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Warwick Anderson
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Australian Energy Regulator
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By email: TaxReview2018@aer.gov.au

31 May 2018

Dear Warwick

**Response to Issues Paper - Review of Regulatory Tax Approach**

Jemena welcomes the opportunity to engage with the AER on its Review of Regulatory Tax Approach and looks forward to working collaboratively with Government, the AER and the ATO in any review of these arrangements.

We understand that there is concern in the community about energy prices, and in this environment an apparent divergence between an allowance for a particular cost and the actual costs incurred may heighten that concern. However, Jemena believes that maintaining the current incentive based regulatory framework based on a benchmark efficient company best serves the national energy objectives and provides the best outcomes for customers. To that end, simple year on year comparisons with tax paid do not reflect the complexities of either the tax system or the regulatory framework.

We note that a feature of incentive based regulation is that there will always be differences between actual costs and allowed costs. It follows from this that actual tax paid will differ from the tax allowances calculated in the regulatory models. There are a number of valid reasons why actual tax paid in any given year might be different to regulatory tax allowances. Many of these reasons have been outlined in the AER Issues Paper and we have provided our comments in more detail in this submission.

Since it was established in 2007, Jemena has in good faith complied with applicable energy and tax laws, regulations and rules. To assist stakeholders in understanding our ownership, company structure and financial position, we disclose additional tax information under the Voluntary Tax Transparency Code[1]. As discussed in that report, Jemena's ultimate Australian holding entity SGSP (Australia) Assets Pty Ltd (SGSPAA) only has business activities and investments in Australia, with some international related party dealings.

[1] http://jemena.com.au/getattachment/About/investors/annual-reports/SGSPAA-CY16-Tax-Transparency-Report.pdf.aspx

Jemena also supports the submission in response to the AER Issues Paper made by Energy Networks Australia (ENA).

## Background

*Understanding the problem*

The AER developed and implemented the building block incentive based regulatory model with the knowledge that there would likely be differences between actual costs and regulatory allowances. The purpose of this type of framework is to incentivise efficiency and penalise inefficiency, not to identify actual costs for each individual business.

One of the fundamental principles of the model is the concept of a benchmark efficient entity, a hypothetical standalone Australian domiciled network business. The benchmark efficient entity is central to the AER's methodology for assessing critical elements of building block revenue such as the:

- Return on debt, a component of rate of return, is set by reference to the return required by debt investors in a benchmark efficient entity[2]; and
- Estimated cost of corporate income tax building block is based on an estimate of taxable income that would be earned by a benchmark efficient entity[3].

In the ATO note and the AER Issues Paper, the implication is that there is a problem in that the actual tax payments of regulated entities differ from the AER's benchmark efficient tax allowance. However, as noted previously, differences between actual costs and benchmark efficient regulatory allowances are to be expected, and indeed encouraged, in an incentive-based regulatory framework where allowed revenues are set to compensate regulated businesses for benchmark efficient costs, and no more.

Indeed, under incentive-based regulation, practically every actual cost will differ from the regulator's benchmark efficient allowance. If this is viewed as a problem to be fixed, the obvious solution is to move to a cost-plus regulatory approach whereby the regulated firm recovers its actual costs plus a fixed margin. Under that model, the regulatory allowance is always equal to the actual cost.

In Jemena's view, setting allowances on the basis of the AER's determination of benchmark efficiency provides consistency across the industry for all stakeholders (including businesses, investors and customers) and helps to maintain stability of prices:

- Consumers pay no more if actual expenses are higher than the benchmark efficient allowance
- Regulated businesses are strongly incentivised to conduct their businesses more efficiently than the benchmark; and

[2] National Electricity Rules, clause 6.5.2(j), (k), and National Gas Rules rule 87(10), (11).

[3] National Electricity Rules, clause 6.5.3, National Gas Rules rule 87A.

- Consumers pay no more if the ownership of the regulated asset changes, even at a price in excess of the RAB.

Tax law and energy law are entirely different, with different objectives and incentives. Indeed, even if the two regimes were exactly aligned when a regulatory allowance is set, within a five year regulatory period tax laws could quite conceivably change (and the Australian tax system is in fact dynamically changing) such that the actual tax paid over that period would still differ from the regulatory allowance.

It is unclear whether changes to tax law that may have resulted in some differences were taken into account by the ATO or AER in their analysis.

Based on these factors and those presented below, it is Jemena's view that the issues raised by the ATO do not warrant changes to the current regulatory framework.

*Implications of changing the current regulatory framework*

The implication of the ATO note and the instigation of this review is that the regulatory framework should be amended so that tax allowances more closely reflect actual tax paid by each business. This could only be achieved by moving away from the ex-ante benchmark efficient entity incentive model. Some of the implications of this would be:

- Losing the incentives, symmetry and consistency of the framework and exposure of customers to potential inefficient tax arrangements and unstable prices;
- The risk of capital withdrawal from the industry. Long term investors in the industry are attracted to and have made investment decisions on the basis of the current framework, and changes that reduce profitability could see investors pulling out and heighten perceptions of sovereign risk; and
- Depending on the tax position of each business in any given year, revenues and therefore prices might arbitrarily increase for the customers of one business and decrease for another, completely unrelated to capex or opex efficiency, service improvement/decline or any other factor related to provision of energy services. Assuming any change applied across the board and reflected the observations of the ATO, tax allowances and recoverable revenues for government owned corporations (GOCs) would likely increase, arbitrarily increasing prices for the customers of those business.

*Scope of the review*

We echo the concerns raised by the ENA that the high-level analysis conducted by the ATO, the assumptions and exclusions in carrying out the comparative analysis (especially where the ATO has had to apportion data to isolate electricity distribution businesses in mixed overall businesses), could have a material impact on the results.

Further, the ATO note refers only to electricity distribution businesses. However, the AER Issues Paper analyses gas network business tax allowances, suggesting that regulation of gas businesses is also under review.

We note that the form of control is relevant when analysing tax allowances and actual tax paid. Under a price cap, which is generally applied to gas networks, the business is exposed to volume risk, meaning revenue and therefore tax may be higher or lower than the allowance in any given year. There has been no acknowledgment on the part of the ATO or the AER that a variation in revenue would result in higher or lower tax paid compared to the allowance.

Also of concern is the timeframe of analysis. As noted in the following section, some differences between regulatory tax and actual tax are due to timing. Actual tax payable may fluctuate above and below the tax allowance over longer periods of time for both private entities and GOCs. This would not be captured in an analysis covering only a few years.

**Responses to specific questions**

The AER has requested specific feedback along two themes: information sources and the drivers behind the differences. Jemena has concerns with respect to both of these aspects of the review, outlined below.

*Information sources*

The ATO's analysis included some assumptions and exclusions due to data limitations, and data was apportioned by the ATO where companies were mixed businesses or in a group[4]. Further, in the issues paper the AER noted that publicly available data sources were scarce and conflicting[5].

Jemena is not aware of publicly available sources of data additional to those identified in the issues paper, or that would provide accurate, comparable data, as companies do not arrange tax matters on the basis of regulation or their regulated businesses. Further, there is no requirement for companies to report a difference in performance between regulated and unregulated businesses. Therefore, the available information cannot properly reflect the differences in each business that influence whether particular outcomes are due to performance factors or tax factors.

If the AER requested an estimate of tax attributable to only the regulated business, comparison may still be compromised, as the basis of apportionment would be subjective to each taxpayer and therefore difficult to rely upon and not useful for comparison purposes.

Due to the lack of comparable data, we observe that it will be difficult for the AER to undertake meaningful analysis on which to base a proper assessment of the issue and determine the case for regulatory changes. We recommend that it takes into account the following factors during this process:

- **The ATO reported on an aggregate basis:** Consistent with incentive regulation generally, some businesses may have paid tax above the allowance

[4] ATO Note, p1.

[5] AER, Review of regulatory tax approach: Issues paper, May 2018, p1.

and others below the allowance, with the net position falling above or below. Any changes that are applied symmetrically could lead to lower prices for some customers and higher prices for others;

- **Tax payable at the shareholder level:** While some deductions may reduce tax payable, those deductions may be a source of income to the shareholder and be taxed elsewhere. For example, shareholder debt may be used to fund the purchase or construction of regulated assets. The interest expense on this debt will be deductible to the regulated business (reducing actual tax paid), but will be assessable to the shareholder (as ordinary income or subject to withholding tax); and
- **Settling corporate tax affairs is a complex and lengthy process:** Legitimate differences of opinion between the taxpayer and the ATO can take years to resolve, and may result in material changes to the final tax liability for a given year.

*Drivers*

Jemena submits that the majority of drivers suggested in the AER Issues Paper do not warrant a change to the current regulatory framework. This is because most of the drivers are either related to timing or are symmetrical in nature:

- **Timing:** some drivers result in timing differences to tax payable, not the amount of tax payable, for example accelerated depreciation. It seems unnecessary to make a change based on timing differences that do not affect the aggregate regulatory tax allowance associated with an asset;
- **Symmetrical:** some drivers are based on outperformance/underperformance of benchmark entity allowances, which means that the outcome could be higher or lower than actual tax paid compared to the allowance. This goes to the discussion above regarding the intent of incentive based regulation. Where the outcome is symmetrical, there will be some instances where adjusting the allowance to meet the actual results in a higher tax allowance and prices, and some instances that will result in a lower tax allowance and lower prices. Generally in these cases, the increase in cost that has caused the lower tax paid is not recovered.

The table below outlines the drivers raised by the AER and provides a discussion regarding their characteristics in the context of timing and symmetry.

| Potential Driver | Current tax practice | AER approach | Effect of difference | Characteristics of driver |
|---|---|---|---|---|
| Ownership structure | Some ownership types may attract a lower statutory tax rate (15% or 0% where the tax is payable at the investor level). | Use the statutory corporate income tax rate for Australian companies (30 per cent). | A lower tax rate means a lower tax payable amount than in the AER model. | This driver is not affected by timing or symmetry. That is, structuring so that tax is paid in a lower tax entity means that actual tax paid is lower compared to allowance. However, as noted in the section 'Information Sources', when analysing this it is important to take into account the full tax picture, including additional income tax that may be paid at the shareholder level. |
| Gearing | NSPs may be highly geared (greater than 60 per cent). | Use the benchmark gearing (60 per cent). | Interest expense is higher than in the AER model, and so taxable income is lower. | Gearing may be higher or lower than the benchmark of 60%, meaning interest expense and taxable income may also be higher or lower. Where a business has incurred a higher interest expense, this is an uncompensated higher cost that has a flow-on effect to reducing tax payable. Through the incentive framework, customers have not funded that higher cost. |
| Diminishing value | NSPs may adopt diminishing value depreciation for tax purposes, which front-loads asset depreciation. | Use straight-line depreciation for tax purposes. | Tax depreciation is higher than in the AER model, and so taxable income is lower (in this period). | Depreciation drivers only cause timing differences between tax allowed and tax paid. A $100 asset with a 20 year life depreciated at $5 per year over 20 years or $20 per year for 5 years results in the same total depreciation and the same deduction from revenue for tax purposes. |
| Self-assessed asset lives | NSPs may self-assess shorter asset lives for tax purposes. | Use the ATO standard asset lives for tax purposes. | Tax depreciation is higher than in the AER model, and so taxable income is lower (this period). | Timing differences, as above. |
| Low-value pools | NSPs may aggregate assets worth less than $1,000 and then rapidly depreciate them. | Always use the tax asset lives that apply to the original asset class. | Tax depreciation is higher than in the AER model, and so taxable income is lower (in this period). | Timing differences, as above. |
| Prior tax losses | NSPs may have available tax losses. | The AER models recognise prior tax losses, but at present no NSPs were expected to accrue tax losses. | Current taxable income is offset (reduced) by past tax losses, so tax payable is lower than in the AER model. | Prior year tax losses are a timing issue and do not change the total amount of tax paid over the life of an asset. Further, tax losses relate to the owner of an asset and not the asset itself. A company may have tax losses unrelated to the regulated asset base that it uses to offset taxable income, which should not form part of the regulatory regime. |
| Research & Development (R&D) deductions | NSPs may reduce their taxable income to reflect expenditure on R&D. | No R&D deductions included in models. | Taxable income is lower than in the AER models and so tax payable is lower. | This is not due to timing and is not symmetrical. However, the ATO has made it known that it is looking to tighten use of the R&D allowance which may |

| Potential Driver | Current tax practice | AER approach | Effect of difference | Characteristics of driver |
|---|---|---|---|---|
| | | | | reduce the impact of this driver. |
| Cost of debt | NSPs may borrow at rates above (below) the regulated cost of debt; this may also include borrowing from related parties. | Use the benchmark regulated cost of debt. | If interest rates are higher (lower) than the regulated cost of debt, interest expense is higher (lower) than assumed in the AER model, and so taxable income will be lower (higher). | This driver is symmetrical and the outcome is similar to gearing. Debt markets and other factors will influence the actual interest rates paid by businesses and could vary year to year or period to period. As noted for gearing, higher interest costs are uncompensated. |
| Tax Asset Base (TAB) revaluation | NSPs may revalue their TAB as a result of a sale or corporate restructure. | TAB is not revalued. | If the revaluation is upward, TAB is higher than in the AER model. Subsequent tax depreciation will be higher than in the AER model, and so taxable income will be lower. | The revaluation could be upward or downward, which means that this driver is symmetrical. Further, in the case of an upward revaluation, the increased depreciation cost is uncompensated. |
| Immediate expensing of refurbishment | NSPs may treat refurbishment capex as an expense, so that it is immediately depreciated for tax purposes. | Use standard tax asset lives for the refurbishment capex. | Tax depreciation is higher than in the AER model, and so taxable income is lower (this period). | Timing differences, as above for other depreciation drivers. |

## Conclusion

Jemena is cognisant of the circumstances surrounding the instigation of this review. However, we firmly believe that due to the following factors, changes to the current regulatory framework are not necessary:

- The current ex-ante incentive framework with regulatory tax allowances based on the benchmark efficient entity provides the best outcomes for customers and encourages efficient investment in the industry; and
- Almost all the drivers raised by the AER are due to timing differences or are symmetrical in nature.

If you wish to discuss this submission, please contact Sandeep Kumar on (03) 9173 8218 or at sandeep.kumar@jemena.com.au.

Yours sincerely

Usman Saadat

General Manager Regulation