Submission to AER Issues Paper: Review of regulatory tax approach

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Background

I am a PhD student through Curtin University and parts of my PhD have involved examining the difference between the tax allowance and tax paid for a number of organisations and industries, including the electricity industry. I have studied several price regulators and how the regulatory process works in conjunction with our tax system.

This is a link to a paper and conference I presented at in 2016 which gives a high-level overview of my research at that time. My studies have progressed since that time. https://www.business.unsw.edu.au/About-Site/Schools-Site/Taxation-Business-Law-Site/Documents/Doueihi_%20ATTA-Paper-Submitted.pdf

In addition, in my capacity as a taxation specialist of a regulated entity, I was involved in the IPART workshops when IPART moved to a post-tax WACC framework. Several of the recommendations I made at these workshops were adopted by IPART in their calculation of the tax allowance.

This submission draws on some of the research undertaken in the course of my candidacy to date and my work experience. Where possible, I have referenced statements back to source documents. Where confidential work is mentioned, I have used the phrase “in my experience”.

Thank you for taking the time to read and consider the points raised in this submission.

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Overview

Whilst I haven't been able to locate the AER's principles for the tax allowance, most regulators believe that the tax allowance is not meant to mirror the tax paid. In a study undertaken by CME Australia for the Essential Services Commission of Victoria, it was noted that there are intended differences between the tax paid and tax allowed by the price regulator.[1] Further, the AEMC estimates the efficient tax.[2] With this in mind, this submission has been prepared on the basis that differences between the tax allowance (as calculated by the AER) and tax payable (referring to the actual tax remitted to the ATO) are to be expected, and that the aim of the tax allowance is not to mirror the tax payable, but rather to present a view of what tax payable would have been for an efficient business within the constraints of the regulatory framework.

The drivers that determine the calculations in the price determination are different from those used in the tax return. For example, the tax allowance is set on a forecast basis – price determinations are based on forecast demand, income and expenses. However, the tax return and resultant tax payments are based on actual results. As a starting point, the AER needs to consider how much of the difference between the tax allowance and tax paid was driven by differences "above the line" – those which resulted from differences in forecast demand, income and expenses to actual.

Further, an item that produces a greater tax allowance could be resulting in a benefit to customers "above the line". For example, a regulated entity might have a tax allowance which is higher than the tax payable. That difference might result from a forecast $200m in expenses, where actual expenses were $300m. From a tax perspective, the tax allowance would appear to be overstated by $30m because the higher actual expense has resulted in a higher deduction, leading to a lower taxable income and therefore less tax payable. However, customer bills have only allowed for the forecast $200m in expenses, rather than the actual expenses of $300m. As a result, customers are advantaged by $70m overall (being the $100m understatement of expenses less the $30m overstated tax allowance).

As illustrated in the example above, not all the differences resulting in a higher tax allowance are to the detriment of customers.

Sources of data

ATO data – Tax transparency report

Companies lodge their tax returns on a consolidated basis. Where a regulated entity is a subsidiary and part of a larger group, the information reported to the ATO, both through the tax return and in tax payments, is on a consolidated basis. The ATO has no visibility of tax payments on an individual entity basis where that entity is part of a larger consolidated group. Therefore, the AER needs to have a means of being able to accurately extract the information relevant only to the regulated entity from the consolidated data available from the ATO if it chooses to rely on the Tax Transparency Report.

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[1] "Regulatory arrangements for the cost of capital and tax in the regulation of Victorian water companies: issues and ideas" pg. 6. (CME for ESC Victoria)

[2] AEMC: Review into the use of total factor productivity for the determination of prices and revenues.

Using AGL as an example: AGL provides gas and electricity to over 3.6 million customers across Australia. It is Australia's largest electricity generator and the largest ASX-listed investor in renewable energy.[3] AGL operates in both the regulated and retail markets in the electricity and gas industries. The 2017 annual report shows two pages of subsidiaries.[4] To attempt to extract the AER-regulated portion of tax payments from the tax transparency report (or even from the financial statements, any other publicly-available information, or even the tax return (not publicly available)) for such a large and complex organisation is a near impossible task (I have tried!)

Annual reports/Financial statements

Again, these are prepared on a consolidated basis. If the regulated entity is part of a consolidated group, the AER might be able to extract out the regulated entity data either through the segment data reported in the financial statements, or if the regulated entity is the head entity of the consolidated group.

It is also important to note that not all information in the financial statements is presented in such a way to be of use for the AER's exercise.

Cash Flow Statement from Annual Report and Financial Statements

I note that the AER examined the tax payments from the Cash Flow Statements in Table 4.3: *Reported tax payment data from cash flow statements for privately owned NSPs across 2012-17*[5]. The tax payments from the Cash Flow Statement are an unreliable measure of tax assessed in any one income year. The tax payments in the cash flow statement will usually relate to two financial (and therefore tax) years. In any one year, the last instalment and any outstanding tax payment/refund for the prior year are included in the current year tax payments, and the final instalment and any outstanding tax payment/refund for the current year will be included in the following year's Cash Flow Statement. In addition, the current year tax payments from the Cash Flow Statement could also include tax payments or refunds resulting prior year amendments or the result of ATO audits.

The tax payments in the cash flow statement are a measure of tax paid in a financial year, not the tax paid relating to that financial year.

Total Tax Expense from Annual Reports and Financial Statements

Further, I note that the AER examined the Total Tax Expense in Table 4.4: *Reported tax payment data from income statements (income tax expense) for privately owned NSPs across 2012-17*[6]. The Total Tax Expense is the sum of Current Tax Expense and Deferred Tax Expense. AASB112 defines current tax as "the amount of income taxes payable (recoverable) in respect of the taxable profit (tax loss) for a period." The deferred tax expense relates to "amounts of income taxes payable in future periods in respect of taxable temporary differences."[7]

Many of the tax adjustments that occur affect both the Current Tax Expense and the Deferred Tax Expense (except for any "permanent" differences), resulting in a Total Tax

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[3] https://www.agl.com.au/about-agl/who-we-are/our-company
[4] AGL 2017 Annual Report, pg. 44-45.
[5] AER, Issues Paper: Review of Regulatory Tax Approach, Table 4.3, pg. 13.
[6] AER, Issues Paper: Review of Regulatory Tax Approach, Table 4.4, pg. 13.
[7] AASB112: Income taxes. Para 5, definitions.

Expense that is not indicative of tax paid or payable. For example, a tax depreciation adjustment might reduce the taxable income (and therefore Current Tax Expense) by $100m. However, as a result of the increased tax depreciation, the Deferred Tax Expense will increase by $100m, resulting in a nil difference to Total Tax Expense. Therefore, using the Total Tax Expense as an indicator of tax payable is inaccurate.

The closest indicator of tax payable is the Current Tax Expense in the Financial Statements. The Current Tax Expense is, in effect, a calculation of the tax on taxable income at that time. Please note that the Current Tax Expense in the financial statements contains only preliminary tax payable figures which are then "trued-up" after the financial statements have been finalised and when the tax return is prepared. Any differences between the preliminary figures in the financial statements and the final figures in the tax return are reported as "prior year adjustments" in the following year's tax expense note. In addition, any tax payable/refundable resulting from amendments to tax returns are also reported as "prior year adjustments."

Deferred tax asset/loss

Section 4.5 of the Issues Paper notes that very limited information is available on tax losses.

AASB112 requires the carryforward of unused tax losses to be recognised as a deferred tax asset. Therefore, any tax losses are normally recognised in the deferred tax asset note of the financial statements. However, these losses will likely be the consolidated group tax losses and any losses relating to regulated activities will need to be extracted.

AER – RIN

The Regulatory Information Notice (RIN) is an excellent source of information about the results of regulated entities. The Economic Benchmarking RIN provides an excellent source of data on income, expenses, provisions and assets. The AER might choose to use its information-gathering powers to expand the RIN to require regulated entities to provide more information about their actual tax position.

Australian Bureau of Statistics (ABS)

The ABS collects limited tax data. However, this is unlikely to be of sufficient detail for the AER's purpose.

Drivers between tax allowance and tax paid

Differences between forecast and actual

As discussed in the opening, the price determination is based on forecasts of demand, income and expenses. The tax return and resulting tax payments are prepared based on actual figures. As a starting point, the AER should consider how much of the difference between the tax allowance and tax paid was driven by the difference in the forecasts and actual results.

Imputation credits

This submission is not disputing or questioning the adjustment for imputation credits in determining the tax allowance, however in order to enable a like-for-like comparison, I believe the AER needs to remove the effect of the imputation credits from the tax allowance when it performs its comparison to the tax payable.

To illustrate:

AER	ATO
AER calc of estimated taxable income Tax at 30% (a) (Less: Imputation credits) = Tax allowance	Actual taxable income per tax return Tax at 30% - This is the tax payable

As can be seen from the above table, in order to compare like-with-like, the AER needs to compare the difference between the tax allowance before the application of any imputation credits. This is illustrated as (a) in the table above. This is because the tax payable as the ATO calculates it does not recognise a similar imputation credit adjustment in the tax return. I could find no evidence of either the ATO or AER calculations having taken this into account.

I note that the AER has done this in Table 3.1: *AER estimate of tax payable across 2012-17*.

Depreciation, low value pools, and other asset-related deductions

In your issues paper, you noted a number of differences were related to assets and depreciation-related differences, specifically:

- The AER uses straight-line depreciation, where many NSPs adopt diminishing value depreciation for tax purposes.
- The AER uses ATO standard asset lives for tax purposes, whereas NSPs have the option to self-assess effective lives.
- The AER does not allow for low-value pools, where these might be in use by NSPs.[8]
- The AER does not revalue the TAB, whereas NSPs may revalue their TAB as a result of a sale or corporate restructure.[9]

The AER could avoid all asset, tax depreciation, and low value pool differences by adopting the actual forecast tax depreciation by the NSPs. IPART currently does this as part of the calculation of the tax allowance for its regulated entities. IPART states:

> Tax depreciation will be based on businesses' existing financial modelling of tax depreciation adjusted to remove unregulated activities.[10]

In addition, the AER needs to ensure that tax depreciation is not being indexed. In my experience, price regulators sometimes incorrectly index depreciation for inflation as part of their calculation of the tax allowance. However, current tax laws do not allow for any inflation or indexation related adjustments to tax depreciation.

[8] AER Issues Paper: Review of Regulatory Tax Approach; pg. 16
[9] AER Issues Paper: Review of Regulatory Tax Approach; pg. 17
[10] IPART: The incorporation of company tax in pricing determinations; pg. 2.

Capital gains tax

In my experience, price regulators do not account for capital gains tax in the tax allowance component of their price determinations.

For regulatory purposes, when an asset is disposed, price regulators usually remove the total sale proceeds from the regulated asset base. However, in the work I've done to date, I haven't yet found a price regulator which makes any adjustment for capital gains tax.

I could not see that this had been taken into consideration in either the AER issues paper or the ATO Note. This could potentially be a large driver of the difference between the tax payable and tax allowance, especially if there have been large asset disposals.

Debt to equity ratio and Cost of debt

As mentioned in Table 5.1: *Potential drivers from the ATO note – material drivers of lower tax payments for privately owned* networks a potentially large difference between the tax allowance and tax paid results from the difference between the debt to equity ratio allowed for in the price determination and the actual debt to equity ratio.

Further, and as discussed in Table 5.2: *Additional potential cost drivers*, cost of debt itself could be a driver of differences in interest allowed in the price determination and the interest deduction. The AER makes assumptions on benchmark credit rating and return on debt, but this may not match the actual interest rates paid by the regulated entity.

These items have implications in other parts of the building block which should be considered in conjunction with the tax effect.

Gifted assets/developer contributions

Although the AER has made little mention of gifted assets/developer (or capital) contributions, in my experience this has been a large driver of the difference between the tax allowance and tax paid. (As an aside, I have included further information about this topic as Appendix A).

Gifted assets or developer contributions are typically difficult to forecast accurately. In my experience, there has been a material difference when comparing the developer/capital contributions or gifted assets included in the price submission and the actual figures. On this basis, the AER might want to consider this as an area to examine for potential differences between the tax allowance and tax paid.

Tax losses

Table 5.1: *Potential drivers from the ATO note – material drivers of lower tax payments for privately owned networks* discusses the effect of available tax losses in reducing tax payable.

I believe these tax losses need to be examined for their origin. Questions to be asked include:

- Were the losses generated by non-regulated or unregulated activities?
- Were the losses incurred by another member of the tax consolidated group?
- Did any of the losses relate to a time before the activities became regulated?

Unregulated and non-regulated activities

The AER should be aware of the extent to which unregulated or non-regulated activities have formed part of the responses to the above. Where possible, any unregulated or non-regulated activities should be removed from the categories above.

I could find no evidence of the removal of unregulated or non-regulated activities from the actual tax payments in the analysis performed by the AER and ATO.

Abnormal items

Abnormal items or unexpected events can be one of the drivers between the difference between the tax allowance and tax paid. Examples of abnormal items include any changes to the consolidated group, large divestments, restructures or acquisitions; and the effect these had on the tax asset register and any tax payable, tax refundable or tax losses.

Information the AER would need to obtain on actual tax payments

Details of the consolidated group

Gaining a greater understanding of the consolidated group will enable the AER to determine whether tax was being paid at 30% in Australia. Details needed would include whether the consolidated group consisted of any stapled structures or partnerships and would enable the AER to determine whether any differences between the tax allowance and tax paid were due to the ownership structure.

Statement of Taxable Income by subsidiary or sector

A statement of taxable income (STI) by subsidiary or sector would enable the AER to be able to accurately quantify the tax payments that related to the AER-regulated segment of the business.

As an alternative, the AER could request the tax return broken-down by subsidiary.

Summary of main accounting to tax differences

The summary of main accounting to tax differences details the drivers that make up the difference between accounting profit/(loss) and taxable income/(loss). If obtained by subsidiary or sector, this could be a good alternative to the statement of taxable income.

Actual tax depreciation

The AER can request, as part of its RIN, the actual tax depreciation data including details of whether there have been any disposals, use of self-assessed effective lives, and the use of low value pools. The AER could then compare these to the AER's models and might wish to consider the use of actual tax depreciation forecasts rather than relying on its own calculations if the differences between the two are material.

Tax losses

The AER should use its data collection powers to gather information about any tax losses; including whether those tax losses were generated by unregulated or non-regulated activities or by any other members of the tax consolidated group, and whether any of these tax losses from the regulated segment of the business related to a time when that segment was not subject price regulation.

Abnormal items

The AER should request details of any abnormal items or events. For example, any changes to the consolidated group, large divestments, restructures or acquisitions and the effect these had on the tax asset register and any tax payable, tax refundable or tax losses.

Capital gains tax

If the AER chooses to include capital gains tax in its tax allowance, the AER would need details of regulated asset disposals and any capital gains/losses on these disposals.

Unregulated and non-regulated activities

The AER should be aware of the extent to which unregulated or non-regulated activities have formed part of the responses to the above. Where possible, any unregulated or non-regulated activities should be removed from the categories above.

Tax sharing and tax funding agreements

The AER might consider obtaining information about any tax sharing agreements in consolidated groups. Where there is a tax sharing agreement in place, each member in a tax sharing agreement are liable for a share of the total tax liability (s 721-25 to 721-40). Where no tax sharing agreement is in place, all members of the consolidated group are jointly and severally liable to pay the whole amount of tax (s 721-15 to 721-20). This will ensure that the AER is aware if a regulated entity could potentially become liable for the tax payments of another, non-regulated, member a tax consolidated group (and whether these non-regulated or unregulated tax payments form part of the regulated entities tax payments).

Potential adjustments to the regulatory treatment of taxation

True up mechanism

The AER might choose to adopt a true-up mechanism to enable adjustments to a future price determination where the tax allowance provided in the current price determination was largely over or understated. This could include taking into accounts items such as:

- Tax losses that might not have been recognised in the determination of the tax allowance in the current price determination;
- Any large capital gains that were unexpected or not forecast;
- Gifted assets/developer contributions where the forecasts provided were materially different to the actual amounts;
- Any abnormal items that were not included in the current price determination;
- Any other items the AER deems necessary to adjust.

Depreciation, low value pools, and other asset-related deductions

As discussed earlier, the AER might consider choosing to change its methodology on the estimate of tax depreciation and other asset-related items and instead choose to adopt the regulated entity's actual forecasts.

Tax losses

The AER might choose to review its current treatment of tax losses after reviewing the current losses in the electricity industry.

Appendix A

Regulatory Treatment

The regulated asset base only includes assets that a utility has purchased for consideration or constructed. As a result, the regulatory asset base on which prices are set doesn't take into consideration any gifted assets or developer/capital contributions.

Accounting Treatment

Under AASB Interpretation 18, paragraph 11 states that "*if an entity concludes that the definition of an asset is met, it shall recognise the transferred asset as an item of property, plant and equipment in accordance with paragraph 7 of AASB 116 and measure its cost on initial recognition at its fair value in accordance with paragraph 24 of that Standard*". Therefore, for accounting purposes, any gifted assets are recognised as revenue in the year they are received and are included in the asset register at the fair value of that asset.

Then, each year, these assets are impaired because they generate no revenue to the regulated entity (as they are not included in the regulated asset base, and so do not generate income through prices).

For example, the book value of assets as at 1 July 2016 might have been $100 million, and throughout 2016-17, $1 million of gifted assets might have been received, bringing the total accounting book value of assets to $101 million. Assuming nothing else has changed during the year, when performing the comparison of the assets to discounted cash flows, the $100 million RAB is compared to the accounting book value of $101 million, and the excess $1 million is written off as an impairment. This means the net effect of the gifted assets is nil – the $1 million included as income has been effectively matched by a $1 million impairment expense, giving a nil effect on profit (assuming no revaluation of assets have previously taken place in this simplified example).

Tax Treatment

For tax purposes, any gifted assets are treated as assessable income under section 21A – Non-cash business benefits.[11]

Using the example above, the $1 million would be treated as assessable income. However, any impairment is not deductible for tax purposes, so the $1 million impairment will be added back during the preparation of the tax return as a non-deductible expense. The net effect then results in $300,000 in tax payable on assets that generate no income for the business.

However, the inclusion of the $1 million in assessable income then entitles the regulated entity to a tax depreciation deduction over the life of the asset.

As it currently stands, the inability of an asset to be converted to cash is not considered when determining arm's length value.[12] This presents a potential problem where the reason that most of these assets are gifted to begin with is because legally they are not allowed to be sold; or to be run by any entity without the required licenses.

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[11] *Income Tax Assessment Act 1936* (Cth).

[12] Paul Naglan and Charles Ferraro, 'A hidden tax cost for infrastructure projects' (2014) 49(6) *Taxation in Australia* 337, 338. S 21A(2)(b) ITAA36.

Regulatory treatment of gifted assets/developer contributions in the tax allowance

There have been a number of different ways of overcoming the issues that arise from gifted assets. These can include:

- The price regulator allows for tax on the gifted assets when determining prices. This results in the cost of gifted assets being recovered through prices in the bills that all consumers pay. The overall effect is an increase in revenue and therefore taxable income. This is the approach that IPART takes.[13] I note that the AER also takes this approach.[14]
- In some instances, the price regulator advises the regulated entity to charge the tax back to the entity doing the gifting. This results in the gifted asset also being recognised in the form of increased revenue, however, this time it is payable by the developer rather than by the bill payers. For example, Western Power charges developers for any gifted assets.[15]
- The State-owned entity's State or Territory Treasury can adjust the dividend to reduce the tax effect of these gifted assets. In this case the return on equity ratios are affected as they are adjusted for the value of gifted assets received. This is the approach taken by the Department of Treasury and Finance WA in calculating the dividend for Water Corporation.[16]
- Or the State Treasury and the price regulator can do nothing, and the state-owned corporation can end up worse off. This ultimately results in the entity "wearing" the cost of the gifted assets.

Once gifted assets have been reported as income, and tax paid on the value, the receiving entity can claim tax depreciation deductions over the useful life of the asset. Therefore, the only real difference is the time value of money of the tax depreciation deductions versus the tax paid upfront. Because infrastructure assets are typically long-lived, this could be a significant loss for the receiving entity.

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[13] IPART: The incorporation of company tax in pricing determinations; pg. 2.
[14] https://www.aer.gov.au/system/files/Proposed%20proposed%20post-tax%20revenue%20model%20%28PTRM%29%20explanatory%20statement%20-%20April%202008.pdf; pg. 12.
[15] http://3ece.com.au/wp-content/uploads/2014/12/WP-LDIU-2014.12.11-Tax.pdf
[16] Water Corporation 2017 annual report; pg. 84. https://www.watercorporation.com.au/-/media/files/residential/about-us/our-performance/annual-report-2017/2017%20annual%20report%20-%20web%20version.pdf