Review of regulatory tax approach

Public Forum

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Outline

1. Incentive-based approach
2. Benchmark efficient tax allowance
3. Suggested principles
4. Worked examples

Networks support focus on incentive-based regulation

- Consumers need to be able to have confidence in regulatory benchmarks
  - increased transparency and shared understanding around AER regulatory practice and models is an opportunity in this process
- Networks strongly support the:
  1. AER position on importance of an incentive-based framework
  2. Focus on incentive frameworks needing to inform any proposed future options (AER expert report, Lally)
- Agree that movement to an actual cost pass through approach would harm the interests of consumers, for the reasons set out in the AER's commissioned report
- Key objective for the review - establishing whether the AER could implement a better benchmark for tax costs that maintains consistency with the incentive framework, and is clearly superior to the current approach
- This will rely on a evaluative task once the AER has access to information that relevant to this objective

Incentive-based regulation and the benchmark efficient cost of tax

- Appropriate focus for this review is to determine an approach for setting the amount of corporate tax that would be paid by
  - a benchmark efficient entity;
  - as a result of the provision of the relevant services
  - if such an entity, rather than the actual NSP, operated the business. (NER cl. 6A.6.4; NGR r. 87A).
- It is appropriate for the AER to reconsider, from time to time, whether its regulatory allowances are consistent with the benchmark efficient practice.
  - encourages regulated firms to seek efficiencies and to fold those efficiencies into the regulatory framework when they are identified, for the long-term benefit of consumers.
- Consider that the benchmark efficient practice in relation to corporate tax should be determined by examining the actual practices of networks
- A key plank of the incentive-based regulation framework is that changes are not made retrospectively
  - incentive-based regulation to work it is crucial that businesses are able to make decisions (improve efficiency) based on the rules of the day, knowing that those rules will not be changed retrospectively some years later.

Benchmark efficient tax allowance

- Current benchmark approach by the AER avoids customers in different suburbs and sides of the street paying different charges on the basis of different tax positions of individual businesses and the risk of sudden price rises when there is a change of ownership.
- If there are changes to the way network taxation allowances are to be derived, these must be in the long-term interests of customers
  - careful deliberation must be given to all the impacts to current and future customers of any alternatives that are proposed.
- Some suggested features of a regulatory taxation approach that promote the long-term interests of customers
  - **Unbiased**: avoids current and future consumers paying systematically biased regulatory allowances for tax;
  - **Prospective and certain**: does not impair business value arising from individual past business decisions, transactions and structuring choices and recognises different roles and remits of ATO and AER; and
  - **Consistent with revenue and pricing principles**: provides network owners a reasonable opportunity over the life of the operation of network assets used to deliver regulated network services to recover associated tax liabilities

Suggested principles for next steps

1. Targeting information requirements to the **information necessary to meet the defined task**
2. A change should only be made **if there is evidence that such a change would better reflect the efficient practice of the benchmark efficient firm**
3. Any changes should only **be made prospectively and not have any retrospective effects**, consistent with the proper operation of the incentive-based regulatory framework; and
4. A **cost and its tax effect must be treated consistently** – either:
   - both are outside the regulatory framework (in which case NSPs are entirely responsible for the cost and its tax consequences); or
   - both are inside the regulatory framework (in which case the cost and its tax effect fall to customers).

See worked examples to follow.

Review of regulatory tax approach

Worked examples

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Case study 1: Replacement vs. refurbishment

- Consider an asset that can be either replaced or refurbished (to an ‘as new’ standard):
  - Replacement costs $100 and can be tax depreciated over its useful life.
  - Refurbishment costs $90 and is tax deductible in the year of expense.
- Currently, both are treated symmetrically in the PTRM:
  - Both costs go into the RAB.
  - Both are tax depreciated over their useful life.
- If the refurbishment is treated as immediately deductible in the PTRM:
  - The current year cash cost will be $100 for the replacement option.
  - The current year cash cost will be $117 for the refurbishment option ($90 plus reg. tax allowance reduced by 0.3×90=$27).
- Thus, regulatory tax treatment interacts with opex/capex/totex decisions:
  - It is important that these interactions be properly understood.
  - Otherwise tax changes have the potential to drive inefficient behaviour.

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Case study 2: Non-regulatory expenditure

- Some expenditure sits outside the regulatory allowance.
- At present, the expenditure, and the tax consequences of it, are the responsibility of the NSP. Customers are not required to make any contribution.
- Examples include R&D that is outside the regulatory allowance, interest expense that exceeds the regulatory allowance and stamp duty paid on corporate transactions.
- These expenditures will result in real-world tax payments being less than the regulatory allowance for corporate tax.

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Case study 2: Example parameters

- Start with a set of example parameters.
- Nothing turns on these figures – just designed to make the conceptual point in a concrete manner.

Example parameters	
RAB	1000
Asset life	20
Annual depreciation	50
Annual opex	70
Return on equity	9%
Return on debt	6%
Gearing	60%
WACC	7.2%
Tax rate	30%
Gamma	0.4

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Case study 2: Standard PTRM regulatory allowance

PTRM regulatory allowance

	Current PTRM
RAB	1,000.00
Return on capital	72.00
Depreciation	50.00
Operating expenses	70.00
Research and development	
Tax allowance	13.17
Less value of imputation credits	-5.27
Allowed revenues	199.90

This is just the standard PTRM calculations for determining the annual revenue requirement.

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Case study 2: Regulatory tax calculations

PTRM regulatory allowance

Regulatory tax calculations

	Current PTRM
RAB	1,000.00
Return on capital	72.00
Depreciation	50.00
Operating expenses	70.00
Research and development	
Tax allowance	13.17
Less value of imputation credits	-5.27
Allowed revenues	199.90
Interest	-36.00
Depreciation	-50.00
Operating expenses	-70.00
Research and development	
Taxable income	43.90
Corporate tax	-13.17
Corp tax % of reg taxable income	30%
Corp tax % of real world taxable income	30%

Taxable income is computed by applying tax deductible expenses to the allowed revenue.

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Case study 2: Non-regulatory expense

PTRM regulatory allowance

Regulatory tax calculations

	Current PTRM	Non-reg. expense (e.g., R&D)
RAB	1,000.00	
Return on capital	72.00	
Depreciation	50.00	
Operating expenses	70.00	
Research and development		10.00
Tax allowance	13.17	
Less value of imputation credits	-5.27	
Allowed revenues	199.90	
Interest	-36.00	
Depreciation	-50.00	
Operating expenses	-70.00	
Research and development		-10.00
Taxable income	43.90	
Corporate tax	-13.17	
Corp tax % of reg taxable income	30%	
Corp tax % of real world taxable income	30%	

NSP makes $10 payment and receives $10 tax deduction. Consumers have no role in either.

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Case study 2: Real-world tax position

PTRM regulatory allowance

Regulatory tax calculations

	Current PTRM	Non-reg. expense (e.g., R&D)	Real-world tax position	
RAB	1,000.00			
Return on capital	72.00			
Depreciation	50.00			
Operating expenses	70.00			
Research and development		10.00		
Tax allowance	13.17			
Less value of imputation credits	-5.27			
Allowed revenues	199.90		199.90	
Interest	-36.00		-36.00	
Depreciation	-50.00		-50.00	
Operating expenses	-70.00		-70.00	
Research and development		-10.00	-10.00	
Taxable income	43.90		33.90	
Corporate tax	-13.17		-10.17	
Corp tax % of reg taxable income	30%		23%	10.17 ÷ 43.90
Corp tax % of real world taxable income	30%		30%	10.17 ÷ 33.90

Allowed revenue is unchanged. NSP deducts its cost for real-world tax purposes.

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