Major Energy Users Inc.

21 July 2018

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

Dear Warwick

Review of regulatory tax approach
Initial Report

The Major Energy Users Inc (MEU) thanks the AER for providing the opportunity, through the release of its Initial Report in June 2018, to provide further input into the AER review of regulatory tax approach to assist in the development of its revised guideline on setting the allowed rate of return (RoR) for regulated energy transport networks.

In its response to the Issues Paper on this topic (released for comment in May 2018) the MEU observed that there is considerable concern about the extent that consumers are required to provide funding through the building block approach to setting network revenues for costs that networks do not incur. The MEU response also indicated reasons why privately owned networks consistently paid less tax than did the publicly owned networks. With this in mind, the MEU response to the Initial Report does not address this issue further, but focuses on the mechanisms available to privately owned networks to reduce the amounts of tax they actually pay.

As the MEU sees it, the AER has two basic approaches available to it to address the clearly identified disparity between allowances provided and actuals paid. The approach implied by the Initial Report is to attempt to address each element in the tax approach that allows a network to reduce its tax payable – an approach that the MEU is concerned with because it provides significant opportunity for the networks to argue that when the AER has reached a conclusion that its conclusion is incorrect, not feasible to apply or does not reflect the actual issues faced by each network.

The MEU also notes the report from McGrathNicol which highlights that the various corporate structures that are used by the different networks also makes the AER approach more complex and difficult to apply. This makes establishing an appropriate corporate structure for the Benchmark Efficient Entity (BEE) more challenging considering the variety of different structures that exist, the degrees to which each reflects unregulated services provided by the entity and differences between ATO and regulatory approaches to tax.

While the MEU agrees with the Initial Report conclusions about each of the various avenues for limiting tax payable and which are appropriate for further investigation, the MEU is concerned that even using the AER information gathering powers, such an approach might not deliver the best outcome for consumers.

The MEU provided views in its response to the Issues Paper and referenced its response more to addressing the values used for “gamma”, but further discussion highlights that the AER is also concerned with the starting point of using a corporate tax rate of 30% as the basis for its establishing the allowance for tax. Aware of the AER desire to use independent market evidence to drive its decisions, the MEU has taken a different approach to that proposed in the Initial Report and which were supported by a number of submissions to the Issues paper.

The MEU is aware that during the continuing debate in Australia about reducing the corporate tax rate, there have been divergent views as to the effectiveness of a corporate tax reduction. In particular, the tax debate has highlighted that there are different measures for assessing corporate tax rates. In addition to the headline tax rate (ie the 30% used by the AER in its building block approach) there are at least two other valid measures used – the effective average corporate tax rate (EATR) and the effective marginal corporate tax rate (EMTR), both of which are measurable and have been calculated by different entities. What these different tax rates measure incorporates the impacts of the allowances that tax laws allow in each country and the abilities of firms operating in those countries to utilise these allowances to legally minimise the tax they are required to pay.

In March 2017 the United States Congressional Budget Office (CBO) released a report assessing the effective tax rates for countries in the G20[1]. In this report, the CBO observes on page 3,

> “All three types of corporate tax rates affect a company’s decisions, but each influences a different choice. Because of their broader scope, average and effective corporate tax rates are better indicators of a company’s incentives to invest in a particular country than is the statutory corporate tax rate.

[1] International Comparisons of Corporate Income Tax Rates available at https://www.cbo.gov/system/files/115th-congress-2017-2018/reports/52419-internationaltaxratecomp.pdf

> The average corporate tax rate [the EATR] reflects a country's corporate tax rate schedule, the system's tax preferences for business investments, any surtaxes, and possibilities for tax avoidance or evasion. Companies consider the average corporate tax rate when deciding whether to undertake a large or long-term investment in a particular country.
>
> The effective corporate tax rate [the EMTR], which is a measure of the tax on a marginal investment, is more informative for decisions about whether to expand ongoing projects in those countries in which a company already operates.
>
> In contrast, businesses focus on the narrower statutory corporate tax rate when They develop legal and accounting strategies to shift income earned in high-tax countries to low-tax jurisdictions—especially low-tax jurisdictions in which those businesses do not plan to invest and from which they thus expect no benefits from tax preferences for business investments."

With these descriptions in mind, it would seem that the tax rate most applicable to be applied for network regulation would be the "effective marginal corporate tax rate" (EMTR) which would be used to replace the headline rate currently used as this would apply to networks already owned and operating in Australia and would apply to the additional investments that networks make either for augmentation of the existing networks or for replacing assets that have reached their "use by" date..

The CBO report provides a summary table[2] detailing these three tax rates in each G20 country and which would be paid by a firm operating in those countries

[2] The MEU notes that the assessment is based on taxes applying in 2012, but it also points out that with the more recent moves in corporate taxes in Australia since that time, the rates might be less than those shown in the table.

Summary Table 1.

Corporate Tax Rates in G20 Countries, From Highest to Lowest, 2012

Top Statutory Corporate Tax Rate[a]		Average Corporate Tax Rate[b]		Effective Corporate Tax Rate[c]	
United States	**39.1**	Argentina	37.3	Argentina	22.6
Japan	37.0	Indonesia	36.4	Japan	21.7
Argentina	35.0	**United States[e]**	**29.0**	United Kingdom	18.7
South Africa	34.6	Japan	27.5	**United States**	**18.6**
France	34.4	Italy	25.8	Brazil	17.0
Brazil	34.0	India	25.6	Germany	15.5
India	32.5	South Africa	23.5[d]	India	13.6
Italy	31.4	Brazil	22.3	Mexico	11.9
Germany	30.2	Russia	21.3	Indonesia	11.8
Australia	30.0	South Korea	20.4	France	11.2
Mexico	30.0	Mexico	20.3	Australia	10.4
Canada	26.1	France	20.0	China	10.0
China	25.0	Turkey	19.5	South Africa	9.6
Indonesia	25.0	China	19.1	Canada	8.6
South Korea	24.2	Australia	17.0	Saudi Arabia	8.4
United Kingdom	24.0	Canada	16.2	Turkey	5.1
Russia	20.0	Germany	14.5	Russia	4.4
Saudi Arabia	20.0	United Kingdom	10.1	South Korea	4.1
Turkey	20.0			Italy	-23.5

Source: Congressional Budget Office, using data from KPMG International, the Organisation for Economic Co-operation and Development, the Internal Revenue Service, and the Oxford University Centre for Business Taxation.

G20 = Group of 20.

a. Statutory corporate tax rates are specified in law. The top rate applies to each additional dollar of taxable income in the highest tax bracket.

b. The average corporate tax rate is the total amount of corporate income taxes that companies pay relative to their income. In G20 countries other than the United States, those are the rates that U.S.-owned foreign companies faced, by country of incorporation. They reflected total worldwide income and corporate taxes paid to all countries in which that income was taxable. The U.S. average rate is shown for foreign-owned companies incorporated in the United States. It is based on income those companies earned in the United States and on U.S. corporate taxes.

Because of the small number of businesses incorporated in Saudi Arabia, the Internal Revenue Service's disclosure rules prevented the release of information for that country in most years. Similarly, tax information for Indonesia and South Africa could not be disclosed for 2012. For those two countries, CBO substituted the 2010 average tax rates for the 2012 rates. In 2011, Indonesia introduced a provision that reduced taxes on new investment in specified sectors for a limited period; that provision might have lowered the 2012 average tax rate relative to the rate reported for 2010.

c. The effective corporate tax rate is the percentage of income from a marginal investment—that is, an investment that pays just enough to make the investment worthwhile—that must be paid in corporate income taxes.

d. 2010 value.

e. Because the calculation of the U.S. average rate differs from the calculations used for other countries, the U.S. rate is not directly comparable to the rates estimated for the other countries. See Appendix A for an explanation of the differences.

The stand out from this assessment is that the effective tax rates are considerably lower than the headline tax rate. When gamma is applied to this effective tax rate, the outcome is much more consistent with what the AER has observed of the actual taxes paid by privately owned networks.

The MEU is also aware of a study carried out by the University of Oxford into these two effective tax rates which has higher estimates for the average and marginal rates[3]. Oxford carried out their calculations of these different rates for Australia and arrived at higher values for the two effective rates.

[3] See https://www.sbs.ox.ac.uk/faculty-research/tax/publications/data

country	year	EATR	EMTR
AUS	2000	0.325312	0.256893
AUS	2001	0.307178	0.240255
AUS	2002	0.270932	0.207902
AUS	2003	0.270932	0.207902
AUS	2004	0.270932	0.207902
AUS	2005	0.270932	0.207902
AUS	2006	0.270932	0.207902
AUS	2007	0.266302	0.190944
AUS	2008	0.266302	0.190944
AUS	2009	0.240349	0.080634
AUS	2010	0.266302	0.190944
AUS	2011	0.266302	0.190944
AUS	2012	0.266302	0.190944
AUS	2013	0.266302	0.190944
AUS	2014	0.266302	0.190944
AUS	2015	0.266302	0.190944
AUS	2016	0.266302	0.190944
AUS	2017	0.266302	0.190944

The MEU points out that there is significant variation year on year in the Oxford University series and questions the legitimacy of the calculations as the tax rates and tax laws in Australia have not changed sufficiently to warrant some of the changes (see for example the massive change in 2009)

This disparity between the CBO and Oxford calculations is discussed by John Menadue AO in his 15 February analysis of the debate surrounding the “Emma Alberici view” about whether corporate tax reductions are needed. In this analysis Mr Menadue comments[4]

> **“The headline 30 per cent rate is misleading**
>
> ... Effective tax rates are said to drive investment decisions and take account of what companies actually pay once deductions, depreciation and other tax minimisation strategies are considered.
>
> According to a report published last year by the US Congressional Budget Office, Australia’s effective tax rate, at 10.4 per cent, is among the lowest in the world.
>
> The average rate paid by American companies in Australia is just 17 per cent.
>
> The Treasurer’s office takes issues with these figures, claiming they are out of date because they are based on data from 2012. The Government prefers a study by

[4] See https://johnmenadue.com/emma-alberici-theres-no-case-for-a-corporate-tax-cut-when-one-in-five-of-australias-top-companies-dont-pay-it/

> Oxford University that puts Australia's effective average tax rate at 26.6 per cent and at the higher end of the scale.
>
> Several analysts … disagree. Managing director of Plato Investment Management, Don Hamson says:
>
> "Whilst the data used in the 2017 CBO report is from 2012, it is the best analysis available and I don't believe the Australian company tax landscape has changed significantly since 2012."
>
> Dr Hamson has worked in banking and finance in Australia, as a university professor in Australia and the United States and has served on the ASX Corporate Governance Council.
>
> Regardless of which effective tax rate you prefer, both the Oxford and the CBO data demonstrate the folly of focusing exclusively on the headline corporate tax rate of 30 per cent."

It is clear that using the headline taxation rate is not the most appropriate rate to use to reflect the actual tax rates incurred by energy network owners and there are other more applicable inputs to use to address what is clearly a major issue for consumers.

While it would appear that the most appropriate effective tax rate to use in the building block approach is the effective marginal tax rate (EMTR), the MEU recommends that the AER assess both effective tax rates as a measure against the actual tax rates that are observed for the privately owned networks to identify which measure delivers the closest correlation[5]. The outturn effective tax rate identified would then be applied to the building block model used for all networks, including those owned by governments.

The MEU notes that the AER operates an incentive regulatory approach where networks are expected to out-perform the benchmark efficient entity and by doing so deliver benefits to consumers over the longer term. To achieve this, the AER needs to know actual outcomes from the network operations to compare these to exogenous benchmarks which provide a guide as to where the efficient costs might be.

With access to this data, the MEU would hope to see the AER ultimately using the actual outcomes from the networks to set the allowance in the future, just as it does from operating cost benchmarking and in considering the future cost of debt allowance based on a data set derived from actual costs observed over a sufficient number of years.

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[5] The MEU notes that the AER has carried out a similar approach using exogenous market measures for assessing a reasonable cost of debt by testing for the most appropriate measure to reflect actual cost of debt outcomes in its recent draft decision on the rate of return instrument

However, based on the work by McGrathNicol, such an expectation might not be achievable for tax rates when considering the many different structures that exist amongst the networks. If this is the case, the MEU considers that the continued use of the EMTR assessed by the CBO might be the most appropriate tax set point to use, considering that it is the most robust and best recognised of those available.

Should the AER require additional explanation as to the concerns expressed herein, please contact the undersigned.

Yours sincerely

David Headberry
Public Officer