Australian Government

Department of the Environment and Energy

Submission to the AER's Review of Regulatory Tax Approach

Department of the Environment and Energy

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DEPARTMENT OF THE ENVIRONMENT AND ENERGY SUBMISSION

Former Minister Frydenberg's initial request to the AER

On 15 May 2018, the former Minister for the Environment and Energy the Hon. Josh Frydenberg MP wrote to the AER asking them to investigate whether regulated network service providers (NSPs) were being overcompensated for their company tax liabilities. This followed advice from the Australian Taxation Office (ATO) that there was a discrepancy between the tax allowance passed on to consumers by NSPs, and the company tax they actually paid.

As part of this investigation, the former Minister asked the AER to:

- Exercise its information gathering powers, if necessary, to determine whether NSPs are being overcompensated by consumers for their company tax liabilities;
- Review how it models its company tax costs under the current framework; and
- Consider whether the method for estimating the cost of company income tax as set out in the National Electricity Rules remains appropriate.

The AER were asked to deliver a final report to COAG Energy Council on the results of its investigation and provide recommendations on any changes by December 2018.

The AER's Discussion Paper

On 2 November 2018, the AER released a Discussion Paper on the Review of Regulatory Tax Approach (the Review) and accompanying expert advice setting out its proposed findings in response to Minister Frydenberg's request.

The AER's Approach

The Department of the Environment and Energy (the Department) is concerned with three key aspects of the AER's process in undertaking its Review: engagement with the ATO, the use of the AER's information gathering powers and the timing of any modelling changes.

1. Engagement with the Australian Taxation Office (ATO)

The Department is concerned that the ATO was not closely consulted in the preparation of the Discussion Paper. As the principal revenue collection agency for the Australian Government, the ATO would be ideally placed to advise on the operation of tax, particularly given the complexities of this issue.

In preparing its Final Report, the AER should work closely with the ATO to fill in the information gaps noted in the Discussion Paper, and consider the practicalities of operating an alternative mechanism for calculating company tax.

The Department would be happy to work with the Treasury, ATO and the AER to identify and then work to remove any legislative obstacles to information sharing between the two agencies.

2. Information gathering powers

In developing its Discussion Paper, the AER have only relied on a limited subset of publically available information or material voluntarily provided by some (but not all) NSPs. While the AER

has compelled additional information from the NSPs through its Regulatory Information Notices (RINs), this material has not been examined in time for inclusion in the Discussion Paper.

Given the AER has yet to analyse all available information, we consider it is premature for it to conclude that its current approach remains appropriate.

3. Timing of final report

The AER has indicated that if it receives additional information that leads to changes in its proposed findings, it will deliver an interim report to COAG Energy Council in December 2018 and a final report in March 2019.

The Department is concerned any delays in delivering the final report will mean that changes to the AER's regulatory tax calculation model will not be incorporated in time for the April 2019 revenue determinations. Consumers served by those networks in NSW, Tasmania, NT and the ACT could then be locked into paying a tax allowance until 2024 that the AER may later find to be not fit for purpose. As a matter of priority, the AER should seek to make any modelling changes before these revenue determinations are finalised.

The AER's proposed findings

Aside from certain timing-related issues, the Discussion Paper proposes no change to the current approach to the calculation of the tax allowance. The Department is concerned that a number of fundamental issues with the current model remain unaddressed in the Discussion Paper. These are that under the current incentive based model:

- Consumers are effectively compensating NSPs for company tax, even where they have no statutory obligation to pay it; and
- Where an NSP pays less company tax than the AER has modelled, consumers do not receive a benefit.

The AER's notes in its Discussion Paper its approach to the calculation of company tax should be guided by the long-term interests of consumers, as set out in the National Electricity Objective (NEO) and National Gas Objective (NGO). The purpose of providing a tax allowance is to ensure NSPs are able to cover their statutory company tax liabilities, not as an additional source of revenue. The long term interest of consumers is not served by providing a benefit to NSPs who happen to pay less company tax than the AER's modelled outcome. Consumers would be better served by an approach where network businesses are only compensated to the extent they need to meet their statutory obligations. As such, the Department does not consider the Discussion Paper justifies the current model.

The Discussion Paper considers alternative approaches to calculating tax, although these focus heavily on their complexity and potential unintended consequences rather than the outcome for consumers. The analysis of these approaches focuses on the theoretical rather than practical, with a focus on maintaining consistency with the incentive based regulatory framework. This ignores that the AER already allows for a pass through for other sector or state based charges as part of their revenue determinations.

Incentive based regulation makes sense for calculating the operational and capital expenditure of NSPs, as cost savings are shared with consumers and an efficient level of expenditure is established for future revenue determinations. But an incentive based approach with a common benchmark does not work for tax, as networks do not share any reduction in their calculated tax liabilities with consumers, nor is it used to inform the calculation of tax in future revenue

determinations. Accordingly, the increased cost to consumers does not seem to be in their long term interest. This appears to the Department to be a critical consideration that should be addressed.

That the current approach is not in the long term interest of consumers is demonstrated by a comparison of ATO tax transparency data against the AER's calculation of company tax for privately owned tax paying entities. In the three years from 2013-14 to 2015-16, the AER forecast that these businesses would pay $1.05 billion in company tax.[1] But ATO tax transparency data can only account for these entities paying $296.1 million in company tax[2], which includes company tax paid for their unregulated activities. Factoring in a deduction for gamma, privately owned NSPs as a collective were able to retain a benefit of at least $450 million beyond what they needed to meet their statutory obligations.

A key issue is the use of the Australian company tax rate as a common benchmark for setting the tax allowance. This appears inappropriate given that:

- Only seven of the 17 NSPs are taxed as an Australian company.
- No NSP is majority owned by Australian-resident companies whose shareholders are majority Australian.
- Partnerships, trusts and superannuation funds do not pay Australian company tax.
- Foreign entities who are the beneficiary of a trust or partnership, or have related party transactions with an Australian company, may not be paying tax at the Australian company tax rate.

In preparing its final report, the AER may want to test the practical implications of moving to an alternative mechanism by collaborating with the ATO – in particular a cost-pass through mechanism. This could include improved information sharing between agencies, or having the ATO support the AER's administration of the tax allowance.

In addition to these fundamental issues, the Department has a number of specific issues with the contents of the Discussion Paper (outlined below):

- The AER's assessment of the current approach and its alternatives.
- Problems with applying the 'benchmark efficient entity' to tax.
- The drivers of the difference between tax paid and the AER's forecast of tax liabilities.
- The AER's analysis of what might occur in the future.
- The level of information relied upon in the AER's Discussion Paper

1. The AER's examination of the current approach and its alternatives

This part outlines the Department's concerns with the way in which the AER has gone about its assessment of the current approach, and the advantages and disadvantages of other approaches.

[1] AER Initial Report, page 19.
[2] AER Initial Report, page 22.

The benchmark approach

The current AER approach to the provision of tax allowances is known as the ‘benchmark approach’. It is described as follows:[3]

> [The] benchmark approach is important for economic efficiency, which services the long-term interests of consumers, as it provides incentives for businesses to adopt the most efficient practice which consumers are able to benefit from. That is, if a business is able to be more efficient compared with our benchmark costs, then through our regulatory framework, it is able to retain parts of the benefits which are then passed onto consumers in subsequent determination periods.
>
> This would also apply to our calculation of the expected tax costs of the regulated businesses. If there are more efficient tax practices that a business can adopt to validly reduce its tax liability, then it should be able to keep those benefits, but they should then be passed onto consumers, albeit following the subsequent reviews of our tax approach.

The Department does not understand how the efficient tax practices of a particular entity are passed onto consumers in subsequent reviews under the current benchmark approach. The benchmark approach, as it currently operates, assumes that all NSPs use the same entity - an Australian company that pays tax at the 30 per cent rate - regardless of the tax rate that applies to that entity. A saving in the cost of tax could be passed onto consumers if the AER accounted for the tax rate that actually applied to these businesses in setting revenue. But the Discussion Paper rules that out as an option.

The Discussion Paper states that the effect of the benchmark approach is that an efficient tax practice will be passed onto consumers without providing any evidence that this has in fact occurred in the past. The AER may want to demonstrate in its Final Report any example of a cost saving from efficient tax practices under a benchmark approach being shared with consumers.

Finally the Department is concerned about the periods of time between tax reviews, given that the AER was established in 2005, and this is the first tax review that has been undertaken. In that time, NSPs have been allowed to collect over $4.3 billion from consumers to cover their company tax liabilities. The current review of the calculation of regulatory tax is long overdue. The suggestion that tax reviews in the future will be conducted ‘from time to time’[4] does not address the concern. In its final report, the AER may want to consider what would be an appropriate timeframe to review its regulatory approach to tax.

The cost-pass through approach

An alternative to the benchmark approach that is examined by the Discussion Paper is a ‘cost pass through’ approach. Such an approach would involve tax allowances being provided for tax actually paid, rather than an estimate of tax payable. One of the AER’s key stated concerns with the adoption of a cost pass-through approach is as follows:[5]

> The alternative of a tax cost pass-through is unlikely to encourage businesses to adopt efficient tax practices as there would be no incentive to do so – as any tax liability would be wholly passed onto consumers. This could lead to increased charges over time.

The Department is concerned this ignores that had a cost pass-through approach been applied to historical tax payments, any cost saving from the discrepancy identified by the ATO in its advice to the former Minister would have been passed through to consumers.

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[3] AER Discussion Paper, Page 102.
[4] AER Discussion Paper, Page 105.
[5] AER Discussion Paper, Page 103.

It is also not clear what is meant by efficient tax practices. The AER may want to seek advice from the ATO on what would be an efficient tax practice, and whether a business could adopt an inefficient approach to paying company tax.

The Department is concerned about the statement that company tax cost pass-through ‘could lead to increased charges over time’ being made without any attempt to ascertain whether this would in fact be the case, either from a qualitative or quantitative perspective. Such a statement would benefit from an assurance by the ATO that such an outcome might be a genuine possibility. If it is considered to be a reasonable possibility, these risks could be managed through adopting a cap to the tax allowance or some other feature.

Even if NSPs were to increase their current tax payments by restructuring to an Australian company, they would be subject to company tax. Consumers would be no worse off, and in addition receive a welfare benefit as revenue previously retained by investors will now be paid as tax.

2. Problems with applying the benchmark efficient entity concept to tax

Part of the AER’s approach to benchmarking is to assume that each NSP is a benchmark efficient entity, and to forecast how the tax system would apply when such an entity did the things the network does.[6] The AER assumes that a benchmark efficient entity is a company whose applicable tax rate is the company tax rate.

Identity of the benchmark efficient entity

According to the Discussion Paper, slightly less than 30 per cent of NSPs are Australian companies (by Tax Asset Base Value)[7]. The remaining 70 per cent are a combination of flow-through entities with a variety of investors, and state or territory governments (including businesses that make notional tax payments through the National Tax Equivalent Regime (NTER)).

This raises the question as to whether a company that pays tax at the Australian company tax rate should continue to be the AER’s benchmark efficient entity given less than a third of businesses operate under such a structure.

Flow-through entities

PwC’s Expert Advice notes that where a NSP is a flow-through entity, its actual cost of debt and equity may be lower when compared to a company.[8] This arises because the NSP does not pay company tax, and banks generally determine lending capacity based on post-tax cash flows.

The effect of the current AER approach is to assume that the NSP is a company, both for the purposes of the calculation of its allowed rate of return, and for the purposes of the tax allowance calculation. The combined effect of this is to:

- Provide a rate of return above the entity’s actual cost of debt and equity that is attributable to the use of the flow-through entity.
- Provide a tax allowance that is above the entity’s actual tax payable that is also attributable to the use of a flow-through entity.

[6] AER Discussion Paper, Page 32.
[7] AER Discussion Paper, Page 39.
[8] PwC Expert Tax Advice, Page 43.

Accordingly, PwC's advice is that these NSPs are being compensated twice for what is a single efficiency – being the non-payment of company tax. The Department is concerned that the Discussion Paper ignores PwC's statements as to why entities use stapled structures, and whether it is appropriate for such entities to receive any tax allowance at all.

3. Problems with the AER's analysis of the drivers of the difference

Distinguishing regulated and unregulated activities

The AER Discussion Paper finds that a material driver for the difference between tax paid and the AER's estimate of tax paid is:[9]

> [T]he tax obligation relevant to the regulated activities may not be clearly visible in the tax return of the reporting entity because it may have a tax position arising from other businesses or unregulated activities.

The Department does not think that this has been demonstrated in the Discussion Paper as:

- No evidence has been provided to suggest the existence of unregulated business revenue operates to reduce actual tax paid by the entity group.
- It may be possible that the presence of unregulated businesses could increase actual tax paid. This is because:
  - The nature of regulated businesses is that they tend to have large values of depreciating assets for tax purposes.
  - The certainty of cash-flow in regulated businesses would lend itself towards higher levels of gearing as against the cash-flows from unregulated businesses.

An estimate of the likely materiality of this issue could be found through publicly available information for certain NSPs that disclose the extent to which their revenue and Earnings Before Income Tax (EBIT) are attributable to regulated and unregulated activities. The AER may want to have had regard to this information in its final report.

Dismissal of the Net Present Value (NPV) benefit from losses

The Discussion Paper notes:

> [W]e consider that dealing with the primary drivers of the underlying tax difference should also address that portion of past losses relevant to the regulatory approach. This is particularly so for timing differences around depreciation in chapter 6. These naturally reverse so that tax losses built up in the first portion of an asset's effective life will be drawn down in the later portion (albeit with a lasting NPV effect)[10]*.*

The Department is concerned about the AER's dismissal of the NPV benefit from the provision of an upfront tax allowance to finance the payment of company tax that may or may not occur until many years' time. The effect of the AER's current practice is to over-compensate for the real cost of tax liabilities.

Interest expenses

The Departments notes the AER's statement in its Discussion Paper that:

> [W]e sought detailed debt information as part of the RINs to examine its materiality. However, we received the information just before finalising this discussion paper, and so we are currently analysing it. As such, we have not made any decisions about whether a possible change is warranted in this area. […] We will include

[9] AER Discussion Paper, page 37.
[10] AER Discussion Paper, page 44.

> further analysis on this issue in our December report, along with findings from information received in response to RINs.[11]

The Discussion Paper does analyse a number of proposed changes in this area.[12] The Department is not in a position to provide a detailed response until it reviews the proposed changes in the AER's December 2018 report. However, the Department does note that the Discussion Paper seems to equate loans obtained from third parties with loans obtained from related entities (most likely parent financing). For example, the Discussion Paper states:

> Given that customers are not providing an additional return for the higher interest costs, it could be argued that NSPs should retain the benefits of higher interest deductions; and that such a change would be contrary to our incentive regulation. [13]

The premise of this passage is that interest expenses always represent true expenses for investors. This may be the case for third party bank debt. But interest expenses can, in certain circumstances, be deductible even if they are being paid to the related parties. The AER may want to explore this further, in consultation with the ATO.

Other related party dealings

The Department is concerned that the AER has not sought to identify whether any other related party dealings that can operate to reduce tax paid by entities regardless of the type of structure they adopt may also be a driver in the difference observed. The AER may want to work with the ATO to determine the impact of any related party dealings.

4. The AER's analysis of what might occur in the future

Effect of future legislation

The Discussion Paper states:

> We also consider that recently introduced or imminent tax legislation changes will reduce the difference between our regulatory provisions for tax costs and tax paid by regulatory networks. To the extent to which this is the case, amendment to the AER's tax framework is unnecessary.[14]

The Department understands the reference to 'recently introduced or imminent tax legislation' is a reference to amendments proposed by the Treasury Laws Amendment (Making Sure Foreign Investors Pay Their Fair Share Of Tax in Australia and Other Measures) Bill 2018. The Department considers that this passage oversimplifies the effect of that this proposed legislation will have on the tax actually paid by NSPs. Specifically, the Department understands that the Bill proposes:

- A transitional period under which:
  - Certain foreign investors into flow-through entities will pay tax at a 15% rate until 1 July 2034.
  - Certain sovereign wealth investors will not pay any tax for seven years.
  - Certain foreign pension funds will not pay withholding tax on certain types of income for seven years.

[11] AER Discussion Paper, page 87.
[12] AER Discussion Paper, page 88.
[13] AER Discussion Paper, page 94.
[14] AER Discussion Paper, page 14.

- To retain differences between tax actually paid and the company rate of tax in a number of situations (regardless of the transitional period):
  - Foreign investors into flow-through entities will pay tax at a 15 per cent rate for 15 years in respect of certain new investments, subject to Government approval.
  - Certain sovereign entities with investments of less than 10 per cent[15] retain the ability to not pay tax on certain categories of income.
  - Foreign pension funds with investments of less than 10 per cent[16] will continue to not pay withholding tax on certain types of income.
- Double gearing as described on page 38 of the Discussion Paper may still be consistent with Australia's thin capitalisation rules if the investment is less than 10 per cent.[17]
- No change in respect of the tax rates paid by investors into flow-through entities other than Managed Investment Trusts (e.g. the tax rates applicable to certain superannuation funds is retained).

The AER may want to note that even if the Bill referred to passes, there will be many situations (particularly during the transition period) where NSPs will not pay the company rate of tax.

5. Comments about the level of information in the AER's Discussion Paper

Upstream investors

The AER notes that it does not have access to the tax records of upstream investors, and cannot compel this information through its RINs.

But these upstream investors (including foreign investors) are well known, and tax information relevant to them could be attained through their publically available financial reports. The AER may want to incorporate this information into its Final Report, including the company tax rate applicable to these entities and any other differences to treatment under the Australian tax system (such as the taxing of interest income).

Other comments about the level of information in the Discussion Paper

Other concerns the Department has with the Discussion Paper:

- The omission from the Discussion Paper that two large NSPs were, until recently, owned in a flow-through structure.
- According to page 24 of the PwC Report, only eight of the 12 private sector entities that were sent the questionnaire voluntarily provided the information requested.
- According to page 12 of the PwC Report, none of the upstream investors into any entity provided their tax information.
- According to page 53 of the PwC Report, the 0 per cent rate for sovereign wealth funds "is only expected to continue to apply to investors noted in our investigations until 2026". The Department notes that statement:

[15] Subject to certain integrity rules.
[16] Subject to certain integrity rules.
[17] Subject to certain integrity rules.

- Cannot be proven given no information was provided by upstream investors, and
- Omits that the 0 per cent rate for sovereign wealth funds will continue to be available in respect of certain funds and taxes beyond 2026, if the Bill referred to above was enacted as proposed.