5 June 2018

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

Via email to: TaxReview2018@aer.gov.au

Dear Mr Anderson,

RE: Submission to the Australian Energy Regulator on the Review of the Regulatory Tax Approach

Infrastructure Partnerships Australia (IPA) is pleased to respond with this submission to the Australian Energy Regulator's (AER) issues paper regarding a review of the regulatory tax approach for energy networks.

As Australia's peak infrastructure body, representing public and private infrastructure owners and operators, of all types, we are keen to contribute to this consultation process, as the results will no doubt carry large implications for confidence in regulatory frameworks for energy network businesses, the broader energy sector and investor confidence across all infrastructure sectors.

From the outset, we wish to express our concern with regard to the brevity of the consultation period and as such, offer this submission as our initial response to the consultation process.

With this in mind, we have limited our comments to two key areas:

1. Rising investor uncertainty and the need to account for the additional risk posed by prospective changes to the regulatory framework, as well as a commitment that changes will not be retrospective in nature; and
2. Incentive based regulation and the expectation that there will always be differences between actual versus allowed costs.

In terms of our substantive views with regard to the regulatory risks facing energy network businesses, we attach the following to be considered alongside this submission:

- Submission to the COAG Energy Council on the proposed binding rate of return amendments (18 April 2018);
- Submission to the Senate Standing Committee on Environment and Communications on the Abolition of the Limited Merits Review Regime (22 September 2017);

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- Submission to the Minister for Energy on the Review of the Limited Merits Review Regime (16 March 2017); and
- Submission to the COAG Energy Council on the Review of the Limited Merits Review Regime (2 October 2016).

RECOMMENDATIONS

1. The Australian Energy Regulator's initial report to be released in June should include clear statements regarding:
   a. the need to preserve incentive based regulation, with particular attention paid to ensuring that incentives are not incrementally eroded across multiple reviews; and
   b. the impact of any prospective regulatory changes with regard to additional risks posed to investor confidence and expected regulated return, as well as a commitment to rule out any retrospective action.
2. The Federal Government should consider the cumulative impact of regulatory changes currently underway for energy networks and adopt a more comprehensive policy review process that addresses the long term impact on consumer bills.

CONTEXT

The AER determines the tax allowances for energy network service providers in accordance with the relevant legislation – specifically, the National Electricity Rules (NER) and the National Gas Rules (NGR).

The Australian Tax Office (ATO) has reviewed the tax allowance data published by the AER and the income tax return data lodged by the electricity distribution businesses over a four year period.

The analysis focused solely on electricity distribution businesses (excluding electricity transmission and gas businesses) as they comprise the majority of expected tax payable for all regulated networks.

The businesses reviewed were either state owned National Tax Equivalent Regime (NTER) entities or private and public owned (taxpaying) entities.

The ATO's analysis found that:

- the aggregate tax allowance provided to taxpaying entities consistently overstated the actual tax payable; and
- the aggregate tax allowance provided to NTER entities consistently understated the notional tax payable.

The AER is reviewing the difference between the tax allowances and the actual tax payments made to the ATO by the regulated networks.

We acknowledge that network businesses and investors have expressed their willingness to actively participate in the AER's tax review. However, it is essential that any proposed regulatory changes are considered with reference to preserving the regulatory compact in the long-term interests of consumers, rather than as a result of reactionary changes in policy.

KEY POINTS

Investor uncertainty, risks posed by prospective changes and ruling out retrospective action

Economic regulatory frameworks for energy network service providers are at the centre of substantial change and uncertainty. This recently proposed review of the regulatory tax approach only continues the threat of intervention in Australia's energy market and further increases instability.

We submit that the Federal Government should recognise the damaging impact successive reviews and inquiries have on investor certainty – not only in the energy sector, but across the broader infrastructure market. Instead, what investors need is a settled, stable and predictable regulatory regime in order to maintain confidence and continue investing in Australia's energy networks and other national infrastructure.

Investment is important because it provides capital and asset management expertise, which assist in promoting the long-term interests of consumers. In making long-term investments in regulated assets, investors will logically consider the regulatory regime that governs the expected return on investment. Uncertainty about the 'rules of the game' will increase the return on capital required by investors, which in turn will serve to further inflate the price consumers pay for energy.

The National Electricity Market (NEM) and gas market are already experiencing significant stress through a wide range of regulatory and political interventions, which means a predictable and stable regulatory framework is even more important.

With this in mind, to maintain regulatory certainty, we submit that the AER should immediately rule out any retrospective action in regard to possible changes to the regulatory tax approach. It is important for consumers, investors and the network businesses to have certainty that although the 'rules of the game' may change in the future, changes should not impact on decisions made previously.

We note that although ruling out the possibility of retrospective action is necessary, it will not mitigate the impact on investment risk in the future. Consequently, such a rising risk should be accounted for in the regulatory risk allowance as part of the Rate of Return Guideline review process. At a time of considerable flux within the energy sector, investors require ongoing certainty in the regulatory framework, which reduces risk and maintains a low cost of capital, putting downward pressure on prices.

Incentive based regulation and the drivers of differences in actual versus allowed tax

Across Australia and much of the world, incentive based regulation is used for the economic regulation of infrastructure assets which hold natural monopolies over their markets. In order to calculate the revenues that the asset is allowed to earn, the regulator sets a benchmark of efficiency for the way the asset should be financed and operated.

Firms that outperform the efficiency benchmark are rewarded in the short term, by keeping additional profits from their allowed revenue. Conversely, firms which underperform compared to the benchmark are penalised as additional costs incurred through inefficiency erode the firm's expected profit margin. The benefit of this regulatory framework is that it incentivises firms to innovate and become more efficient, thus revealing information that can be used by the regulator to set higher benchmarks of efficiency in subsequent regulatory periods, which in turn benefits consumers.

Therefore, a key advantage of incentive based regulation is often not realised until the next regulatory period because efficiency savings made by the network business in the current regulatory period only translate into a lower revenue allowance in the next regulatory period. This places continual downward pressure on consumer prices, but with a time lag.

This also means that simple year on year comparisons of actual tax payments versus tax allowances reflect a misunderstanding of the purpose of incentive based regulation.

The incentive based model sets allowed revenues in order to compensate regulated businesses for benchmark efficient costs. This provides consistency across the industry for all stakeholders and helps to maintain price stability. For example, just as tax allowances may overstate actual tax payable, if the opposite occurs consumers are not required to pay more to make up for the understated tax allowance.

Given the fundamental nature of incentive based regulation, it follows that there will always be a difference between allowed tax and actual tax payable. Moreover, the fact that there is a difference indicates that the incentive framework is working in the long term interests of consumers, by encouraging networks to become more efficient.

The alternative to incentive based regulation, would be to move to a cost-plus regulatory model whereby the regulated business passes through its actual costs to consumers, while also recovering a fixed margin. Under this framework, the issue of difference between actual tax payable and allowed tax is resolved, as the regulatory allowance is always equal to the actual cost. However, this gives rise to greater price volatility as consumers pay the actual costs incurred by businesses, which could be higher or lower than those of an efficient benchmark entity. Importantly, under a cost-plus model, there is no incentive for businesses to operate more efficiently as any costs incurred are passed through to customers.

Both the ATO and the AER highlight several key drivers of the differences in actual tax payable compared to allowed tax. However, for many of these drivers, the difference is simply a matter of timing or an expected result of the incentive based regulatory framework. A brief summary of the key drivers is outlined below.

Gearing ratios and cost of debt

Differences in actual tax paid and allowed tax can also occur due to differences between the benchmark and actual gearing ratios, as well as differences between the benchmark regulated cost of debt and the actual cost of debt. These differences can make actual tax paid either higher or lower than the tax allowance.

Energy networks can be highly geared due to the stable, regulated revenues they receive, which allow predictable cash flows to be matched with debt repayment schedules. Additionally, energy networks have high fixed costs and regularly make large capital intensive investments which require significant amounts of debt. Thus the gearing ratio chosen by a network business is based on a range of factors, including the expected capital expenditure requirements and market factors such as prevailing interest rates.

The AER assumes a gearing ratio of 60 per cent, but a network business may have a higher or lower gearing ratio than this benchmark. Networks that are highly geared have high debt servicing expenses, resulting in higher interest expenses which reduces the amount of tax payable.

However, these higher interest expenses are not funded by consumers, instead they are borne entirely by the network. Therefore, it is reasonable that since networks bear the cost of higher interest expenses, they should also receive the tax deduction associated with those expenses.

Research and development

In a similar vein to higher interest expenses, research and development costs are borne entirely by networks because they are not included as a benchmark efficient cost. Nevertheless networks invest in research and development in order to innovate and reduce costs for the business, as well as improving service quality for consumers.

As a result of research and development expenditure, networks are able to claim tax deductions to reduce the amount of tax payable, which has the potential to cause differences between allowed tax and actual tax paid. As with other expenses that are covered by networks as opposed to consumers, it stands to reason that networks should also have access to the tax deduction benefit associated with this cost.

Accelerated depreciation

Differences in payable versus allowed tax caused by 'Diminishing Value', 'Self-Assessed Asset Lives' and 'Low-Value Pools' are solely due to timing of when depreciation occurs, but do not result in a difference in the aggregate amount of depreciation on an asset (in nominal terms).

In all of these accelerated depreciation scenarios, increased depreciation expenses at the front end of an asset's life are offset by the corresponding reduction in depreciation expenses towards the end of the asset's life. Therefore, although depreciation and the resulting revenue deductions are exactly the same (in nominal terms), actual tax payable can be lower than allowed tax due to a mismatch in timing.

Ownership structure

We note that one of the key entity structures listed under this driver includes stapled structures. Issues surrounding stapled structures are relevant to the entire economy and as such are best dealt with via the changes currently underway as part of the recently released *Stapled Structures Exposure Draft*. Given that this issue is being resolved at an economy-wide level, it is unnecessary and imprudent to pre-empt these policy changes.

CONCLUSION

IPA welcomes the release of the initial public report in June and will be making further submissions to this review in due course. We note however, that the lack of time given for responses from interested parties can only magnify both the real and perceived risks of rapid regulatory changes currently faced by network businesses and their investors.

Thank you for your consideration of this submission, if you require any further detail please contact IPA's Senior Policy Adviser Lydia Robertson on (02) 9152 6011 or Lydia.robertson@infrastructure.org.au.

Yours sincerely,

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