ENERGY CONSUMERS AUSTRALIA

A Suite 2, Level 14, 1 Castlereagh Street
Sydney NSW 2000
T 02 9220 5500
W energyconsumersaustralia.com.au
@energyvoiceau
in /energyconsumersaustralia
f /energyconsumersaustralia

ABN 96 603 931 326

30 November 2018

Mr Warwick Anderson
General Manager, Network Finance and Reporting
Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601

By email: TaxReview2018@aer.gov.au

Review of regulatory tax approach 2018

Energy Consumers Australia is the national voice for residential and small business energy consumers. Established by the Council of Australian Governments Energy Council in 2015, our objective is to promote the long-term interests of energy consumers with respect to price, quality, reliability, safety and security of supply.

We appreciate the opportunity to comment on the Australian Energy Regulator's (AER) *Review of regulatory tax approach 2018, Discussion Paper (the Paper)*. This submission builds on our response to the issues paper and our contribution at the AER workshop on 7 November 2018.

The fundamental purpose and objective of energy networks as regulated businesses is to serve the long-term interests of consumers with respect to price, quality, reliability, safety and security of supply. This is an objective and purpose enshrined in the legislative framework as the National Energy Objective or 'NEO'. This means that current and future consumers pay no more than they need to for the quality of services they require. Or to put it in even simpler terms, that not one dollar more than necessary is spent and not one day earlier than it is needed.

We support the AER's process to review the tax settings in the building block model to save money for consumers. We also offer additional thoughts on how to optimise the model over time.

Incentives and tax settings

The current framework for the regulation of energy network businesses is a hybrid model. The energy network businesses are provided with a revenue allowance determined on the basis of the AER's estimate of efficient costs, but the energy network businesses are provided with incentives to outperform the efficient costs.

In competitive markets it is the possibility of retaining some of the economic value of cost reduction that provides the incentive for managerial effort to realise the reduction. It is this incentive that we attempt to implement with the policy referred to as "incentive regulation." However, over the last decade the experience of energy consumers has been of ongoing real price increases for energy services – well beyond inflation and wage growth – that suggests that the incentives were not working as intended.

The tax allowance is one component of the building block model used to determine allowed revenue. The Australian Taxation Office (ATO) has provided advice that the allowances provided to networks have generally been in excess of actual tax payments. However, the Government owned networks are actually making tax equivalent payments in excess of the allowance, which is effectively a way that the owner (state government) takes its dividend. This discrepancy suggests that if the regime were changed to making the tax allowance simply a recovery of tax paid that the lack of incentive would result in privately owned firms simply reducing effort in (lawful) tax minimisation.

We note that the AER's further investigations since the release of the Discussion Paper indicate that while there is a difference between tax allowances and tax paid it is not as great as initially suggested by the ATO. The AER's challenge is how to ensure that energy network businesses are not over-compensated for their tax liabilities without reducing the incentives for efficient cost management. The AER has identified in the Paper seven key issues for which the Energy Networks Australia and Consumer Challenge Panel perspectives were summarised in presentations at the Workshop.[1]

These issues are outlined in the table below:

Issue	AER Position	ENA Preliminary view	CCP View
Actual tax pass through vs benchmark approach	Maintain benchmark approach	Agree	Agree subject to robust benchmarks
Entity structure and ownership	Maintain Australian corporate 30% rate	Agree	Agree
Asset revaluations	Maintain current approach	Agree	Agree
Depreciation	Move to DV where appropriate	Agree	Agree
Interest expense	Still considering	Maintain benchmark approach	Still considering
Refurbishments	Reflect up-front deduction	Maintain current approach	Agree in principle
Asset lives for gas pipelines	Reflect 20-year asset life	Maintain current approach	Agree in principle

There is uniform agreement on the first item, that the incentive approach to tax allowances should continue. We note there is a high level of agreement on the next three quite substantive issues. The question of interest expense becomes at best problematic, because if there is a higher interest expense than is systematically allowed for in the Benchmark Efficient Entity (BEE) it suggests that the gearing ratio used for the BEE is too low. Energy Consumers Australia agrees with the AER and Consumer Challenge Panel (CCP) on the issues of refurbishments and asset lives for gas, and we find the CCP suggestion that refurbishment could be dealt with by a refinement of the benchmarking approach worthy of further analysis.

Reframing the discussion

While there is agreement by all parties that an incentive regime is appropriate, there are variations in expectations of how the lower costs obtained from tax minimisation should benefit consumers. The

[1] https://www.aer.gov.au/system/files/4.%2020181107_ENA%20Presentation%20-%20Regulatory%20Taxation%20Review%20Public%20Forum%20-%207%20November%20-%20Final%20Clean.pdf and https://www.aer.gov.au/system/files/3.%20CCP22%20-%20Public%20Forum%20presentation%207%20Nov%20%2718_final_0.pdf

CCP questions whether the incentive on tax management is too high, being set as the tax allowance is currently set at the highest level that a firm could be expected to pay; it makes little allowance for tax minimisation. We acknowledge that Government owned networks are paying 'tax' at a higher rate, but since the recipient is still the shareholder there is no value to the 'investor' in tax minimisation in that case.

The AER acknowledges that, unlike the operation of incentives to underspend capex and opex allowances, the network business enjoys the value of underspend on tax allowance. The AER's suggested approach is to conduct regular (every four or five years) tax reviews and use these to 'pass through' efficiency savings. The networks believe there should be no change.

These various positions mask an unresolved issue of the relationship between the allowed rate of return and the operation of the incentive schemes. The AER's profitability analysis comparing allowed to actual return on assets for the network businesses almost uniformly demonstrates that the operation of the regime is such that the allowed rate of return is a baseline while the actual return is always higher.[2] This is inconsistent with the theory underpinning the Capital Asset Pricing Model that assumes the actual returns will be normally distributed around the expected return.

Incentive regimes can operate with an allowed rate of return that is consistent with a low risk rate and the variability of return all on the upside. Certainly the way the tax allowance currently operates only provides upside risk.

The alternative is to structure the incentives so that businesses are just as likely to be penalised for inefficiency (or failure to minimise tax) as they are to be rewarded. The allowed rate of return then needs to be higher to reflect this different risk profile.

It is our contention that the current regulatory settings, even allowing for the changes likely to flow from the 2018 Rate of Return Review, reflect a risk asymmetric incentive regime with an allowed rate of return that assumes symmetric risk (as it is based on the CAPM). Consequently, a move to a symmetric incentive regime, especially in relation to tax, will not necessitate a revision to the allowed rate of return.

This approach would enable the AER to operationalise the idea of the tax allowance as an effective incentive mechanism subject to review. Rather than setting the allowance by intricate modelling of the tax the AER expects the entities are liable to, it could be set based on a proxy measure as the average of tax actually paid by networks as a percentage of revenue (or EBIT or some other earnings measure) in previous years. The actual choice of measure could be informed by choosing one that has a low variability across businesses.

The AER need not wait for a further tax review to make this change to the tax allowance, it could be implemented immediately. Based on the tax data presented to date the effect of this change would be a reduction in the revenue allowance for the Government owned networks and an increase in the revenue of privately-owned networks (though possibly no more than the likely reduction in revenue allowance from the new allowed rate of return).

The implementation of this review

The suggestion above is a synthesis of the perspectives of a number of stakeholders, seeking to prioritise simplicity and a sharper approach to incentives. However, we acknowledge that it is a new idea that will require time to consider and we do not want to slow down changes that can save money for consumers.

[2] https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/profitability-measures-for-electricity-and-gas-network-businesses/aer-position

We encourage the AER to move swiftly to allow consumers to share the benefits of the network providers existing tax minimisation strategies and to apply any changes to the April 2019 revenue determination decisions.

If you have any questions regarding our submission, please contact David Havyatt, Senior Economist of Energy Consumers Australia on 02 9220 5500 or david.havyatt@energyconsumersaustralia.com.au.

Yours sincerely,

Chris Alexander

Director, Advocacy and Communications