Review of regulatory tax approach

Response to AER Issues Paper

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Energy Networks Australia

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1 Overview

Key messages

- Energy network businesses are keen to contribute to the review and to reach an outcome where consumers can have confidence that current and future consumers are not paying regulatory allowances for tax that are above that required.
- Australia's incentive based regulatory framework avoids consumers paying any costs above those that would be incurred by an efficient benchmark firm.
- This approach avoids customers paying different charges, or incurring network price rises driven simply by changes in the ownership of networks or firms' actual tax arrangements.
- There are a range of drivers of differences between benchmark regulatory tax allowances and actual tax paid – critically, the most significant of drivers reflect costs asset owners incur that are not compensated in any way through the benchmark regulatory allowance.
- Movement to approaches of matching regulatory tax allowances to actual tax paid would be inconsistent with incentive-based regulatory approaches and introduce perverse investment and operation incentives for networks.
- The review should focus on estimating the corporate tax that would be paid by the benchmark efficient entity, within the context of the Australian regulatory framework.

Energy Networks Australia (ENA) welcomes the opportunity to contribute to the AER's review of its regulatory taxation approach.

Australia has adopted an incentive-based framework for regulating natural monopoly infrastructure assets. Within this framework, the regulator sets allowed revenues to reflect benchmark efficient costs. The outcomes of this overall approach are that:

- consumers pay no more if actual expenses are higher than the benchmark efficient allowance;
- regulated businesses are incentivised to conduct their businesses more efficiently than the benchmark; and
- consumers pay no more if the ownership of the regulated asset changes, even at a price in excess of the regulatory asset base.

Under incentive-based regulation, asset owners are free to depart from regulatory benchmarks, but consumers are not required to pay for any such departures.

The AER and ATO have identified a number of reasons for differences between actual tax paid and the regulatory tax allowance. The majority of these reasons relate to payments being made by network owners that go beyond the benchmark efficient regulatory allowance, and which are therefore uncompensated in that they are not included in AER allowed revenues.

Such payments include additional interest expenses (whether due to a higher quantum of debt or a higher interest rate), additional research and development expenses, and stamp duty. None of these are included in AER allowed revenues.

In these cases, since the asset owner bears the cost in its entirety, any tax deduction in relation to it should also flow to the asset owner. It would be inconsistent with the coherent operation of an incentive-based regulatory system for an asset owner to bear the full cost of such a payment, and then to pay again in relation to the tax deductibility of that payment.

That is, it would clearly not be appropriate to *reduce* the regulatory allowance in relation to a payment made entirely by the asset owner and to which consumers did not contribute. Similarly, it would be inconsistent and incorrect to consider a reduction in tax paid in isolation, while ignoring the fundamental driver or cause of that reduction (e.g. an uncompensated increase in interest payments and/or stamp duty costs).

On the basis of its highly qualified analysis, the ATO identifies four main drivers for differences between regulatory tax allowances and aggregate tax paid. The AER Issues Paper identifies other possible drivers. Such differences are expected under an incentive-based regulatory framework and the fact that a divergence exists does not of itself indicate there is a problem. Rather, to identify any issues to address the reason for any differences must be fully identified and considered.

Reasons that do not relate to the amount of tax that would be paid by the benchmark efficient entity are not relevant to the regulatory task of setting a regulatory allowance for tax under the National Electricity and Gas Rules. A change to the regulatory allowance should only be made if there is strong evidence that the allowance differs from the benchmark efficient cost of tax.

A number of significant adverse consequences and practical problems would arise if the regulatory tax allowance were changed from a benchmark efficient cost of tax to an alternative approach, such as regulatory pass-through of the actual cost of tax. This approach would result in:

» **Inconsistency with incentive framework –** for example, by customers being required to pay more where a highly efficient firm was able to exceed regulatory benchmarks and targets.

» **An inconsistent standard between regulatory cost allowances -** Using an actual cost of tax would be inconsistent with other regulatory cost allowances.

» **Customer price differentials based purely on corporate transactions -** Using the actual cost of tax would result in customers of different networks paying different prices depending upon corporate transactions involving their networks.

» **Added complexity and cost -** Collecting information on actual tax paid would be extremely complex as many network businesses have multiple upstream owners with varying tax profiles. Collecting information to identify who they are and what tax they paid in relation to their investment in the asset would be near impossible for some of the network assets owners (e.g. an infrastructure fund that holds a 10% interest in the network may have 50 equity investors). Further complications would arise if there was a change of any ownership during any year.

- Potential retrospective impact – Long-lived private sector investments in network businesses have been made on the reasonable expectation that the Australian regulatory framework of incentive-based regulation would be maintained, reflected by, for example, the establishment of guiding Revenue and Pricing Principles and the National Electricity and Gas Objectives.

An example of the perverse consequences for network innovation will illustrate some of these impacts, with consideration of any research and development expenditure that is not included as a benchmark efficient cost. This expenditure is borne entirely by the network, with the intention of benefitting consumers in the future via a reduction in costs or improvement in the level of service. That expenditure also provides the network with a tax deduction, reducing actual tax paid. If the research and development cost itself remains uncompensated, but the benefit of the tax deduction is passed through to consumers, the net effect of an actual tax paid approach is that the network has funded that expense in full, and would receive a lower regulatory allowance for having done so (via a reduction in the corporate tax allowance), compared to a business that had not undertaken this activity.

2 Review context and approach

2.1 Preliminary high-level findings

The AER released an initial Issues Paper in relation to its review of regulatory tax allowances on 15 May 2018, providing stakeholders with 12 business days to make submissions.

The Issues Paper was accompanied by some initial high-level analysis that has been conducted by the ATO pertaining to the 2013-2016 tax years. This analysis is presented in the form of a three-page note. The ATO warns that:

> *It should be noted that we made some assumptions and exclusions in undertaking this comparative analysis due to limitations in the data available* [1]

and that:

> *We are only able to provide limited information to you.* [2]

Significantly, the ATO notes that where entities conduct a mixed businesses, or operate within a consolidated group, the ATO has either apportioned the data "on a reasonable basis where possible to attempt to isolate the electricity distribution businesses" or excluded the entity from the aggregated amounts. No further information is given, but this apportionment and exclusion could be having a material impact on the results.

Subject to these limitations, the ATO concludes that:

- For private sector networks, actual tax payments are generally lower than the regulatory tax allowance; and
- For state-owned networks, the national tax equivalence regime (NTER) payments are generally higher than the regulatory tax allowance.

2.1.1 Reasons for lower tax paid by private sector entities

The ATO note identifies four main reasons driving the lower actual tax payments made by private sector entities:

- Higher interest expense:
  - If the firm has issued debt beyond 60% of the RAB, its actual interest expense may exceed the allowed regulatory interest expense. This does not result in any increase to allowed revenues, but provides the firm with a larger tax deduction.

[1] ATO Note, p. 1.
[2] ATO Note, p. 3.

- Higher depreciation expense:
  - Regulated firms may adopt accelerated depreciation methods, use shorter asset lives, or utilise the low value asset pool method to write off some assets to increase depreciation expense.
- Tax loss carry-forwards:
  - Tax paying entities may have available tax losses carried forward which reduce taxable income. The AER notes that its model recognises prior tax losses, but at present no network service providers were expected to accrue tax losses.
- Structures that pass tax obligations through to investors:
  - Under stapled security and partnership structures, profits that are generated in the relevant trust or partnership are passed through to investors and taxed at the investor's marginal tax rate.

2.1.2 Reasons for higher tax paid by state-owned entities

The ATO note provides two explanations for why state-owned entities may have actual tax payments in excess of the regulatory allowance:

- They do not tend to engage in the activities set out above for private sector entities; and
- The ATO "suspects"[3] that they may have more conservative tax positions (e.g., being less likely to claim R&D tax deductions).

2.2 Is there a problem to fix?

From public statements surrounding the commencement of the review, and some of the initial consultation materials, the implication could be drawn that there is a problem in that the actual tax payments of regulated entities differ from the AER's benchmark efficient tax allowance. However, differences between actual costs and benchmark efficient allowances are to be expected in an incentive-based regulatory framework where allowed revenues are set to compensate regulated businesses for benchmark efficient costs, and no more.

Indeed, under incentive-based regulation, *every* actual cost will differ from the regulator's benchmark efficient allowance. If this is viewed as a problem to be fixed, the obvious solution is to move to a cost-plus regulatory approach whereby the regulated firm recovers its actual costs plus a fixed margin. Under that model, the regulatory allowance is always equal to the actual cost.

However, the Australian regulatory system is based on the incentive-based model where allowed revenues are set to compensate regulated businesses for benchmark efficient costs. The reasons for the adoption of that framework are set out in the subsequent section. Within this framework, the key question is whether the regulatory

[3] ATO Note, p. 1.

allowance is above or below the benchmark efficient cost. In the case at hand, the question is whether the benchmark efficient firm would pay more or less tax than the regulatory allowance. There are at least two scenarios in which a group of firms (private sector entities) might have actual tax payments that are lower than the regulatory allowance:

- The firms in question are all operating in accordance with all regulatory benchmark assumptions but are paying less tax than the regulatory allowance. In this case, the benchmark efficient cost of tax (which is the tax that would be paid by a firm following all regulatory benchmark assumptions) would appear to be lower than the regulatory allowance. If this is the case, the regulatory allowance should be adjusted to match the benchmark efficient cost.
- The firms in question have departed from the regulatory benchmark assumptions in a way that involves them incurring (tax deductible) costs in excess of the regulatory allowance. Those additional costs are not compensated in the Australian regulatory framework and must be borne entirely by the regulated entity. Since these additional costs are paid for entirely by the asset owner, any tax effect relating to it also pertains entirely to the asset owner. In the Australian framework, neither the additional costs, nor their tax effect, have anything to do with the regulatory bargain between the asset owner and consumers. Prices do not change and consumers are protected from these additional costs and pay only for the efficient costs of the benchmark efficient entity, and no more.

In summary, the appropriate policy or regulatory response will depend on the reason why actual tax payments differ from the regulatory allowance. If the difference occurs because the benchmark efficient firm would pay less tax than the regulatory allowance (i.e., the estimate of the tax allowance does not reflect the benchmark efficient tax costs) the regulatory allowance should be adjusted. But if the difference arises due to the firms bearing costs beyond the regulatory allowance (i.e. unrelated to the benchmark efficient approach) there is no reason to adjust the regulatory tax allowance. Under incentive-based regulation, those additional costs (and the tax impacts of them) are entirely up to the regulated firm to bear and manage and have nothing to do with benchmark efficient regulatory allowances or prices paid by consumers.

Consequently, it would be wrong to observe a difference between an actual cost and the relevant regulatory allowance and to immediately conclude that the regulatory allowance or the approach to estimating the allowance should be adjusted. Indeed, under an incentive based framework the expectation is that there will be a difference.

The reason for the difference must be identified. A change to the regulatory approach should only be made if there is strong evidence that the regulatory allowance differs from the benchmark efficient cost.

The following section of this submission demonstrates that the initial purchase of private sector assets often results in actual interest expense being greater than the regulatory allowance and deductions being available for stamp duty costs. Under the Australian regulatory framework, the asset owner receives no compensation for these additional costs – the additional costs (and their tax effects) are outside the framework of benchmark efficient allowances. The higher interest expenses identified by the ATO for private sector businesses (and stamp duty costs) can arise as a by-product of the very transaction that resulted in those businesses becoming private sector businesses. This is also consistent with the observation that there are no such additional expenses (i.e. arising from the purchase of network assets) for state-owned businesses.

2.3 The objective in setting the corporate tax allowance

ENA considers that it is important for this review to carefully distinguish between matters that are relevant to estimating the amount of corporate tax paid by the benchmark efficient entity (and which are therefore relevant to this review) and those that are not.

ENA considers that costs that are beyond the benchmark efficient allowance (and which are therefore excluded from allowed revenues), but which might create tax deductions for an asset owner that bears those costs in full, to be irrelevant to the question of tax paid by the benchmark efficient entity.

In this regard, the AER's Issues Paper notes that the NER and NGR state that the estimated cost of corporate income tax must be computed using an estimate of the taxable income that would be earned 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.[4]

2.4 Can we use benchmark efficient costs for everything else, but a pass-through for corporate tax?

The Australian regulatory framework is based on the NSP being able to recover benchmark efficient costs. This applies to all costs, including corporate tax. As noted above, the Rules in relation to corporate tax are based around the taxable income that would be earned by a benchmark efficient entity operating the business – with a benchmark efficient regulatory allowance and benchmark efficient costs.

Under this framework, any costs that a particular NSP might bear that are in excess of the benchmark efficient allowance are a matter for them. They are entirely up to the regulated firm to bear and manage and have nothing to do with benchmark efficient regulatory allowances or prices paid by consumers. From time to time, Australian tax law allows some of those costs to be tax deductible. However, it would be very odd indeed for the benefit of that tax deduction to be passed through to consumers (via a lower corporate tax allowance), when those consumers have made no contribution at all towards the cost that generated that deduction. Symmetrically, it would be just as odd for consumers to be asked to pay a higher corporate tax allowance to the extent

[4] AER Issues Paper, p. 19; NER cl. 6A.6.4; NGR r. 87A.

that an NSP is able to beat a regulatory cost allowance and consequently increase its profits.

Perhaps the best example here is any research and development expenditure that is not included as a benchmark efficient cost. This expenditure is borne entirely by the NSP, with the intention of benefitting consumers in the future via a reduction in costs or improvement in the level of service. Of course, that expenditure also provides the NSP with a tax deduction, reducing actual tax paid. If the research and development cost itself remains uncompensated, but the benefit of the tax deduction is passed through to consumers, the net effect is that the NSP has funded that expense in full, and receives a lower regulatory allowance for having done so (via a reduction in the corporate tax allowance). By contrast, customers in these circumstances would pay nothing for the R&D, receive the future benefit of it for free, and also receive (in effect) an up-front payment as well.

Such a framework clearly makes no economic sense, which is why the Australian model (which is reflected in the Rules) has always been to set the regulatory allowance in relation to the efficient costs of a benchmark efficient entity.

3 Incentive-based regulation and the benchmark efficient entity

- Australia has adopted an incentive-based framework for regulating natural monopoly infrastructure assets.
- Within this framework, the regulator sets allowed revenues to reflect benchmark efficient costs.
  - Consumers pay no more if actual expenses are higher than the benchmark efficient allowance.
  - Regulated businesses are incentivised to conduct their businesses more efficiently than the benchmark.
  - Consumers pay no more if the ownership of the regulated asset changes, even at a price in excess of the RAB.
- It is inconsistent to consider any benchmark allowance in isolation. For example, it would be wrong to consider a reduction in corporate tax paid in isolation, while ignoring the cause of that reduction (e.g., an uncompensated increase in interest payments and/or stamp duty costs):
  - Under incentive-based regulation, asset owners are free to depart from regulatory benchmarks, but customers are not required to pay for any such departures.
  - For example, an asset owner is free to incur interest expense in excess of the regulatory allowance, but any such excess (including its tax effect) is irrelevant to the regulatory allowance.
- Similarly, if a regulated asset sells at a price above the RAB:
  - Stamp duty will be incurred; and
  - Interest expense increases (as more debt finance is required to fund the higher purchase price); in which case
  - Taxable income, and consequently tax paid, is reduced, but, importantly
  - Allowed revenues and prices are unchanged.
- The higher interest expenses identified by the ATO for private sector businesses (and tax loss carry-forwards due to stamp duty costs) can arise as a by-product of the very transaction that resulted in those businesses becoming private sector businesses. This is also consistent with the observation that there are no such additional expenses for state-owned businesses.

3.1 The Australian regulatory framework

3.1.1 Incentive-based regulation

In Australia, the framework for regulating natural monopoly infrastructure assets is based on incentive regulation relative to an efficient benchmark. The regulator determines the approach that a benchmark efficient entity (BEE) would take to financing and operating the asset in question and the regulatory allowance is set accordingly. This creates an incentive for regulated firms to operate as efficiently as possible. In particular, if the actual cost incurred by a regulated firm exceeds the benchmark efficient allowance, the excess is borne by the firm – consumers pay only for the efficient level of costs and nothing more. The setting of regulatory allowances by reference to an efficient benchmark incentivises the regulated firm to meet or outperform the benchmark.

The alternative is 'cost-plus' regulation, whereby the regulated firm recovers all of its actual costs, plus a fixed profit margin. In this case, there is no real incentive for the firm to minimise costs or to operate efficiently. Consumers pay for all of the actual costs incurred by the firm, regardless of the efficiency of those costs.

The incentive based approach applies to all elements of the building block framework applied in Australia, for example:

» The rate of return is currently estimated by reference to the efficient financing costs of the benchmark efficient entity with a similar degree of risk to the service provider. The rate of return is not estimated by reference to the service providers' actual financing costs.

» Operating expenditure allowances are assessed by reference to the efficient costs that a benchmark efficient operator would require.

» Capital expenditure forecasts are similarly assessed by reference to efficient costs of a benchmark efficient operator.

The cost of corporate tax is no different, and is estimated by reference to benchmark efficient costs. The benchmark efficient cost of tax is, by definition, the tax that would be paid by a firm following all regulatory benchmark assumptions.

The driver towards promoting efficient investment and operation of regulated networks and recovery of only efficient costs is also reflected in the overarching national electricity objective and national gas objective and the revenue and pricing principles.

3.1.2 RAB roll-forward

Another key plank in the Australian incentive-based regulatory framework is the approach taken to locking in and rolling forward the regulated asset base (RAB). Under this framework, the regulator sets an initial RAB (or it is set by the National Electricity Rules), which is then increased according to inflation and to reflect new capital expenditure, and decreased to reflect depreciation.

Importantly, any corporate transaction relating to the regulated assets has no effect on the value of the RAB, or allowed revenues, or prices paid by consumers. If, for example, a regulated firm with a $1,000 RAB sells in a corporate transaction for $1,200, there is no marking-to-market – the RAB remains at $1,000 and allowed returns are based on that same $1,000 RAB.

3.1.3 Regulatory allowances are unaffected by corporate transactions

An important outcome of the Australian regulatory framework is that corporate transactions relating to the ownership of regulated assets have no effect on allowed revenues or the price that consumers pay. Consider, for example, two network business that are identical in all respects, except that one is the subject of a corporate transaction that involves a new owner purchasing the asset for 1.2 times the RAB.

Under the Australian regulatory framework, allowed revenues will be the same for both networks and the corporate transaction has no effect on the prices that consumers will pay. Because the networks are identical in all respects, the regulator's estimate of the efficient cost of operating the network will be the same. And because the RAB is independent of any corporate transactions, it will remain the same for both networks, and consequently the allowances for depreciation and the return on capital will be identical for both networks.

Similarly, the regulatory allowance for corporate tax will be identical for the two networks. This is because the allowed return on capital, allowed depreciation, and the allowances for efficient operating costs are identical across businesses – so taxable income and the allowance for corporate tax are also identical across networks.

As noted above, the benefit of this approach is that corporate transactions such as privatisations will not have an impact on how the building block allowances, and therefore prices paid by customers, are derived. In addition, the incentive properties in the framework encourage service providers to operate more efficiently in order to outperform the benchmarks, to the benefit of the service provider and consumers.

3.2 Asset owners are free to depart from the regulatory benchmark

Under incentive-based regulation, the regulatory allowance is set according to efficient benchmark costs. Asset owners are free to depart from the regulatory benchmark, but any such departure (including its tax effect) is irrelevant to the regulatory allowance. For example, an asset owner is free to adopt gearing in excess of the 60% regulatory benchmark, which is likely to have the effect of increasing interest expense beyond the regulatory allowance. However, any such excess (including its tax effect) has no effect on the regulatory allowance nor the price paid by consumers.

If consumers were being asked to pay for the increase in interest expenses, it would be appropriate to offset the reduction that this would cause to corporate tax payments. However, consumers rightly do not contribute anything towards the increase in interest expense – and since that increase is paid for entirely by the asset owner, any tax effect relating to it also pertains entirely to the asset owner. Neither the additional interest, nor its tax effect, have anything to do with the regulatory bargain between the asset owner and consumers – which is for consumers to pay for the efficient costs of the benchmark efficient entity, and no more.

As noted above, the benchmark efficient cost of tax is, by definition, the tax that would be paid by a firm following all regulatory benchmark assumptions. The fact that a firm that has costs that are *in*consistent with the regulatory benchmark assumptions also has a cost of tax that is inconsistent with the regulatory benchmark is not surprising and a function of the benchmark approach.

3.3 Why do asset sales sometimes reduce actual corporate tax paid?

3.3.1 Current taxation rules

Higher interest expense and stamp duty costs

Under current taxation rules,[5] when a regulated asset is sold for a price that exceeds the RAB, there are two impacts on actual corporate tax paid:

1. Stamp duty - Stamp duty must be paid on the transaction, and this duty can be deductible in the year of purchase in relation to a long-term lease.
2. Interest - The annual interest expense will be higher than the regulatory allowance for interest. This is because the purchase price exceeds the RAB, so the amount of debt financing (interest paid) will exceed the benchmark efficient estimate of the amount of debt required to finance the asset in question.

It is important to note that the new asset owner is not compensated for either of these additional expenses in regulatory allowances. Allowed revenues, and consumer prices, are not adjusted to reflect the fact that the new owner has paid a higher price for the asset and that the higher capital investment must be recovered over the life of the asset via higher depreciation expense. They are also not adjusted to reflect the fact that the new owner has needed to raise more debt finance to finance the higher capital investment and this in turn results in higher interest expense. Similarly, they are not compensated for any stamp duty associated with the transaction.

Under the Australian incentive-based regulatory framework, these additional expenses are uncompensated because they are firm specific and outside of the benchmark efficient costs. In the context of asset sales, potential purchasers understand that these additional expenses will go uncompensated and that is reflected in the price that is bid for such assets.

Due to the fact that post-transaction interest expenses are higher and stamp duty may be deductible, and because allowed revenues are held constant, taxable income will be reduced and tax paid will be reduced. But for the reasons outlined above, this does not indicate a problem. Indeed, it would be perverse for an asset owner to bear the full cost of such a payment, and then to pay again in relation to the tax deductibility of that payment. That is, it would make little sense to *reduce* the regulatory allowance in relation to a payment made entirely by the asset owner from which consumers are protected and not required to contribute.

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[5] Current rules have applied since 2001 under Division 58 of the Income Tax Assessment Act.

Illustrative example of the effects of a corporate transaction

To understand the effects of a corporate transaction on actual corporate tax payments, consider a simple illustrative example with parameters set out in Table 1 below.

Table 1: Parameters for tax allowance illustrative example

Parameter	Regulatory allowance
RAB	1,000
Asset life	20
Annual depreciation	50
Annual capital expenditure	50
Annual opex	70
Return on equity	9%
Return on debt	6%
Gearing	60%
WACC	7.2%
Tax rate	30%
Gamma	0.4

Source: Sample estimates for illustrative purposes.

Under the Australian regulatory framework (i.e. when inserted into the AER's Post Tax Revenue Model) the parameters summarised in Table 1 above produce the regulatory allowances that are set out in Table 2 below.

Within this framework, the allowed revenue is set equal to the sum of the four 'building block' allowances – all of which are based on the regulator's estimate of benchmark efficient costs.

Taxable income is then set equal to the allowed revenue less the regulator's estimate of those benchmark efficient costs that are tax deductible.

Table 2: Calculations for tax and return allowances illustrative example: Pre-transaction

Parameter	Regulatory allowance	Source
RAB	1,000.00	Given
Return on capital allowance	72.00	7.2%×1,000
Depreciation allowance	50.00	1,000/20
Operating expense allowance	70.00	Given
Tax allowance	77.90	Solved in PTRM
Allowed revenues	199.90	Sum of above four building blocks
Interest	-36.00	6%×60%×1,000
Depreciation	-50.00	As above
Operating expenses	-70.00	As above
Taxable income	43.90	Sum of above four items
Corporate tax	**-13.17**	**30%×43.90**
NPAT	30.73	43.90-13.17
Add back depreciation	50.00	As above
Less capex	-50.00	Given
Regulatory cash flow to equity	30.73	Sum of the above three items
Value of imputation credits	5.27	0.4×13.17
Return to equity ($)	36.00	Sum of above two items
Return on equity (%)	9.00%	36/(0.4×1,000)

Source: Calculations consistent with PTRM.

Now suppose that the above asset is sold for a price equal to 1.2 times the RAB. In this example, the required return on equity and debt for the new owners are identical to the regulatory allowance, and the new owners continue to adopt 60% gearing on a market value basis. The source of additional value (leading to a RAB multiple above 1) might include, for example:

- payments from improved network performance or cost efficiencies being forecast to be higher under private sector ownership;
- the new owner might consider that it will be able to extract value from the development of unregulated assets alongside the regulated network; and
- the new owner might consider that it is better able to exploit future growth opportunities.

The RAB multiple of 1.2 results in the purchase price of the asset being 1,200, of which 62.56 represents stamp duty (being 5.5% of the net purchase price of 1,137.44). This means that debt financing increases to 60%×1,200=720, with a consequential increase in interest expenses.

Under incentive-based regulation, the purchaser receives no compensation for paying a purchase price above the RAB, no compensation for stamp duty, and no compensation for any additional interest expenses. None of these things have any effect on the efficient regulatory allowance or on prices. The allowed revenues are based on the RAB, which does not change as a result of the transaction, and regulatory allowances are based on efficient regulatory benchmarks rather than on actual costs incurred.

The equivalence of the regulatory allowed revenues pre-transaction and post-transaction is illustrated in the first six rows of Table 3 below.

Table 3: Calculations for tax and return allowances illustrative example: Post-transaction under current tax rules

Parameter	Regulatory allowance	Source
RAB	1,000.00	Unchanged
Return on capital allowance	72.00	Unchanged
Depreciation allowance	50.00	Unchanged
Operating expense allowance	70.00	Unchanged
Tax allowance	77.90	Unchanged
Allowed revenues	199.90	Unchanged
Interest (actual)	-43.20	6%×60%×1,200 (Higher due to more debt)
Depreciation (actual)	-50.00	Unchanged
Operating expenses	-70.00	Unchanged
Stamp duty	-62.56	5.5% of net purchase price
Taxable income	-25.86	Sum of above five items
Corporate tax	0	**Negative taxable income**
Tax loss carry-forward	25.86	Negative taxable income above

Source: Calculations consistent with PTRM and current tax rules.

Table 3 shows that actual taxable income has been reduced because:

- Allowed revenues have been held constant;
- Interest expense is higher; and
- Stamp duty is deductible in full in the year of purchase.

The result of the transaction is that actual taxable income in the year of purchase is negative, so no actual corporate tax will be paid. Moreover, because taxable income is negative, there will be tax loss carry-forwards that can be offset against future tax obligations.

It is important to recognise that the additional tax deductions arise in relation to expenses that are borne by the new owner that are not compensated under the regulatory regime – the regulatory allowed revenues are unchanged by the transaction. These are additional uncompensated expenses that are borne entirely by the new owner, and under Australian tax law those additional expenses are tax deductible. As the asset owner is entirely responsible for bearing these additional costs, they are also entitled to the tax deduction in relation to them.

3.3.2 Previous taxation rules

A number of network businesses were sold under the taxation rules that applied prior to 2001. Under those rules, there was no up-front deduction in relation to stamp duty, but the new owner was allowed depreciation deductions based on the purchase price of the asset. In the context of the previous example an asset with a RAB of 1,000 and asset life of 20 years receives a depreciation allowance of 50 per year. If that asset was sold for 1,200:

- The allowed revenues under the regulatory framework would be unchanged – because corporate transactions have no effect on regulatory allowances or consumer prices under the Australian framework; and
- The new owner is entitled to depreciation deductions of 1200/20 = 60 per year. That is, the additional 200 cost that the new owner paid to acquire the asset (and to which consumers make no contribution) can be deducted over the life of the asset.

The calculations in relation to this example are set out in Table 4 below. The table shows that the benchmark efficient regulatory allowance is unchanged. This is because the fact that this asset was the subject of a particular transaction has nothing at all to do with the amount of corporate tax that would be paid by the benchmark efficient entity.

The new owner pays more interest than the benchmark efficient allowance and has paid 200 more than the benchmark efficient allowance for the return of capital. Consumers are not asked to contribute to either of these expenses as they go beyond the regulatory estimate of benchmark efficient costs. Consumers pay precisely what they would have paid if the transaction had not occurred. Under the Australian regulatory framework, the additional costs (in excess of the benchmark efficient allowance), and any tax effects relating to them, are entirely a matter for the new owner to fund.

As noted above, it would be perverse and asymmetric for an asset owner to bear the full cost of these additional payments, and then to pay again in relation to the tax deductibility of those payments by *reducing* the regulatory allowance in relation to a payment made entirely by the asset owner and to which consumers did not contribute.

Table 4: Calculations for tax and return allowances illustrative example: Post-transaction under pre-2001 tax rules

Parameter	Regulatory allowance	Source
RAB	1,000.00	Unchanged
Return on capital allowance	72.00	Unchanged
Depreciation allowance	50.00	Unchanged
Operating expense allowance	70.00	Unchanged
Tax allowance	77.90	Unchanged
Allowed revenues	199.90	Unchanged
Interest (actual)	-43.20	6%×60%×1,200 (Higher due to more debt)
Depreciation (actual)	-60.00	1200/20
Operating expenses	-70.00	Unchanged
Taxable income	26.70	Sum of above four items
Corporate tax	8.01	Lower than pre-transaction base case

Source: Calculations consistent with PTRM and pre-2001 tax rules.

3.3.3 Summary of impact of corporate transactions

The key point being made in this section is that corporate transactions may result in new asset owners making payments in excess of the benchmark efficient regulatory allowance.

Under the Australian regulatory framework, customers are not asked to make any contribution to those additional costs – the new owner bears those costs in full. From time to time, Australian tax law allows some of those costs to be tax deductible. That all occurs outside the regulatory framework because the benchmark efficient entity would not bear those costs.

If it is considered that those costs should *not* be tax deductible, that is a matter for the *Income Tax Assessment Act* – it is not something that should be addressed in the regulatory framework for regulated firms only. It is certainly not something that should be addressed by abandoning the Australian framework of setting regulatory allowances to reflect the efficient costs of the benchmark efficient entity.

3.4 The implications of changing to an actual tax allowance

A number of issues would arise if the regulatory tax allowance were changed from a benchmark efficient cost of tax to an actual cost of tax:

- Inconsistency with incentive framework - Using actual cost of tax would be inconsistent with the incentive-based regulatory framework, as set out above.
- Inconsistent standard between regulatory cost allowances - Using an actual cost of tax would be inconsistent with other regulatory cost allowances. As noted above, it would be inconsistent to adopt one figure for interest costs when setting the allowed return on debt (benchmark efficient interest costs) and to adopt a different figure for the same item when setting the corporate tax allowance (actual interest costs).
- Complexity and information limitations - Collecting information on actual tax paid would be extremely complex as many network businesses have multiple upstream owners with varying tax profiles. Collecting information to identify who they are and what tax they paid in relation to their investment in the asset would be near impossible for some of the network assets owners (e.g. an infrastructure fund that holds a 10% interest in the network may have 50 equity investors). There would then be further complications if there was a change of ownership during the year or if there was an amendment to the tax return in respect of taxes paid by an equity investor.
- Potential retrospective impact – Long-lived private sector investments in network businesses have been made on the reasonable expectation that the Australian regulatory framework of incentive-based regulation would be maintained, reflected by, for example, the establishment of guiding Revenue and Pricing Principles and the National Electricity and Gas Objectives.
- Customer price differentials based purely on corporate transactions - Using the actual cost of tax would result in customers of different networks paying different prices depending upon corporate transactions involving their networks.

Moreover, changing the corporate tax allowance on the basis of *past* observations of actual tax payments would be even more fraught with problems.

For example, one of the reasons that has been proposed for the difference between actual tax payments (at the network level) and regulatory tax allowances for some firms are tax loss carry-forwards that are available in the years following a corporate transaction. As these carry-forwards are exhausted, future actual tax payments will diverge from past tax payments. Another reason that has been proposed for a potential altered approach is the use of stapled securities and other structuring arrangements, however, the use of such structures will no longer be available under the recently released *Stapled Securities Exposure Draft*. Again, past actual tax payments may not be representative of future tax payments at the network level.

4 Specific issues raised in the ATO note and the AER Issues Paper

Summary

- In relation to **accelerated depreciation**, ENA submits that:
  - Changes to the approach to tax depreciation will affect timing of cash flows in an NPV-neutral way.
  - If there is evidence that the efficient approach to tax depreciation is to use various methods for accelerating depreciation expense, that assumption could be adopted as the efficient benchmark.
  - The ATO note does not provide any such evidence. Before any change is made in this regard, the AER would require proper evidence about the practice of firms and would have ensure a consultation process occurred in which stakeholders could properly evaluate that evidence.
- In relation to **ownership structuring**, ENA considers that:
  - The ATO identifies that Australian tax collections are reduced if profits are passed through to ultimate investors who pay little or no tax in Australia.
  - This is an issue that applies throughout the economy, not just to regulated assets. Consequently, it requires an economy-wide response such as the recent exposure draft in relation to stapled securities.
  - The appropriate response to this issue is to ensure that the appropriate amount of tax *is* paid, rather than to assume that it will not be paid and to adjust the entire regulatory framework accordingly, leaving the issue untreated in every other industry.
  - Moreover, many regulated assets are owned by companies that pay tax at the corporate rate, so moving away from the current regulatory approach would be inappropriate for them.
- In relation to **tax loss carry-forwards**, ENA submits that:
  - Under the Australian regulatory framework, the allowed revenues (including the tax allowance) are set for the forthcoming year for the benchmark efficient entity.
  - The fact that the owner of the regulated asset may have tax loss carry-forwards that they have generated somewhere in the past, and that they can use to offset their tax obligations in the future, is irrelevant to the task of assessing a benchmark efficient regulatory allowance.
  - The AER's tax allowance methodology already allows for any prior tax losses incurred by the benchmark efficient firm.
- In relation to **gearing beyond the 60% benchmark**, ENA considers that:

- Asset owners are free to depart from the regulatory benchmark, but any such departure (including its tax effect) is not relevant to the regulatory allowance setting task.
- Since any increase in interest expense is paid for entirely by the asset owner, any tax effect relating to it also pertains entirely to the asset owner. Neither the additional interest, nor its tax effect, have anything to do with the regulatory bargain between the asset owner and consumers – which is for consumers to pay for the efficient costs of the benchmark efficient entity, and no more.

» In relation to **tax-equivalent payments**, ENA supports the AER's longstanding approach of making no distinction whatsoever between private sector and state-owned networks.

» In relation to **research and development tax deductions**, ENA notes that the asset owner bears the cost of any additional costs not included in operating or capital allowances in their entirety. It would not be symmetric or internally consistent to *reduce* the regulatory allowance in relation to a payment made entirely by the asset owner.

» In relation to **interest rates in excess of the regulatory allowance**, ENA notes that the asset owner bears the cost in its entirety. It would not be appropriate or internally consistent to *reduce* the regulatory allowance in relation to a payment made entirely by the asset owner.

» In relation to **tax asset base increases**, ENA understands that such adjustment of the tax asset base has not been permitted since 2001 under Division 58 of the Income Tax Assessment Act. Transactions prior to 2001 are considered in Section 3.3.2 above.

4.1 Accelerated depreciation

The ATO note posits that private sector businesses may be employing accelerated depreciation approaches and using shorter asset lives relative to the regulatory benchmarks and that they may also be using low-value asset pool write-offs.

The first point to note in relation to the speed of depreciation is that it is NPV-neutral. That is, under the Australian regulatory framework (and the AER's PTRM), accelerating or delaying depreciation has the effect of moving the associated tax deduction through time in an NPV-neutral way. Thus, any change made in this regard will have no impact on the current value of a regulated business or the total present value of consumer payments. However, it may have inter-generational effects, changing the balance between payments made by current versus future consumers.

If it is apparent that regulated asset owners are using methods to accelerate depreciation for tax purposes, that effect can be accommodated within the current incentive-based framework and PTRM. Such evidence would indicate that the efficient benchmark is one that involves accelerated depreciation and the regulatory allowance would then reflect that efficient benchmark.

Indeed this is precisely how incentive-based regulation is designed to work. Regulated businesses have an incentive to maximise efficiency. If a regulator observes businesses generally departing from a particular regulatory benchmark, that highlights for the regulator the possibility that the particular regulatory benchmark may no longer be efficient.

However, the ATO note provides only very high-level analysis which is subject to material limitations. It is certainly not evidence that the regulatory tax allowance no longer represents a benchmark efficient tax allowance. Before any change is made in this regard, the AER would require proper evidence about the practice of firms and would have conduct a consultation process in which all stakeholders could fully evaluate that evidence.

4.2 Ownership structuring

The ATO note observes that some regulated asset ownership entities are structured as trusts or partnerships such that profits are passed through to investors and taxed at the investor's marginal tax rate.

The ATO note also observes that this point is irrelevant for investors who are taxed at a rate in excess of the 30% corporate tax rate. For those investors, the net effect is that the source profit is taxed at the investor's marginal rate. Consider, for example, a resident investor with a marginal rate of 45% and a regulated entity that earns a $100 profit:

» If the entity is structured as a trust or partnership, no tax is paid at the entity level and the full $100 is passed through to the individual who pays $45 tax;
» If the entity is structured as a company, $30 of corporate tax is paid and the remaining $70 is passed through to the investor as a franked dividend, on which an additional $15 of personal tax must be paid – resulting in total tax collected of $45.

In both cases, the regulated entity must be allowed to collect the same pre-tax profit of $100.

The ATO note goes on to consider cases where the ultimate investor pays tax at a rate below the corporate tax rate, citing sovereign wealth funds, foreign superannuation funds, and investors based in low-tax jurisdictions. In those cases, trust and partnership structures result in less net tax being collected by the ATO because profits are passed through to the ultimate investors who face low (or zero) tax rates or who pay their taxes to foreign governments.

Of course, these issues are not unique to regulated assets – they are much broader questions relating to how different legal entities should be taxed in Australia. That is, they are not issues to be fixed, for regulated firms, by compromising the critical framework of incentive-based regulation. Rather, they require more general action such as the recent exposure draft in relation to stapled securities. The appropriate response to this issue is to ensure that the appropriate amount of tax *is* paid, rather than to assume that it will not be paid and to adjust the entire regulatory framework accordingly, leaving the issue untreated in every other industry.

In this regard, ENA notes that the recently released *Stapled Structures Exposure Draft* proposes various measures to remove the ability of sovereign wealth funds and foreign pension funds to be taxed at a concessional rate of less than 30% on their investments through stapled security structures. The exposure draft proposes that (after a transition period) income will be taxed at the 30% corporate rate to non-resident investors.

Since the issue of ownership structuring has been addressed in this broader setting, it would appear to be duplicative and represent a form of 'double-counting' to seek to address it again in the regulatory setting via an adjustment to the corporate tax allowance. Moreover, the only way of making such an adjustment within the regulatory setting would seem to be by changing the definition of the benchmark efficient entity to be an entity that had adopted a stapled security structure – which would be an anomalous approach in light of the effective dismantling of such structures under the draft legislation.

Moreover, many regulated assets *are* owned by companies that *do* pay tax at the corporate rate, so moving away from the current regulatory approach would be inappropriate for them.

4.3 Tax loss carry-forwards

Tax loss carry-forwards reflect only timing differences and do not affect total tax paid over the life of an asset. For example, an asset may be loss-making for part of its life and then profitable for the remainder of its life. An entity that owns an asset during its loss-making phase generates tax loss credits that it can use to reduce any of its future tax obligations. That is, those tax loss carry-forwards relate to the owner and not to the particular asset in question.

Under the Australian regulatory framework, what is relevant are the benchmark efficient costs (including taxes) for the forthcoming regulatory year. The allowed revenues (including the tax allowance) are set for the forthcoming year for the benchmark efficient entity. The fact that the owner of the regulated asset may have tax loss carry-forwards that they have generated somewhere in the past and that they can use to offset their tax obligations in the future is not relevant to the task of assessing the benchmark efficient regulatory allowance.

If tax loss carry-forwards were somehow relevant to the regulatory allowance, the perverse effect would be that consumer prices would change every time an asset changed hands – according to how many or how few tax loss carry-forwards the new owner had available to it. This would be quite inconsistent with the framework of benchmark efficient costs in relation to the forthcoming regulatory year, and is difficult to reconcile with the National Electricity or Gas Objectives.

It should also be noted that the AER's tax allowance methodology already captures any prior tax losses incurred by the benchmark efficient firm.

4.4 Levering beyond the 60% benchmark gearing

The ATO note also considers the case where the asset owner employs more than the benchmark 60% gearing, such that actual interest expense exceeds the regulatory allowance. As noted above, under incentive-based regulation, the regulatory allowance is set according to efficient benchmark costs. Asset owners are free to depart from the regulatory benchmark, but any such departure (including its tax effect) is irrelevant to the regulatory allowance setting process.

If consumers were being asked to pay for the increase in interest expenses, it would be appropriate to offset the reduction that this would cause to corporate tax payments. However, consumers do not contribute anything towards the increase in interest expense – since that increase is paid for entirely by the asset owner, any tax effect relating to it also pertains entirely to the asset owner. Neither the additional interest, nor its tax effect, have anything to do with the regulatory bargain between the asset owner and consumers – which is for consumers to pay for the efficient costs of the benchmark efficient entity, and no more.

4.5 Tax equivalent payments made to state governments

Under Australia's competitive neutrality framework, state-owned entities must make tax-equivalent payments to their state government owners at the standard 30% corporate tax rate.

The fact that the tax-equivalent payments are paid to a state government under established competitive neutrality agreements is not a matter determined upon under the Australian regulatory framework. ENA supports the AER's longstanding approach of making no distinction whatsoever between private sector and state-owned networks. Indeed, the same benchmark efficient tax allowance would be made even if the network owner paid no tax at all, as would be the case, for example, if a network was purchased by the Future Fund. Under the Australian regulatory framework, the regulator identifies a benchmark efficient entity and sets the regulatory allowance based on the efficient costs of that benchmark efficient entity – that being the basis of incentive-based regulation.

This position is also consistent with the AER's longstanding approach of setting the allowed return on debt on the basis of an efficient commercial benchmark rather than using the actual cost of debt for a state borrowing authority (which is irrelevant because it reflects the entire balance sheet and taxing power of the state).

Moreover, distinguishing between state-owned and private sector networks on the basis of actual tax payments would seem to lead to adjustments being made in opposite directions – because state-owned businesses appear to pay more corporate tax than the regulatory allowance according to the ATO's (very preliminary) analysis. It would be a material departure from the AER's current approach of not distinguishing between private- and state-owned networks when setting allowed revenues. Of course, before any such change could even be contemplated, a full analysis (i.e., beyond the ATO's three-page note) would have to be conducted to determine whether state-owned networks do in fact pay more corporate tax (equivalents) and if so, why that is the case.

ENA supports the AER's current approach of setting all regulatory allowances, including the corporate tax allowance, on the basis of efficient benchmark costs that are independent of the identity of the owner.

4.6 Research and development tax deductions

The AER notes[6] that its regulatory allowance typically makes no provision for research and development expenditure. Thus, any such research and development expenditure beyond capital or operating allowances would result in lower taxable income as far as the expenditure is not compensated in the regulatory allowance. In this case, since the asset owner bears the cost in its entirety, any tax deduction in relation to it should also flow to the asset owner. It would be a perverse public policy outcome for an asset owner to bear the full cost of such a payment, and then to pay again in relation to the tax deductibility of that payment. That is, it would not be logically consistent to *reduce* the regulatory allowance in relation to a payment made entirely by the asset owner.

4.7 Interest rates in excess of the regulatory allowance

The AER notes[7] that it provides a regulatory allowance for the benchmark efficient cost of debt. If a particular regulated firm has borrowed at a higher rate, the additional interest cost is deemed to be inefficient and so would be uncompensated in the regulatory system. However, this additional interest would be tax deductible and would have the effect of lowering taxable income.

As for R&D expenditure above, since the asset owner bears the cost in its entirety, any tax deduction in relation to it should also flow to the asset owner. Again, it would be asymmetric and have poor incentive properties to *reduce* the regulatory allowance in relation to a payment made entirely by the asset owner.

4.8 Tax asset base revaluation

The AER suggests[8] that tax asset bases can be adjusted as the result of a corporate transaction. ENA understands that since 2001, such adjustment of the tax asset base is not permitted under Division 58 of the *Income Tax Assessment Act*.

Networks that were sold prior to 2001 were able to reset the tax asset base under the tax laws at that time, however that had no effect on allowed revenues or on the prices paid by consumers, as explained in Section 3.3.2 above. The effect of tax laws at the time was to allow the new owner a deduction (over the life of the asset) for the amount of the purchase price that was in excess of the benchmark efficient allowance for the return of capital. In the example in Section 3.3.2, the new owner paid 200 in

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[6] AER, May 2018, Review of regulatory tax approach, Issues Paper, Table 5.2, p. 17.
[7] AER, May 2018, Review of regulatory tax approach, Issues Paper, Table 5.2, p. 17.
[8] AER, May 2018, Review of regulatory tax approach, Issues Paper, Table 5.2, p. 17.

excess of the benchmark regulatory allowance for the return of capital and, under pre-2001 tax laws, this amount was deductible over the life of the asset.

4.9 Issues that may be relevant to the benchmark efficient cost of corporate tax

This submission seeks to differentiate between matters that are relevant to estimating the amount of corporate tax paid by the benchmark efficient entity (and which are therefore relevant to this review) and those that are not. Many of the items considered above relate to tax deductions that are not available to the benchmark efficient entity because they relate to costs that are outside the benchmark efficient regulatory allowance.

Items that are potentially relevant to the corporate tax paid by the benchmark efficient entity, and which would therefore be relevant to this review, include:

- The use of accelerated depreciation for tax purposes;
- Research and development expenditure – to the extent that R&D expenditure would be included in the benchmark efficient expenditure allowance it would also be included in the corporate tax calculation, but to the extent that it remains excluded from the regulatory cost allowance it would remain excluded from the corporate tax calculation.

5 Responses to AER Questions

Question 1: Are there other publicly available sources that provide tax data for the regulated networks?

ENA is unaware of any such data sources.

Question 2: Of the available data sources, which are the most appropriate for the purposes of the AER's review?

ENA considers that the issues are largely conceptual in nature, as set out in this submission. ENA submits that the only data that is relevant is data that would inform the issue of the corporate tax that would be paid by the benchmark efficient entity.

Question 3: 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?

ENA considers that, within the Australian regulatory framework the relevant question is whether the benchmark efficient firm would pay more or less tax than the regulatory allowance.

The AER and ATO have identified a number of reasons for differences between actual tax paid and the regulatory tax allowance. The majority of these reasons relate to payments being made by network owners that go beyond the benchmark efficient regulatory allowance, and which are therefore uncompensated – they are not included in allowed revenues. Such payments include additional interest expenses (whether due to a higher quantum of debt or a higher interest rate), R&D expenses, and stamp duty – none of which are included in allowed revenues. In these cases, since the asset owner bears the cost in its entirety, any tax deduction in relation to it should also flow to the asset owner. It would be perverse for an asset owner to bear the full cost of such a payment, and then to pay again in relation to the tax deductibility of that payment. That is, it would make little sense to *reduce* the regulatory allowance in relation to a payment made entirely by the asset owner.

Thus, ENA considers data on how costs that are beyond the benchmark efficient allowance (and which are therefore excluded from allowed revenues) might create tax deductions for an asset owner that bears those costs in full to be irrelevant to the question of tax paid by the benchmark efficient entity.

Question 4: Are there other potential drivers that could cause the difference (between expected tax costs and actual tax paid) identified in the ATO note?

ENA considers the ATO and AER papers to have identified the key drivers of differences between actual tax and the regulatory allowance for corporate tax.

Question 5: How should we assess materiality of the potential drivers?

As above, reasons that relate to payments being made by network owners that go beyond the benchmark efficient regulatory allowance, and which are therefore uncompensated, and are irrelevant to the estimation of tax paid by the benchmark efficient entity. Question 6: Which of these potential drivers should be the focus for the AER's review?

The AER's review should focus exclusively on drivers that might inform the estimation of the corporate tax paid by the benchmark efficient entity. This includes accelerated depreciation and R&D expenditure (to the extent that it is allowed as a recoverable cost).