1 June 2018

Mr Warwick Anderson
General Manager, Network Finance and Reporting
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3001

Dear Mr Anderson

Review of Regulatory Tax Approach

Ergon Energy Corporation Limited (Ergon Energy) and Energex Limited (Energex), as Distribution Network Service Providers (DNSPs) operating in Queensland, welcome the opportunity to provide comment to the Australian Energy Regulator (AER) on its Review of Regulatory Tax Approach Issues Paper (Issues Paper).

Together, Ergon Energy and Energex cover 1.7 million km^2 and supply 37 208 GWh of energy to 2.1 million homes and businesses. Ergon Energy and Energex are both members of Energy Networks Australia (ENA), the national industry association that represents businesses operating Australia's electricity transmission and distribution and gas distribution networks. The ENA has prepared a response to the Issues Paper and we are supportive of the positions presented in their response.

Ergon Energy and Energex agree that the suggested explanations in the Australian Tax Office (ATO) Note for the variance between the regulatory tax allowance set by the AER and the actual tax paid to the ATO largely explain the key drivers for the difference. We suggest that the following reasons may also be attributable to the variance:

1. The tax practice of immediately deducting capitalised overhead costs.
   Ergon Energy and Energex suggest that the impact of this practice should be analysed against the AER model, in particular:
   - whether the tax depreciation calculation has regard to the lower (opening) tax base that arises due to 'capitalised' costs being deducted up front;
   - whether 'taxable expenses' is understated due to the deductibility of large 'capital' outlays; and
   - whether forecast capital additions (and consequential tax depreciation) has regard to the tax cost (as distinct to the accounting cost).

2. The calculation of tax depreciation.
   The AER model appears to analyse the tax base at a point in time (the start of the regulatory period), with forecast tax depreciation based on the opening tax base and forecast capital additions during the period. However, in practice, the actual tax depreciation may be influenced by tax base 'refreshes' that may

occur during the period (such as a change in corporate structure / corporate ownership or privatisation giving rise to a tax cost setting exercise).

3. Long asset lives and the treatment of depreciation.
   The differences in methodology in calculating actual tax (using tax law) versus calculating the tax allowance (using the AER model) is likely to result in a 'swings and roundabouts' effect. That is, at certain points in the lifecycle of particular assets the tax allowance may exceed the actual tax paid but at other points the reverse may be true. The use of diminishing value depreciation for 'actual tax' versus the AER model of straight line depreciation is an example of this. However, the nature of the assets as having very long effective lives (up to 40/50 years) may mean that it takes a very long time to 'even out'. Changes in corporate structure, ownership models or other attributes of the business (e.g. other loss making activities) could potentially disrupt the underlying theoretic process of 'evening out' over time (with those changes in corporate structure potentially giving rise to new and intervening tax influences, such as resetting tax cost bases or legitimate availability of tax losses).

4. Treatment of repair costs.
   Some DNSPs may have a mismatch in the treatment of repair costs, such as deducting for tax purposes but capitalising for accounting / regulatory asset base, thereby potentially causing anomalies in the timing of the tax allowance versus the actual tax calculation.

5. The extent of unregulated activities in a DNSP's corporate group.
   Given that many corporate groups will be treated as a single entity for tax purposes, the unregulated activities of the corporate group will influence the overall tax position, whereas the AER tax allowance is only calculated with reference to the regulated activities.

Ultimately, all of the above issues could have varying degrees of impact on calculating the tax allowance. Notwithstanding, Ergon Energy and Energex suggest that it is not appropriate to look at the tax building block compared to the actual tax payments without also looking at the other building blocks. Moreover, a difference in ownership structure (such as government owned versus privately owned) influences the applicability of the building block components. For example, as government owned businesses make tax equivalent payments to their shareholder, there is no need for an allowance for dividend imputation credits. If each building block component is to be analysed on this basis, the AER would need to develop an individual regulatory approach for each DNSP. Ergon Energy and Energex would not support such an approach as it is inconsistent with the current incentive based regulatory framework which sets allowances based on a benchmark efficient entity.

Furthermore, a 5 year snapshot is not representative of an asset which has an expected life of between 30 and 50 years, as noted in point 3 above. Over such a long time frame it is also likely that tax policy and legislation will have changed. As such, tax payments made in the past as a result of the tax policy/legislation at that time may vary to the tax payments made in the future.

Should you require additional information or wish to discuss any aspect of this submission, please do not hesitate to contact either myself on (07) 3851 6416 or Trudy Fraser on (07) 3851 6787.

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Yours Sincerely

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