Consumer
Challenge
Panel

Submission to the Australian Energy Regulator (AER)

Consumer Challenge Panel

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

Sub-Panel 22

Eric Groom

Bev Hughson

Mark Grenning

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1. Introduction

This supplementary submission to the AER provides:

- commentary on the Department of Environment and Energy (DoEE)[1] and Australian Tax Office (ATO)[2] submissions on the Discussion Paper and the ENA's supplementary submission[3] responding to the DoEE submission

- commentary on discussions we have had with Ofgem and Ofwat in the UK on how they calculate tax allowances, and

- the excel models used in our earlier submission on the Discussion Paper to provide the basis for our support for the immediate expensing of refurbishment capex in the tax calculation.

It also reflects CCP22's considerable concerns with the very tight timetable that the AER faces in preparing its Final Report for the COAG Energy Council. The compressed timetable has meant that the stakeholder consultation has been based on limited voluntarily provided information rather than RiN data along with guidance from PwC and Dr Lally.

There is clearly much left to consider and we acknowledged that at the time of our first submission on the AER's Discussion Paper it was too early to be definitive on some issues, such as the treatment of gearing and interest rate costs in the tax calculation. We also noted that final decisions on the pass through of taxable income adjustments versus benchmark allowances can best be made in the context of the data available from the networks and the ATO. We look forward to the forthcoming Final Report and further opportunity for stakeholder consultation on issues with the benefit of the RiN data, particularly around interest expense.

The DOEE is suggesting that the AER:

> "…test the implications of moving to an alternative mechanism by collaborating with the ATO – in particular a cost-pass through mechanism".

We very much welcome on consumers' behalf, that that the ATO has now committed to closely collaborating with the AER on refining the various measurements and tax law requirements. We agree with the DoEE submission that such collaboration is essential for the future progress in this review.

The ENA's supplementary submission takes issue with a number of matters raised by the DoEE.

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[1] Department of Energy and Environment "Submission to the AER" 23 November 2018, p 4.
https://www.aer.gov.au/system/files/DoEE%20Submission%20-%2023%20November%202018.pdf
[2] ATO "Submission to the AER" 23 November 2018
https://www.aer.gov.au/system/files/ATO%20submission%20to%20AER%20Review%20-%2023%20November%202018_Redacted.pdf
[3] ENA "Supplementary Submission – Regulation Taxation Discussion Paper" 4 December 2018
https://www.aer.gov.au/system/files/ENA%20-%20Supplementary%20Submission%20-%20Regulation%20Taxation%20Discussion%20Paper%20-%204%20December%202018.pdf

While CCP22 is also appreciative of the co-operation of many of the networks in providing the voluntary information, it was disappointing to note that some did not do so. Moreover, we note the ENA's comment in their Supplementary Submission that (p.6):

> "…none of the upstream investors approached by the AER provided data in response to the voluntary information request".

It is our expectation that such vital data should be provided in response to the AER's RIN requests and in time for the AER to incorporate this data into their recommendations to the COAG Energy Council. We do not accept that upstream investors can hide behind the cloak of complexity of disaggregation, while expecting Australian energy consumers to fund tax rate costs that they do not incur. Our discussions with other regulators outside Australia indicate that such information, can be reliably calculated given appropriate allocation principles, and that doing so posed no substantial difficulty to the businesses. Therefore, absent the provision of actual audited information provided by the businesses on this matter, CCP22 would expect the AER to proceed on the basis of 'reasonable' assumptions using publicly available information, ATO advice and current tax law.

The rest of this submission focuses on the following themes:

- The importance of the AER providing a clear timeline for the progressive development of the treatment of taxation. In our view, a clear timeline, including appropriate consultation with the ATO and all other stakeholders, will address some of the concerns by stakeholders of the outcomes of the current analysis of the issues.

- The need to consider both the tax rate and taxable income in "narrowing the gap". The DoEE's submission calls for investigation of an 'alternative mechanism' that is effectively a pass through arrangement which relates to the former, not the latter. We have some sympathy with the DoEE's concern that (p.3):

  > "…consumers are best served by an approach where the network businesses are only compensated to the extent they need to meet their statutory obligations." (re the tax rate).

  We consider that our proposal for two benchmark tax rates (30% for corporate structures and 15% for all other structures) is sensible and practical middle ground between the DoEE's proposed pass through than the AER proposed 30% rate.

- On the determination of the taxable income, CCP22 suggests that there is a greater role for benchmarking although this conclusion is conditional on whether a meaningful benchmark can be established, particularly for 'immediate expensing'. Alternative approaches may need to be explored to reduce the significant gap arising from this issue. We also propose some options for the AER to consider with respect to the treatment of gearing and interest rates differences, following recent discussions we have had with officers from Ofgem and Ofwat.

Our objectives are to ensure:

- Where a change can be achieved by a change to the PTRM model that these changes be implemented in time for the AER's April 2019 decisions for the 2019-24 revenue reset period,

- Where a change required a rule change that this be clearly identified and pursued with haste to apply to AER's April 2020 decisions for the 2020-25 revenue reset period, and
- that the AER will continue to enhance its information base and modelling approach in the future. Best practice regulation requires continuous updating to reflect current industry practice.

2. The Time Line – Clarifying the Next steps

Despite the AER's best efforts, the timeline under which the AER has had to undertake this review has not allowed sufficient time to address all the many and often conflicting positions which have arisen over the course of the consultation period.

For example, the data on interest expense will only be available in the AER's December report. In our November submission, CCP22 rejected the argument that the assumptions on gearing for the estimation of the taxable income of the entity should be the same as the estimation that is made for the calculation of pre-tax revenue[4]. We believe that it is essential that the AER consider this issue from a tax perspective separately from its approach to the estimation of the pre-tax revenue allowance. Ofgem and Ofwat adopt different gearing assumptions for the calculation of the tax allowance and determination of the WACC and do not consider this raises any issues of inconsistency. Furthermore, that has been a longstanding policy that is well accepted.

We look forward to the AER's report to the COAG Energy Council in mid-December will provide the following:

- The proposed engagement process with the ATO
- An indication of the quality and extent of the information provided by the networks (including the upstream owners) through the RIN process, and the information gaps that remain including the reasons given by the networks for not supplying information
- A clear distinction between what can be addressed through modification of the PTRM for both the electricity and gas networks and what can be achieved only through rule changes
- An outline of the consultation processes required to implement changes to the PTRM by April, 2019 in accordance with the current consultation requirements under the Rules
- An outline of the processes and expected timing for any Rule changes including identifying opportunities for fast track rule changes.
- A discussion on what parameters can and cannot be amended during a 5-year regulatory period, for example, changes in taxation rates, or treatment of immediate expensing of assets.

[4] See CCP22 "Submission to the AER's Discussion Paper" November 2018, pp. 50-51. We noted, for instance, that the AER implicitly uses the same definitions of debt and equity in its estimation of pre-tax revenue and the taxable income of the network. However, this does not accord with the fact that the AER's definition of debt and equity differs from the definitions of debt and equity in the tax law (see p. 50). Similarly, we argued that there is no reason for the treatment of depreciation in the pre-tax revenue to be the same as the treatment of depreciation in the calculation of the taxable income (see pp. 50-51).

- A recommendation for a formal review period, which we suggest should be conducted in line with the next rate of return review.

In addition, we would recommend that the AER be allowed sufficient time to liaise with international regulators who are facing similar issues. Our discussions with Ofgem and Ofwat indicate that they are moving towards a stricter and more transparent regime of cost allocation between the regulated and non-regulated components of the businesses and of their corporate structures. Both Ofgem and Ofwat also have in place frameworks that include ex-post mechanisms to claw back any reductions in tax liabilities due to gearing or changes in tax rates. Again, it would be useful for the AER to consider such mechanisms along with progressive enhancement of its modelling of the tax allowance.

3. Distinguishing the Taxation Rate from the Taxable Income

In responding to the AER, CCP22 has found it useful to make a clear distinction between the taxable income of the entity and the taxation rate that would be applied to that specific taxable income. Both factors contribute to the 'gap' between the tax costs allowed by the AER in the current regulatory framework and the actual tax paid. While the tax rate for different entities is set out specifically in the tax law, the rules around calculating the taxable income are less clear. The latter can, for example, depend on a network's interpretation of tax rulings and can therefore lead to differences between the AER's estimation of taxable income and the taxable income submitted by the entity to the ATO.

For example, the taxable income is affected by the choice of the depreciation rate – the tax law allows entities to use either straight-line depreciation (SL) or diminishing value (DV), with the only significant constraint being that a firm cannot change their approach for a given asset(s) over the life of the asset. Similarly, the tax law and interpretation of that law by the ATO provides fairly wide discretion to the networks on what assets could be expensed in a year – leaving scope for the businesses to make very different decisions depending on the type and age mix of their assets and their perception of risk in incurring a subsequent tax review.

4. Taxation Rate

CCP22's submission in November did not agree with the AER's proposal to retain a 30% tax rate for all entities irrespective of their actual tax rate. Rather, we proposed that the AER should adopt two 'benchmark' rates, a 30% tax rate for corporate structures and a 15% tax rate for all others for the next regulatory period(s).

We argued for this approach on the basis that the AER is seeking to reflect what is actually happening in developing the benchmarks. Yes, there are announced taxation changes that will increase the tax rate to 30% for some investors that currently pay less than 30%, but this will not occur for some years beyond the 2019-24 regulatory period.

Our approach using two 'benchmark' rates represents a "quasi" cost pass through approach, but one that we believe is practical and achievable by April 2019 if it is possible by a PTRM model change. We do not have a strong issue, however, with any further refinement of these proposed benchmarks towards something that more closely approximates a cost pass through – for taxation rates.

We are not convinced by the argument that these two tax rates would adversely impact on the willingness of particular investors to invest in the sector. Long term investors in the sector look to long term returns driven by the fundamental nature of the sector, not by whether the AER's calculation of the tax allowance continues to allow a gap between the tax allowance and actual tax paid. Irrespective of the AER's approach to the regulatory tax rates, these businesses will still retain the benefit of a lower tax rate, relative to the corporate 30% tax rate in their accounts.

Subsequent to our November submission it has been suggested that applying the 15% tax rate to superannuation fund investors goes against the Federal Government's superannuation policy intent. We think it is important to separate out:

- Government policy on superannuation to achieve certain broader budgetary objectives eg less expenditure on old age pension
- Requirements of the NEO and the CCP's focus on the long term interests of electricity consumers

When we read the AEMC's interpretation of the NEO/NGO[5] it talks about the focus being on the consumer (p.5) and not on 'broader policy objectives' (pp 10-11). The examples its gives of 'broader policy objectives' are affordability (the NEO says 'price' not 'affordability') and environmental objectives. The AEMC clearly sees these wider matters as outside its consideration of the NEO/NGO.

> "Governments of course are concerned about issues such as affordability as well as a host of other policy objectives relevant to the energy sector including environmental ones. This means that governments may have potentially multiple and conflicting objectives to manage, which results in trade-offs being made between different objectives on behalf of consumers. Therefore, the achievement of such policy objectives is typically associated with a subjective value judgement which typically differs depending on a particular view and may potentially have broad societal impacts; rather than a more narrow, objective assessment based on technical engineering, economic or financial considerations such as those relevant to energy objectives. Governments also have other policy mechanisms available to them such as income measures and environmental regulations to address policy objectives beyond the impacts of the variables listed in the energy objectives.
>
> Importantly, the Commission does not ignore wider policy objectives in carrying out its role as adviser to governments, since consideration is given to potential negative impacts on certain stakeholder groups. However, these wider policy objectives are not taken into account when the Commission makes rules, or recommendations…

The ENA proposes an approach that is consistent with the AEMC when it says in its supplementary submission (pp6-7):

> "Maximising the level of collected taxation payments may be a relevant objective for the Australian Taxation Office. ENA does not understand, however, how the AER as an

[5] AEMC "Applying the energy objectives – a guide for stakeholders" 1 December 2016 https://www.aemc.gov.au/sites/default/files/content/Applying-the-energy-market-objectives-for-publication.pdf

> independent economic regulator can place any weight on policy objectives clearly laying outside its functions and powers."

The DoEE submission made no mention of wider Government policy requirements. To the contrary, the Department is supporting pass through. To argue for special consideration for superannuation companies is effectively asking consumers to continue to pay a higher network charge to subsidise the Government's retirement income objective. Along with the AEMC, we do not think this continuing subsidy is consistent with the NEO/NGO. What is consistent with the NEO/NGO, and an established part of AER's regulatory framework, is to have tax benchmark tax rates reflecting what is actually happening.

We regard our position as a sensible compromise (at least for this round of determinations), even though it might return less of the 'gap' to consumers than the DoEE's approach. This is not meant to exclude super funds from investing in the sector. They still may receive a better return that those network investors investing through a conventional company structure.

Differences in statutory rates have not been a practical issue of concern for UK regulators, given UK tax structures and utility structures. However, as the PWC report indicates, US regulators have used blended tax rates that reflect different statutory tax rates of the respective owners where a 'pass-through' structure is used.[6]

5. Taxable income

In our view, the situation is somewhat different and more complex in assessing the taxable income (to which the agreed taxation rates will apply), particularly in areas such as tax depreciation, 'immediate expensing', related party loans and more complex company structures where there is a tax benefit but some degree of risk of an adverse ruling. Each entity can make its own decision on its preferred approach balancing the risks and benefits. However, we believe it may be possible for the AER to establish certain principles and benchmarks that provide a closer reflection of common behaviour by the networks that reflect efficient tax practices.

There are multiple factors that drive a wedge between the AER's allowed taxable income and the actual taxable income of the entity reported to the ATO. Some of this wedge can be explained by different approaches to tax depreciation and immediate expensing of capital projects between the AER's modelling of taxable income and the actual tax practices of the networks. Other differences arise from the treatment of gearing and interest rates between the AER's modelling assumptions and the actual tax practices of the business.[7]

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[6] PWC "AER Tax Review 2018: Expert Advice" September 2018 https://www.aer.gov.au/system/files/PwC%20-%20AER%20tax%20review%202018%20expert%20advice%20-%2026%20October%202018_0.pdf, p98.

[7] For example, the business may adopt a higher gearing than the AER currently assumes, thus reducing the tax it actually pays relative to the AER's view. Similarly (although now more constrained by amendments to the tax law), the business may adopt a higher cost of debt under transfer pricing arrangements and therefore lower its taxable income relative to the AER's assumptions.

One argument against changing the AER's approach to calculating taxable income to one that more closely reflects actual practice, is that the difference is merely one of the timing of the cost recovery of the assets. The DoEE submission, for instance, appears to be somewhat dismissive of these timing factors as having significant importance in the tax review process relative to the tax rate issues.

However, CCP22 has strongly supported the analysis by Dr Lally[8] indicating that there is a NPV benefit to the networks of using DV and immediate expensing of certain asset classes, relative to the AER's approach. Importantly, Lally explains why this 'timing' difference matters with respect to the estimation of taxable income in the PTRM. He states (p.11):[9]

> "However, the regulator's choice of 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."

The principle that the AER's approach should seek to achieve a NPV=0 outcome over the life of the assets is to our mind a key element in ensuring the long-term interests of consumers are preserved.

Our November submission outlined our specific recommendations:

- Adopt DV depreciation in its calculation of tax depreciation expenses for all future asset investments (while retaining SL depreciation for the pre-tax revenue calculation)
- Adopt DV depreciation for existing assets where a network has used DV in its existing tax returns
- Accept SL depreciation for all existing assets where a network has used SL in its existing tax returns reflecting the constraint on the network changing its approach to depreciation over the life of the specified assets (while they are retained by the network).
- Develop a benchmark(s) for the immediate expensing of certain assets aligned with an assessment of the ATO's interpretation of current tax law on immediate expensing. We would expect this would require further collaboration with the ATO to refine what is common acceptable practice. We are now also open to the option of networks indicating in advance which asset acquisitions are expensed in their regulatory proposals, with this forming the basis of the AER's assumption – perhaps with claw-back provisions in the event of the network adopting a different policy in their actual tax returns.[10]

On the issue of interest expense, we look forward to the RiN data in the AER's December report. In anticipation of this, CCP22's preliminary discussions with staff from Ofwat indicated:

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[8] Dr M Lally "AER tax review – Review of submissions" 25 October 2018, pp. 10-17 https://www.aer.gov.au/system/files/Dr%20Martin%20Lally%20-%20AER%20tax%20review%20-%20Review%20of%20submissions%20-%2025%20October%202018.pdf

[9] This difference arises because there is no inflation in the calculation of the forecast of the tax asset base. For the same reason, Lally argues that there is no requirement for consistency in the treatment of depreciation between the pre-tax revenue allowance and the taxable income calculation (p. 11)

[10] We are aware that this will require more detailed categorisation of asset expenditures for the forecast pre-tax revenue calculation than is currently the case. However, this would allow the AER to be more responsive to individual circumstances to the benefit of the individual network and the consumers.

- It uses the firms actual gearing rather than assumed gearing and that this has not been controversial and is fairer to consumers
- While this requires allocation of debt between the businesses in the entity, this has not been seen as overly contentious of difficult. Ofwat has detailed accounting rules to guide such allocations
- It operates a claw-back mechanism for changes in gearing during a regulatory period if, for instance, the utility suddenly increases gearing after the revenue reset
- However, Ofwat uses interest rates from the WACC determination rather than actual interest rates.

CCP22 considers there is considerable merit in further examining this approach and its relevance to the Australian regulatory context. This will require the AER to develop more detailed cost allocation protocols that allow an auditable and transparent approach to the allocation of taxable income costs between the various regulated and unregulated entities in the business. This does not appear to have been a major issue in the UK following the establishment of such allocation protocols and are confident that the AER can, over time, develop an appropriate methodology in the Australian setting.

6. Modelling of the alternative treatments of immediate expensing

In our earlier submission we referred to modelling of the alternative tax treatments of refurbishment expenditures using the model developed by ENA. We have been able to discuss the modelling with ENA and AER and we are now able to submit the models (attached) which support the views express in our submission.