23 November 2018

Mr Warwick Anderson
General Manager Networks Finance and Reporting
Australian Energy Regulator
GPO Box 520
MELBOURNE VIC 3001

Via email: TaxReview2018@aer.gov.au

Dear Warwick

AER Discussion Paper –Review of regulatory tax approach

SA Power Networks, Australian Gas Infrastructure Group, CitiPower, United Energy and Powercor (**the Businesses**) are pleased to provide this submission in response to AER's Discussion Paper- Review of regulatory tax approach, dated November 2018 (**Discussion Paper**).

As with previous submissions, the Businesses endorse and adopt the Energy Networks Australia submission in response to the Discussion Paper. The Businesses support the AER's indications in the Discussion Paper in respect of those matters where changes are not considered necessary. In respect of the matters where the AER has proposed changes, this submission emphasises the issues the Businesses have particular concerns about for further consideration by the AER.

Asset lives for gas pipelines

Under current tax laws, gas networks have a choice to adopt longer than 20 year asset lives. The Businesses disagree that it should be accepted that the benchmark efficient practice is to adopt 20 years for gas assets.

As explained in more detail in the Energy Networks Australia submission, the provisions introducing statutory capped effective lives in 2002 were intended to provide an incentive to businesses and promote investments in the Australian gas industry. The purpose behind the statutory capped effective lives was "to address the broader national interest where large increases in 'safe harbour' effective lives resulting from the review of the existing effective life determination by the Commissioner would have a significant effect on investment in industries with national economic implications".

The AER's Discussion Paper appears to assume that tax law currently requires the use of the 20 year statutory capped effective life for gas assets. However entities may either adopt the Commissioner's effective lives (the statutory cap) or self-assess the effective lives of gas assets. In the event that an entity chooses to self-assess the effective life of gas assets based on their own circumstances, the capped life will not apply to these assets.

In light of the above, it should be accepted that the benchmark efficient practice could encompass either the adoption of 20 year lives or self-assessed lives, as allowed for by tax legislation since 2002. It follows that gas networks should also have that choice in the depreciation of its regulatory tax asset base. This is consistent with observed practice since 2002 where some businesses chose not to adopt 20-year lives.

The Businesses otherwise refer to and adopt the Energy Networks Australia submission on this issue.

Interest Expense

The AER observes in the Discussion Paper that, based on the ATO's high level note, some networks may claim a tax deduction that is higher than the AER's return on debt allowance. The AER has indicated that it has not yet had time to determine whether any change is warranted.

The Businesses consider that no change to the current approach is justified. As the Energy Networks Australia submission explains, that fact that networks may claim tax deductions (for example, due to differences in gearing) which differ from the regulatory debt allowance is consistent with the incentive framework and not an indication that a change needs to be made.

Further, debt that is outside of the regulatory asset base is irrelevant to the regulatory allowance. If a buyer acquires a network at a price in excess of the RAB value, the buyer must fund the excess and no contribution is received from consumers through the regulatory allowance. It follows that debt funding outside of the RAB should be disregarded for the purposes of determining whether any change to the regulatory allowance is necessary.

The Businesses otherwise rely on and support the Energy Networks Australia submission on this issue.

Refurbishment costs

The Businesses are concerned with the indication that the AER is considering amending its models to provide for the immediate expensing of some categories of capital expenditure. The current approach, where refurbishments and replacements are treated consistently, encourages networks to refurbish assets where it is efficient to do so. As explained in more detail in the Energy Networks Australia submission, the change being considered by the AER will have the opposite effect, incentivizing networks to replace assets rather than refurbish them. This outcome would be inconsistent with the long term interests of consumers and will not contribute to the achievement of the national electricity and national gas objectives.

The AER recognizes, at a high level, the potential negative capex incentives that could be created by the immediate expensing of refurbishment costs.[1] The AER's expert advisor PWC also recommends consideration be given to the impact of such a change on asset replacement decisions.[2] However, in the discussion that follows the AER's observation (in Table 6.1) that this could be a "con" of the approach, there is no detailed consideration of this issue, nor any balancing of that risk against the potential advantages of the approach. The impact of any proposed change on the incentive properties in the regulatory framework and the long term interests of consumers should be of paramount importance in this review.

[1] AER Discussion Paper, Review of regulatory tax approach, November 2018, Table 6.1 page 48.

[2] PWC, AER Tax Review 2018 Expert Advice, 26 October 2018, Page 20

Instead, the AER's discussion of the issue is focused on the NPV=0 condition. The AER also seems to rely quite heavily on its finding that, on the information received so far, the treatment of capex is a material driver of the underlying tax difference for *some* networks. We make the following submissions:

- The NPV=0 condition, while important, is only one factor that needs to be considered in assessing whether any change in approach is required.
- As we have sought to explain in previous submissions in this review, the fact that there is a difference, even a material one, in the tax paid and the regulatory tax allowance does not of itself mean there should be a change in approach. In this instance, the AER notes that this is only the case for some, but not all networks. In our view, this does not indicate there is a need for change, or that expensing capital expenditure upfront reflects a benchmark efficient approach.
- As noted above and explained in detail in the Energy Networks Australia submission, we have serious concerns that the effect of the AER's proposed change will be to incentivise replacement of assets, rather than refurbishment, in circumstances where that may not be efficient. This is not in the long interests of consumers.
- The possibility of the AER's proposed approach having a benefit to consumers in the short term (because of a higher tax deduction) and disadvantaging future customers' is not adequately addressed. The AER notes (in respect of the current approach) that reducing generational inequity encourages efficient use of energy services and is in the long term interests of consumers.[3] We agree, but the same issue arises in respect of the AER's proposed approach. Refurbishment of assets is to the benefit of current and future customers, but under the AER's proposed approach, only future customers would pay. In fact, the more that is spent by networks on refurbishment, the lower the price that will be paid by current customers.
- It could be expected that under the current approach, where it has been efficient to do so, networks will have refurbished rather than replaced assets. If there is now a change in approach, those networks will be penalized because they will have higher refurbishment costs than would otherwise be the case.
- Further, the AER only goes so far as to find that this change could be in the long term interests of consumers[4,] not that it is. For the reasons explained in detail in the Energy Networks Australia submission and noted above, the Businesses submit that there has not presently been enough consideration of the impacts of this proposed change for the AER to form a view that it is in the long term interests of consumers.

The Businesses stress the need for the AER to give full consideration to these issues, and those raised in the Energy Networks Australia submission, before a final decision is made in this review.

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[3] AER Discussion Paper at page 61.
[4] Ibid at page 62.

Lodgment of SA Power Networks regulatory proposal- request for extension of time

As the AER is aware, SA Power Networks regulatory proposal is currently due to be submitted by 31 January 2019. In light of the ongoing uncertainty arising from this review of the regulatory tax approach, as well as other reviews, such as the Rate of Return Guideline review, it will be extremely difficult and impractical for SA Power Networks to finalise its regulatory proposal for lodgment by 31 January. It is in the interests of all stakeholders for there to be certainty about the approaches to tax and rate of return prior to SA Power Networks putting forward its proposal for consideration. To do otherwise will necessarily result in SA Power Networks having to revise its proposal once there is greater certainty as to the outcome of the current reviews.

On that basis, SA Power Networks requests an extension of time to lodge its regulatory proposal for a period of one month, to 28 February 2018. SA Power Networks considers this to be a reasonable request in the circumstances of the current reviews.

Please contact Patrick Makinson on [redacted] if you would like to discuss this submission further.

Yours sincerely

[redacted]

Patrick Makinson Company Secretary	Renate Vogt General Manager Regulation	Craig de Laine General Manager People and Strategy