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

23 Nov 2018

Dear Warwick

Response to Discussion Paper - Review of regulatory tax approach

Jemena is appreciative of the AER's level of engagement with stakeholders in its Review of Regulatory Tax Approach to date and welcomes the opportunity to comment on the AER's discussion paper dated 1 November 2018 (**Discussion Paper**). The process undertaken by the AER to date has been well considered and we look forward to continued collaboration with the AER on this matter.

We also wish to take this opportunity to provide comment in relation to the appropriate treatment of interest expense, having regard to the fact that the AER is yet to form a preliminary view on this issue. -

1. Tax pass-through

Jemena supports the AER's preliminary position that a tax pass-though is not warranted, noting that this view is also consistent with the conclusions of PwC and Dr Lally[1].

In our view, the current ex-ante incentive framework with regulatory tax allowances based on the benchmark efficient entity provides the best outcomes for customers and efficient investment in the industry.

2. Benchmark tax rate

Jemena supports the AER's proposal to not depart from using the 30% corporate tax rate as the benchmark tax rate, based on an Australian domiciled company structure.

This approach is consistent with the principle of the single benchmark entity in the incentive regulatory framework. Further, whilst Jemena is not privy to the position of

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[1] AER, Discussion paper: review of regulatory tax approach, November 2018, p99.

other taxpayers, PwC's assessment that the majority of TAB value of regulated entities are effectively subject to a 30% corporate rate does not come as a surprise.

3. Refurbishment capex

Jemena is concerned by proposed changes to reflect immediate expensing of refurbishment expenditure (i.e assumed immediate deductibility) in the regulatory framework. We do not support a benchmark approach or any approach that applies a single assumption across all businesses on this matter.

We believe that such an approach in the regulatory framework will incentivise and reward businesses taking a view that refurbishment capex is immediately deductible as a rule when in actual fact the question of deductibility of capex should be assessed on a case by case basis having regard to the specific facts and circumstance of the particular business in question. We also observe that this approach could arguably create a perception of the AER endorsing immediate deductibility of capex as a rule (contrary to ATO guidance on the issue).

Further to the above, it is Jemena's understanding that the evidence suggests that some businesses claim small amounts and some claim large amounts, ranging from less than \$10m to over \$200m, for immediate refurbishment deductions, and that the amounts claimed are unrelated to the size of the business[2].

For completeness, such a finding would appear consistent with our view that the deductibility of refurbishment capex needs to be assessed on the specific facts. Importantly, this finding also means that any chosen benchmark will be materially different to the actual position for most businesses and may well result in unintended outcomes.

Notwithstanding our position above, if the AER resolves that a change is needed to the treatment of capex in the regulatory framework, Jemena recommends that:

- Changes are prospective and apply only to new refurbishment expenditure

- Any adjustment to reflect immediate expensing of capex should only apply to businesses that are in a position to apply this rule for deductibility of capex. The quantum of deductible capex can be assessed based on the business' forecasts of the value of relevant deductible expenditure at the time of the regulatory reset.

4. Diminishing value depreciation method

Jemena understands that the AER has proposed that the regulatory framework be changed to incorporate diminishing value (**DV**) depreciation to more closely reflect actual tax practices. While we acknowledge that a change to DV would most likely

[2] AER, Discussion paper: review of regulatory tax approach, November 2018, p58.

close the gap on the time value of money gain being achieved by most businesses who use DV, we are concerned that this change, if applied to existing assets, would raise intergenerational inequity by changing the profile of benefits to consumers.

Under straight line depreciation, users of network assets pay for those assets equally over the lives of those assets and receive the tax benefit equally over the lives of the assets. In contrast, applying DV for the tax side of the equation means that consumers using the assets in the early years of the asset lives receive a greater tax benefit, thus paying a lower effective price for the same utility value than those using the assets later in the asset life.

As noted in the Discussion Paper, the ability for businesses to respond to the benchmark incentives by changing their actual tax practices is important[3]. Given that taxpayers are not able to change the basis of tax depreciation (e.g. from straight line to DV) after the initial choice has been made (which would have been made at the start of the asset's life and which would have underpinned the investment decision), businesses cannot respond to the change in the regulatory framework.

This appears to us to be inconsistent with an important design feature of the regulatory regime (until all assets currently in the TAB reach the end of their useful lives).

We also wish to highlight the distortion that would be created by changing from one method of depreciation to another method of depreciation during an asset's life, whereby the impact of the change would differ depending on the remaining life of the specific asset. In particular, the impact of the change will be more significant for a long-lived asset that is in its first few years of useful life as compared to an asset towards the end of its useful life. This will result in arbitrary windfall gains and losses to customers, depending on the asset age profile of each business.

If the AER does decide to change the regulatory framework to incorporate DV for tax purposes, we recommend that it should be implemented on a prospective basis only.

5. Cap gas asset lives

We understand that the AER has proposed that the regulatory framework be changed to incorporate capped asset lives for gas pipeline assets to more closely reflect actual tax practices. A change to cap asset lives for gas pipelines to 20 years would appear to close the gap on the time value of money gain being achieved by a number of businesses[4].

For reasons similar to those outlined for diminishing value depreciation, we consider that, if such a change is to be made, it should be applied on a prospective basis to new assets only.

[3] AER, Discussion paper: review of regulatory tax approach, November 2018,p 70.
[4] AER, Discussion paper: review of regulatory tax approach, November 2018, p46.

6. TAB revaluation

Jemena supports the AER's proposal to make no change to the regulatory framework with respect to TAB revaluations.

Under the current regulatory framework, any changes to the tax cost base recognised by the ATO are not recognised in the TAB and represent a potential difference in tax payable relative to the estimate of regulatory tax cost. The AER has stated that it is appropriate to preserve a consistent regulatory approach that insulates consumers from changes in valuation of assets, on both the RAB and TAB[5]. Consistent with that rationale, it is reasonable that where a business is not compensated for a higher return on capital and return of capital building block, that it is also not impacted by a lower tax building block. For similar reasons, it is reasonable for the AER not to increase the TAB on account of stamp duty.

7. Treatment of interest expense

The AER has not yet provided a preliminary position in relation to the treatment of interest expense on the basis that it required more information to do so. We also understand that it is the AER's expectation that the RIN information provided by the businesses will provide a basis upon which it can form a view. However, in the interim, several options have been raised for consideration that could be implemented to reduce the difference between actual interest deductions claimed and those allowed in the regulatory framework.

In general, any of the four options discussed in the paper would create an asymmetry between what is compensated within the regulatory framework and what is outside the regulatory framework. Differentiating interest paid (through gearing, market value of debt, actual debt cost or hybrid securities) for tax purposes from the benchmark debt cost in the rate of return means customers would receive (pay) the tax benefit (cost) of a higher (lower) interest cost that they have not funded (benefited from) through the benchmark rate of return.

When considering the evidence and options, it is important to keep in mind the intention of the review which is to better measure efficient tax costs in the context of the long term interests of consumers[6]. As noted by the AER, it is not necessarily the case that reducing the difference between the allowance and the actual tax paid will necessarily produce a better outcome for consumers in the long term.

Further, changes made to reduce the difference might create (dis)incentives resulting in sub-optimal outcomes over time. For example, businesses whose actual gearing is below the new benchmark would be incentivised to increase gearing which may be a decision outside of its risk preferences and therefore not efficient for that business' circumstances.

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[5] AER, Discussion paper: review of regulatory tax approach, November 2018, p82.

[6] AER, Discussion paper: review of regulatory tax approach, November 2018, p2

Jemena supports the conclusions of Dr Lally[7] and the Independent Panel[8] for the rate of return guideline review that gearing for rate of return should be consistent with gearing for tax calculations. Further to their arguments, we urge the AER to carefully consider potentially distortionary incentives that may arise from using a different benchmark for tax purposes.

If you wish to discuss this submission please contact Sandeep Kumar on [redacted] or sandeep.kumar@jemena.com.au.

Yours sincerely

[redacted]

Usman Saadat

General Manager Regulation

[7] Lally, M, Tax payments versus the AER's allowances for regulated businesses, June 2018, p32.
[8] Independent Panel, Review of the Australian Energy Regulator's rate of return draft guidelines, September 2018, p35