23 November 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 Discussion Paper (Discussion Paper).

As noted in our response to the Initial Report, Ergon Energy and Energex agree there are variances between the regulatory tax allowance set by the AER and the actual tax paid to the Australian Tax Office (ATO). Notwithstanding, these variances should be expected given that tax paid is based on actual financial performance and in accordance with Australian taxation law and the regulatory tax allowance is a forecast benchmark allowance set in accordance with the regulatory framework. We do not support a move away from an incentive-based regulatory framework and welcome the AER's recommendation to retain a benchmark approach.

Ergon Energy and Energex are concerned that this review could potentially blur the lines between tax law and regulatory policy and the role of the AER as the regulator and the ATO and Government as policy makers. All businesses operate within the bounds of Australian taxation law and policy in terms of the corporate tax rate, depreciation expenses and interest expenses. It is understood that a tax policy which offers tax incentives to induce certain types of investment or spending reflects the policy decisions of the Government. The extent to which these policies are no longer appropriate in ensuring that an appropriate amount of tax is paid by these businesses should be a decision for the Government to amend through Parliamentary processes. The AER should not seek to undermine a tax policy that provides for these lower tax outcomes.

We note the AER's Discussion Paper recommends that a change in the treatment of depreciation could be implemented. In particular, a change from straight line to diminishing value and the immediate tax deduction of certain types of capital expenditure (capex) such as refurbishments capex could be considered. We note that in accordance with tax law, assets must continue to be depreciated using the same methodology for the entirety of the asset life, and therefore we recommend that any changes apply prospectively to new assets only. Furthermore, we note that the Discussion Paper suggests around 65 per cent of private sector networks are currently depreciating the assets using diminishing value. While we recognise the economic theory to capitalise on bringing forward tax depreciation, this is likely to result in more lumpy deductions as new assets come on line during periods of intense capital investment and that current customers will benefit from the cost to future customers. As a government owned entity, we need to consider the trade-off of this benefit with balancing tax revenue and profits to our shareholders, and due to the nature of long asset lives, suggest a smoothed impact on prices is more equitable to our customers.

We strongly encourage the AER to consider carefully how best to implement this proposed change and to appropriately transition the post-tax revenue model and roll forward model to a diminishing value method. As noted above, we suggest only applying such a change prospectively to new assets. Further, due consideration should be given to the complexity in implementing the change from a system perspective and from a regulatory information notice (RIN) reporting perspective. Assuming many assets will remain depreciating at straight line for a significant time; systems will need to be capable of reporting two different methodologies for different individual assets within the same class. Moreover, we caution against setting a benchmark which creates incentives for inefficient behaviours and behaviours which are inconsistent with currently accepted tax practices. An efficient benchmark is not always one reflecting the most aggressive tax management practices.

Ergon Energy and Energex agree that it seems reasonable that the tax benchmark should reflect that certain capitalised costs are immediately deducted for tax purposes. However, any decision to assume within the tax model that certain refurbishment activities or capitalised overheads are immediately deductible should be made on a basis that provides for consistent treatment across all DNSPs. Any attempt to treat replacement expenditure as deductible in the tax model should clearly articulate which works are to be so treated – ideally with appropriate endorsement from the ATO. While it is fair and reasonable that customers should arguably enjoy the time value for money impact achieved by deducting refurbishment/repair costs, network providers ought not be put in a position of having to pursue uncertain or aggressive tax positions (and adopt actual tax risk) in order to meet the AER benchmark. As such, we suggest the AER engage with the ATO to determine clear guidelines on the extent of allowable capitalised refurbishment/repair/overhead costs so that all DSNPs are on a level playing field.

With respect to gearing, Ergon Energy and Energex believe that the same estimate of benchmark efficient gearing should be used consistently throughout the regulatory process. That is, as the weighted average cost of capital and the regulatory tax allowance are both inputs in determining the revenue allowance for DNSPs, the same estimate of gearing should apply to both measures.

As noted above, deductible interest expenses are a matter of tax policy and if tax laws are breached such that excessive interest expenses are being claimed, then the ATO should deny these claims and amend the tax bill accordingly. We do not agree that the AER should allow the extra interest in its model and therefore reduce the tax wedge. However, if the tax laws are not being breached and the full interest is legitimately tax deductible, then a proposal that the tax wedge should be reduced seems only possible if the underlying benchmark gearing ratio is correspondingly increased. We note that the AER have not made a recommendation regarding interest expense at this stage while the information gathered through the RIN process is still being analysed and considered.

Ergon Energy and Energex understand the AER have been working to meet the timeframes required by the Federal Minister for Environment and Energy. However, we do not believe that the AER have had sufficient time available to them to inform a well-considered determination, and that these compressed timeframes for analysis may undermine the quality of the AER's findings and any proposal to implement changes to how tax allowances are determined, which is not consistent with the national electricity objective. Specifically, we do not believe the implementation of any recommendations can be appropriately assessed and analysed prior to the requirement to publish a Final Report and Recommendations by December 2018.

Finally, as noted earlier, Ergon Energy and Energex would only support prospective changes to the framework. Business decisions and tax payments made in the past are as a result of the tax policy/legislation in place at that time and may no longer be seen as efficient if any changes were made retrospectively.

Should you require additional information or wish to discuss any aspect of this submission, please do not hesitate to contact either myself on [redacted] or Trudy Fraser on [redacted].

Yours Sincerely

[redacted]

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