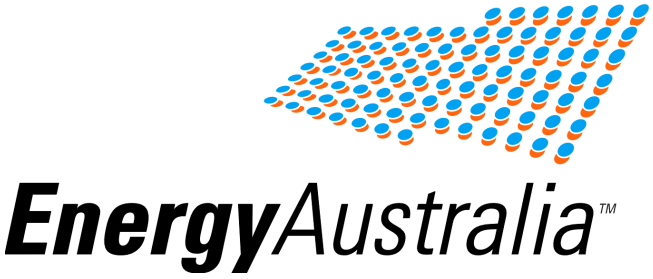


EnergyAustralia's Proposed Pass-Through Rules

September 2003

Proposed Pass Through Rules

1 REGULATED PASS THROUGH

1.1 Rules form part of revenue cap

These Pass Through Rules form part of the revenue cap set by the Commission to apply to EnergyAustralia for the regulatory control period commencing on 1 July 2004.

1.2 Entitlement to Pass Through

(1) If a Pass Through Event occurs, EnergyAustralia is entitled to amend the revenue cap to pass through the financial effect of the Pass Through Event in accordance with the procedures set out in these Pass Through Rules.

(2) Any Pass Through Amounts determined in accordance with these Pass Through Rules forms part of the revenue cap.

1.3 Form of Pass Through Amount

A Pass Through Amount may be expressed in any form which reasonably reflects the factors in clause 2.3 including:

(1) as a dollar increase in the amount of the allowable revenue cap for the relevant year or years (with EnergyAustralia to determine the corresponding change in customer charges in accordance with the National Electricity Code);

(2) as a percentage change in one or more customer charges; or

(3) as a change to one or more customers charges.

2 PROCEDURE

2.1 Pass Through Event Statement

If EnergyAustralia believes it is or will be entitled to pass through the financial effect of a Pass Through Event, then it may give a Pass Through Event Statement to the Commission specifying:

(1) details of the relevant Pass Through Event including the date on or from which the relevant Pass Through Event took effect or will take effect;

(2) the estimated financial effects of the Pass Through Event on the provision of revenue capped transmission services including any documentary evidence that is reasonably available that substantiates the claimed financial effects of the Pass Through Event ;

(3) the Pass Through Amount proposed by EnergyAustralia in respect of the relevant Pass Through Event and the proposed form of the Pass Through Amount; and

(4) the date from, and period over which, EnergyAustralia proposes that the Pass Through Amount may be applied.

2.2 Commission's Decision

(1) Upon receipt of a Pass Through Event Statement, the Commission must determine whether the Pass Through Event specified in the Pass Through Event Statement did occur or will occur and, if the Commission decides that the Pass Through Event did occur (or will occur), the Commission must decide:

(a) the Pass Through Amount in respect of the relevant Pass Through Event;

(b) the form of the Pass Through Amount; and

(c) the date from, and period over which, the Pass Through Amount may be applied,

and notify EnergyAustralia in writing of the Commission's decision.

(2) The Commission must give a notice under clause 2.2(1) within 40 Business Days of receiving a Pass Through Event Statement. Subject to clause 2.2(3), the Commission may, at its discretion, extend this period:

(a) on more than one occasion;

(b) for an aggregate period of up to 40 Business Days; and

(c) by giving written notice to EnergyAustralia, prior to expiry of the previous period, specifying the period of the extension.

(3) In exercising its discretion to extend the period for assessment of the Pass Through Statement pursuant to clause 2.2(2), the Commission must use reasonable endeavours to notify EnergyAustralia of its decision under clause 2.2(1) on or before 31 March of the relevant year so as to enable EnergyAustralia to have sufficient time to incorporate the Pass Through Amount into its transmission pricing and notify relevant stakeholders for commencement from 1 July of that year.

(4) If the Commission does not give a notice to EnergyAustralia under clause 2.2(1) within 40 Business Days (or such extended period as is notified pursuant to clause 2.2(2), of receiving the relevant Pass Through Event Statement, then the Commission is taken to have notified EnergyAustralia of its decision that:

(a) the relevant Pass Through Event has occurred (or will occur); and

(b) the Pass Through Amount and the manner in which the Pass Through Amount is to apply are as proposed by EnergyAustralia in the Pass Through Statement.

2.3 Relevant Factors

In making a decision under clause 2.2, the Commission must seek to ensure that the financial effect of EnergyAustralia associated with the relevant Pass Through Event is economically neutral taking into account the following factors:

(1) the financial effect on EnergyAustralia associated with the provision of revenue capped transmission services attributable to the Pass Through Event and the time at which the financial effect took place or will take place;

(2) the time cost of money for the period over which the Pass Through Amount is to be applied;

(3) in relation to a Change in Taxes Event:

  (a) the amount of any reduction in another tax, rate, duty, charge, levy or other like or analogous impost intended to offset in whole or in part the relevant Change in Tax Event and the manner in which and the period over which that reduction occurs; and

  (b) the amount included in the operating expenses or other cost inputs or parameters of EnergyAustralia's revenue cap;

(4) in relation to an External Event, any loss, damage, cost or expense of any nature directly or indirectly caused by, resulting from or in connection with:

  (a) the External Event; or

  (b) any action taken in controlling, preventing, suppressing or in any way relating to the External Event;

(5) in relation to an Insurance Event:

  (a) the amount of any loss, damage, cost or expense of any nature directly or indirectly caused by, resulting from or in connection with the Insurance Event and including:

    (i) the cost of any material increase in premium paid or payable by EnergyAustralia beyond that provided for in EnergyAustralia's revenue cap;

    (ii) the cost of any material increase in deductible paid or payable by EnergyAustralia beyond that provided for in EnergyAustralia's revenue cap; and

    (iii) if an Insurance Event occurs and EnergyAustralia either does not continue the relevant insurance or continues that insurance on different terms, losses resulting from any uninsured event or partially uninsured event where that event would have been insured or fully insured by Insurance at the date of the Date of the Determination, and

(b) the economic consequence for EnergyAustralia of a decision, following the occurrence of an Insurance Event, to self insure for all or part of a risk of the sort for which EnergyAustralia previously maintained Insurance; and

(6) in relation to a Regulatory Event, the financial effect on EnergyAustralia associated with any increased costs or risks (including in the nature, scope or asymmetry of risks) resulting from the Regulatory Event including, where relevant, an appropriate self-insurance allowance relating to the increased risks.

2.4 Application of Pass Through Amount

If EnergyAustralia has:

(1) received or is taken to have received a notice under clause 2.2 allowing EnergyAustralia to pass through a Pass Through Amount; and

(2) notified its affected customers of:

(a) the Pass Through Amount; and

(b) the form in, date from and period over which EnergyAustralia will apply the Pass Through Amount,

EnergyAustralia may apply the Pass Through Amount in the form, from the date of and over the period specified or taken to be specified in the notice from the Commission.

3 DEFINITIONS & INTERPRETATION

3.1 Definitions

Applicable Law means any legislation, delegated legislation (including regulations), codes, licences or guidelines relating to the provision of a revenue capped transmission service and includes the National Electricity Code and the National Electricity Law.

Business Day means a day that is not a Saturday, Sunday or public holiday in New South Wales.

Authority means any government or regulatory department, body, instrumentality, minister, agency or other authority or any body which is the successor to the administrative responsibility to that department, body, instrumentality, minister agency or authority and includes IPART, NEMMCO, NECA and the Commission.

Change in Taxes Event means:

(1) a change in the way or rate at which a Relevant Tax is calculated (including a change in the application or official interpretation of a Relevant Tax);

(2) the removal or imposition of a new Relevant Tax,

to the extent that the change, removal or imposition:

(3) occurs after the date of the Determination; and

(4) results in a material change in the amount EnergyAustralia is required to pay or is taken to pay (whether directly, under any contract or as part of the operation

expenses or other cost inputs or parameters of EnergyAustralia's revenue cap) by way of Relevant Taxes.

Commission means the Australian Competition and Consumer Commission;

Determination means the determination of the Commission setting out the revenue cap for EnergyAustralia's transmission business in relation to the regulatory control period commencing on 1 July 2004;

External Event means an event, including a Terrorism Event, that:

(1) was unforseen and was not reasonably foreseeable at the date of the Determination; or

(2) was identified as a potential, but unlikely, risk at the date of the Determination but:

(a) a reasonably prudent person would not determine it necessary to obtain Insurance for such event; or

(b) the event is not covered by Insurance because Insurance is unavailable or is not available at reasonable commercial rates,

and EnergyAustralia has not made any allowance for self-insurance,

and such event results in EnergyAustralia incurring (or being likely to incur) directly or indirectly materially lower or higher costs in providing capped revenue transmission services than those contemplated at the time the Determination was made.

Fees Event means a change in, the removal of or imposition of fees and charges paid or payable

(1) to an Authority in connection with any licence for the provision of capped revenue transmission services; or

(2) in connection with any other membership or contribution that is required by an Authority;

to the extent that the change, removal or imposition:

(3) occurs after the date of the Determination; and

(4) results in a material change in the amount EnergyAustralia is required to pay or is taken to pay by way of such fees and charges; and

(5) is not a Regulatory Event or a Change in Taxes Event.

Insurance means insurance whether under a policy or a cover note or other similar arrangement:

(1) for risks of the sort for which EnergyAustralia was covered at the date of the Determination;

(2) for amounts not less than amounts underwritten in favour of EnergyAustralia at the date of the Determination; and

(3) on terms, including terms specifying deductibles payable and any applicable exclusions, no less favourable than the terms in place at the date of the Determination.

Insurance Event means where one or more of the following circumstances occurs:

(1) where Insurance in respect of any risk becomes unavailable to EnergyAustralia;

(2) where Insurance in respect of any risk becomes unavailable to EnergyAustralia at reasonable commercial rates;

(3) where Insurance in respect of any risk becomes unavailable to EnergyAustralia on terms which are at least favourable to EnergyAustralia as those generally available at the date of the Determination; or

(4) where the cost of Insurance (including premiums and deductibles) in respect of any risk becomes materially lower or higher than the cost of Insurance at the date of the Determination.

Pass Through Amount means a variation to EnergyAustralia's revenue cap as a result of a Pass Through Event determined in accordance with these Pass Through Rules. A Pass Through Amount may be positive or negative.

Pass Through Event means:

(1) a Change in Taxes Event;

(2) an External Event;

(3) a Fees Event;

(4) an Insurance Event; or

(5) a Regulatory Event.

Pass Through Event Statement means a notice in writing made by EnergyAustralia in accordance with clause 2.1.

Relevant Tax means any tax, rate, duty, charge, levy or other like or analogous impost that is:

(1) paid, to be paid, or taken to be paid by EnergyAustralia in connection with the provisions of transmission services; or

(2) included in the operating expenses or other cost inputs or parameters of EnergyAustralia's revenue cap;

but excludes

(3) penalties and interest for late payment relating to any tax, rate, duty, charge, levy or other like or analogous impost; and

(4) fees and charges paid or payable in respect of a Regulatory Event.

(5)

(6)

Regulatory Event means a decision made by the Commission, IPART or any other Authority or any introduction of, or amendments to, an Applicable Law after the date of the Determination that:

(1) has the effect of:

(a) imposing or varying minimum standards [(including safety or technical standards)] on EnergyAustralia relating to revenue capped transmisison services that are more onerous than the minimum standards applicable to EnergyAustralia in respect of revenue capped transmisison services at the date of the Determination;

(b) altering the nature or scope of services that comprise the revenue capped transmission services including requiring EnergyAustralia to undertake any activity as part of the revenue capped transmission services in addition to those required to be undertaken at the time of the Determination;

(c) substantially varying the manner in which EnergyAustralia is required to undertake any activity forming part of revenue capped transmission services from the date of the Determination; or

(d) increasing EnergyAustralia's risk in proving the revenue capped transmission services; or

(2) results in EnergyAustralia incurring (or being likely to incur) materially lower or higher costs in providing revenue capped transmission services than it would have incurred but for that event; or

(3) results in EnergyAustralia incurring (or being likely to incur) materially lower or higher costs in complying with obligations imposed by the Commission not listed above in regards to regulated transmission service providers than would have incurred but for that event.

Terrorism Event means an act, including the use of force or violence and/or the threat thereof, of any person or group of persons, whether acting alone or on behalf of in connection with any organisation or government, from which its nature or context is done for, or in connection with, political, religious, ideological, ethnic or similar purposes or reasons, including the intention to influence or intimidate any government and/or put the public or any section of the public in fear.

3.2 Interpretation

In these Rules, unless the contrary intention appears:

(1) a reference to:

(a) a document, including these Rules, includes any variation or replacement of it;

(b) a particular person includes a reference to the person's successors, substitutes (including person taking by novation) and assigns;

(c) the word "person" includes an individual, a firm, a body corporate, a partnership, joint venture, syndicate, an unincorporated association, or any Authority;

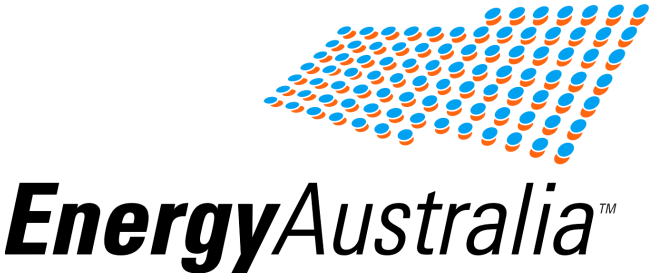
(d) a statute, ordinance, code or other law includes regulations and other instruments under it and consolidations, amendments, re-enactments or replacements of any of them; and

(e) a clause, annuexure or schedule is a reference to a clause in or annexure or schedule to these Rules;

(2) headings are for ease of reference only and do not affect the meaning of these Rules;

(3) the singular includes the plural and vice versa; and

(4) “including” and similar expressions are not and must not be treated as words of limitation.



EnergyAustralia's Proposed Treatment of Capital Contributions

A Regulatory Solution

The issue

The financial contribution by a customer towards the capital investment required to connect that customer to the network, or to augment the network to meet that customer's specific needs, is an economically efficient and effective means to signal on an *ex ante* basis the cost of the investment. The use of customer contributions is commonplace within the electricity distribution sector and is a practice that is supported and encouraged by EnergyAustralia on a number of theoretical grounds. The introduction of capital contributions has, however, raised many issues within the regulatory framework. This document examines the impact of taxation on customer contributions and how this may or may not be addressed within the ACCC's regulatory framework.

The treatment of capital contributions in the regulatory framework varies from the treatment of capital contributions in standard accounting practice. Capital Contributions are considered a revenue item under standard accounting practice, and are considered a taxable revenue item under the Australian Tax Office (ATO) rules. In contrast, the regulatory treatment of capital contributions seeks to exclude both the revenue and the related asset from consideration in the regulatory regime. This is done to ensure that customers do not pay for assets that have already been paid by other customers. The regulatory treatment also ensures that TNSPs are not penalised for managing financial risks and providing pricing signals through the use of capital contributions.

The ACCC has partially addressed the inconsistency in the treatment of capital contributions by requiring TNSPs to prepare their regulatory accounts in a manner that does not recognise capital contributions as revenues, and thereby does not allow capital contributions received to impact the assessment of compliance with the revenue cap[1].

However, this only partially manages the inconsistency between the objectives of the regulatory regime and the operation of the ATO regime. Regardless of the ACCC's recognition or otherwise of capital contributions as revenue the ATO recognises capital contributions as taxable revenue and this disparity creates a potential difference between the assumed taxable revenue for regulatory purposes and the assessed revenue for tax purposes[2]. Whilst the taxation regime does enable TNSPs to claim the full value of the received capital contribution in the form of depreciation over the underlying asset's life, there is a material timing difference. This timing difference creates an asymmetric value risk borne by TNSPs.

To provide an understanding of the issue and its impact Table 1 below has been taken from EnergyAustralia's submission to IPART and sets out the annual NPV value impact of not addressing the issue for distribution. This example has been chosen as it demonstrates the impact of the current framework where capital contributions are an integral tool in managing the funding of connection specific assets.

[1] Whilst the ACCC does not consider capital contributions when assessing whether a TNSP has complied with their revenue cap it does consider capital contributions when assessing the regulatory asset base and therefore the determined revenue cap.

[2] It should be noted that for EnergyAustralia's distribution business IPART recognises capital contributions as revenue. This recognition does not alleviate EnergyAustralia's concerns of value erosion due to the taxable nature of capital contributions.

> ***"Table 1:** Annual value impact of income tax paid on capital contributions during 2004/05 to 2008/09*

Expected annual value of customer contributed assets	*$30M*
Expected annual tax paid on capital contributions	*$9M*
Tax Life	*20*
Annual tax depreciation allowed	*$0.45M*
WACC	*7.50%*
NPV of tax saved on tax depreciation at WACC rate	*$4.59M*
Annual difference in business value	*-$4.41M*

> *From the table above it is clear using the WACC as the discount rate applied to the timing difference between paying the income tax on capital contributions and receiving the offsetting tax depreciation allowances EnergyAustralia's value would be reduced by almost half the income tax paid annually. The application of the current capital contribution policies during the 2004 regulatory period will result in $22.06 million of value being systematically destroyed over the tax life of the contributed assets."*

Although EnergyAustralia has generally observed capital contributions as a distribution concern, it has become clear over the course of the current determination that capital contributions do indeed occur in the transmission network. In particular EnergyAustralia received capital contributions to partially fund transmission works associated with the Olympic sites at Homebush.

Whilst the timing of this meant that the Homebush works were not assessable for income tax purposes due to EnergyAustralia being subject to differential taxation regime at the time, this will not be the case for future capital contributions. Therefore, to ensure a robust investment framework, EnergyAustralia submits that a regulatory solution must be established to manage this potential issue, particularly in light of the list of probable future capital contributions included in EnergyAustralia's pro forma templates[3].

EnergyAustralia proposes the following regulatory solution to manage the regulatory imperative of ensuring that TNSPs do not receive a windfall gain from capital contributions, and ensure that the financial value of the prudent and efficient transmission investment is protected.

EnergyAustralia's Proposed Regulatory Solution

EnergyAustralia has held several meetings with the ATO and as a result of those meetings EnergyAustralia is aware that the ATO does not believe that this issue warrants a change in the interpretation of taxable revenue. Therefore, in the absence of a solution within the taxation regime itself, EnergyAustralia proposes a regulated solution to the investment value risks borne by TNSPs.

Capital contribution policies provide positive incentives and benefits to both customers and TNSPs. These benefits include the management of asset specific risks on the part of TNSPs, as they do not face the same level of risk for customer specific assets as for other assets, and promotes a "causer pays" approach to appropriate augmentations thereby limiting the cross subsidies in general pricing. EnergyAustralia's proposal preserves these benefits whilst maintaining the integrity of the revenue cap and the investment framework.

EnergyAustralia proposes that the net present value (NPV) lost due to the tax paid on receipt of capital contributions including physical assets, cash or otherwise, be recognised as EnergyAustralia's contribution towards bringing the relevant assets into service. In other

[3] These projects are not yet committed however they form part of EnergyAustralia's probabilistic capital expenditure program, and relate to projects in both the Eastern Suburbs of Sydney and the Central Coast.

words, EnergyAustralia proposes that the value lost due to income tax paid on capital contributions be recognised as capital expenditure on the assets.

By recognising the value lost due to the tax paid as capital expenditure, the real value of the contribution made by EnergyAustralia will be maintained. Moreover, the capital costs associated with the additional taxation being paid by EnergyAustralia will be met as the present value calculation uses the cost of capital as the discount factor. Finally, the pricing effect of the value lost due to the tax paid on the capital contribution will be spread over the tax life of the underlying asset, consistent with the time frame of present value risk that gives rise to the issue. The pricing that results from EnergyAustralia's proposal also ensures temporal and inter-generational equity.

This regulated solution is necessary, as merely requiring additional contribution from the asset contributor would simply increase the amount of tax paid. Similarly, an initial fee paid to EnergyAustralia to cover the value of the tax paid would not place EnergyAustralia in a neutral position, as the payment itself would also be taxable. Finally, requiring additional revenues to recover the costs of the additional tax paid in full in the year that it is paid would be inappropriate due to the short term pricing volatility that can be expected with capital contributions potentially varying significantly year on year.

EnergyAustralia proposes that where capital contributions relate to a specific customer the NPV lost would be incorporated into the relevant cost reflective network charge as appropriate. Where more than one customer will utilise the capital contributed assets EnergyAustralia proposes that the NPV lost would be included in the common network charges. These two approaches preserve the integrity of the pricing methodologies currently employed by EnergyAustralia that seek reflect the economic costs of dedicated assets to their beneficiaries, and ensures that pricing for smaller customers maintains the equity objectives.

EnergyAustralia submits that its approach to the value lost due to the tax paid on capital contributions is equitable as it manages both the pricing impacts to customers and ensures that the time value of EnergyAustralia's contribution to bringing the asset into service is maintained.

Attached below is an extract from a proposed submission to the ATO that whilst never formally presented for consideration due to other discussions with the ATO, it does provide some technical background on the taxable nature of capital contributions.

Extract of Capital Contributions Submission to Australian Tax Office

The purpose of this letter is to request a private ruling from the Australian Tax Office ("ATO") for EnergyAustralia in relation to the NTER issues surrounding connection assets.

As discussed, we would like to hear the ATO's views in relation to this matter as soon as possible and have arranged a meeting with you and members of EnergyAustralia for 13 December 2001 to discuss.

Background

EnergyAustralia has a franchise distribution area covering an area from South Sydney to Port Stephens. EnergyAustralia's business is to perform all functions related to the distribution and supply of energy and to provide energy related services. One particular function is that within the franchise distribution area, EnergyAustralia owns and maintains all of the distribution assets required to deliver electricity from the transmission lines owned by TransGrid (the New South Wales government owned transmission entity) to the connection point for every customer within the franchise distribution area. In this regard, the Electricity Supply Act 1995 (NSW) prescribes the powers and responsibilities of the electricity distributors and their relationship with customers within their franchise distribution area. One such obligation imposed on electricity distributors is that they must, under Section 15 of the Electricity Supply Act, provide "connection assets" to the premises of any person who owns or occupies premises within their distribution area upon application by such a person. The connection assets – power lines, transformers, underground cables, etc - are usually built and maintained by EnergyAustralia based on the distribution needs and capacity of the areas served.

From time to time, customers may request to be connected to EnergyAustralia's network or to have an increase in load capacity made available. The cost of connection is the customer's responsibility. If a customer requests connection, the distributor determines whether new or upgraded assets will be required. In this regard, customers have the right, under Section 31 of the Electricity Supply Act 1995 (NSW), to either use EnergyAustralia's construction division ("Enerserve") or an accredited third party provider to build the connection assets required. That is, the construction of connection assets is "contestable".

The construction of connection assets is governed by a separate contract between the customer and either Enerserve or the accredited third party provider as the case may be. The customer will pay the contract provider for the construction services depending upon whom the customer chooses as the provider of the services. Whilst the customer contracts for the construction of the assets and meets the costs of construction, upon construction of the assets in question it is common parlance within the industry to treat the assets as having "vested" in the electricity distributor. In this regard, it is noted that Section 51 of the Electricity Supply Act provides as follows:

> *"…51 Ownership of electricity works*
>
> *(1) A network operator [being a distributor or TransGrid as applicable] is the owner of its electricity works, whether or not the land in, on or over which they are situated is owned by the network operator…"*

This provision supports the accepted treatment as to the ownership of connection as having vested with the distributor and appears to attempt to override real property law that would otherwise vest the title of fixtures to land in the owner of the real property.

However, the view that assets automatically vest with the electricity distributor has been brought into question by the NSW Independent Pricing and Regulatory Tribunal ("IPART"). In this regard, IPART stated (in Determination No 10 of 1996 in relation to Pricing for Capital Contributions and Recoverable Works) that:

> *"Historically, ownership of connection assets has been vested with distributors. However…where assets are fully funded by customers, the Tribunal believes customers should be provided with the choice of whether to own the asset or hand over the asset to the distributor. Distributors should alert customers contemplating this decision to the fact that ownership of assets brings with it responsibility for those assets. Responsibilities include ongoing maintenance of*

those assets, insurance in relation to public risk, and licence requirements for intending private distributors. Where a customer fully funds network assets that are not on the customers' property, there may be legal considerations. The Tribunal recommends that the [NSW] Department of Energy investigate issues associated with customer ownership of networks assets with the aim of making such information available to the public"

There is some uncertainty as to who the owners of connection assets are for legal purposes. In this regard, we are not aware of any power IPART can exercise in relation to the ownership of electricity assets or how the "choice to own" can exist alongside Section 51 of the Electricity Supply Act. We are also not aware of any information on this issue released by the NSW Department of Energy in relation to the ownership of these assets. This being the case, the following analysis in relation to the NTER treatment of connection assets has been prepared on the basis that no specific guidance as to the legal ownership of these assets exists. The analysis assumes that EnergyAustralia will become the legal owner under the vesting process and that customers do not elect to retain ownership of the assets.

Facts

On the basis of the above, the relevant facts in relation to the NTER treatment of connection assets is summarised as follows:

- Where a customer requires connection to EnergyAustralia's network, it must make an enquiry of EnergyAustralia who then provide the customer with initial consultation services and design information.
- Subsequently, if the customer decides to connect to the EnergyAustralia network, they may require the construction of a "dedicated asset" in order for connection to occur. If a dedicated asset is required, the customer chooses, and contracts with, a licensed contractor to build the dedicated asset. The contractor selected by the customer may be either Enerserve or a third party licensed contractor. The customer must pay the contractor for the construction of the dedicated asset whether the contractor is Enerserve or a third party contractor. This payment is known as a "capital contribution".
- Once the asset is built by the contractor on behalf of the customer, Network "energise" the asset under a separate contract with the customer. Immediately before the asset is energised, at the time of hand-over of the asset to the customer by the contractor, the customer enters the contract with Network and under that contract may elect to retain ownership of the asset. If no election is made, Network (ie EnergyAustralia) owns the asset. The motivation for a customer to elect to transfer ownership of the asset to Network is that the customer does not have to pay for the continuous maintenance of the asset once the asset has been handed over to Network. Network has no motivation to either accept or decline ownership of the asset because maintenance costs can ultimately be recovered from customers. By contrast the asset itself does not from part of the Network regulated asset base and therefore a return is not be derived by EnergyAustralia on that asset (discussed further below). Furthermore, the transfer of the asset to Network does not involve any exchange, monetary or otherwise, and that the transfer of the distribution asset by the customer to Network is not for consideration.
- EnergyAustralia is subject to a cap on revenue that can be earnt (being 7% of its regulated asset base). The value of assets contributed to EnergyAustralia in the manner described above, is not included in Network's regulated asset base. This is because IPART does not consider EnergyAustralia to have provided consideration (ie incurred a cost) in exchange for the receipt of the asset. Because the contributed assets are excluded from the regulated asset base, IPART will not pay a return to EnergyAustralia (or any entity acquiring the contributed asset from EnergyAustralia). Accordingly, EnergyAustralia is unable to generate income in respect of contributed assets either as additional revenue or through subsequent disposal of the contributed asset to a third party.
- The future maintenance costs for the contributed assets will be included in Network's regulated asset base and EnergyAustralia does therefore derive income to offset the future maintenance costs.

Taxation Issues

We seek the Commissioner's confirmation that the vesting of connection assets in EnergyAustralia, where customers do not elect to retain ownership of the assets, should be treated as a gift for NTER purposes and as such should not be assessable to EnergyAustralia. Alternatively, if the receipt is assessable income in the hands of EnergyAustralia, that it has a nil value. In this regard, we set out below a technical analysis in relation to these points for your consideration.

Technical Analysis

Treatment of Connection Assets as Gifts

In relation to the taxation treatment of the cash and asset contributions received by EnergyAustralia from customers, the leading authority on the issue is *GP International Pipecoaters Pty Limited v. FC of T (90 ATC 4413).*

In that case, the taxpayer was a special purpose joint venture company incorporated for the sole purpose of performing a contract to coat pipes. Under the terms of the contract to coat the pipes the taxpayer was required to construct plant to perform the coating and in this regard it was agreed that the taxpayer would receive "establishment costs" from the customer equivalent to the estimated cost of the plant.

The Full High Court held that the establishment costs were an income receipt for taxation purposes and as such were taxable when received by the taxpayer. The fact that the receipt was used to acquire a capital asset was said not to be indicative of the nature of the receipt. Instead, it was said that the nature of the receipt is determined by reference to the scope of the taxpayer's business activities and the purpose of the taxpayer in engaging in those business activities. On this basis it was said that, "by constructing the plant and coating the pipe the taxpayer performed the obligations in consideration for which it was entitled to be paid the establishment costs and other moneys payable under the contract. It earned the money by doing the work it had contracted to do. The establishment costs were not received in exchange for an item of capital or a right of a capital nature". Accordingly, the Court concluded that the receipt of the "establishment costs" was a receipt of income.

The case reconfirmed a number of factors, which are relevant to determining whether a receipt is of a revenue or capital nature. The factors are:

- The periodicity, regularity or recurrence of the payments.
- The character of the right or thing disposed of in exchange for the receipt.
- The scope of the transaction, venture or business in or by reason of which the amount is received.
- The recipients purpose in entering the transaction, venture or business.

On the basis of our comments below, it is our view that the outcome in *GP International Pipecoaters v. FC of T* should not apply to the facts in relation to capital contributions received by EnergyAustralia:

- The payment of the establishment costs was an essential prerequisite for GP International Pipecoaters to be able to undertake the contract. By contrast EnergyAustralia is able to connect customers to the network regardless of whether the "dedicated asset" is transferred to EnergyAustralia.
- Under the terms of the contract to provide pipecoating services, GP International Pipecoaters also undertook to construct the pipecoating plant. By contrast the construction of the dedicated asset may be undertaken by EnergyAustralia or another contractor. Accordingly, the transfer of the asset to EnergyAustralia should be regarded as a separate transaction from the construction of the asset and where Enerserve constructs the asset. This would be the case when an independent contractor builds the asset.
- In the case of GP International Pipecoaters, the establishment costs were received in consideration for the construction of an asset used to undertake the pipecoating activities. Similarly, where Enerserve undertakes the construction of the "dedicated asset", the payments received from customers are taxed as assessable income in the hands of EnergyAustralia. The transfer of the asset to Energy Australia's

network division, subsequent to its construction by either Enerserve or an independent contractor, is, as stated above, a separate transaction. The transfer of the asset is not a precondition for the provision of electricity to the customer as is evidenced by the customers option to elect not to transfer the asset. EnergyAustralia does not dispose of a right or thing in exchange for the receipt of the dedicated asset. Accordingly, it is submitted that, in the case of EnergyAustralia, the transfer of the asset should be viewed as a gift because the receipt of the asset is not an integral part of the supply of electricity to the customer and as such cannot be said to be a product or incident of EnergyAustralia's income producing activity.

On the basis of the above factors it is submitted that the dedicated assets transferred to EnergyAustralia by customers should not be assessed as income in the hands of EnergyAustralia. The present case should, on the basis of the factors noted above, be distinguished from GP International Pipecoaters and the receipt of the asset should be considered a gift to EnergyAustralia for taxation purposes.

Value of Receipt

Alternatively, if it is considered that the transfer of the asset from the customer to EnergyAustralia is a taxable receipt in the hands of EnergyAustralia, it is submitted that the value of the receipt is nil.

In contrast to GP International Pipecoaters, EnergyAustralia receives an asset and not cash. Accordingly, in order to tax the receipt it will be necessary to place a value on the asset received. On the basis of the following factors we are of the opinion that the value of the receipt should be nil.

In cases where the asset is constructed by Enerserve it is proper to regard the construction of the asset for a customer and the transfer of the asset to EnergyAustralia as distinct transactions. When Enerserve constructs the asset they are paid for that services as is the case where an independent contractor constructs the asset. Just as with an independent contractor, the transfer of the asset to EnergyAustralia is not consideration for the assets construction and accordingly the value of the asset at transfer to EnergyAustralia is distinct from the cost of constructing the asset.

- Gifted assets do not form part of an electricity distributors regulated asset base. Accordingly EnergyAustralia is unable to derive income from the asset either in the form of a return from IPART, or by virtue of the supply of electricity to the customer (the tariff being the same whether or not the asset is gifted) or by sale of the asset because no other distributor would pay for the asset because income cannot be derived from it. On a similar basis, the asset has no value to the customer.
- Further, no monetary consideration is paid by EnergyAustralia to obtain the asset from the customer in the form of a rebate for the transfer of the asset. As stated above, there is also no difference in tariffs between those customers who have transferred assets to EnergyAustralia and those who have not.

On the basis of the above, we believe that if the transfer of the asset is an assessable receipt in the hands of EnergyAustralia (which we do not consider to be the case) the value of the receipt is nil.

Conclusion

Given the background and analysis outlined, we submit that the taxation consequences of the transaction as stated above should apply. In particular, we submit, that the gifting of assets to EnergyAustralia by customers should not be regarded as a taxable receipt. Alternatively, if the gifting of assets is considered to be a taxable receipt the value of the receipt should be nil for taxation purposes. We therefore seek a ruling to confirm the taxation treatment of “gifted assets” for income tax purposes.