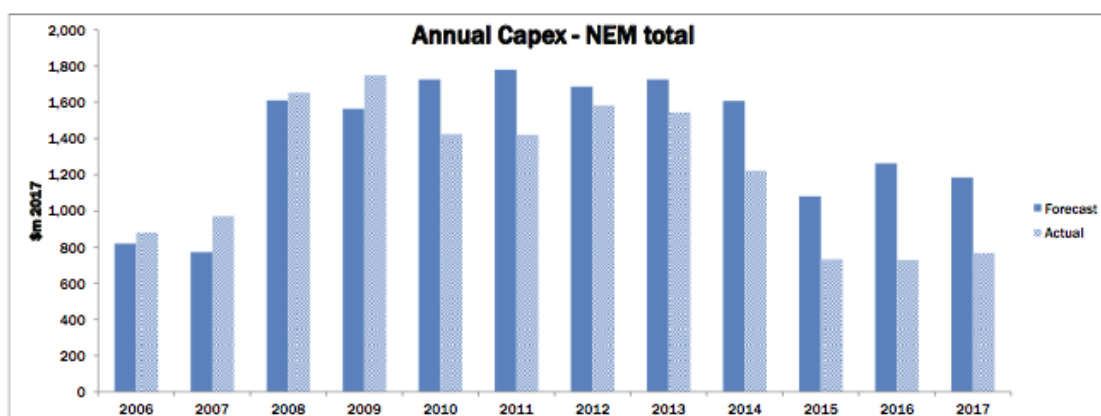
³⁹ See for instance, <https://www.aer.gov.au/networks-pipelines/network-performance/transmission-performance-data-2006-2017>

⁴⁰ That is, this 'value weighted average age' is not the same as the average age of the assets. Some assets will still be in service beyond their service life for calculation of tax depreciation and be fully depreciated for tax purposes. This outcome will apply to both electricity and gas network assets, however, it will be particularly relevant to gas assets with the application of the tax depreciation life of 20 years, compared to the technical life included in the pre-tax revenue depreciation.

⁴¹ Because we are considering the assessment of the treatment of tax depreciation for existing assets, it is not relevant whether the forecast capex and RAB growth rates are declining.

Source: AER Electricity Distribution Network Service Provider Performance Data, November 2018.

Capex



Capital expenditure measures the new investments in the transmission networks. This includes augmentation of the network, replacement of assets, improving network performance and non-network investments (e.g. buildings). All data is reported on an as-incurred basis.

Source: AER, *Electricity Transmission Network Service Provider Performance Data*, November 2018.

Our conclusion is therefore, that the AER should seek to minimise the ongoing distortion that would arise with respect to existing assets if it continues to apply SL depreciation when the NSP has applied DV for its existing assets. We note that this will require adjusting the TAB to set a new starting point for the use of DV on these existing assets, and then applying DV to both existing assets and to new assets in future assessment of the tax costs allowances.

CCP22 also recognises, however, that adjusting the TAB based on using DV for each of the existing assets, will be a data intensive exercise, although the NSPs are likely to have relevant data to assist this process. Therefore, we suggest to the AER that this task is undertaken only after a more detailed analysis of the NPV outcomes that recognise the issues we have raised above.

We understand from Lally's table (see below), that he (and PwC) do not recommend a change to the AER's SL approach for existing assets, even when the network has used a DV tax depreciation approach. Lally's argument appears to be based on the claim that there is little benefit to consumers from doing so given the average age profile of the existing assets which he assumes in his modelling to be 15 years (over an asset life of 40 years).

However, we consider Lally's examples using average asset ages is too simplistic. As discussed above, the use of average asset ages to estimate the benefit of a change to the AER's approach in NPV terms, is likely to understate the impact of the recent high levels of capex investment and therefore, the NPV benefit to NSPs.

As a consequence of the issues we raise above, it is likely that the average age of the assets still being depreciated will be lower for depreciation purposes than the technical/operational average used by Lally. In addition, as we have noted above, the value-weighted average life for tax purposes will be even shorter since tax depreciation is based on historic costs and not indexed. As a result,

newer assets will have a high acquisition costs and a much greater weight in the TAB. Under the DV approach, the younger the assets the greater the NPV benefit of DV relative to SL.

The network has used SL approach to the depreciation of its existing assets

Some networks (including some 35-40% by value of private sector networks) have for various reasons calculated their taxable income for the ATO using SL depreciation of their tax asset base. CCP22 agrees that the tax law does not prevent a network adopting this approach. For most networks using DV depreciation would currently appear to be more tax efficient although PwC has identified cases where it may be an optimal approach for a particular network.

The ATO does, however, require that, once a business has adopted a particular depreciation approach for any asset, it must not change that approach while it continues to own the business⁴². For this reason, we recognise there may be legitimate concerns by these networks about the AER imposing the DV approach to its existing assets and reassessing the network's TAB and the taxable income on this revised DV basis. Moreover, the impact of this will vary from network to network depending for example, on the age of their existing assets.

In addition, these networks using the SL approach have (generally) not achieved the positive NPV outcomes for the business in the way that networks using the DV approach to tax depreciation have been able to achieve.

In our view, therefore, before any decision can be made on the AER's treatment of tax depreciation for these networks, a much better understanding of the risks and benefits of amending the network's current TAB as if they had used DV approach from the initial acquisition of the asset is required⁴³. Moreover, in terms of the ex-ante forecast of the revised TAB in the revenue determination, the AER would assume DV tax depreciation while the network was 'locked' into SL depreciation,

There are also questions raised by PwC. PwC suggests that if the AER imposed a notional DV approach on these businesses for their existing assets it may be adopting a position that is inconsistent in principle if not law with the ATO. PwC states⁴⁴:

“Specifically, as noted above once the depreciation methodology is chosen it is irrevocable pursuant to section 40-130. Accordingly, from a legislative perspective there is no ability to change the depreciation method that has been applied to existing assets for regulatory purposes.

...

⁴² Tax law does generally allow a change of depreciation approach on the transfer of an asset to a new owner.

⁴³ For a network that had purchased and retained continuing ownership of the asset, this purchase amount should be available from their historical accounts. The problem may be more difficult for new purchasers of assets who continue to use SL tax depreciation. CCP22 does not know the extent of this potential issue, i.e, how many of the new asset owners have continued the SL approach or adopted SL where the previous owner used DV. Lally gives some examples, but as noted, we have some concerns with Lally's overall approach.

⁴⁴ PwC, October 2018, op. cit., p 79.

Accordingly, we note that this is a policy choice that has been historically made by the AER which we cannot comment on given it is inconsistent with the application of tax legislation.”

CCP22 cannot comment on whether this potential issue identified by PwC is relevant or not. However, it highlights the importance of the AER having a much better understanding of the legal and financial risks to the networks of amending the tax depreciation approach to existing assets when the network has used a SL tax depreciation approach. Overall, we are more inclined – at this stage- to agree that the AER should continue to use SL for the existing assets of these particular networks. Adopting this approach will avoid the extensive difficulties of resetting the TAB. There is also a significant risk that resetting the TAB based on DV since acquisition may result in substantial swings (positive and negative) in the tax allowance.

In coming to this conclusion, CCP22 is also cognisant that these networks have not obtained an additional benefit in the tax allowance in NPV terms compared to the other networks who have used DV approach. Nor will these networks obtain a benefit if the AER continued to use an SL tax depreciation approach in the PTRM for these networks (only)⁴⁵.

This is because those networks adopting SL tax depreciation (for whatever reason) are following an approach that happens to also be broadly congruent with the AER’s existing SL approach. To this extent, therefore, we consider the situation for these networks is quite different than for those who have used DV approach in their tax costs and gained an advantage in NPV terms in the past and may well continue to do so in the future if the AER does not adjust its approach.

(iii) Lally’s analysis of different options for treatment of tax depreciation of existing assets

In our discussion above, we have queried Lally’s conclusions and recommendations for the treatment of tax depreciation for existing assets. In particular, we are concerned that Lally’s analysis of the outcomes for networks that have used DV for existing assets uses an average age that does not sufficiently account for the fact that there has been a large surge in capital expenditure, RAB and TAB growth in recent years. In our view it is likely that by using the average age, Lally has understated the potential cost to consumers over the remaining life of the existing assets of the AER continuing its existing SL approach for tax depreciation (see discussion above).

Lally’s analysis, however, takes better account of the various historical changes in both the networks approach and the regulator’s approach to tax depreciation as illustrated in the table below from Lally’s October report.

Lally has set out four categories (with two subcategories), based on his understanding of current practices – all using the example of a 40-year asset life with an average age of around 20 years. For the *electricity networks*, this includes⁴⁶:

⁴⁵ In coming to this conclusion, CCP22 leaves open the question of whether a network currently using SL tax depreciation approach for its existing assets should have the right to negotiate with the AER to adopt DV tax depreciation in the PTRM (albeit continuing to use SL for its actual tax calculation). The AER would need to be confident that such a change remains consistent with the NPV =0 principle.

⁴⁶ See Lally, October 2018, pp. 21 – 25.

1. The network uses DV for tax depreciation purposes, and the regulator has applied SL for assessing tax depreciation since the commencement of regulation of the assets (“Case 1”);
2. The network uses SL for tax depreciation purposes, and the regulator has applied SL for assessing tax depreciation since the commencement of regulation of the assets (“Case 2”);
3. The network currently uses DV for tax depreciation purposes, and the regulator(s) have used DV but switched to SL in the current regulatory period (“Case 3”); and
4. The network uses SL depreciation for the purposes of their tax payments and the regulator(s) have used DV depreciation since the purchase of the asset (“Case 4”).

Lally’s are summarised in the following table from his October report⁴⁷:

	Firm	Regulator	Switch Effect	Recommendation
Case 1	DV	SL	Minimal	Don’t Switch (Can’t Help)
Case 2a	SL (DV*)	SL	Minimal	Don’t Switch (Can’t Help)
Case 2b	SL	SL	N/A	Don’t Switch (Ideal)
Case 3	DV	DV, then SL	Minimal	Don’t Switch (Almost Ideal)
Case 4a	SL (DV*)	DV, then SL	Minimal	Don’t Switch (Almost Ideal)
Case 4b	SL	DV, then SL	Minimal	Don’t Switch (Can’t Help)

Case 1 and Case 2b correspond to CCP22’s discussion above. Cases 2(a), 3, 4a and 4b are particular more complex variants, and in particular, 3 and 4a and 4b relate primarily to the AER’s amending the previous regulator’s use of DV to align with its preference for SL. In the absence of further explanation from the AER on how it identified and managed these latter situations, we do not consider them particularly relevant to the assessment of the underlying principles.

CCP22 agrees with Lally’s conclusions with respect to Option 2b (network adopts SL, AER adopts SL). However, we are not yet satisfied with Lally’s conclusions on 1 (and possibly 2a), where the network has used DV, and the AER currently uses SL.

As set out in the table, Lally recommends no change to current practice for existing assets when the NSP uses DV for tax depreciation as it “can’t help”. However, as suggested above, CCP22 does not consider Lally’s analysis based on average ages has sufficient granularity regarding the shape of the age profile, the impact of the significant growth in investment in the last 10 years and the effect of historical tax depreciation on the value weighted average age. For this reason, we have recommended that the AER conduct further investigation into the optimal approach for businesses that have used DV for tax depreciation and have gained a benefit in the past and will continue to gain a benefit arising from the preponderance of newer investments as a proportion of the total depreciation costs.

⁴⁷ Ibid Table 4, p.25

However, we note PwC's observation that the AER has previously transitioned existing assets from the DV method to the SL method, and in doing so, the AER has ignored the application of the tax legislation.⁴⁸ We are interested in understanding how the AER managed this process and whether any of the AER's experience in doing this would be relevant to the current situation.

7.3 International Evidence

PwC considers that the treatment of tax depreciation in the US is "relatively settled" based on their observations of the decisions by the FERC and by various state Public Service Commissions. PwC states⁴⁹:

"...it appears the debate regarding the appropriateness of the depreciation methodology to be included in tax allowance in the United states is now largely settled, in that *the benefit of accelerated depreciation is largely passed on to consumers.*" (emphasis added)

PwC also refers to the Supreme Court conclusions on this issue. In this instance, the Supreme Court stated that⁵⁰:

"It soon became apparent that *accelerated depreciation, in practice, resulted in permanent tax savings.* ... Accordingly, the Commission required utilities using accelerated depreciation for tax purposes to use the same method for calculating their cost of service, and thus, "*flow through*" any tax savings to their customers... Subsequently, the Commission decided that it would *impute the use of accelerated depreciation for ratemaking purposes regardless of the method used for computing actual taxes*⁵¹..." (emphasis added)

CCP22 recognises that the Supreme Court's analysis cited above was made in the context of the US cost of service regulatory framework. Nevertheless, the essential points remain true for Australia. The current differences in the AER and most networks in their approach to tax depreciation does lead to permanent tax savings in NPV terms,⁵² and that this difference should be addressed by the regulatory body and the tax savings returned to consumers. Feasibly, customers should receive some return either by the ex-ante revenue allowance using the DV approach, or some ex-post true up. CCP22 would favour the former, as this is more consistent with incentive regulation and the estimation of the efficient tax cost allowance for the efficient benchmark entity.

⁴⁸ PwC, October 2018, op. cit., p 79.

⁴⁹ Ibid, pp. 95-96.

⁵⁰ Cited in Ibid, p. 96. The Supreme Court was ruling in the matter of *FPC v Memphis Light, gas and Water Division*, (1973).

⁵¹ The Supreme Court noted that initially the Commission required the "flow through" approach meaning that the utility was only required to return the benefit to the customer when the utility used the accelerated depreciation approach in its tax statements. As indicated, the Commission then amended its decision to apply accelerated depreciation for the estimation of the tax cost irrespective of the approach adopted by the utility.

⁵² The Supreme Court's argument for permanent tax savings was somewhat different than the argument around the NPV neutrality, but the outcome is much the same. See PwC p. 96 for details on the US Court's arguments.

In the UK, Ofgem's current arrangements in the existing price control framework includes 'ex-post' mechanisms to claw back any reductions in tax liabilities due to gearing or change in tax rates⁵³.

As part of RIIO-2, Ofgem has initiated a review of its current arrangements for determining the tax allowance for the regulated network companies to pay corporation tax, with the aim of "preventing any significant mismatches between tax allowed and tax paid by network companies"⁵⁴. In its initial stages of the review, Ofgem proposed three options to consider further⁵⁵:

- Option A: build in additional clawback mechanisms (depending on the reasons for persistent variances)
- Option B: to pass through the actual tax paid to the Government
- Option C: to introduce a 'double-lock', so that consumers pay the lower of a capped allowance, and the actual tax paid to the Government.

Ofgem notes that there were significant differences between respondents; some claimed Ofgem did not need to change its current approach, some supported change if the difference was found to be material, others indicated a preference for Option A. There was little support for Options B and C.

Ofgem concludes that RIIO-1 ('claw-back of gearing or changes in tax rates) provides a foundation but they will continue to collect data and at this stage will not rule out any changes.

CCP22 observes that at this stage, it does not appear that Ofgem has specifically considered the relationship between the TAB, taxable income, tax depreciation and the regulatory framework. While acknowledging there are differences between the tax paid and the tax allowed, the RIIO-2 decision document does not progress this specific component of the 'gap', nor is it specifically recognised in the current RIIO-1 claw back arrangements.

⁵³ See: Ofgem, RIIO-2 Framework – Final, July 2018, p.p. 59-62.

https://www.ofgem.gov.uk/system/files/docs/2018/07/riio-2_july_decision_document_final_300718.pdf

⁵⁴ *ibid*, p. 59.

⁵⁵ *Ibid*, p. 60.

8. Other matters

Recommendations:

The AER apply the 20-year cap to all new and existing assets at the earliest opportunity. We make no recommendations at this stage on the detailed implementation of this cap.

The AER continues its current approach to the treatment of revaluations in the TAB (and RAB), namely to not recognise changes in market valuations as reflected in sale prices etc.

On the treatment of stamp duty there is insufficient information available to us to make a final recommendation on this matter.

The AER continue its current proposed approach with respect to self-assessed asset lives and low value pools.

8.1 Capping Age of Gas Assets

The effective lives of depreciable assets identified for tax purposes by the network relative to the effective asset life adopted in the TAB may also have an impact on the taxable incomes. In considering this issue, PwC identified that there are different statutory requirements for electricity and gas assets. As explained below, this does not appear to be a significant explanatory driver for electricity assets (based on the data to date), but may be an important driver for gas assets.

Tax law specifies that for all depreciable assets, a business can either adopt the ATO's effective life for that category of assets, or can self-assess the effective life under certain conditions. The effective life of the assets can only be changed over the life of the assets under certain conditions⁵⁶.

The PwC analysis indicates that, for electricity assets, there is only small difference between the effective life of electricity assets in the TAB and the effective life recorded in the tax fixed asset registers (TFAR), being 41.56 years and 39.94 years respectively. PwC reports that this small difference would indicate only a marginal timing difference in the depreciation being claimed by the electricity sector in determining the tax allowance and actual tax paid.

For policy reasons, however, in 2002 the Australian Government introduced statutory caps for gas transmission and distribution assets of 20 years. This cap also applies to assets that were capitalised prior to 2002. Reflecting this policy decision, PwC notes⁵⁷:

- The statutory cap has only been applied to six of the 11 gas participants in the TAB, however this is sufficient to skew the average effective life of gas assets in the TFAR relative to the TAB.
- The average life of assets in the TFAR (27.83) is significantly lower than the average life in the TAB.

⁵⁶ PwC, October 2018, op. cit., p 80.

⁵⁷ ibid pp. 83-84.

PwC therefore concludes that⁵⁸:

“This would indicate depreciation is being claimed by some sector participants (i.e. the five participants where capping is not being applied) at a faster rate in determining actual tax paid as compared to the tax allowance determined [in the] existing regulatory approach.”

Both PwC and Lally therefore recommend that the AER adopt a 20-year effective life cap to apply for all gas assets assessed in the TAB. For instance, Lally highlights the potential significance of the issue suggesting that where the AER has not included the 20 year effective life cap in the TAB/taxable income assessment (but the network has in its tax returns), the incremental benefit to the network in PV terms is around 19%, and this benefit is not currently being passed on to consumers via lower prices.⁵⁹ Lally therefore concludes as follows⁶⁰:

“Thirdly, the life of gas assets is capped for 20 years for purposes of determining depreciation deductions claimed by firms, and this is *not recognised by the AER in determining its tax allowance in some cases*. Further, this seems to be a *significant issue*. Accordingly, the AER should use the capped life in its determination of the tax allowances for *all gas businesses*.” [emphasis added]

The AER has set out three implementation options being:

1. Apply 20 year cap to new capex only;
2. Apply the cap to new capex and existing assets by capping remaining lives to 20 years; and
3. Apply the cap to new capex and existing assets by relative adjustment such as pro-rata.

CCP22’s recommendation is for the AER to apply the cap to both new and existing assets in calculating the TAB and taxable income, consistent with options 2 and 3 above. While option 2 appears to be a more simple and transparent approach, we note the AER’s comment that⁶¹:

“it may result in a large step in the tax allowance in 4 regulatory periods when a large proportion of the TAB is fully depreciated.”

If the AER’s modelling indicates that this is significant issue, then a pro-rata approach may be preferable. At this stage, CCP22 is not in a position to advise on this issue but we look forward to further analysis by the AER once the full set of RIN data is available.

CCP22 recognises that that our recommendation on the treatment of effective lives for gas assets differs from the more cautious position we have adopted on the question of tax depreciation that was discussed above. In coming to this conclusion, we highlight three interrelated differences between our recommended treatment re the capping of the effective life for the gas assets in the TAB, and the treatment of tax depreciation for both electricity and gas assets in the TAB, as follows:

⁵⁸ Ibid, p. 84

⁵⁹ Lally, October 2018, op. cit., p. 20.

⁶⁰ Ibid, p. 3.

⁶¹ AER, November 2018, Table 6.3, p 50.

- The tax law that caps the effective life of gas assets was introduced in 2002 and had retrospective effect for existing gas assets, such that all the gas businesses should now have implemented that policy in their asset registers for new and existing gas assets. In fact, it would seem that the AER's approach (for at least some of the businesses) is currently inconsistent with tax law.
- The tax law capping the effective life of gas assets is quite specific and does not provide any discretion with respect to both pre and post 2002 gas assets. However, the tax rules around depreciation do provide discretion for a business to choose between DV and SL tax depreciation. Therefore, for the AER to impose DV retrospectively on those networks that have historically adopted SL in the TAB is more of an open question.
- The benefits flowing to gas networks where the AER has not included the 20-year cap in calculating the TAB are substantial, and the outcomes are inequitable for both consumers and for those gas networks where the AER has adopted the 20-year cap.

In addition to the above three factors, CCP22 considers that the AER should consider whether it has made a factual error in its construction of the PTRM by not imposing a cap of 20 years in the calculation of the TAB for gas assets.

While this recommendation may require the AER to recast the existing TAB in the PTRM (for these five gas networks), we do not consider this an excessively onerous task given that the relevant networks have already been through this process in readjusting their historical gas assets in 2002 and maintained these adjustments since then in accordance with the tax law. Nor does CCP22 consider this change would reasonably be considered a 'retrospective change' in the sense that it is changing the 'rules of the game'. The networks' tax returns are presumably in line with the ATO's requirements and already incorporate a 20-year cap. The AER is merely correcting the assumptions it has made in its own model which do not recognise the relevant tax law.

8.2 Effects of changes arising from corporate transactions and revaluation of the asset base ("value effects").

Revaluation of the assets

As highlighted by the AER, under the Tax Law, networks may revalue their TAB to reflect the market value of their depreciable assets. The revaluation might follow changes to how the cost of an individual asset is measured, asset privatisations and resetting the tax costs base of an entity/asset on entering a tax consolidated group⁶². CCP22 notes that recent asset privatisations and sales have been at significant multiples of the regulatory RAB of around 1.5, creating a substantial gap between the market valuation, the RAB and the TAB.

This revaluation gap will in turn alter the actual depreciation expenses linked to these revalued assets. If the revaluation is up, the TAB and future depreciation costs are higher than in the AER's model based on historical costs, while taxable income is (all other things being equal) lower than in

⁶² AER, November 2018, op. cit., p. 81

the AER's model. It is recognised that this is one of the factors that may drive a wedge between the observed tax paid and the AER's tax expense allowance in the regulatory building blocks.

The AER states that it does not propose to adjust the TAB (or the RAB) in response to market transactions for the regulated assets⁶³. The AER's conclusion is consistent with the views of both PwC and Lally, although PwC and Lally provide different reasons for this conclusion.

The AER explains its conclusion on asset revaluation as follows⁶⁴:

“Where an asset trades at a multiple in excess of the regulatory asset base (RAB), the incremental value sits outside the regulatory framework. Customers do not pay for higher return on capital and return of capital building blocks, but they also do not pay a lower tax building block.”

First, such a process would be complex and the calculations themselves would add risks to both networks and consumers. The PwC report has identified a difference in the written down values in of some 13.1% between the TAB and the TFAR (the TFAR being higher) across the industry. However, there is also a range of factors that would explain the differences⁶⁵. These include the items discussed previously (immediate expensing and depreciation approach/asset lives), but also the inclusion of unregulated assets and step up in tax costs arising from acquisition of regulated and unregulated assets that are not recognised in the TAB (or RAB).

More generally, the AER notes the limitations of the current data on this issue, and the extensive analysis required to unpick the impact of revaluations of the regulated assets on the observed differences between the TAB and the TAFR.

Second, CCP22 agrees that the costs to consumers of a higher RAB (following a positive revaluation) might be substantial and would continue over the remaining life of the asset. These include the return on capital and the ongoing adjustment of the RAB for inflation, and the return of capital in the RAB through regulatory depreciation of the RAB. These costs over the life of the asset are likely to be significantly greater than any potential flow through of benefit from adjusting the TAB and taxable income to align with the new revaluation (assuming an increase in the TAB) – although we have not seen the modelling to support this conclusion at this time.

Put another way, if the AER's approach was amended to recognise the impact of revaluation and higher depreciation (assuming a positive RAB multiple) in the TAB, then the network would no longer enjoy the expected benefit of the difference between the AER's TAB and the TFAR. However, if this change using market value for the TAB, was correspondingly reflected in revaluation of the RAB, then consumers would face full exposure to the increased return on and return of capital and the annual inflation adjustment of the RAB in the pre-tax revenue calculation.

⁶³ Ibid, p 78.

⁶⁴ Ibid, p 78.

⁶⁵ See AER, November 2018, op. cit., p 81 for details.

Nevertheless, we do not at this stage endorse the rationale provided by Lally and endorsed by the AER to support their argument for not recognising the revaluation of the assets in the TAB (albeit we support the conclusions). Lally suggests, for instance, that by altering the valuation through the recognition of a higher tax costs base, a rational bidder will lower prices to the disadvantage of the seller. In turn this will discourage sellers and hinder the operation of an efficient market.

However, in our mind this depends on whether the AER recognises the re-valued assets in the RAB as well as the TAB. The AER does not currently endorse revaluation of the RAB and we would support that approach. However, the networks have strongly suggested that if the revaluation is recognised in the TAB, then it should be recognised in the RAB (albeit calculated on a different basis going forward based on indexation of the RAB).

If the revaluation is recognised in the RAB, then surely the AER's own arguments point to the fact that the buyer will benefit from the pre-tax revenue adjustments such as indexation of the RAB, returns on and of capital for the higher RAB etc. Therefore, the buyer still has a strong incentive to purchase an asset at a premium if it believes that it can achieve higher cost efficiencies and generate a higher return than the AER's allowances. While the sale price may be marginally reduced because of the loss of a notional tax wedge benefit, the outcome from a consumer/social perspective will still be a more efficient outcome than one where the purchase price reflects (inter alia) artificial tax gains.

CCP22 also does not agree with a number of the reasons provided by the networks for not adjusting the TAB. For instance, as indicated elsewhere in this paper, we do not consider the 'expectations' of a tax wedge gain on purchase of an asset is a relevant consideration for the AER. A buyer must undertake due diligence and incorporate risks into their modelling that recognises the AER might adjust its approach at some point in the future when the current approach does not serve the long term interests of consumers.

The AER cannot be locked into abiding by the assumptions that different buyers may make in the competitive asset sale and acquisition market; nor should buyers who price high be rewarded by the AER for their failure to assess future risks that other bidders may have taken into account. The AER is obliged to conduct clear and transparent processes when reviewing its regulatory parameters (within the rules and the law), but it is not bound to specific conclusions in the review process; these conclusions must evolve over time to improve processes in the long term interests of consumers and to respond effectively to changing circumstances.

Finally, CCP22 notes that most recent asset sales and associated revaluations have been at a premium to the RAB. However, it is possible that in the future, some asset sales will be at a loss reflecting for instance, an owner that has incurred excessive debt that is not recoverable under the regulated revenue arrangements. Given the support by networks for the AER not including revaluations as part of the RAB and TAB, we seek assurance that the same 'rule' will apply in the event of a negative revaluation including revaluations arising from capital redundancy when assets cease to contribute to the delivery of network services⁶⁶.

⁶⁶ Currently the NGR allows for "capital redundancy" as part of an access arrangement under certain conditions (NGR, rule 85). However, there is no equivalent clause in the NER. However, the ACCC amongst other entities have suggested that the NER should allow this in the future.

Stamp Duty

The AER proposes that there be no change to the treatment of stamp duty as stamp duty is excluded from the costs of providing the regulated services. However, the AER also acknowledges it currently has very limited information on the extent of this issue and will review its position on receipt of more information from the RINs when it makes its final decision.

Self-assessed asset lives and Low value pools

Based on the voluntary data provided by the networks to date, CP22 agrees with the AER that two of these drivers – ‘self-assessed asset lives’ and ‘low value pools’ - may not have a material impact on the outcome⁶⁷. Therefore, subject to confirmation based on the RIN responses, the AER’s current proposal that it need not take account of these two factors seems reasonable.

9. Interest expense

Recommendation:

There is no basis for the view that the tax calculation should simply apply the 60/40 debt equity ratio in the draft AER Rate of Return Guideline.

CCP considers this a very important issue and look forward to making further comments when the RIN data is available in the December report. We make the following comments at this stage of the review.

We do not feel bound by the 60-40 ratio used in determining WACC. There is clearly a difference in the debt/equity ratio (60/40) used for an “above the line” AER revenue determination (including assessment of regulatory taxable income), and a “below the line” calculation of tax allowance. There are different definitions of debt and equity for regulatory and tax purposes and difference between regulatory and market valuation.

The AER notes (p.35) that the Independent Panel in the Rate of Return Review has made a clear statement on this point:

"The only significant interaction of the gearing ratio with other building blocks is with the taxation component. Because interest costs are tax deductible, consistency requires the same gearing ratio to be used in the rate of return and taxation building blocks."

We do not consider that this necessarily follows. Depreciation is also a tax deductible expense and on the same logic it would follow that the same depreciation profiles should be used for taxation and the pre-tax revenue building blocks. Applying the same Panel logic, given depreciation is based on asset values the same asset values should also be used. However, this ‘consistency’ argument has not been accepted by the AER in its assessment of the tax depreciation schedule for new assets. In

⁶⁷ See also, PwC, October 2018, op. cit., pp. 76-77. The data suggests that these drivers explain a very small percentage.

addition, the consistency argument assumes the definition of debt and equity for regulatory and tax purposes are the same, and this is not the case.

Furthermore, regulatory practices in other jurisdictions do not support the proposition that the assumptions used should be the same. Differences between the tax depreciation assumption and the depreciation revenue building block are common place. Any presumption of a link has been broken completely in the UK through the move to fast money/slow money. Furthermore, it includes an adjustment for the tax advantage for highly geared firms. Similarly, as noted in section 7 above, the US has accepted alternative approaches to tax depreciation.

10. Implementation

Recommendations

Implement those changes that can be achieved with model changes in the April 2019 round of AER network revenue decisions

Proceed with require rule changes as quickly as possible to ensure application to the next round of AER network revenue decisions on April 2020

As we noted in our previous submission on this matter, we strongly support the implementation of as many of the reviews conclusions as possible with the AER April 2019 final decisions for the 2019-24 revenue period.

The Paper has relatively high level comments on the implementation pathway.

Possible Change	How it is achieved (references to the AER Discussion Paper)
Introduction of a second “concessional” tax benchmark	Given this was not a recommendation there was no comment; expect that it will require a rule change
Immediate expensing of refurbishment capex	Unclear: “...immediate expensing could potentially require a rule change” (p.19) Model amendment (p.48) CESS type incentive scheme to remove incentives if applying a network specific approach “...would likely require a rule change” (p. 58)
Using diminishing value rather than straight line	Model amendment (p.49)
Gas pipeline asset life	Seems to be a model change (p.50)
Gearing ratio/interest expense	“May require a rule change to implement” (p.88)

We look forward to December Final Report containing more guidance on the implementation pathway:

- Whether by model change or rule change

- The details of what would be required to implement the model changes, particular for expensing and depreciation

We expect that changes that require a model change will be implementable prior to the April 2019 decisions. Changes that require a rule change will take longer. We would hope that these latter changes would be completed prior to the next round of AER revenue decisions in April 2020.

Some networks may argue that further work needs to be done before implementation and hence the changes cannot apply in the April 2018 decisions. For example, Ausgrid and its equity investors their submission in May, said⁶⁸:

“...in relation to the start date of implementing changes, we would oppose any reforms to be applied to the forthcoming 2019-2024 regulatory period for Ausgrid given that the regulatory proposal has already been submitted.”

CCP22 would suggest that networks have been aware of this review and the topics under consideration since May 2018. While Ausgrid submitted its proposal on 30th April 2018, it does not submit its revised proposal until January 2019, after the release of the final tax position paper by the AER.

While we acknowledge that there will be work involved to adapt the models and this is discussed in the Paper, eg capped 80 days for model changes⁶⁹, and implementation around expensing, we expect that the information required to populate the models with the proposed changes, should be readily available with the networks given many are doing that now and would have detailed internal forecasting of the proposed level in 2019-24.

Given the AER has assessed the impact of these changes as providing a material benefit to consumers in the context of the NEO/NGO, we do not see administrative complexity as a reason to prevent consumers getting these benefits for another 5 years.

⁶⁸ IFM Investors, Australian Super and Ausgrid p.19
<https://www.aer.gov.au/system/files/Ausgrid%2C%20IFM%20and%20Australian%20Super%20-%20Submission%20to%20Issues%20Paper%20-%2031%20May%202015.pdf>

⁶⁹ See Paper p. 14