

29 June 2018



Network Finance and Reporting Branch
Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601

Via email: rateofreturn@aer.gov.au

**Response to additional AER and Australian Taxation Office materials -
estimating the value of imputation credits**

Dear Mr Anderson,

Energy Networks Australia (ENA) welcomes the opportunity to provide this brief further submission to the Australian Energy Regulator's Rate of Return Guideline Review on issues related to the estimation of the value of dividend imputation tax credits (gamma).

This submission concerns the use of Australian Taxation Office (ATO) tax statistics for the purpose of estimating a 'utilisation' gamma defined as the ratio of credits redeemed to credits created.

Energy Networks Australia has previously submitted a short note prepared by Dr Neville Hathaway, dated 12 December 2017. In that note, Dr Hathaway concludes that the ATO's records of credits redeemed (i.e. credits utilised against Australian tax obligations) and credits created is reliable and, consequently, a utilisation gamma can be reliably estimated as the ratio of those two quantities. He recognises that there are difficulties in reliably estimating credits distributed from the ATO data in that the two available methods (the 'dividend' and 'franking account balance (FAB)' methods) produce different estimates. However, he notes that the estimate of gamma does not require an estimate of dividends distributed, so any difficulty in estimating that quantity is irrelevant to the estimation of gamma.

Since that submission the AER has:

- » Published a brief AER staff note that documents discussions it has had with ATO staff, dated 29 March 2018;
- » Published a brief note prepared by ATO staff, dated 10 April 2018;

- » Commissioned and published an expert report prepared by Dr Martin Lally dated 7 May 2018, which considers, among other things, the use of ATO tax statistics; and
- » Convened a telephone conference with representatives from the ATO Revenue Analysis Branch, held on 21 June 2018. AER staff and advisors and ENA members and advisors participated in that conference.

ENA has asked Dr Hathaway to consider this material and to provide a short response in relation to them. The terms of reference and Dr Hathaway's response are attached to this submission.

Dr Hathaway concludes that none of the information in the new material commissioned by the AER leads him to change the view stated in his previous note that a utilisation gamma can be reliably estimated as the ratio of credits redeemed to credits created.

Concerns relate to Franking Account Balance data

Dr Hathaway notes that the majority of the points raised in the AER and ATO notes relate to explanations about why it would be unsafe to rely on FAB data when estimating credits distributed. This, however, has no impact at all on either of the quantities that are required to estimate a utilisation gamma – being credits redeemed and credits created. During the ATO telephone conference, ATO staff set out a number of reasons why the FAB data should not be relied upon including:

- » The FAB data is an 'information label' field that does not feed into any tax calculation. The data in such fields can be unreliable.
- » Using aggregated data related to the imputation system from taxation statistics, including FAB, net tax amounts, dividends etc., in a time series analysis doesn't allow for entries and exits (e.g. corporate transactions and events). For example, a firm may build up a franking account balance over some years and then liquidate, resulting in the elimination (not the distribution) of those credits; and
- » It is difficult to track credits through group structures.

In his attached note, Dr Hathaway concludes that, if the ATO data *is* to be used to estimate dividends distributed, the 'dividend' method should be adopted in preference to the FAB approach. The dividend method is the standard approach that produces the 70% figure that has been used for many years in Australian regulatory determinations.

During the ATO telephone conference, ATO staff noted that the data on credits created and credits redeemed is more reliable than FAB data. No issues at all were raised in relation to the data on credits redeemed. Two minor issues were raised in relation to the data the ATO publishes in relation to credits created:

- » The ATO publishes data on tax owed rather than tax paid (which is what gives rise to the creation of credits). Previous indications provided were that

differences may not be material. This would need to be compared with the accuracy of alternative approaches such as the equity ownership method.¹

- » Some tax paid does not create imputation credits because it is paid by non-resident companies. The AER notes that the amounts in question appear to be small. Dr Hathaway has further investigated this issue and confirms, in the attached note, that the amounts in question are indeed immaterial.

Implications for the Lally (2018) report

The concerns that have been expressed in relation to the reliability of the FAB data also have an impact on the approach of estimating the distribution rate using the 20-firms approach advocated by Dr Lally. That approach is based on a comparison of credits distributed (as attached to dividends) with the change in the reported FAB over the relevant period. Thus, issues relating to the reliability of approaches that are based on reported FAB data would need to be considered when determining the weight to be applied to the Lally 20-firms approach. For example, the ATO note states that:

It would be difficult to use this data to reconstruct franking accounts due to the dynamic nature of the tax system as it impacts on business.²

One example provided by the ATO is:

Churn within consolidation groups.³

That is, some credits are extinguished without being distributed to shareholders. An example of the BHP dividend equalisation scheme was provided in this regard during the AER's Concurrent Evidence Session.

As noted in our submission of 30 April 2018, ENA has concerns about the Lally 20-firms approach because:

- » The firms in question are not representative of either of the relevant characteristics of the BEE, being that it is a highly-levered, capital intensive firm providing access to its infrastructure assets operating wholly within Australia;
- » The approach is affected by the general problem of the difficulty of estimating the distribution rate for an individual firm (this is the point raised in the ATO note); and
- » A number of issues and inconsistencies relating to the Lally estimates have been identified and are not yet resolved.

¹ The ENA submission to the AER's Issues Paper sets out a number of problems and inaccuracies with the equity ownership method.

² ATO Note, p. 1.

³ ATO Note, p. 1.

In his report of 7 May 2018, Dr Lally considers the imputation credit distribution rate for five comparator firms: APA, Ausnet, DUET, Envestra, and Spark.⁴ However, there are a number of problems with this analysis:

- » Dr Lally is unable to find the required FAB information in relation to three of those firms, although for one of those firms he *assumes* a closing FAB and proceeds on that basis.
- » For one of the two remaining firms, he replaces his empirical estimate of the distribution rate with his assessment of what he considers the distribution rate would have been if the company in question had adopted what he considers to be more efficient behaviour.
- » For the one remaining firm (Ausnet), Dr Lally concludes that the distribution rate must be 1 because the 2017 FAB is less than the 2007 FAB. However, Ausnet annual reports reveal that the FAB increased materially from \$10.3 million in 2006 to \$28.6 million in 2007 to \$51.2 million in 2016. The FAB recorded for 2017 is -\$26.4 million. The cause of this large reduction in the FAB is *not at all* related to the distribution of credits. Rather, it is due to Ausnet receiving a large tax refund during that financial year. The 2017 Ausnet Annual Report highlights:

The reduction in franking credits that will arise from the receipt of tax refund for FY2017 from the ATO⁵

and notes that:

The refund for FY2017 arises primarily from increased deferred tax resulting from differing tax and book depreciation profiles.⁶

This serves to highlight the dangers of using a high-level analysis of FAB data to estimate the distribution rate for any firm. Not every reduction in the FAB is caused by the distribution of credits. Moreover, a materially different estimate of the distribution rate would be obtained if the sample period had started one year earlier (2006) or finished one year earlier (2016).

For the reasons set out above, ENA considers that:

- » The ATO data on credits redeemed and credits created is reliable and can be used to produce a direct estimate of a utilisation gamma.
- » If an estimate of the distribution rate is required, the 'dividends' approach should be used due to complexities that make the FAB approach unreliable.
- » The Lally 20-firms approach should not be used to estimate the distribution rate due to its reliance on FAB figures, and for the other reasons set out above.

⁴ Lally (2018), pp. 19-20.

⁵ Ausnet 2017 Annual Report, p. 107.

⁶ Ausnet 2017 Annual Report, p. 107.

ENA looks forward to further constructive engagement with your team and opportunities for input as your review of this issues progresses.

If you should wish to discuss any of the issues raised in this letter or ENA's responses any further please contact me on (02) 6272 1507.

Yours sincerely,



General Manager, Economic Regulation

