



7 August 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 Consultation Paper -
Initial Report 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) consultation paper – initial report regarding the review of the regulatory tax approach for energy networks. This work builds on our previous submission:

- [Submission to the AER on the review of the regulatory tax approach](#) (5 June 2018).

As Australia's peak infrastructure body, representing public and private infrastructure owners and operators of all types, we welcome the opportunity to contribute to this consultation process. The results will no doubt have significant implications for confidence in regulatory frameworks for energy network businesses, the broader energy sector and investor confidence across all infrastructure types.

From the outset, we wish to express our concern with regards to the sheer volume of regulatory and policy reviews being undertaken in the energy sector. These successive reviews are eroding policy and regulatory stability within the sector. A lack of stability in the sector, reduces certainty and increases risks for investors, leading to a higher cost of capital and thus creating poorer outcomes for energy consumers in the long-term.

In this submission, we have focused our comments on two key areas:

1. We welcome the AER's acknowledgement of the shortcomings of the cost pass through model and reiterate the purpose and benefits of incentive based regulation; and
2. To minimise investor uncertainty and resulting increases in the cost of capital, the AER should rule out retrospective changes to the regulatory framework, if any changes are to be made at all.

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);
- [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 should commit to:
 - a. the preservation of incentive based regulation, with particular attention paid to ensuring that incentives are not incrementally eroded across multiple reviews; and
 - b. ruling out any retrospective action regarding potential changes to the regulatory tax approach.
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 to address investor certainty, which in turn will place downward pressure 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).

Earlier this year, the Australian Tax Office (ATO) 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 initiated a review and consultation process to examine the difference between the tax allowances and the actual tax payments made to the ATO by the regulated networks. To date, network businesses, investor groups and consumer associations have actively participated in the AER's tax review, providing feedback on the potential drivers behind the difference in tax allowances and actual tax paid.

The AER's initial report summarises this feedback and provides advice on many of the key drivers through expert reports conducted by Dr Martin Lally and McGrathNicol.

KEY POINTS

Preservation of incentive based regulation

For infrastructure assets that hold natural monopolies over their markets, best practice is to use incentive based economic regulation as a substitute for competitive forces to drive cost efficiency, innovation and service quality improvements. Under incentive based regulation, the regulator sets a benchmark of efficiency for the way the asset should be financed and operated in order to calculate the revenues that the asset is allowed to earn.

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 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.

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 pass through model whereby the regulated business passes on 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 leads to greater price uncertainty as consumers pay the actual costs incurred by businesses, which could be higher or lower than those of an efficient benchmark entity. Importantly, there is no incentive for businesses to operate more efficiently as any costs incurred are passed through to customers.

The AER's initial report cautions against a move to a cost pass through approach for tax payments and the expert report provided by Dr Lally strongly recommends against such a move. The AER's initial report highlights that any move to adjust tax allowances to reflect actual tax payments by energy networks:

“would exclude tax costs from the benchmark incentive framework that governs our overall approach to setting regulated revenues. Our current assessment is that we should exercise caution before moving to a tax pass-through approach. Such a move could lead to increased consumer charges across time. It could also create windfall gains or losses at the point of transition, and an incentive to shift tax between unregulated and regulated components of each corporate entity.”

Similarly, Dr Lally’s report explains that a move to a cost pass through approach has several disadvantages, including:

“higher prices for consumers than those consistent with the NPV [Net Present Value] = 0 principle, if tax payments exceeded the level allowed under the current regime, and this disadvantage would exist regardless of whether complete pass-through was applied at the individual firm or sector wide level. Such an outcome is not consistent with the long-term interests of consumers.”

With reference to both the AER’s comments and Dr Lally’s expert report, we submit that the AER should definitively rule out introducing a cost pass through model as a result of this review. Moreover, we welcome the AER’s position in recognising the benefits of incentive based regulation as it relates to the regulatory tax approach for energy networks.

Ruling out retrospective action to minimise investor uncertainty

The National Electricity Market (NEM) is already experiencing significant stress due to changing consumption profiles, the transition to new technologies and a wide range of policy interventions, which means having a predictable and stable regulatory framework for energy networks is even more important.

To maintain regulatory certainty, we submit that the AER should immediately rule out any retrospective action regarding possible changes to the regulatory tax approach. It is important for consumers, investors and network businesses to have certainty that although the ‘rules of the game’ may change in the future, changes should not impact on past decisions.

At a time of considerable flux within the energy sector, investors require ongoing certainty in the regulatory framework, which reduces risk and places downward pressure on the cost of capital – a key criterion for achieving long-term affordability for consumers.

Furthermore, 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.

CONCLUSION

Infrastructure Partnerships Australia looks forward to the AER's final report and recommendations to be released in December 2018. However, we note that the lack of time given for responses from interested parties will only serve to 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 our Senior Policy Adviser Lydia Robertson on [REDACTED] or lydia.robertson@infrastructure.org.au.

Yours sincerely,



Adrian Dwyer
CHIEF EXECUTIVE OFFICER