Consumer
Challenge
Panel

Submission to the Australian Energy Regulator (AER)

Consumer Challenge Panel

Submission to the AER on Review of regulatory tax approach - Initial Report June 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 comments on the Issues paper released by the AER on 28th June 2018 "Review of regulatory tax approach – Initial Report"[2].

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. They also operate under an implicit social licence that sets community expectations of how they will behave in owning and operating this monopoly. These concepts provide the framework for this submission.

Section 2 highlights the concerns all consumers have around the large increase in electricity prices recently highlighted by the ACCC report and the role of networks as the major contributor to that rise over the last decade. The NEO/NGO have been lost. While networks are talking about putting the consumer at the centre", the evidence is not always there to support it. Networks have a social licence to operate a monopoly essential service. They operate under a "regulatory bargain" with consumers and the AER. However, consumers have borne most of the risk and, not surprisingly perhaps, now question the integrity of the regulation framework. They are not alone, with regulators and politicians increasingly aware of the adverse impact that high energy prices are having on consumers and the wider economy of Australia. Transparency around all matters – in particular tax – is key to regaining consumer trust and support for framework integrity.

Section 3 comments on the network perception of sovereign risk in the current framework. We argue that we do not see this risk. It is important to distinguish between the incentive based regulatory framework and operational implementation of that framework and it is risk around the latter that is the area for debate. The AER is not changing the framework, it is ensuring that the framework adapts so that it continues to reflect a workably competitive market meeting the NEO/NGO. We assume network investors continually evaluate regulatory risk. A decision to change that operational framework to bring an outcome that better meets the NEO/NGO is part of the normal course of network business.

Section 4 provides a framework for estimation of the benchmark efficient tax allowance to apply to all networks.

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[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 "Initial Report Review of Regulatory Tax Approach" June 2018 https://www.aer.gov.au/system/files/AER%20-%20Tax%20Review%202018%20-%20Initial%20Report%20-%2028%20June%202018%20-%20FINAL%20PUBLIC.pdf

Section 5 comments on the conclusions in Dr Lally's paper[3]. We agree with some, disagree with others and explain why.

Section 6 answers the specific questions asked by the AER in the Initial Report.

In summary:

1. Any change considered by the AER should have the NEO/NGO as its central focus.
2. It is legitimate for networks to seek to manage their tax affairs within the bounds of the existing tax law and ATO rulings.
3. Our preliminary view, subject to seeing more data, is that continuation of the current approach is not an option available to the AER as it would be inconsistent with the NEO and NGO. However, we acknowledge that this needs to be tested through better data and the transparent evaluation of alternatives against clear criteria.
4. We suggest a framework for establishing the tax allowance based on a sector wide benchmark that:
    - Reflects the tax strategies of a private company operating in a workably competitive market subject to any additional requirements under the network's social licence to operate
    - Provides an unbiased estimate of tax payments by the benchmark entity
    - Is consistent with the NPV=0 principle
    - Provides a level of transparency by the AER sufficient to enable third party verification within the constraints of commercial confidentiality
    - Takes into account the benefits to consumers relative to the regulatory costs imposed on networks and the regulator.
5. Implementing this framework would require the AER to:
    - Establish a sector wide benchmark entity which we describe as:

      A pure-play Australian-owned regulated network utility in private ownership that adopts commonly implemented, legal strategies to minimise tax payments over time.

    - Determine the basis of application of the benchmark eg
        - estimate an average effective tax rate for the sector and apply this rate to all NSPs; or

[3] Dr Martin Lally, "Tax Payments versus the AER's Allowances for Regulated Businesses", 16 June 2018. https://www.aer.gov.au/system/files/Dr.%20Martin%20Lally%20-%20Tax%20payments%20versus%20the%20AER%20s%20allowances%20for%20regulated%20businesses%20-%2016%20June%202018_0.PDF

    - estimate the tax payments for each NSP of benchmark tax strategies (such as depreciation schedules, gearing for tax purposes, ownership structures) that impact on the taxable income of the NSP or statutory tax rate [4]
- Evaluate and test the application against transparent criteria, and
- Document the methodology for estimation of tax allowances and its application to specific NSPs.

6. We support the AER's proposed issuance of RIN notices to obtain additional data. We acknowledge the limitations of this process in terms of data availability eg given overseas ownership, and the very tight timetable for agreeing the RINs and provision of data.

7. We support implementing as many findings as possible to the April 2019 AER determinations, particularly those that can be achieved without a rule change process. This may require the AER to consider a two-stage process where some changes are made by April 2019 while others are developed through a rule change process.

We look forward to working with the AER, its tax advisor, PWC, and the networks to quickly agree on the proposed RIN to be circulated to networks in September.

[4] Specifically, the benchmarking approach could include or be limited to adoption of an alternative, commonly used approach to tax depreciation, that would change the taxable income of the entity compared to the AER's current approach. The question then arises as to what tax rate to apply to the lower (or higher) taxable income.

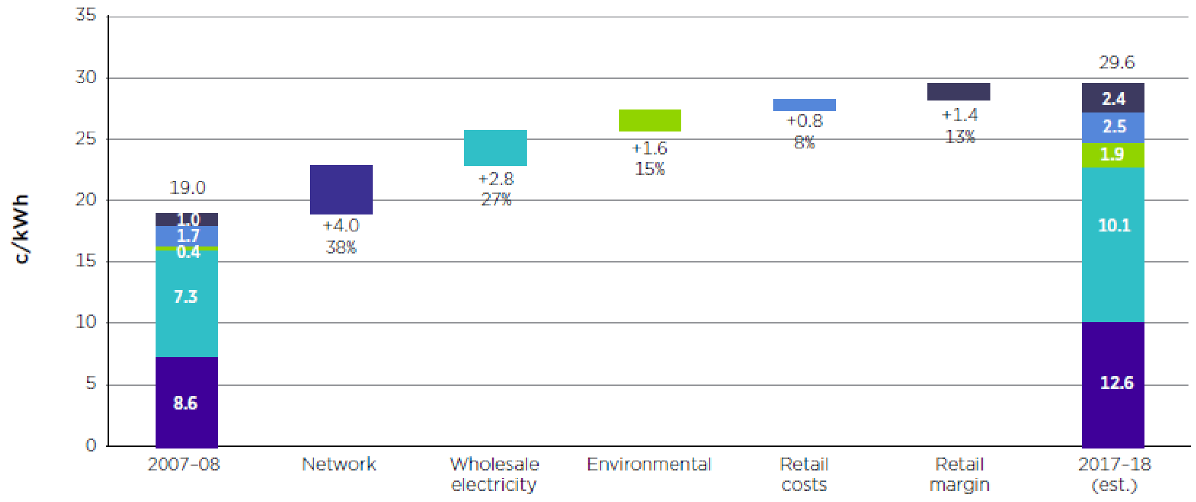
2. What consumers think?

In our earlier submission on this matter[5], 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. Since that submission, the ACCC has published its Final Report on the electricity market that concluded[6]:

> "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."

Over the 10 years to 2017/18, residential consumers have seen the real price/kWh increase 56% with over a third of that increase caused by networks[7].

Figure B: Change in average residential customer effective prices (c/kWh) from 2007-08 to 2017-18, NEM-wide, real $2016-17, excluding GST



Note: The percentages show each components' contribution to the total increase between 2007-08 and 2017-18.

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.

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[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

[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

The high level evidence they see in this matter from both the AER and the ATO suggests that taxation may be a source of the "affordability problem". So further work needs to be done to see if any of the difference between the regulatory allowance and actual tax paid is part of the problem and, if so, what are the factors, how material are they and what changes should be made. Consumers do not accept the view that "it is simply incentive based regulation working" even if they knew what incentive based regulation actually was.

Consumers are encouraged to see networks embracing a philosophy that has "consumers at the centre". They appreciate networks like AusNet Services transparently providing data on actual tax paid compared with their regulatory allowance and indicating the materiality of various drivers, noting that this is much easier given their simplified company structure[8].

On the other hand, they wonder about the commitment to put consumers at the centre from some network submissions that suggest there is no benefit in seeking to measure the actual difference between the AER tax allowances and tax paid, nor understanding how material are the networks' reasons for this difference. The response is a combination of "the reasons are well recognised", "it is too complex to measure", "in any case, don't worry about it because we pay our legal tax obligations" (or, as suggested at the Public Forum, they pay the "correct tax") and "any change would not be in the long term interests of consumers". Jemena concluded[9]:

> "…the issues raised by the ATO do not warrant changes to the current regulatory structure"

before the AER has even started to obtain more information. The APA submission on the AER Issues Paper says that[10]:

> "…[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.
>
> …that the AER should acknowledge the widely accepted reasons for the differences between the regulatory tax allowance and the amount of (cash) tax paid, and confirm the regulatory regime's approach to estimating the tax liability that stands today. (p.2)

And yet the submission does say:

> "It is important for the AER to be able to understand the causes of any differences between the tax allowances for regulatory purposes and the (cash) tax paid…Once those differences are understood, the AER can proceed with confidence in the integrity of the regulatory

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[8] AusNet Services "Submission to Issues Paper" 31 May 2018 https://www.aer.gov.au/system/files/AusNet%20Services%20-%20Submission%20to%20Issues%20Paper%20-%2031%20May%202018%20-%20PUBLIC.pdf

[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

> regime…APA assures the AER that it is fully compliant with its regulatory determinations and with the Australian tax law" (p.3)

APA expressed concern at the 18th July Public Forum on the lack of tax expertise in the AER. When the AER informed the forum that it had appointed PWC as tax advisor, APA raised potential conflict of interest concerns. Consumers are at a loss to understand how APA expects the AER "…to understand the causes of any differences…" if it believes the AER does not has the expertise but, on a very broad conception of conflict of interest, will not provide information to the experts engaged by the AER.

The combined submission from Ausgrid, IFM and Australian Super[11] discussed four drivers advanced by the ATO as possible reasons for difference – entity structure, interest expense, available tax losses and deductions for depreciation. Its conclusion was that all reasons reflected normal business practices and were no cause for any adjustment in the tax allowance. In their subsequent response to the specific questions posed by the AER, the submission said:

> "We submit that it is both difficult and non-productive for the AER to try to identify all potential drivers of differences between regulated tax allowances and actual tax paid." (p.15)
>
> For the reasons set out above, we consider it is not appropriate to apply a selective lens to the potential reasons for variations between regulated tax allowance and estimated tax paid. There will be a wide range of different drivers (which are subject to change over the life of the network asset) and it will be very complicated for any regulator to attempt to disentangle and isolate a defined selected range of potential drivers…
>
> Further this question implies that differences between the regulated tax allowance and estimates of actual tax paid is not consistent with the long term interests of customers. This has not been demonstrated. If this is considered to be a concern, then the reasons why this is the case, along with supporting evidence, should be set out and businesses provided the opportunity to respond. (p. 16)

These submissions misunderstand the reason consumers are supportive of this review, which is the apparent difference between tax allowed and tax paid, not that the tax paid is too low per se. Surely if "customers are at the centre", networks will seek to help consumers understand the reasons for the differences highlighted by the AER and ATO. Surely if "consumers are at the centre", networks will not seek to put the onus of proof on the AER to prove something when they well know that the AER can only understand the reasons for these differences and their relevance by obtaining the required information as best it can – through RIN notices to the networks.

We all agree that it there are many complications in getting the required data. Simply apparently refusing to try to provide it, is not a good start. Absent network cooperation on this, one of two outcomes will arise. Either the AER will be forced to select a benchmark that does not reflect actual

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[11] Ausgrid, IFM and Australian Super "Submission to Issues Paper" 31 May 2018 https://www.aer.gov.au/system/files/Ausgrid%2C%20IFM%20and%20Australian%20Super%20-%20Submission%20to%20Issues%20Paper%20-%2031%20May%202015.pdf

practices, or the AER will not act – in which case, consumers will continue to press for answers to the question: "why should I pay a network to recover costs that it does not, has not and will not incur? "

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 service that meets the NEO/NGO. However, consumers see the bargain being one-sided. The ACCC Electricity Report agrees[12].

> "In networks, the framework that governs regulation of monopoly infrastructure was loosened, leaving the regulator with limited ability to constrain excess spending by network owners."

Networks have faced incentives to overinvest and earned rates of return above that which would be the case in a workably competitive market. Consumers consider that they have borne most, if not all, of the regulatory risk with the bargain one way. Consumers believe that networks have not lived up to their social licence obligations from providing an essential service. They have lost consumers' trust and belief in the integrity of the regulatory framework. We agree with the comments made by APGA in its submission[13]:

> "We consider the AER ought to, at the outset of this review, make it clear that the integrity of the incentive regulation framework is the key driver of what it does during the review."

A key part of the regaining this trust is transparency. Yet we see some networks apparently unwilling to provide information and data to the AER – ether because it is not relevant or hiding behind a "too difficult to provide" veil. We would expect to see a response something like "we recognise there are difficulties and complications but let's work together to see how we can best provide the information needed to better understand the differences highlighted by the ATO and AER".

If the AER's methodology for estimating efficient opex resulted in estimates that were persistently below the actual opex of the best performing NSPs would the networks accept the AER should not try to make a better, unbiased estimate because it is difficult to estimate the efficient costs or that there might be a cost in providing the data required?

3. What the networks think – the sovereign risk perception

We comment on two issues – perceptions of sovereign risk and the role of the AER in tax matters.

Sovereign risk

Many submissions to the Issues Paper argued that changing the taxation building block was a sovereign risk issue for investors eg

[12] ACCC op cit, p. iv

[13] APGA "Submission to the AER Issues Paper: Review of regulatory tax approach" 31 May 2018 https://www.aer.gov.au/system/files/APGA%20-%20Submission%20to%20Issues%20Paper%20-%2031%20May%202018%20-%20PUBLIC.pdf

> “Private sector investments in network businesses have been made on the reasonable expectation that the Australian regulatory framework of incentive-based regulation would be maintained.
>
> Changes to the current arrangements will have different impacts for different types of investors. Overall, increased regulatory uncertainty and risks could dampen investor appetite to invest in this sector which will have negative consequences for customers.”[14]

No doubt this comment is in the context of other recent decisions like abolition of limited merits review and the recent draft WACC decision that will become binding. We offer four comments:

(i) The AER is not proposing to move away from the incentive based regulatory framework

The AER notes:

> “Our current approach is that we should exercise caution before moving to a tax pass-through approach.”

We agree.

(ii) Operational implementation

The fundamental features of the network regulatory framework – revenue cap, incentive based, key parameters of WACC, opex and capex that are set on the basis of a benchmark efficient entity, consumers taking demand risk – are not being changed. Yes, the operational implementation of this framework is changing, but that is fundamental to ensuring it continues to reflect best practice regulation to meet the NEO/NGO.

The operational implementation has evolved over many years and will continue to evolve[15]. What began as price cap has moved, for most networks, to a revenue cap. What began as depreciated optimised replacement cost methodology for asset valuation with periodic revaluation in 1999, changed in 2006 away from these revaluations to an approach where RAB was ‘locked in’ at the end of a regulatory period and carried forward to the next period. Actual capital expenditure was rolled into the asset base, rather than a deemed efficient amount of expenditure. There was no ex post review of capex.

Subsequently various incentive structures – Efficiency Benefit Sharing Scheme (EBSS) for opex and the Capital Expenditure Sharing Scheme (CESS) for capex have been introduced to provide an incentive for efficient expenditure and for consumers to share the benefits of that improved efficiency. The Service Target Performance Incentive Scheme (STPIS) program was introduced to ensure a balance between the EBSS/CESS and network performance. More recently a Demand Management Incentive Scheme was introduced.

[14] Ausgrid et al, p 19
[15] See the discussion of this evolution in ACCC op cit, pp 156-159

Review of the taxation building block is a normal part of the continuing review process the AER is obliged to undertake to ensure the operational implementation continues to meet the NEO/NGO.

(iii) Regulatory risk is a matter that network investors should be fully aware of, and incorporate in, their planning

Investor concern about the recent decisions eg LMR and WACC, seem to suggest that these represent "unacceptable" sovereign risk in a jurisdiction they thought had a "stable" regulatory framework without the risk that might be more apparent in some other "less developed" jurisdictions. The implication is that these investors (debt and equity) will lessen their willingness to fund future network opex and capex. For example, Infrastructure Partnerships Australia's submission noted[16]:

> "Economic regulatory frameworks for energy network service providers are at the centre of substantial change and uncertainty. This recently proposed review of the regulatory tax approach only continues the threat of intervention in Australia's energy market and further increases instability.
>
> We submit that the Federal Government should recognise the damaging impact successive reviews and inquiries have on investor certainty – not only in the energy sector, but across the broader infrastructure market. Instead, what investors need is a settled, stable and predictable regulatory regime in order to maintain confidence and continue investing in Australia's energy networks and other national infrastructure.
>
> The National Electricity Market (NEM) and gas market are already experiencing significant stress through a wide range of regulatory and political interventions, which means a predictable and stable regulatory framework is even more important."

In an efficient regulatory framework, there will always be a tension between what investors and consumers think is the "right" level of expenditure to meet the long term interests of consumers and give investors their opportunity costs of funds. Consumers are firmly of the belief that there has been a considerable imbalance over the last decade, with allowed costs exceeding efficient costs leading to the large prices rises discussed above. Despite what the networks may argue, the ACCC and other reports have confirmed consumers' perceptions.

LMR is illustrative of this tension. As the ACCC notes[17]:

> "LMR was initially brought in by the Energy Council in 2008, and then reviewed in 2012 following significant increases in electricity prices resulting from Tribunal decisions. Following that review, and amendments to the LMR regime in 2013, 12 of 20 AER gas and electricity decisions were subject to review by the Tribunal. The 12 network businesses sought to increase their revenue by $7 billion over five years…

[16] IPA "Submission to Issues Paper" https://www.aer.gov.au/system/files/IPA%20-%20Submission%20to%20Issues%20Paper%20-%205%20June%202018.pdf
[17] ACCC op cit, pp 158-9

> The ACCC considers that LMR led to significant increases in prices, has drawn out the length of time taken for regulatory determinations, and has created significant uncertainty around network pricing. It notes that the 2012 review also concluded that the LMR arrangements did not lead to positive price outcomes. The ACCC also notes that merits review of certain ACCC decisions in telecommunications was similarly removed in 2010, in order to promote regulatory certainty and timely decision-making."

So, what began as a legitimate judicial review role of regulatory decisions led to a consumer perception that networks were gaming the process that was not contributing to the NEO/NGO. Consumers advocated for change, but the 2012 LMR changes did not change networks behaviour. Consumers were only left to go a political route to seek the abolition of LMR given their reasonable perception that further reform would not bring the changes they desired.

While networks may like to cite the abolition of LMR or a possible change in the methodology for calculation of the taxation building block as examples of unacceptable sovereign risk, they should not have been surprised given the community sensitivity of high electricity prices. Those investors evaluating the recent NSW privatisations did so at a time of heightened community concern about electricity prices. Presumably they would have undertaken extensive due diligence on the regulatory framework that applies and incorporated sensitivity analysis into the models driving the price they were willing to pay for the network investment. Inevitably some assumptions around regulatory framework will work out to be in their favour, others will not. But that is the nature of every investment decision.

In any case, managing sovereign risk is not about 'no change'. All regulation and legislation must adapt and the review of taxation is simply part of the ongoing process of reform of a complex regulatory system in order to better achieve the objectives set out in the NEL and NGL. These objectives have not changed since the introduction of the NEL and NGL. There is no uncertainty around the objectives, but the regulator must be able to constantly review the regulatory process to ensure that the objectives are being achieved, particularly during a period of change including ongoing privatisation of most of the network assets.

(iv) Any changes to the tax allowance calculation should not be retrospective

The AER is proposing that any changes should apply from the April 2019 Final Decision round. We support this. However, we recognise that a number of important changes will involve changes to the Rules. For this reason, CCP22 has suggested the AER consider a staged process. This will enable the AER to deliver some important outcomes by April 2019 while not closing the door on further reform.

<u>The role of the AER in tax matters</u>

A number of network submissions take issue with any change in the taxation building block being outside the role of the AER and a matter for Government to set the tax law and the ATO to enforce it. For example, APA discusses the case where the "perceived" difference between allowance and actual is:

> "…caused by the amount of tax required to be paid as being 'too low'"(p.4)

and then discusses a number of factors eg carryover losses, that contribute to the difference and conclude:

> "These are matters to be addressed by the government, in its role as the taxation authority, not by the utility regulator.
>
> In the context of incentive regulation, a principle tenet is that the regulator confines its interventions to a high level, in order to encourage the creativity and skills of management in delivering more efficient outcomes. It is in this context that the AER's regulatory framework adopts a "vanilla" tax structure assumption consistent with this high level approach to incentive regulation" (p.4)

We think this is a misreading of the AER's intent and of the role of incentive regulation. The AER's role is to set the taxation allowance on the basis of a benchmark efficient entity – we discuss this more in the following section. As with capex and opex, this benchmark level is constantly being reviewed to ensure it remains a good estimate of "efficient" costs. It is a dynamic, not a static concept. In any case, while consumers share the benefits of management's skills in lowering capex and opex below the benchmark efficient entity level, they receive no benefits in the tax allowance. The AER is making no judgment about whether the actual tax paid is "too much" or "too little". It is simply seeking to set the taxation allowance based on what it observes as "efficient" – no different to its revealed costs approach to opex.

It is difficult to understand APA's position when it says:

> "APA considers that it would be outside the philosophy of the AER's regulatory framework to guess at, or mandate, particular financing or tax structure that may be used by different entities." (p.4)

when that is the standard approach the AER currently takes in setting the tax allowance – mandating a standard company structure with 60/40 debt equity and paying a 30% tax rate based on taxable revenue for a benchmark efficient entity. While the AER develops these benchmarks by looking at the behaviour of businesses and applies these 'benchmarks' accordingly, it places no obligation on any NSP to act in a particular way or have a particular corporate finance structure.

The conventional corporate structure is used by AusNet Services and AGN. Other networks use other structures[18]. Just as the AER observes revealed costs to inform its setting of benchmark opex, it is consistent with the incentive based regulation framework for it to use observations on actual corporate structures and tax rates to inform its setting of the rules for determining the tax allowance. It is not passing judgement, simply observing current practice. Once this tax allowance benchmark is set, "the creativity and skills of management in delivering more efficient outcomes" come very much into play.

[18] Lally, M (2018) op cit, pp10-11.

4. Framework for setting the tax allowance

Contextual Issues

(i) Tax and economic efficiency

The submissions from the utilities tend to view tax as another cost like opex, capex or interest expense. However, as the box below points out, taxes are a transfer payment rather than a real resources cost (except to the extent they distort behaviour).

> **Box 3.4: Efficiency costs of taxes and transfers**
>
> Tax revenue is used by government to fund goods and services, including transfers — past, present and future. The revenue raised by government is not a cost to society as a whole. Revenue collections are transferred from one set of Australians to another through the tax-transfer system and the broader functions of government. The impact of this transfer on wellbeing depends upon the value assigned by individuals to the goods and services provided by government.
>
> In contrast, efficiency costs represent losses to the Australian community. The vast majority of taxes and transfers affect the choices that individuals and businesses make by altering incentives to work, save, invest or consume things that are of value to them. Individuals and businesses generally respond to taxes by choosing more of lower taxed items and less of higher taxed items than they otherwise would. (They may respond to transfers in ways that increase the payment they receive.) These changes in behaviour can ultimately leave the economy and society as a whole worse off than if the revenue had been raised (or distributed) without affecting their behaviour. It is this consequential loss of value that is referred to by economists as efficiency costs…
>
> The existence of these efficiency, administration and compliance costs does not automatically imply that reducing taxes will result in increased GDP or social wellbeing. Provided that the goods and services supplied by government are of sufficient value to society to offset these costs, the overall wellbeing of society is enhanced. It may, however, be possible to reduce efficiency costs by altering how some taxes are used to raise revenue.
>
> *Source: Australia's Future Tax System ('The Henry Review"), The Architecture of the Tax and Transfer System, Section 3.1, downloaded from http://taxreview.treasury.gov.au/content/Paper.aspx?doc=html/publications/papers/report/section_3-01.htm*

While tax is a cost to the utility which if reduced *and reflected in prices* can benefit consumers it differs from other costs in important aspects.

- Taxes are a transfer payment - the efficiency costs of tax come from distortions to behaviour that it creates rather than the level of tax per se. Responses to minimise tax – such as higher gearing or innovative ownership structures – are not efficiencies but, to a degree, distortions created by tax
- Reductions in tax payments do not reflect more efficient utilisation of resources and are not equivalent to a productivity or efficiency improvement, and

- To the extent that the NSPs pay less tax, others have to pay more. Who are the beneficiaries depends on how this is reflected in the AER's benchmark estimate of tax allowances. If the benchmark is a reasonable approximation of the tax paid, given the typical adaptations to reduce tax payments, the beneficiaries are the energy consumers. If the AER's benchmark persistently overstates the sector's tax payments – as the evidence suggests for privately owned networks – the beneficiaries are the NSPs.

This understanding of the role of taxes was reflected in the comments of the ECA at the Forum on 18 July which questioned whether the incentive to reduce taxes was in fact in the interest of the broader community. However, we acknowledge that the AER's functions are narrower than this. Specifically, its focus is on the NEO/NGO and the long term interest of consumers. From this perspective, tax minimisation may be in the long term interest of consumers if the prices reflect the extent of tax minimisation undertaken by the benchmark entity.

(ii) Incentives and regulation

The fundamental principle of incentive regulation is that the revenues are de-linked from actual costs for a pre-determined period. It is this de-linking of actual costs and revenues that creates the incentive to reduce costs and the strength of this incentive depends on the period for which actual costs and revenues are de-linked.

For example, assuming a five year regulatory period without an EBSS, if a utility can reduce its opex in the first year and each subsequent year of the regulatory period from $100m p.a. to $95m p.a. it increases its profits *relative to what they would have been* by $5m p.a. The impact of a $5m reduction is the same whether the regulator provided an allowance for annual opex of $105m, $100m, or $95m.[19]

The important implication is that the incentives to minimise tax are not affected by the level of the tax allowance. That is, if the regulator were to set a lower benchmark tax allowance it would not promote greater tax minimisation since the incentive to pursue tax minimisation is a function of the difference in profits with and without the tax minimisation. This incentive is independent of the specific assumption on tax expense made by the regulator *if the tax expense allowance is based on a benchmark rather than the actual tax payments by the NSP.*

The utility submissions argue that tax should be treated comparably with other costs and have comparable incentives to minimise tax (which is equated to an efficiency improvement) as to pursue efficiencies in other costs. For example, the ENA argued that[20]:

> In Australia, the framework for regulating natural monopoly infrastructure assets is based on incentive regulation relative to an efficient benchmark. The regulator determines the approach that a benchmark efficient entity (BEE) would take to financing and operating the asset in question and the regulatory allowance is set accordingly. This creates an incentive for regulated firms to operate as efficiently as possible. In particular, if the actual cost

[19] This assumes that the firm's objective is to maximise profits – a fundamental assumption of incentive regulation and economics more generally. This analysis can incorporate broader definitions of profit maximisation to include longer time frames, reputational impacts, and a focus on the 'triple bottom line'.

[20] ENA "Response to AER Issues Paper" 31 May 2018 pp11-12 https://www.aer.gov.au/system/files/Energy%20Networks%20Australia%20-%20Submission%20to%20Issues%20Paper%20-%2031%20May%202018%20-%20PUBLIC.pdf

incurred by a regulated firm exceeds the benchmark efficient allowance, the excess is borne by the firm – consumers pay only for the efficient level of costs and nothing more. The setting of regulatory allowances by reference to an efficient benchmark incentivises the regulated firm to meet or outperform the benchmark.

…

The incentive based approach applies to all elements of the building block framework applied in Australia, for example:

- The rate of return is currently estimated by reference to the efficient financing costs of the benchmark efficient entity with a similar degree of risk to the service provider. The rate of return is not estimated by reference to the service providers' actual financing costs.
- Operating expenditure allowances are assessed by reference to the efficient costs that a benchmark efficient operator would require.
- Capital expenditure forecasts are similarly assessed by reference to efficient costs of a benchmark efficient operator.

The cost of corporate tax is no different and is estimated by reference to benchmark efficient costs. The benchmark efficient cost of tax is, by definition, the tax that would be paid by a firm following all regulatory benchmark assumptions.

The driver towards promoting efficient investment and operation of regulated networks and recovery of only efficient costs is also reflected in the overarching national electricity objective and national gas objective and the revenue and pricing principles."

While not necessarily disagreeing with the approach of using a benchmark tax allowances we would note that:

- Taxes are not the same as other costs and that a reduction in tax paid by an NSP does not reduce the real resource cost of supplying energy in the same way that a reduction in opex or capex does
- The incentives to reduce tax under the current treatment of tax are not the same as the incentives to reduce opex and capex – they are greater. The table below compares the incentives for the different cost components.

Cost	Approach	Strength of incentives	Economic benefits of efficiency gains
Opex	Benchmarking efficiency testing, if not inefficient revealed costs used to set starting opex	Moderate – NSP retains 30% of value of gains	Strong – reduces real resource costs of supplying energy. Supports NGO/NEO and long term interests of consumers (LTIC)
Capex	Forecast capex subject to efficiency testing, actual capex rolled into RAB (generally)	Moderate – NSP retains 30% of value of gains	Strong – reduces real resource costs of supplying energy. Supports NGO/NEO and LTIC
WACC	Benchmark WACC based on efficient financing costs reviewed periodically. Parameters based on observed actuals.	Very Strong – NSP retains 100% of value of gains.	Moderate – Benchmark WACC (if AER does not 'aim high') serves LTIC.
Tax	Benchmark tax, no reference to actual costs	Very strong - NSP retains 100% of value of gains	No efficiency gains from incentive to reduce tax. Current benchmark not in LTIC as it overstates actual tax expense for privately owned NSPs

In the case of opex the regulator may use revealed costs to set the allowed opex for the next regulatory period. If so, in the absence of an EBSS the incentives to reduce costs are constrained to the gains within the regulatory period. In contrast the allowance for tax and is not brought back to revealed costs at the start of the next regulatory period. So the benefits to the utility of reducing taxes continue indefinitely (so long as the tax allowance is not adjusted to reflect actual payments).

This raises the question as to whether it is appropriate to provide stronger incentives to reduce tax payments than opex and capex. The practical effect of this difference in incentives is that the NSP's scarce management resources are better used (from the perspective of profit maximisation) seeking out means for reducing tax than opex or capex. If this is not appropriate, is it feasible to equalise the incentives to reduce tax and opex/capex?

(iii) NPV=0 principle

This is a commonly accepted principle of regulation that is used by Dr Lally in his paper[21]. The practical effect of this principle is that the net present value of the regulated revenues for the efficient business should equal the net present value of its costs. There are two conditions that must be satisfied for this principle to be satisfied:

1) the mathematical equation of the NPV of the allowed revenues and the estimate of efficient costs.

[21] Lally op cit

2) the estimate of efficient costs must be an unbiased estimate of the true efficient costs practically achievable.

Condition (1) would not hold if the allowed costs did not match the estimated efficient costs over the regulatory period. A practical example cited by Dr Lally is that if the AER adopted an asymmetric rule that allowed tax would be the lower of the benchmark tax estimate or the actual tax paid. Given effective tax rates are not constant over time this would make it impossible for the utility to recover the benchmark effective tax rate.

Under incentive regulation the relevant costs included in the equation are the estimated efficient costs (or transition to efficient costs if a transition is allowed). Hence, condition (2) – that the estimate of efficient cost is an unbiased estimate of the true efficient costs – is equally important. If it does not hold, the NPV=0 principle may hold in theory but not in practice. For example, if the estimated tax allowance persistently and systematically exceeded or fell short of the tax paid by benchmark entities, the allowed revenues would be biased up or down and not meet the underlying requirement of the NPV=0 principle; i.e. that the net present value of the regulated revenues for the efficient business should equal the net present value of its costs.

(iv) Tax minimisation and risk

A useful distinction is that between tax minimisation and tax evasion. Tax minimisation is a legitimate and legal activity of networks seeking to manage their tax affairs within the bounds of the existing tax laws and ATO rulings. The point at issue is the extent to which tax minimisation – which is a legal and everyday fact of business life – should be considered in estimating tax expense. If the community is uncomfortable with the level of tax paid through the use of tax strategies that are consistent with tax laws (and the rulings by the ATO in implementing those laws), the responsibility for addressing this rests with the Government, not corporations or the AER.

Tax management options include:

TAX STRATEGY	EFFECT
1. Use of the most favourable depreciation provisions	Reduces taxable income
2. Higher levels of gearing and use of instruments that contain some of the properties of equity and debt but are considered debt for tax purposes	Reduces taxable income
3. Ownership structures that reduce the tax rate applied to profits.	Reduces tax rate applied
4. Accelerated depreciation	Defers tax yielding a NPV benefit even though the total tax paid may not be reduced
5. Higher gearing	Reduces tax paid

Tax minimisation is not risk-free or costless for the business. There are transaction costs (directly in establishing the structures and through the impact on corporate governance) for more complex ownership structures. The boundary line for tax minimisation is also not always clear and more aggressive approaches to tax minimisation run the risk of crossing that line, resulting in damage to corporate reputation, penalties and litigation costs. As a result of these costs and risks, the extent to which firms will pursue tax minimisation will vary, even in competitive markets.

(v) The NGO/NEO and tax

The anchor for the assessment of the options for tax allowances should be the NEO/NGO. These objectives require the promotion of efficient provision and operation energy services in the long term interest of consumers. For example, 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."[22]

As noted above, reducing taxes may reduce costs but it does not improve the efficiency of the provision and operation of energy services. Hence, the impact of alternative approaches to tax allowances must be shown to be in the LTIC in terms of its impact on prices. But this does not imply that if a benchmark is used that the tax allowance should be as low as possible. If the tax allowance is lower than the tax payments achievable by the benchmark entity it may impact on the capacity to finance the necessary opex and capex for the efficient provision of services.

As noted below, on the evidence from the ATO note and in the AER issues paper, the current approach does not satisfy the requirements of the NGO/NEO as it results in an estimate of tax allowances that does not reflect common practice and is biased upwards.

(vi) Implications of the competitive market benchmark

It is often said that regulation should try to mimic the outcomes of competitive markets in which prices reflect the costs of efficient service providers. This places pressure on all providers to reduce costs, including taxes.

As noted above, this does not imply that the costs will reflect the absolute minimisation of tax or lowest tax rate of any participant. Tax minimisation entails risks and costs and each entity will determine its strategy based on its position, opportunities and risk appetite. So the level of tax payments reflected in prices can only be answered quantitatively through observation of the tax paid by market participants. However, it is unlikely to reflect the tax paid through either the pursuit of all tax minimisation opportunities to their fullest extent or payment of tax with minimal use of legally available tax minimisation opportunities.

[22] https://www.aemc.gov.au/regulation/national-energy-objectives

Current Position

Currently AER estimates the tax paid by the NSPs with minimal adjustment for tax minimisation strategies available to the NSPs. This has resulted in tax allowances that:

1. for the privately-owned utilities appear to systematically and persistently exceed their actual tax payments
2. for the Government-owned utilities systematically and persistently exceed their actual payments.

These variations do not appear to reflect systematic under or outperformance against their efficiency targets. For that to be the case, the government-owned networks would need to systematically outperform the efficiency targets and the privately-owned utilities underperform those targets. Furthermore, in the review of profitability measures the AER found that performance incentives had only a small net effect on revenues. [23]

The reasons behind the higher payments by Government-owned businesses requires further exploration, but a possible factor is that they do not have the same incentive to reduce taxes since tax-paid goes to their owning governments.

For the privately owned businesses the differences appear to arise from:

- Use of a different depreciation profile
- Increases in depreciation provisions associated with asset revaluations on acquisition
- A higher level of gearing and/or the use of related party debt that has some of the characteristics of equity while being considered as debt for tax purposes
- Adoption of ownership structures which have the effect of reducing net tax obligations and switching those obligations for company tax on the earnings of the business to personal tax on the receipt of income from the business.

While the first is a timing issue, the others reduce tax obligations over the long term. The concerns with the current approach are that:

- It does not satisfy the NPV=0 principle because the estimates of tax liability are biased upwards i.e. exceed actual tax obligations
- Because of this, it results in prices that are higher than necessary and are not in the LTIC or consistent with the NGO and NEO.

[23] "...we undertook a review of the contribution of incentive schemes to total revenue for a number of electricity distributors using data from the service providers' Economic Benchmarking RIN responses. This found that on average the revenue impact was minor as a percentage of total revenue." AER Draft Position Paper - Profitability measures for regulated gas and electricity network businesses - 27 April 2018 p14 https://www.aer.gov.au/system/files/AER%20Draft%20Position%20Paper%20-%20Profitability%20measures%20for%20regulated%20gas%20and%20electricity%20network%20businesses%20-%2027%20April%202018.PDF

It is our preliminary view that continuation of the current approach is not an option available to the AER as it would be inconsistent with the NEO and NGO. However, we acknowledge that this needs to be tested through better data and the transparent evaluation of alternatives against clear criteria.

Framework for Establishing the Tax Allowance

(i) Objectives and criteria for the tax allowance

The anchor point for the objectives for the tax allowances should be the NGO/NEO, and the long term interest of consumers. Consistent with this, CCP22 considers that the tax allowance should reflect the tax payments consistent with the tax strategies commonly used by businesses in a workably competitive market, 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.

The concept of a social licence to operate:

> "…acknowledges the active role that people and communities play in granting ongoing acceptance and approval of how companies – or entire industries – conduct their business."[24]

In simple terms it is an expectation that companies will strive to be good corporate citizens. These expectations are heightened for regulated essential services, such as the NSPs. The NSPs have been given the right to operate largely free from competition and under a regulatory framework that provides greater protections and certainty for networks return on their investment than other businesses enjoy. That carries with it greater explicit or implicit obligations such as the obligation to serve or an expectation that they will give greater consideration to the interest of the communities that they serve. This is reflected in the priority the sector gives strengthening the social licence to operate in survey corporate responsibility surveys such as that of Deloitte[25].

However, this does not require the AER to take a view on what level of tax minimisation is right or wrong. The AER's role is to simply observe what is happening. It is not standing in the shoes of the ATO as implied, for instance, by APA.

We prefer a sector-wide benchmark approach to setting the tax allowance as it is more likely to achieve the NEO/NGO. Alternative benchmarks should be assessed against the following criteria:

1. It should reflect the tax strategies of a private company operating in a workably competitive market subject to any additional requirements under the NSPs social licence.

2. It should be an unbiased estimate of the tax payments under (1)

[24] KPMG "Maintaining the Social Licence to Operate" 2018, p12
https://assets.kpmg.com/content/dam/kpmg/au/pdf/2018/state-of-trust-survey-2018.pdf
[25] Deloitte "Progress, prospects and impact How business is preparing for the Modern Slavery Act, 2018, p31
http://www.wrightcommunications.co.nz/media/49597/rsk_state-of-csr-report.pdf

3. It should be consistent with the NPV=0 principle

4. The level of transparency provided by the AER should be sufficient to enable third party verification within the constraints of commercial confidentiality

5. The approach should aim to achieve the best estimate of benchmark tax taking into account the benefits to consumers relative to the regulatory costs imposed on networks and the regulator.

Implementation of this approach would require the AER to:

1. Establish the benchmark entity
2. Determine the basis of application of the sector-wide benchmark: eg
    a. Estimate effective tax payment/rates for the benchmark firm and apply to each firm uniformly, or
    b. Determine tax minimisation strategies to be applied across NSPs and estimate the taxable income through the application of these strategies.
3. Evaluate and test the application of the proposed approaches against transparent criteria
4. Document the methodology for the estimation of tax allowances and its application to specific NSPs.

The first two steps are discussed further below.

(ii) The benchmark entity

The proposed benchmark entity is:

> *A pure-play Australian-owned regulated network utility in private ownership that adopts commonly implemented, legal strategies to minimise tax payments over time.*

This definition involves a number of specific choices:

- Reference to a 'pure-play … regulated network utility' is intended to exclude consideration of the unregulated network or non-network activities from the estimation of the benchmark tax position.
- Limiting the benchmark entity to an Australian-owned entity avoids the complexity of considering the impact of overseas ownership on the tax payments through ownership chains extending overseas.
- Using the benchmark of a privately-owned entity is consistent with the cost of debt where the benchmarks is the cost of debt for a BBB/A rated private company.
- What are the relevant legal strategies will be informed by observation of business practice and any subsequent relevant tax rulings. This reflects the assumption that businesses do not consciously adopt tax strategies that are not legally compliant but the tax rulings provide an interpretative function and may result in changes in what is considered legally compliant or not.
- 'Commonly implemented' allows for the variations in tax strategies reflecting differences in the options available and the businesses' assessment of risk and return from tax strategies.

As with the benchmarking opex, there are practical merits in setting the benchmark inside the frontier.

(iii) Establishing the benchmark tax payments

We consider that there are two potential approaches to assessing the benchmark tax payments or tax rate:

1. observe the actual tax payments of the regulated businesses or relevant sub-set of the businesses and calculate a benchmark tax rate to be applied to the regulated businesses – i.e. "benchmark tax rate"
2. calculate a benchmark level of tax payments by each business based on the application of commonly accepted and used tax minimisation strategies to each business – i.e. "benchmark tax strategy".

Both approaches adopt a sector-wide estimate of tax payments or tax strategies to establish a benchmark that is not linked to the actual tax payments of the specific business. Hence, the incentive effects of the two approaches are the same. However, we consider that the benchmark tax strategy approach is, in principle, the better option as it creates a benchmark tax allowance that considers the specific circumstances of the NSP.

The benchmark tax rate approach initially appears simpler and more transparent since it relies on observation of the range for actual tax payments relative to profits and construction of a benchmark based on a statistical measure such as the average rate or the 75th percentile rate. However, the actual tax rates will be affected by actual opex, capex and cost of debt relative to regulatory allowances, and, for businesses under a price cap, energy demand. This raises the question as to whether adjustments should be made for this, complicating the analysis required.

The benchmark tax rate would be applied uniformly across all NSPs irrespective of their specific circumstances. To the extent that it reflects timing factors (e.g. depreciation) or factors within the control of the NSP (e.g. gearing or ownership structure) it can be argued that this is appropriate. But if it were to reflect other non-timing factors beyond the control of the business, it may create a benchmark tax rate that is unachievable for the NSP.

The benchmark tax strategy starts from the observation of legal tax strategies that are commonly accepted and used. It assumes businesses act in good faith and do not intentionally seek to evade taxes but have to balance the obligation to pay their 'fair share' of taxes with their obligation to shareholders to maximise profits. The approach also recognises that tax minimisation strategies involve a balance of risk and return and that it is appropriate to choose a set of strategies that are 'inside the frontier' of the more aggressive tax minimisation strategies.

The ATO advice, AER issues paper and the report by Prof Lally identify a number of factors that have led to lower tax payments:

- use of diminishing value depreciation schedules and shorter asset lives
- use of revalued asset bases for depreciation
- higher gearing and hybrid debt instruments

- cost of debt
- ownership structures that use stapled securities and trusts
- prior period tax losses
- R&D deductions
- Immediate expensing of refurbishment

Under the benchmark strategy approach the AER would observe the extent to which these strategies are used by the networks and determine a set of strategies that reflect the practically achievable level of tax minimisation consistent with current tax laws and tax rulings. As noted above this is consistent with the NEO/NGO and the objective of mimicking competitive market outcomes.

Our preliminary view is that continuation of the current approach is not feasible. However, if the AER concludes that it is not reasonably practical to establish a better benchmark, it would need to consider whether the interests of consumers are best served through pass-through of actual tax payments (possibly with a lag) or the current approach which generates a biased estimate of tax payments to that is not in the long term interest of consumers.

5. Comments on Conclusions of Dr Lally

The paper by Dr Lally[26] provides a very good analysis of the options available for tax minimisation and highlights a number of issues in regard to alternative means of allowing for tax obligations. However, we have a number of specific concerns:

1. It does not assess the current approach – its focusses mostly on the weaknesses and strengths of the alternatives
2. at times it equates the strength of the incentives to reduce taxation with the level of benchmark taxes used.
3. It does not establish clear criteria for the estimation of a benchmark level of tax payable.

As a consequence, while we support many of the recommendations in the report, there are some recommendations that we do not support.

Conclusion 1: Specifying the options

The paper sets out three options as alternatives to the current approach that can be applied in three ways generating 9 alternatives. The options are pass-through at actual costs, a benchmark that reflects specific tax minimisation strategies ('targeting') and a hybrid approaches where the allowed tax is the lower of the actual payments and the targeted benchmark. It then proposes that each of these can be applied at the industry level, individual level, or a mix of the two, suggesting there are nine options in total. However, it is not clear how 'pass-though' would be applied other than at an individual level. If so, there are 5 options: pass through at an individual level, targeting with a single industry benchmark or targeting with NSP-specific benchmark; or a combination of pass-through and targeting at either an industry level or NSP-specific level – see the table below.

[26] Lally M(2018), op cit,

	ACTUAL	BENCHMARK ('TARGETTED')	CAPPED
Company	Feasible	Feasible	Feasible
Sector wide	?	Feasible	?
Hybrid	?	Feasible	?

An important point to note is that the current approach is a form of benchmarking where it is assumed that the benchmark entity takes few steps to minimise its tax other than to use tax asset lives with straight line depreciation. The targeting approach is also a form of benchmarking, which highlights that the incentive property of the two options (current and targeting) are the same or similar. Hence, the relevant test in choosing between these options is which provides the best estimate of the likely tax payments by a benchmark NSP.

Conclusion 2: Pass-through is inferior to capping

While we agree that there are significant issues in the implementation of a pass-through of actual tax payments we do not agree that it can be dismissed as an option at this stage.

Dr Lally concludes that pass-through is inferior to capping because:

1. It would lead to "higher prices for consumers than those consistent with the NPV = 0 principle, if tax payments exceeded the level allowed under the current regime"[27]. As we have argued above, the current approach overestimates tax payments for efficient NSPs and so also fails the NPV-=0 test. Whether it would result in tax allowances and prices that are higher than the current approach would depend on effectiveness of the accompany rules around cost allocation and gearing limits (for tax purposes) that the AER could put in place if it were to move to actual tax pass-through.

2. It could "encourage[e] firms to undertake actions that raise their corporate tax payments but are not desirable"[28]. To the extent it promotes the reversal of structures put in place primarily to reduce tax this is not necessarily and efficiency loss – it may be an efficiency gain. Dr Lally highlights the potential impact on gearing but which OfWat has addressed by limiting actual tax pass-through to firms with high gearing.

A significant issue is the practical difficulty for the AER of supervising the allocation of tax between related parties or between regulated and unregulated activities. where there is a strong incentive to reallocate so as to maximise the recovery of taxes through regulated network charges. We recognise that this will raise difficulties in implementation but note that McGrathNicol was more optimistic that a set of allocation rules could be constructed and supervised.[29] We also note that our initial

[27] Lally, p3.
[28] Lally, p4.
[29] McGrathNicol "Response to submissions on profitability measures" 23 April 2018, p10 https://www.aer.gov.au/system/files/McGrathNicol%20-%20Report%20to%20AER%20-%20Ownership%20structures%20and%20tax%20paid%20-%2026%20Jun%202018.pdf

review of decisions by US regulators indicates that tax allowances for US utilities are based on actual tax payments.

Moreover, many other costs incurred by the NSPs must be allocated to a specific regulated component of their business, including for instance, corporate overheads. The important issue at least at this stage, is that in submitting the RINs for this task, the networks are transparent about the principles/criteria they have used to allocate tax costs – just as they are required to do for corporate overhead costs.

In summary while we consider that the best option would be a better benchmark, the option of pass-through of actual tax costs should not be dismissed at this stage. The option of actual cost pass-can be dismissed once it has been demonstrated that a better benchmark can be implemented. If a better benchmark cannot be developed and implemented it is not clear that the actual cost pass-through, with supervised allocation and minimum gearing rules (for the calculation of tax expense), would result in higher tax allowance than the current approach.

Conclusion 3: Capping is a blunt instrument that fails the NPV=0 test

Agreed.

Conclusion 4: Targeting duplicates ATO and is administratively complex

It is correct to say that benchmarking (or targeting) based on ATO's administration of the tax rules would require the AER to monitor the ATO's tax rulings and adjust its benchmark should there be significant changes. But it would not require the AER to "replicate the efforts of the ATO but with much less chance of success"[30]. The AER's task would be estimate the effect of known and accepted tax minimisation strategies. This is quite different and much more straight-forward than the ATO's task. The ATO has to interpret tax law, review transactions and claims in detail to try to determine the underlying nature (substance) of complex transactions and challenge the legality of arrangements for tax purposes where necessary. For example, the AER would observe the use inter-company loans to increase tax deductible expenses, but, unlike the ATO, the AER would not need to assess and if necessary prove that the inter-company loans are at excessive interest rates or that hybrid instruments are in fact equity.

Dr Lally also expressed concern that "If applied at the individual firm level, tax minimization activities would additionally tend to be legitimized". However, observation and quantification of tax strategies would not in any sense involve the AER in legitimising the tax strategies – nor could it since it is not the tax office.

Dr Lally also expressed concern that "If applied at the sector-wide level, the level of tax minimization activity is likely to increase as firms seek to ensure that their tax payments do not exceed their tax allowances." As noted above, the incentives to minimise tax come from de-linking actual costs and revenues rather than the specific level of the benchmark chosen. The benchmark level of tax currently used is comparatively high yet there is no sign that it has discouraged firms from minimising tax and the ATO data suggests that the risks of greater tax minimisation are small.

[30] Lally, p4.

We consider that the criticisms of targeting (or benchmarking) have been overstated. There are challenges in benchmarking tax expense, as there are challenges in benchmarking opex or capex. But the obligation on the AER is to develop, as best it can within these constraints, an unbiased estimate. The difficulties have not been shown to be so great that AER should abandon this objective and retain is current clearly 'soft' benchmark.

Conclusion 5: Using tax gearing for estimation of benchmark tax expense would distort gearing choices.

The AER could 'target' the benchmark tax allowance on actual gearing for tax purposes at either the sector or individual firm. If it benchmarked tax at the sector level it could observe the average level of gearing for tax purposes for the sector and base the estimate of tax expense on that level of gearing[31]. This would establish a benchmark for the tax expense that was independent of the firm's actual level of gearing for tax purposes and would not affect the incentives of the firm to increase or reduce the level of gearing for tax purposes (see discussion on incentives above). Hence this conclusion does not apply to a sector wide benchmark ('targeting').

If the AER were to base the calculation of the tax expense on each NSP's own gearing for tax purposes it would, as Dr Lally points out, remove the tax advantages from increasing the level of gearing. This would in turn affect financing choices. But it is arguable that it may remove an existing distortion in favour of debt created by its advantage as a tax shield. While it may result in excessive use of equity, as Dr Lally noted, this could be addressed by the hybrid approach adopted by OfWat where actual gearing is used for companies with high gearing, otherwise the benchmark gearing is used.

Conclusion 6: Carried forward of past losses would be irrelevant and/or complex

Agreed to the extent that prior period losses do not arise from regulated activities.

Conclusion 7: AER should use the Diminishing Value depreciation approach (DV) for calculating/benchmarking tax expense

Agreed. Furthermore, the use of DV in this case is for the purpose of calculating a better tax expense benchmark. It does not follow that the same approach should be used for calculating the depreciation for the revenue building blocks. The AER and other regulators already distinguish between the calculation of depreciation for these purposes.

Conclusion 8: The benefits of adopting shorter-than-ATO asset lives is outweighed by the complexity

Agreed. It is not clear that this is significant and in any case it seems to go beyond allowed tax minimisation and is a matter for the ATO rather than the AER.

[31] As the objective is to obtain a better estimate of the tax expense it would not follow that the WACC needed to assume the same gearing.

Conclusion 9: The benefits of adjusting for the low cost pool mechanism is outweighed by the complexity.

Agreed. The potential use of the low cost pool mechanism appears trivial.

Conclusion 10: The impact of asset revaluation on tax calculations should be taken into account.

This is an important issue that requires further consideration. It appears that it could be readily included in NSP-specific benchmarks. The question to be considered is how it would be applied to a sector wide-benchmark. This may require consideration of the use of a sector-wide benchmark with and NSP-specific adjustment for this factor.

Tax Payments by Government-owned businesses

Dr Lally's paper does not consider the tax position of Government-owned businesses in any detail. It is important to understand:

1. Why the tax payments by tax payments by the Government-owned businesses are different to those of privately owned businesses. Clearly the government-owned businesses do not have the same incentive to minimise tax. Indeed, there may be incentives the maximisation of tax payments[32]. Understanding the counterfactual of government ownership and the extent to which differences in performance, depreciation, gearing and ownership structures result in different levels of tax payments may inform the estimation of a better benchmark.

2. Why Government-ownership is not a good basis for assessing benchmark costs.

For governments and the businesses they own, there may be no financial difference between receiving/paying dividends or taxes, but there may be significant difference in the way the payments are perceived by the community. If so, this may have created incentives to increase tax payments that make government-owned businesses a poor benchmark for privately-owned businesses. If regulation is to mimic the outcomes of competitive markets benchmarks drawn from privately-owned businesses would be more relevant.

It is also important to note that the process of privatisation has continued, reducing the importance of government-ownership as a data point. Moreover, there is a well-established principle arising out of the debates around the costs of debt, that the AER's benchmarks should be based on the assumption of an efficient private sector business. It would be inappropriate and inconsistent to vary from this principle on the issue of taxation benchmarks.

6. Comments on specific questions asked by the AER

Introduction

This section addresses the specific questions raised by the AER in its Report. We strongly support the AER's approach of obtaining further data through a RIN request to networks. This will allow all

[32] For example, the public perception of large dividend payments to shareholding governments may be very different from the perception of tax equivalent payments.

stakeholders to better understand the high level data from the ATO and the AER's analysis outlined in the Issues Paper, the difference between allowance and actual tax, and the drivers for that difference.

We acknowledge that there will be gaps in the data provided eg the years for which data is available, and the impact of a change in ownership. We also acknowledge that the AER has a very tight timetable to agree on the RIN and then for the networks to provide the requested data. Nevertheless, the more data the AER has, the more informed will be any decision it makes to change the tax allowance calculation methodology. We suggest the following:

- Ensure that the data collection exercise is not a 'fishing' exercise and that each data request must be supported by a clearly stated explanation of its purpose
- The RIN data requests must reflect the costs and benefits of the collection of such data (which will vary from business to business)
- Collect data for the longest possible period of time possible for that business, up to a maximum of 5 years:

    - there is a trade-off involved in setting the period – a longer period of time (eg five years) is more consistent with the AER's approach of establishing a benchmark in other areas of the regulatory decision-making, particularly in the context of 5-year regulatory period and long-lived assets. In addition, actual tax payments can be expected to fluctuate quite extensively from year to year – and shorter assessment periods will risk greater bias in the outcome within the context of a 5-year regulatory period

    - the longer the period, the greater will be the risk of the assessment capturing exogenous changes such as changes in ownership, changes in corporate structures and changes in tax law

    - we would support businesses electing to provide data for a longer period if they wish to highlight a particular issues eg to show how a particular driver has changed over time

    CCP22 does not accept that the issues around the longer data set are, per se, a reason for not pursuing the information via the RIN. We would note that when the first RINs were issued in 2013, the businesses faced many of the same issues regarding access to and relevance of historical data. For example, collection of estimation of overhead costs required various businesses to allocate corporate costs to the particular individual network business. The current task is therefore not unprecedented and there are now well-established principles in place to guide allocation decisions.

- Provide a clear definition to the businesses of each RIN data category along with proposed cost, income and tax allocation principles, for example:
    - allocation between regulated and unregulated components of the business
    - allocation to the Australian entity
    - treatment of metering costs

Our response to specific questions have considered the reports to the AER by Dr Lally and McGrathNicol and submissions on the Issues Paper by networks and investors. Considerable work remains to finalise the RIN requests and our comments here will be further informed by discussions with the networks and the AER's tax advisors.

Question 1 - The type of detailed tax information we should seek from energy networks

CCP22 considers that the main purpose of the information gathering stage should be to establish a framework for defining the common tax related practices of the networks as a precursor to defining the efficient tax rate for the benchmark efficient entity. In broad terms, this would require the AER to obtain information on the following:

- Corporate structures: including relationships between the regulated and unregulated components of the businesses operating within Australia, Australian versus overseas ownership (direct or indirect).
- Accounting practices: particularly with respect to the approach to tax depreciation, tax asset lives, revaluation/uplift of asset values, treatment of customer contributions, treatment of land assets
- Financial measures: Income of the regulated business (EBITDA), interest costs, actual gearing, sources of funding, other tax deductions
- Specific tax related information: actual tax paid ($), % tax rate, allocation of tax between components of the business (and rationale for this), deferred tax, tax losses, recent tax assessments and outcomes of these, stamp duty on sale of assets, tax paid in other national jurisdictions and any withholding tax paid in Australia
- Other relevant measures: these include information related to issues already raised by the networks in their submissions to the AER including relevant expenditure on, and tax treatment of:
    - R&D expenditure, government & AER funding (through DMIS), relevance to provision of the regulated services
    - refurbishments
    - lease costs
    - Government payments (e.g. government contributions to the Victorian bushfire prevention program).

recognising the increased focus in recent years of both the Federal Government and the ATO on tax minimisation strategies under current tax law through tax rulings.

This expenditure must be demonstrably relevant to the provision of regulated services and the allocation of these costs established on agreed allocation principles. It would take account of changes in any of the above factors eg AusNet's change in corporate structure in 2016 following a tax ruling.

Q2. The list of potential drivers, including the interaction with timing effects arising from different depreciation profiles.

Question 3: The relevance and materiality of potential drivers

The separation of the total tax paid to the notional tax that can be allocated to one segment of the business is further complicated if the firm is structured so that the tax obligation relates to an entity at a higher level in the organisation. The majority of the network businesses are structured in this way.

The ATO and the AER have provided an initial list of potential drivers including ownership structures, actual gearing and other funding arrangements, tax depreciation and tax asset lives, prior tax losses and deferred tax. In addition, important drivers of the tax gap arise from the processes that each NSP uses to allocate revenues, costs and taxes between its regulated Australian business (es) and its various non-regulated activities.

As noted previously, the networks have also suggested a relatively long list of other drivers for the tax differential, including:[33]

- Unregulated versus regulated activities – unregulated activities may incur different tax obligations and rebates than regulated activities.
- R&D costs not accounted for in the regulatory building blocks but beneficial to regulated customers
- Treatment of refurbishment and lease costs (eg expensing versus capitalising)
- Cost of debt which may be higher or lower than the regulated cost of debt
- Capital contributions
- Movements in provisions
- Stamp duty on transfer of ownership of regulated assets.

At this stage, it is not possible for CCP22 to assess the relative importance of these drivers with respect to understanding the tax differentials. As we have noted above, however, it is important that the AER's RIN process collects data that will enable it to consider each of these issues and their relevance to establishing a benchmark tax rate.

Question 4: The list of potential changes in response to the apparent tax discrepancy

The AER has suggested at least three possible responses to the apparent tax discrepancy:

- Changes to the treatment of tax depreciation in our regulatory models (e.g. the PTRM and/or the RFM)

[33] AER op cit, Table 5.2 pp 32-33

- Changes to other aspect of the tax approach that would require a change in the rules (NER and NGR)

- Changes focused on adjusting tax allowances to reflect actual tax payments by energy networks (the 'tax pass-through approach described above).

We offer the following comments on changes to tax depreciation covering both depreciation profile/methodology and asset life.

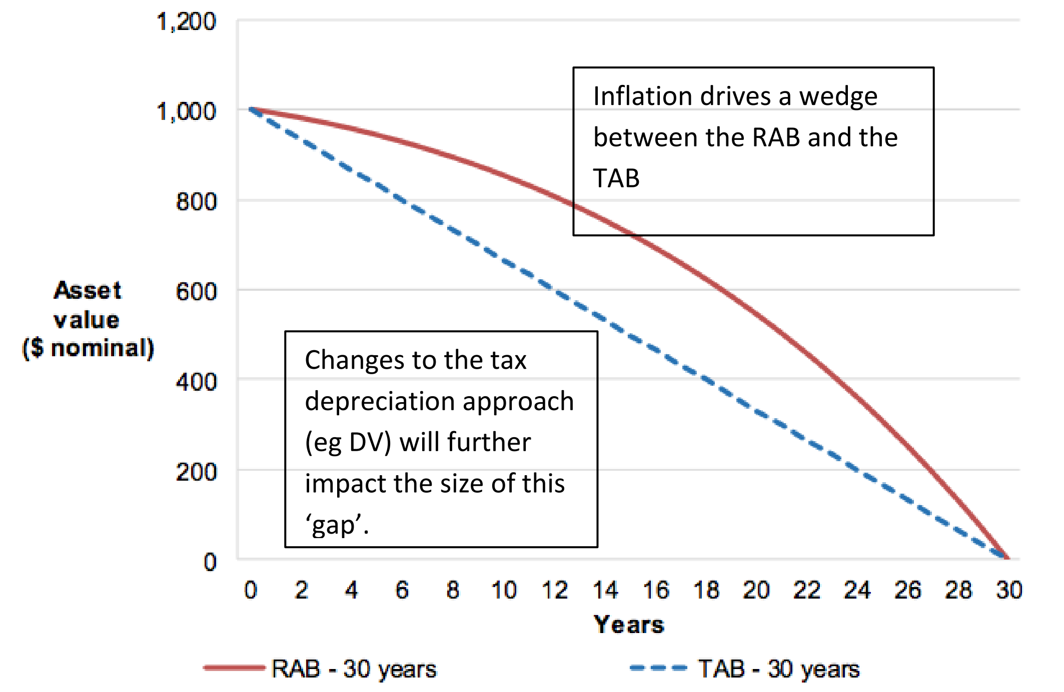
Re the first option above, the AER's PTRM separately calculates a 'regulatory depreciation' for depreciating the RAB, and 'tax depreciation', for depreciating the TAB. As noted above, the RAB depreciation amounts and the TAB depreciation amounts will differ over the life of the assets. This difference arises from two factors:

- The regulatory depreciation of the RAB is higher (all other things being equal) than the TAB depreciation because the RAB is increased by inflation each year where the TAB is not (see Figure 1 below[34])
- The regulatory depreciation uses asset ages for each class of asset base on the technical characteristics of the asset/asset class and historical trends. The tax depreciation uses asset ages taken from the ATO rulings.

Notwithstanding these differences, the AER adopts a straight-line depreciation approach for both the regulatory depreciation and the tax depreciation. In their proposals to the AER, the NSPs also adopt a straight-line depreciation for both regulatory and tax depreciation.

[34] AER op cit, p.14

Figure 1: Regulatory asset base and tax asset base straight-line depreciation profiles.



Source: AER analysis.

However, the evidence provided to date from the networks and from the ATO is that most NSPs appear to use a different depreciation approach in their financial reports and tax assessments. The most common alternative (although not the only one) is for a NSP to adopt the diminishing value (DV) approach in its financial accounts.

The use of DV is explicitly permitted by the ATO as an alternative to straight-line depreciation. The effect of using the DV approach is to 'front-end' depreciation costs and thereby, to lower their taxable income in the early years of the asset life. Dr Lally has demonstrated in his report, that methodologies such as the DV that 'frontload' tax depreciation costs will always raise the PV outcome over the life of the asset 'for any asset life and discount rate'[35]–

Over the life of the asset/asset class, the return of capital will be the same for both approaches in *nominal dollar* terms. As Dr Lally illustrated, the difference is that the PV of the DV approach over the life of the asset/asset class is better. He states in his report:[36]

> "So adoption of this approach [the DV approach] by the AER would reduce the allowed revenues to the level consistent with the NPV=0 principle, which is in the long-term interests of consumers. Furthermore, there is no additional administrative effort for the AER, because it is as simple for the AER to use DV as it is to use SL [straight-line]. So there is a clear case for the AER to use DV."

[35] Lally, p.25
[36] Lally, p.5

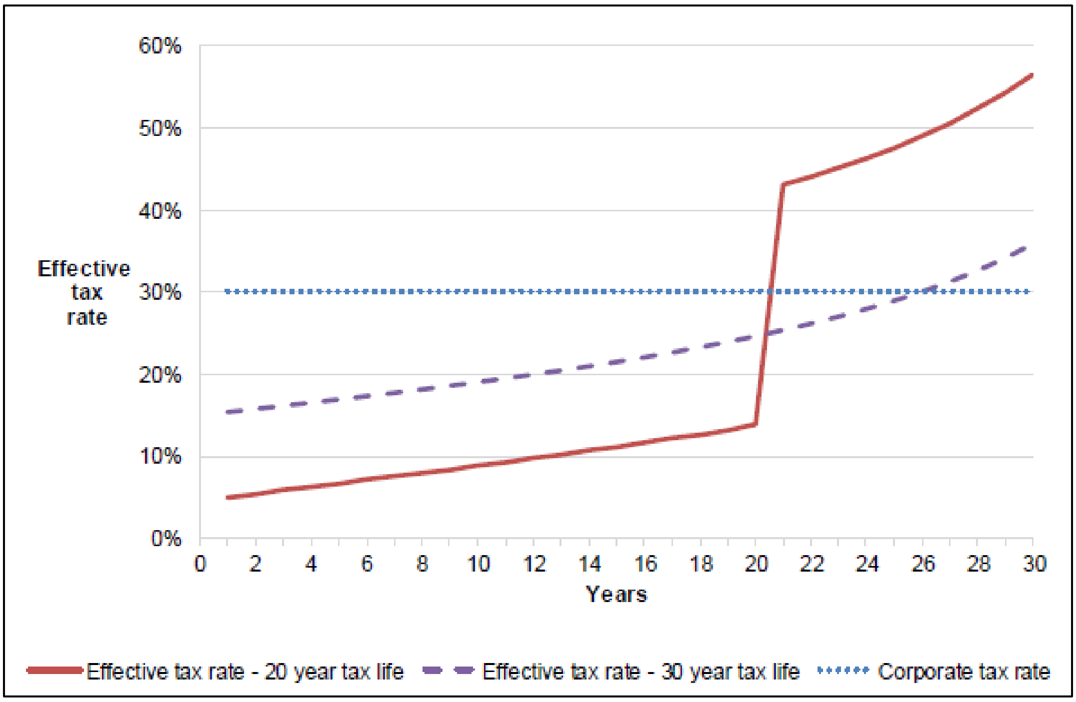
Therefore, adopting the DV approach for tax depreciation is in the long term interests of customers and CCP22 agrees with Dr Lally that it is worth further investigation by the AER.

A second factor that has been identified as explaining differences in taxable income is the assumed age of the asset/asset class. Different assumptions on the age of the asset, will impact on the timing of the depreciation of the asset and therefore taxable income at any point in time (and all other things being equal).

As noted above, for the purpose of calculating tax depreciation for the regulatory proposals and the AER's determinations, the AER and (generally) the NSPs adopt the various tax rulings for different classes of assets.

However, the evidence to date suggests that at least some NSPs modify the age of the assets for the purposes of calculating their actual tax obligations. The ATO allows businesses to make a 'self-assessment 'of the age of their assets, so the practice is in principle, compliant with the tax law. Nevertheless, it has the effect of driving a further wedge between the regulatory tax assumptions and the actual tax paid, even if this is only a timing effect. Figure 2 below demonstrates this point [37].

Figure 2: The effect of tax asset life (years) assumptions on effective tax rate (per cent)



Dr Lally has demonstrated that taking this to the extreme, there can be a significant impact on taxable incomes in any one year from this practice. However, he also suggests that there is no one common practice on this, that the assessment would have to be made on an individual NSP basis and will involve many administrative complexities. For this reason, Dr Lally does not recommend that the AER adjust the PTRM for each NSP to reflect the asset ages used by the NSP in its financial accounts.

[37] AER op cit p.16

CCP22's current position is that we agree with Dr Lally's concerns. We take some further reassurance from the fact that it is unlikely to be a significant issue in practice as it is unlikely that NSPs would adopt a 'self-assessment' that is significantly different from the ATO's rulings. However, our conclusions are subject to evidence from the NSPs provided in response to the AER's proposed RIN requests.

Importantly, any changes to the tax depreciation approach and tax asset lives would involve only an update to the AER's regulatory models (the PTRM and the RFM) and does not involve a rule change. As such, it is possible for the AER to consult on and amend these models in time for adoption by the AER in all its regulatory revenue decisions commencing April 2019.

In summary, we recommend that, subject to further evidence from the NSPs, the AER consider amending its regulatory models (PTRM/RFM) to adopt the diminishing value depreciation approach to the tax calculation component of the models.

- The DV approach appears to be common practice in the networks' assessment of their actual tax obligations in their financial accounts
- The change to DV will not have an impact on the cash position of the regulated networks' regulated revenue
- The change to DV will not impact on the ability of the network to recover the costs of their investment
- (on advice from Dr Lally), the change to the tax depreciation methodology will not change the incentives on the businesses
- The DV approach, by bringing forward tax depreciation costs will over the life of the assets have a positive PV over the life of the assets compared to the current straight line tax depreciation assumption for tax depreciation.

Given our understanding of tax law, this change to the depreciation cannot be retrospective and will only apply to new capital assets following the decision to change. Hence, if a highly network specific approach to the calculation of tax is taken this may lead the AER to adopting different depreciation profiles for different businesses. However, a sector-wide benchmark could be based on a tax strategy for depreciation that is most cost-effective for the businesses and used across all businesses.

Further, subject to further evidence from the NSPs, the AER should maintain its current approach using ATO rulings to assess the expected life of the assets for tax depreciation purposes.

The AER has suggested that in addition to changes that affect the estimate of tax depreciation, two other changes that could be made to address the tax gap, namely:

- Changes to other aspect of the tax approach that would require a change in the rules (NER and NGR)
- Changes focused on adjusting tax allowances to reflect actual tax payments by energy networks (the 'tax pass-through approach described above).

Both of these changes will require significantly more data, and detailed data analysis to understand the extent of the issue and the net benefits of any change. Both will also require amendments to the Rules, which is a much longer and more uncertain process than the changes to the PTRM/RFM.

CCP22's view is that it is important that each of these changes is further explored by the AER and we see the proposed RIN process as a vital step to doing this. Unlike some of the networks, CCP22 does not want to close the door on any reasonable option that may contribute to better achieving the NEO and NGO. So the fact of requiring a rule change is not a reason for ceasing to explore the options just as the difficulty of the data collection process is not a reason for ceasing to address the 'tax gap'.

We therefore encourage the AER to ensure that its RIN process collects the data necessary to examine these options.

Question 5: The advantages and disadvantages of a move to a tax pass-through approach, including the expert advice from Dr Lally released with the AER's initial report.

The AER notes that many stakeholder submissions cautioned us against changing from the current benchmark approach for setting regulated tax allowance to an approach based on actual tax paid by each energy network (a 'tax pass-through approach').[38]

As discussed above, our first preference (at this stage) is for a sector wide tax benchmark that reflects the tax strategies of a private company operating in a workably competitive market subject to any additional requirements under the network's social licence.[39]

If the AER is unable to obtain sufficient quality data from the network businesses to establish a reasonable 'benchmark' tax allowance, the AER may be limited to either continuing with the current statutory rate, or to adopting a tax pass through rate using data revealed by the network.

Both the current methodology based on a fixed statutory taxation rate and the pass-through methodologies have limitations and both are inconsistent with the AER's model of incentive regulation that applies to other elements in the regulatory revenue build-up.

For example, under the current methodology a business has an incentive to lower actual tax payments to the legal minimum, within its perceived risk limits. However, the incentives for this action relate more to profit maximising behaviour than to 'beating' the regulatory regime's statutory tax allowance.[40] Nor do consumers (or the wider community) 'share' in this benefit as they might under EBSS, CESS and STPIS.

[38] AER op cit, p. 38.

[39] See also the discussion on p21 above *("Establishing the benchmark payments*") for more detail on the options available for setting the benchmark payments.

[40] That is, irrespective of the allowed taxation rate, businesses have an incentive to reduce the level of taxation within the tax law. The practices they use to do so will depend on various factors such as existing ownership structures, funding constraints and covenants, and the business's appetite for risk re an adverse tax ruling. The AER's benchmark tax rate will have little or no impact on the final tax strategy.

A tax pass-through regime that is periodically adjusted for changes in actual annual tax payments (similar to the adjustment of STPIS every 5 years) also fails to provide a direct incentive to the business and, as Dr Lally suggests, might lead to perverse outcomes.[41] However, the tax pass through approach, if including a periodic adjustment process, would mean that consumers, over time, might also enable consumers to share the benefits of the lower tax payments.

Thus, while a 'tax pass-through' approach may not be perfect, it may prove a better approach than the current statutory rate of 30% that is applied across the board irrespective of where and how much tax is paid by the business.

In summary CCP22 concludes that:

- There are many practical difficulties with adopting a tax pass-through approach that, all other things being equal, make it less preferable than a revised industry benchmark based on the efficient tax behaviour of the benchmark firm (to be defined)
- The quality of information provided by different networks may vary significantly, such that even with a comprehensive RIN request, the AER may not be able to obtain and/or verify the relevant tax adjustments
- Notwithstanding these very significant issues, it is possible that the tax-pass through approach is still preferable to the current statutory rate in the event that a revised benchmark rate cannot be adequately defined. For this reason, CCP22 believes it is too early to remove this option.

Question 6: The implementation of this review to the April 2019 determination drivers

In principle, we support the application of the review findings to all determinations from April 2019. We see benefit in these changes being in place at the same time the new Rate of Return Guideline comes into effect.

However, we recognise the AER's very tight timetable set by the Minister and the importance to consumers of addressing this issue. Given that different processes to implement any changes, we recommend that the AER consider the option of a two stage process:

1. Changes that involve amendments to the PTRM/RFM only, are implemented in time for the April 2019 determinations. For instance, the AER might implement changes to the tax depreciation approach in the PTRM.
2. Other changes that require a Rule Change process should be postponed, for example, to the commencement of the next round of revenue resets (from 2021). This is because it may not be in the interests of either the businesses or the consumers for such significant changes to apply to some networks and not to others within the normal span of regulatory decisions for the 30 plus networks.

[41] Lally illustrates this point by suggesting that, for instance, a tax pass-through at the individual firm level might provide an incentive to eliminate or reduce debt financing (and therefore remove associated risk) to a level that would otherwise be regarded as because higher financing costs would be offset by higher regulatory allowance. See discussion at Lally, op cit, pp12-14.

Some stakeholders have expressed concern that decisions made in Stage 1 may impact on the decisions made in Stage 2 following the Rule changes. By postponing the implementation of Stage 2 to the next round of regulatory decision-making, this risk can be reduced or even eliminated as the PTRM can be adjusted accordingly.

The argument advanced by Ausgrid et al in their submission[42]:

> "…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."

seems to misunderstand what "submitted" means. While Ausgrid has submitted its proposal on 30th April, it does not submit its revised proposal until January 2019, after the release of the final tax position paper by the AER. Ausgrid's final proposal is still subject to submissions in February 2019, prior to the AER's final decision in April 2019.

[42] Ausgrid et al, p.19