

Submission to the Australian Energy Regulator (AER)

Consumer Challenge Panel

**Submission to the AER on Review of regulatory tax
approach Issues paper**

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 16th May 2018 "Review of regulatory tax approach".

In summary our submission:

- Strongly supports the need for a comprehensive review of the matters raised in the Issues paper.
- Welcomes the opportunity this process provides to electricity and gas networks to provide comprehensive quantitative information to support their previous and current qualitative comments on the matters raised in the Issues paper.
- Believes that the only way to obtain the required detailed quantitative information is through the exercise of the AER's information gathering powers in the Regulatory Information Notices (RIN) process.
- Emphasises the need for the AER in exercising its legislative obligations, to strike an appropriate balance between the confidentiality of the provided data and the need for information transparency to aid stakeholder participation in this review process. We recognise that this may require an innovative approach eg assurance reports by an independent auditor where commercially sensitive data cannot be published.
- Supports detailed work to understand the reasons for any difference between the actual tax paid and the AER's efficient allowance.
- Suggests some issues that might be discussed in the AER's Initial report due on late June.
- Supports the accelerated timetable given to the AER by the Minister so that any changes in the regulatory framework might be applied to the final network decisions due in April 2019. However, we note the considerable burden this timetable will impose on consumer advocates wanting to participate given the issue's complexity. In this context they will no doubt look to the AER to put the long term interests of consumers at the centre of their evaluation.

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

We believe that a key to achieving the NEO of the long term interests of consumers is that the incentive based regulatory framework reflects best practice and is “fit for purpose”. The network environment eg increased distributed and behind the meter generation, changing business models, ownership and corporate structures, is very dynamic. The estimation of efficient tax costs must be dynamic to reflect these changes. In turn the key to this is transparency of information to all stakeholders.

We are not opposed to networks seeking out ways of lowering their tax below the efficient level provided consumers can share in the benefits of this, just as we are not opposed to networks seeking to reduce their capex and opex to below their allowed levels to benefit from CESS and EBSS. The efficient level of capex and opex are continually assessed. Likewise, the efficient tax level should also be continually assessed and adjusted if networks find new ways to reduce their tax burden.

There are three broad pathways as a result of this review:

- (i) Do nothing – which we believe will only be the option if the analysis shows there is no material difference between tax paid and the regulatory tax allowance
- (ii) Amend the regulatory tax allowance calculation to better reflect the current situation
- (iii) Substitute a completely different form of regulation for tax eg cost pass through or a form of sharing of the difference between the efficient and actual tax costs.

We can only make a choice that is in the long term interests of consumers with full and transparent knowledge of the current situation. We expect that the networks would have no concerns with this proposition.

2. The need for a best practice regulatory framework

The regulatory framework within which electricity and gas networks operate needs, at all times, to reflect best practice regulatory decision making that is in the long term interests of consumers. The evidence provided by the ACCC in its recent Preliminary Report of its Retail Pricing Inquiry suggests that it the regulatory outcomes have not been in the long term interests of consumers over the last decade²:

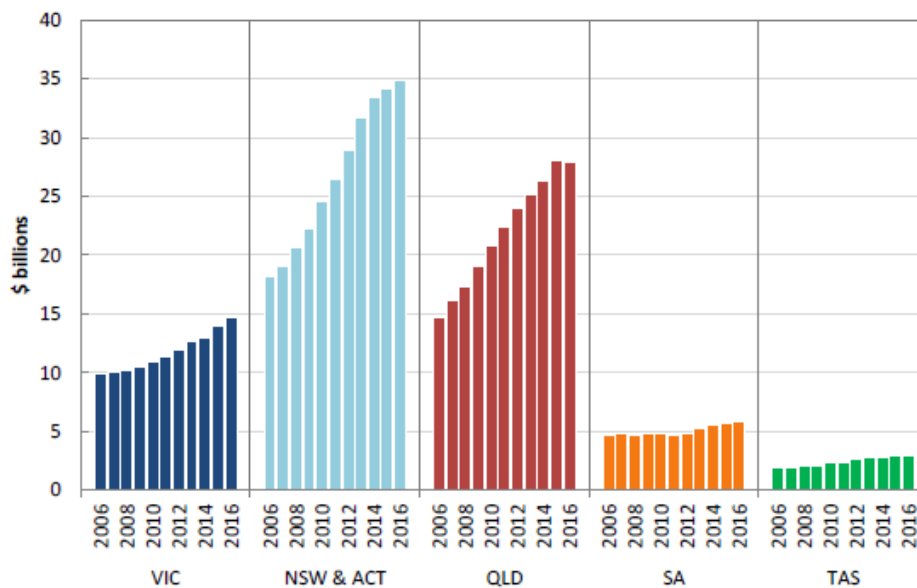
- Network costs made up 48% of the average retail bill in the NEM, and
- Between 2007–08 and 2015–16, increases in residential bills were primarily driven by higher network costs.

While the % of the average bill from network charges has fallen since 2015-16 due to rising generation costs, the costs applying from 1 July 2018 in many jurisdictions are generally not materially lower than 2015-16. A fall in grid demand from increased distribution behind the meter generation plus other factors are supporting network prices.

² ACCC “Retail Electricity Pricing Inquiry – Preliminary Report” September 2017 p. 8
<https://www.accc.gov.au/system/files/Retail%20Electricity%20Inquiry%20-%20Preliminary%20report%20-%202013%20November%202017.pdf>

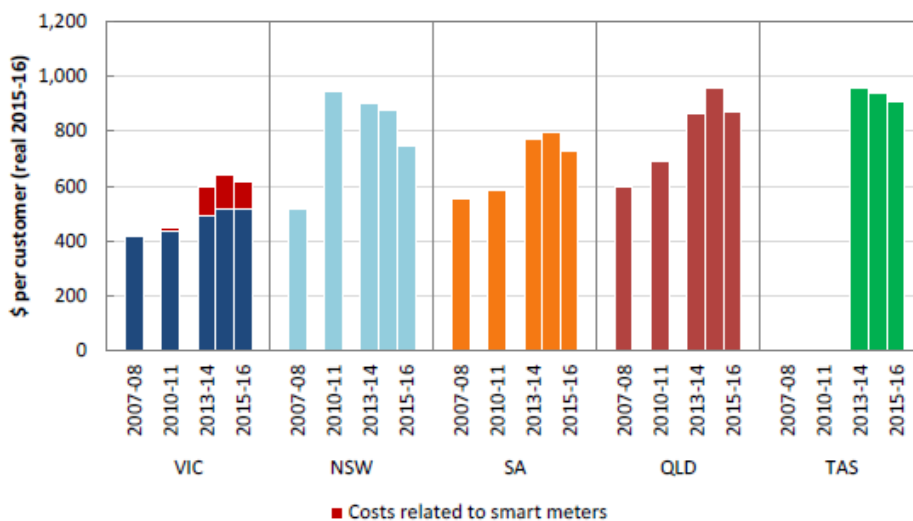
The ACCC also highlighted the large increase in the network RABs over that period³:

Figure 2.34: Regulatory Asset Base from 2006 to 2016, by NEM region, real values in 2015–16 dollars



and increase in average network costs to customers⁴:

Figure 2.35: Average network costs per customer, by state, real values in 2015–16 dollars



The various concurrent reviews around rate of return, profitability and now taxation, are welcomed by consumers as evidence of the need to continually reform the regulatory framework to ensure it best practice in how it meets the long term interests of consumers. The CCP, and consumers more broadly, have long expressed concern that the allowed rate of return was too high for the risks borne by the networks.

³ Ibid p. 63

⁴ Ibid p.64

The CCP, and consumers more broadly, have long expressed concerns that the approach to setting the rate of return led to a level of profitability for the regulated networks was consistently higher than the profits of comparable unregulated businesses and investors' required rate of return. One reason for this can be that the networks pay a lower level of taxation than is provided for under the AER's building block approach to regulatory revenues.

The CCP, and consumers more broadly, have long supported the need for a more thorough examination of the taxation building block. Fundamental to a successful building block approach to regulation is that the method of calculation of the efficient level of taxation is constantly reviewed to endure that it does reflect the intention of the regulatory framework.

A number of consumer groups have questioned the high RAB multiples that investors have paid in the recent NSW privatisations. These groups have argued that one reason may be that the new owners are able to re-structure the network to benefit from a lower tax effective tax rate and arbitrage the difference with the AER tax allowance.

We are not opposed to this. However, in a workably competitive market these gains are transitory and other market participants are able to invoke similar structures and get similar lower tax bills. What was new and innovative becomes the industry standard. Incentive based regulation needs to reflect this transition in how it measures the efficient level of taxation.

We agree with the observation made recently in responding to the announcement of the regulatory tax review, that:

“The network companies have complied with these principles as they are required to do, and the Regulator has approved such calculations.”⁵

Our point is that it is perfectly reasonable, and moreover incumbent on the regulator, to ensure that these principles are up to date and reflect best practice regulation. This is what we believe the current review is seeking to achieve.

Given the privately owned networks' vigorous defence of their position since this review was announced, it seems to CCP22 that this review provides an ideal opportunity for these networks to provide quantitative evidence to support their qualitative statements. As long as confidentiality is respected, they should have no concerns about providing all the information that the AER requests.

3. The available evidence supports the need to thoroughly investigate the issues raised in the Issues paper

The Issues paper brings together two sources of information on the tax paid by networks – Australian Tax Office (ATO) analysis and the AER's own research based on limited public information.

The ATO's conclusion of its analysis of electricity distribution entities is that:

⁵ Comments by Spark Infrastructure CEO Mr Francis quoted in Ben Potter “Spark Infrastructure slams Josh Frydenberg, AER for policy uncertainty” AFR 24th May 2018 <http://www.afr.com/news/spark-infrastructure-slams-josh-frydenberg-aer-for-policy-uncertainty-20180523-h10gwk>

- the aggregate AER tax allowance provided to taxpaying entities (whether ASX listed or privately held) consistently overstated the actual tax payable by those entities; and
- the aggregate AER tax allowance provided to NTER entities (ie Government owned networks) consistently understated the 'notional' tax payable by those entities.

for the four year period 2012-2016.

The AER's own analysis of public domain annual reports and financial statements of the owners of regulated networks (private, ASX listed and public) supported the general conclusion from the ATO's analysis. This was the case for tax payments on either a cash paid or accounting measure of tax liability.

We agree with the AER that this data has a number of limitations. However, fundamentally we believe that the AER has produced enough information to justify a more thorough analysis to increase the level of transparency around the actual situation. The amounts involved are potentially significant as are their impact on network prices to consumers. Consumers need to understand how significant they are to retain confidence in the regulatory process.

4. This information can best be obtained through the AER RIN process

To answer the specific question posed by the AER⁶, we are not aware of any other publicly available sources that provide tax data for the regulated networks.

So, we believe that the best way to obtain this information is by the AER exercising its information gathering powers through the issuance of a Regulatory Information Notice (RIN) to each network as outlined in Table 1.1 of the Issues paper ie consultation on draft RINs and then issuing final RINS.

The limited time available for preparing this submission means that we cannot provide a comprehensive response to the AER's Q3. *"What information would the AER need to obtain on actual tax payments in order to inform this review and any potential adjustments to the regulatory treatment of taxation?"*

As a 'first cut' we would suggest that the AER will need the following data:

- (i) Details of corporate structure and financing (including related party loans and financing). This would include terms, interest rates, and conditions and covenants of any financing
- (ii) Revenue for tax purposes
- (iii) A reconciliation of taxable revenue to revenue from regulated services and annual allowed revenue per AER determination
- (iv) Disaggregated expenses for tax purposes
- (v) Reconciliation by line item of expenses allowed for tax purposes and forecast expenses per AER determination including:
 - (a) Actual gearing for tax purposes
 - (b) Disaggregated tax asset base, assumed lives, and depreciation rates for tax purposes

⁶ Issues paper p.14 Q1.

- (c) Details of debt costs allowed for tax purposes (per (i) above) and reconciliation to debt costs per AER determination
- (vi) Details of any other adjustments or allowance for tax purposes (eg previous period tax losses)

Ideally the data would be collected for all NSPs from the commencement of their regulation by the AER. We recognise that this may not be possible, but the AER should endeavour to collect the fullest data set possible.

We recognise that this collection process will involve commercially sensitive data. In exercising its legislative obligations, the AER will need to strike an appropriate balance between the confidentiality of the provided data and the need for information transparency to aid stakeholder participation in this review process. We believe that this may require an innovative approach eg assurance reports by an independent auditor where commercially sensitive data cannot be published.

5. Once we know the level of taxation actually paid, we need to understand the reasons why this differs from the efficient allowance

If the detailed RIN data supports the initial evidence, then the analysis needs to understand both:

- Why privately owned/ASX listed networks pay less than the taxation allowance, and
- Why government owned networks pay more than the taxation allowance

We agree with exploring the issues listed in both Table 5.1 and Table 5.2. Many have been proposed in a qualitative sense, so we look forward to the networks providing quantitative evidence to assist our all stakeholders understanding of the issues listed. In particular we would encourage the AER to consider the long term position over a number of regulatory periods.

Q4. Are there other potential drivers that could cause the difference (between expected tax costs and actual tax paid) identified in the ATO note?

There could be merit in considering the impact of capital contributions.

Q5. How should we assess materiality of the potential drivers?

We agree with the need to set standards for materiality. However, it is difficult to say what those should be without seeing the data the AER would collect.

Q6. Which of these potential drivers should be the focus for the AER's review?

The AER should focus on those with the largest quantitative impact, but we are unable to say what they would be until we see the data the AER would collect.

6. There are a number of issues that are worth the AER considering and seeking consultation on to better understand the situation

Assuming the detailed data will support the preliminary position indicated by the ATO and AER analyses, here are some issues we believe that the AER should consider, and seek comment on, in its June Initial report.

How the existing incentive based framework might be improved

The incentive based framework is not a static concept by definition. It is designed to reflect an efficient level of taxation that would be paid in a workably competitive market. A workable competitive market is constantly changing as businesses seek new opportunities to lower costs, increase productivity and hence increase shareholder returns. This means the characteristics of the efficient level of taxation will change over time. For example, if the standard corporate structure involves the use of entities that have a lower tax rate than the standard company tax rate then this should be reflected in the calculation of the taxation building block.

Under the current CESS and EBSS incentive schemes for capital and operating expenditure respectively, networks have an incentive to be more efficient and retain 30% of the benefits while consumers receive 70% share of the benefits. This might be worth investigating for the tax payment below and above the efficient level.

Whether for the purposes of the tax building block calculation there should be two definitions – one for private owned/ASX listed networks and one for publicly owned networks

A fundamental feature of the incentive based regulatory structure is that ownership is irrelevant. However, if the data shows that a material reason for the difference in tax paid between the two ownership structures is, say, their corporate structure, then this may be a good reason to have different efficient tax calculations for each.

Publicly owned entities operating in a competitive market would be very unlikely to have tax efficient corporate structures. By contrast, it might be very common for privately owned/ASX listed networks operating in a competitive market to have such structures. As noted above, in a workably competitive market these gains are transitory and other market participants are able to invoke similar structures and get similar lower tax bills. What was new and innovative soon becomes the industry standard. Incentive based regulation needs to reflect this transition. This would suggest that using the competitive market counterfactual (lower tax rate) as the “efficient” level, the publicly owned network, with a less tax efficient structure, should not recover its higher tax rate.

How much is it an ATO issue rather than an AER issue

The empirical analysis may show that a material driver of the lower tax paid by privately owned/ASX listed networks is related to Tax Act provisions eg regarding ownership structure, that allows a lower tax rate than the 30% assumed. One argument that may be advanced in this situation is that this matter should be left to Federal Government’s tax policy, not AER regulatory decisions. This would keep the 30% rate assumption in the AER calculation and changes in the Tax Act would gradually bring the actual tax paid back closer to the AER assumed rate as the Tax Act changes gradually eliminate the tax advantages these structures confer.

We are not convinced by that argument. Firstly, it could take many years for the changes in the Tax Act to have their full impact. And even if they are changed, there may not be the same direct benefit to consumers there would be through network prices. Secondly, the AER must regulate on the basis of the current tax law, its application and the structures and behaviours that it incentivises.

Whether a tax expenditure pass through might be a better option

This approach does have advantages. A network has a strong incentive to minimise its tax payments but under the current approach customers do not benefit from this. In the context of the total tax burden, any under recovery from networks places a greater burden on all taxpayers to make up this under recovery.

However, moving to full tax pass-through would be a substantial change from the incentive based approach that underpins the allowances for other costs and the overall regulatory approach. It could also be very difficult to administer eg how to decide the level of tax that has actually been paid over time given the variety of corporate structures used and how to separate out the regulated and unregulated parts of the business. But the current exercise in getting transparency on actual tax payments could help considerably in assessing the practicality of this approach.

7. The proposed timetable is very demanding on consumer resources

We understand that the timetable – a final position to be released by December with the intention that any changes apply to networks that will begin their new 5 year regulatory cycle on 1 July 2019 – has been provided by the Minister. This is why there has been such a short consultation period on this Issues paper.

Consumers want to see quick changes that will lower their very high electricity prices. However, we just note that the accelerated timetable set out in the Issues paper will impose a considerable burden on consumer advocates wanting to participate in what is a very complex topic where they have limited knowledge and time to build capability. In this context they will no doubt look to the AER to put the long term interests of consumers at the centre of their evaluation.