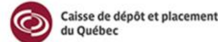


23 November 2018

Mr Warwick Anderson
General Manager, Network Finance and Reporting
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3001

Via email: taxreview2018@aer.gov.au

Dear Mr Anderson,

Re: Submission in response to the AER's Discussion Paper on the review of the regulatory tax approach

The Network Shareholder Group (**NSG**) have invested over $12 billion in Australian energy transmission and distribution network service providers (**NSPs**) serving more than nine million people across multiple states.

As providers of long-term capital to support reliable and affordable energy network services to customers, we are committed to system stability, reliability and minimising costs to consumers to improve affordability. Investment in networks is required to eliminate pricing disparities within the energy market and facilitate entry of new low-cost generation (whether it be fossil fuel or renewable) and storage, which will reduce costs to consumers. The capital needed to ensure affordable and reliable networks for consumers will be funded by investors like us. Ensuring the lowest cost of capital requires a regulatory regime that provides confidence to invest efficiently through stability, predictability and transparency of process and outcomes across multiple regulatory periods.

We welcome the AER's findings in the Discussion Paper of the review of regulatory tax approach that confirm the consumer benefits of maintaining an incentive-based approach to regulation and the continued use of an efficient benchmark entity when estimating the efficient cost of complying with tax obligations. We see the affirmation of these important concepts as providing much-needed clarity in the current regulatory environment.

In addition, we strongly agree with the conclusions of the AER and its expert advisors that tax cost pass-through arrangements are not in the long-term interests of consumers. The complexity of national interest policy frameworks interrelating with tax policy, investment structures and financing arrangements mean that the benefits of a pass-through approach are unclear, difficult and costly to assess, and ultimately could have material and highly adverse outcomes for consumers.

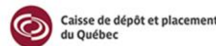
We do not consider that changes to the approach to estimating tax are required because:

- They are unlikely to be material over the life of an asset;
- The current regulatory tax approach ensures consistency within and across the various elements of the regulatory system, i.e. ensures consistency with the regulatory treatment of capital expenditure, depreciation and the rate of return;
- The changes which seek to reflect common practice may not be an efficient practice or provide incentives for efficiency for an individual NSP; and
- The changes will result in significant transition and implementation issues that will need to be addressed.

We have provided further explanation of our views in the attached response.

We are also concerned that the many concurrent reviews underway in the energy sector are largely being conducted as single-issue reviews without adequately considering the implications of how each review, decision and change will inter-relate and deliver positive outcomes in the long-term interests of consumers.

For example, the impacts of the AER's review of the estimated tax liability and revenue for NSPs, and any consequential amendments to the benchmark tax assumptions, will not be known at the time of the AER's final Rate of Return Guideline (**RORG**) is released, which is currently expected in December 2018. However, the impact



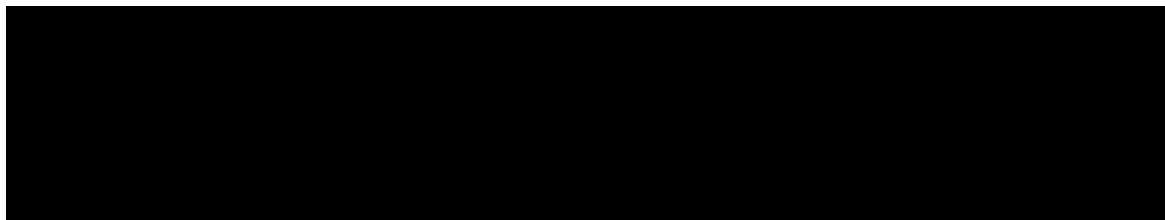
of any changes to the regulatory approach to tax on individual NSPs, together with the significant reductions in the regulated return foreshadowed in the AER's draft RORG, could (is expected to) have significant adverse implications for an NSP's ability to achieve the benchmark credit rating that underpins the estimated regulated rate of return.

We recommend that the AER undertakes analysis to ensure NSPs have the opportunity to recover their efficient costs and that the efficient benchmark capital structure (and assumed credit ratings) of these businesses can be maintained in the future at levels predicted by the AER. This important check cannot be completed without rigorously testing the aggregated financial implications of these two reviews together.

We commend the AER on the process undertaken in this review. It is clear that the AER has sought to understand the issues raised by stakeholders and navigate the complexity of the interaction between the tax system, which is backward-looking based on observable outcomes, and the regulatory framework, which is forward-looking based on assumptions and forecasts. We appreciate that the AER has sought advice from specialist tax advisors and economic regulatory advisors and followed up with stakeholders for further information and views as the review progressed. We also appreciate that stakeholders have been kept informed of developments and next steps. This is better process. In our view, this process has resulted in recommendations that are understood and identifies areas where further consideration and information would be beneficial.

We hope this submission will assist the AER advance its thinking on the remaining areas under consideration. Please contact Sally McMahon via email to sally.mcmahon@sparkinfrastructure.com or by phone on with any questions or follow up.

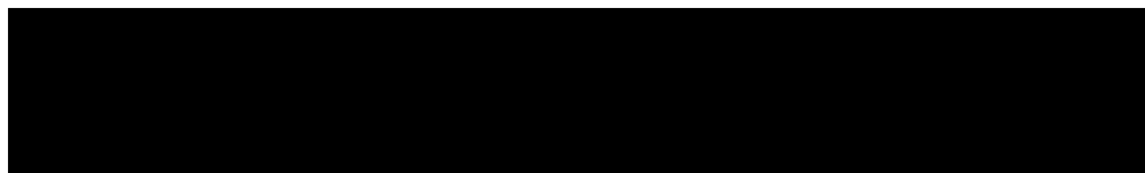
Yours sincerely,



Rick Francis
Managing Director & CEO
Spark Infrastructure

Steven Fitzgerald
Head of Asset Management
HRL Morrison

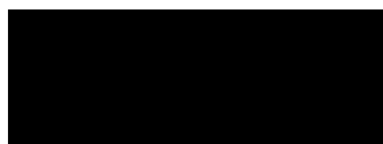
Michael Cummings
Global Co-Head of Asset Management
AMP Capital



Nik Kemp
Head of Infrastructure
AustralianSuper

Michael Hanna
Head of Infrastructure – Australia
IFM Investors

Francis Kwok
Co-Head of Asia-Pacific
Macquarie Infrastructure and Real Assets



Jean-Etienne Leroux
Regional Director, Infrastructure Investments – Australia & New Zealand, CDPQ

Attachment: Response to the AER's Discussion Paper in the Review of the regulatory tax approach

1. Pass through of actual tax liabilities to customers

We agree with the AER that passing through the actual tax liabilities to customers is not in the long-term interests of customers. Passing actual tax liabilities through to customers is likely to increase the costs to customers above the efficient cost of providing regulated services. This is because:

- Tax liabilities associated with unregulated services and activities may be recovered from customers of an NSP's regulated services due to the difficulty of ring-fencing tax liabilities between related parties providing both regulated and unregulated services.
- NSPs will have weaker incentives to adopt efficient tax practices, potentially increasing the amount of tax paid.
- National Tax Equivalence Regime (**NTER**) entities will have an incentive to increase tax payments since they flow through to State Treasuries.
- Where networks have previously depreciated assets in excess of the AER's tax depreciation, customers will pay more tax due to lower future tax depreciation.
- There will be higher costs associated with implementing and administering the regime.

We also note and support the findings of the AER's expert tax advisor, PwC, in relation to the difficulties and potential for higher costs of applying an approach that passes through the actual tax paid:

> *"Accordingly, there is always expected to be an observable difference between actual tax paid and the estimated cost of taxation. This is one of the fundamental restrictions associated with adopting an actual tax paid pass through approach because invariably the amount of actual tax paid would always need to be allocated between:*
>
> - *amounts referable only to the regulatory operations carried on by the NSP; and*
> - *amounts not related to the operation of the regulated business (i.e. non regulated revenue and costs not recoverable under the regulated framework).*
>
> *In this regard a detailed exercise would need to be undertaken to reconcile what portion of the tax actually paid by the NSP (and its upstream investors where the NSP is held in a flow through structure including foreign taxes) is related to the regulated operating activities to ensure integrity with the broader regulatory framework. Any difference in actual tax paid as compared to the amount calculated under the estimated cost of taxation relating to inefficient or unregulated expenditure not recoverable by the NSP under the regulatory framework is appropriate."*[1]

2. Application of an incentive-based regime

We welcome the AER's confirmation that retaining an incentive-based approach to a benchmark efficient entity (**BEE**) is in the long-term interests of consumers. The incentive-based approach takes a forward-looking approach to estimating costs and de-linking the forecast from actual outcomes during the regulatory period. This approach ensures that an NSP has strong incentives to outperform the benchmark assumptions and the benefits of outperformance are shared with customers in the next regulatory period. The stronger the incentives, the greater the benefits. For privately owned NSPs, this regime has delivered significant benefits to customers through lower prices (maintained in real terms despite growth in the scale of the network and service capacity and additional obligations) and services levels in line with the value to customers.

Network prices have declined by between 3% and 5% in real terms across the National Energy Market since 2014 and are expected to continue to decline for privately owned networks.[2] The price reductions delivered by NSPs are in response to strong incentives under the regulatory regime to achieve efficiencies while maintaining services.

[1] PwC, AER Tax Review 2018, Expert Advice, 26 October 2018, p. 18.

[2] AER 2017 distribution network service provider benchmarking report, figure 10 – Forecast impact of AER decisions on residential electricity charges (average annual % decline), by DNSP, page 25, 1 December 2017

These incentives are effective where NSPs respond to financial incentives. This is more evident for privately owned networks.

Network prices for South Australian Power Networks, CitiPower and Powercor (privatised in the late 1990s) have remained flat in real terms, and these entities remain leaders in efficiency and reliability and have absorbed costs of many new obligations such as the advanced interval meter roll-out (smart meters) in Victoria.[3]

The Australian Competition and Consumer Commission[4] has referred to over-investment and under-utilisation in networks. However, these findings are not true for all networks and were found not to be true at all for private networks in South Australia and Victoria (in contrast to the historical State-owned distribution NSPs in NSW and Queensland). The increased private ownership in NSW more recently will increase the effective response to efficiency incentives in the future, the benefits of which are already beginning to flow through to consumers in NSW in the form of lower network prices.[5]

The incentive-based approach ensures that:

- Customers pay no more than the efficient cost of providing regulated network services;
- Strong incentives remain to achieve efficiencies and apply tax practices (in compliance with current tax legislation) that are efficient when compared to the regulatory benchmark; and
- The complexity and cost of administering the regulatory framework are minimised.

3. Estimating the efficient costs of complying with tax liabilities by reference to a benchmark efficient entity

We welcome the AER's confirmation that the efficient cost of complying with tax liabilities will be estimated with reference to a BEE. This approach:

- Ensures customers pay no more than the efficient costs, for example from poor practices or unregulated services and activities;
- Strong incentives remain to achieve efficiencies and apply tax practices (in compliance with current tax legislation) that are efficient when compared to the regulatory benchmark;
- Insulates consumers from volatility in tax payments and rates due to changes in ownership;
- Maintains consistency with regulatory benchmarks for the regulated rate of return;
- Enables benchmark assumptions to be reviewed from time to time; and
- Avoids the complexity and cost of administering the regulatory framework.

A key finding of the discussion paper is that not only is it expected that the estimate of the tax allowance for the BEE will be different to the tax paid by the relevant entity, but also that there are legitimate and appropriate reasons for these to differ - for example, tax losses from prior periods, tax treatment of unregulated activities and re-valuations not paid for by customers of regulated services as well as tax paid on regulated revenue received by the NSP by the ultimate shareholder of the NSP in the investment structure. We welcome this acknowledgement.

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[3] See https://www.sparkinfrastructure.com/system/files_force/compendium_for_minister_taylor_letter_2_october_2018.pdf?download=1

[4] ACCC, Retail Electricity Pricing Inquiry, Final Report, June 2018.

[5] As an example, Ausgrid's draft proposal for the 2019-2024 regulatory control period would reduce its component of network charges by a further 8.7% (real) from 1 July 2019 (a 34% reduction since 2014).

We also consider that it is appropriate for a BEE to be a company subject to the 30% corporate tax rate because:

- More than 70% of current NSPs are taxed as a company or under the NTER scheme at a 30% tax rate;[6]
- Concessionally-taxed investors in flow through holding structures comprise a minority (16.6%) of the overall investment in the regulated network assets (by regulated tax asset base (**TAB**) value);[7]
- In flow through structures, the applicable tax rate for investors may be 30% or greater particularly where foreign taxes are payable without credits for Australian tax paid;[8]
- Of the five NSPs held in flow through structures, only two entities are held in stand-alone flow through vehicles that pay less than 30% and proposed legislative changes will limit the availability of concessional tax rates in respect of stapled structures going forward;[9] and
- It does not distort efficient decisions regarding ownership and structure. If an alternative structure was adopted:
  - An Australian company that owns an NSP and pays tax consistent with the its obligations would be considered to be inefficient under the regulatory regime and penalised for acting lawfully;[10]
  - Some NSPs would be unable to achieve the structure assumed for the BEE and will therefore be structurally disadvantaged in relation to the BEE in the context of the incentive framework;
  - Costs to customers may increase as the building block revenue would not be reduced by the value of imputation credits;
  - The regulatory assumptions would reduce the returns able to be realised by an Australian company compared to other entity structures or ownership, distorting the market for owning and investing in NSPs; and
  - The approach would need to be re-visited imminently given foreshadowed changes to the tax treatment of structures.

We also agree with PwC's caution against adopting a blended tax rate of applicable tax rates of various entities and investors. This approach would not only be complex, but it would also be inconsistent with the tax legislative framework (which levies tax on an identified tax payer) and create winners and losers if parties would be expected to cross subsidies each other for different tax rates.[11]

Various tax arrangements and entity structures within infrastructure investment have been subject to several significant reviews by the Federal Treasury and is the domain of Commonwealth tax policy across the economy rather than the economic regulation of energy networks. The diversity provided for under current tax policy was intended to achieve broader national economic objectives by facilitating investment from domestic and international parties to fund the development of Australian infrastructure. The reviews of stapled structures and vehicles for offshore investors are expected to reduce the use of these structures and vehicles.

In any event, there are only two NSPs that are subject to stapled structures that pay concessional tax rates and PwC identified that the primary explanation of a discrepancy between the tax allowance for the NSP and tax paid for these entities is a lack of profits.[12]

[6] PwC, p. 17

[7] PwC, p. 12.

[8] PwC, p. 18.

[9] PwC, p. 16.

[10] Dr Martin Lally (**Lally**), Review of Submissions on the AER's Review of its Regulatory Tax Approach, 25 October 2018, p. 17.

[11] PwC, p. 18-19.

[12] PwC, p. 12.

4. Changes to tax practices that have an impact on timing of recovery and not the level of recovery

We do not support the adoption of diminishing value tax depreciation. We understand that this is being proposed because the majority of non-NTER NSPs adopt diminishing value depreciation. However, taxation law does not allow for the depreciation method of an existing asset to change or improvements or alterations to assets to adopt a different depreciation method to the existing asset.[13] Therefore, given that the majority of assets (57.39% by TAB value) are depreciated by the prime cost method and 33.3% of TAB value of non-NTER entities is also depreciated using the prime cost method,[14] a change in approach will have a significant impact.

We note that the AER's experts are proposing that the change should only apply to new assets.[15] However, even prospective application will have significant impacts and could result in inefficient outcomes. Many tax paying entities associated with the NSPs are choosing to adopt the prime cost method in certain circumstances and the AER's experts have acknowledged that this can be efficient (and rational).[16] Therefore, imposing diminishing value for all NSPs may provide an incentive for tax paying entities to choose a method that may be less efficient to better match tax liabilities with regulated revenues.

We consider that an approach that enables an NSP to elect whether to adopt a diminishing value or straight-line approach for new assets for regulatory purposes where it is consistent with the method adopted for tax purposes will enable an NSP to choose the most efficient approach according to its individual circumstances and ensure the costs to customers reflect the most efficient approach. This is consistent with the approach adopted by the Economic Regulation Authority in the ATCO Gas Australia Access Arrangement for the current regulatory period (2014 to 2019).[17]

We support the AER's criteria for evaluating possible changes. However, we also consider that prior to making any changes, the AER should fully consider the limitations of the data available to assess the efficient practice and materiality given that the information may not be available for all NSPs and covers a relatively short period compared to the life of assets. Further, when assessing impacts on customers, it is important to consider the holistic impact on building block revenue and therefore prices. For example, the regulatory approach to depreciation defers the recovery of revenue to later years. When applied with diminishing value tax depreciation, which also defers the recovery of revenue to later years, this could exacerbate price impacts in the future.

5. Changes in assumptions for tax purposes that are inconsistent with regulatory assumptions

We do not support treating regulatory capital expenditure categories as an expense when estimating regulatory tax. This change is being proposed on the basis that most of the NSPs that responded to the information request claim an immediate deduction for tax purposes of a component of costs.[18] However, there is limited information available about the prevalence of deductions across categories and the amount deducted varies significantly across the entities that provided information between $5m and $200m.[19] The diversity in application and value suggests that this approach may not be common or efficient.

Further, this change is likely to be subject to significant implementation and transition issues. Implementation of the approach would require the AER to determine which categories of capex should be immediately expensed and whether it should be based on a benchmark or NSP specific approach. There is a wide variation in the practices adopted by the NSP, so an efficient benchmark is unlikely to be observable.

[13] PwC, p. 74.

[14] PwC, p. 76.

[15] PwC, p. 20 and Lally, p. 4.

[16] PwC, p. 73-74. Lally, p. 18.

[17] Economic Regulation Authority, Final Decision on Proposed Revisions to the Access Arrangement for the Mid-West and South-West Gas Distribution Systems, 30 June 2015, p. 455.

[18] PwC, p. 19.

[19] PwC, p. 66.

Further, general application of the approach has the potential to create perverse incentives for an NSP in two ways:

- An NSP may choose to immediately expense particular items where it might be less efficient in order to better match tax liabilities to regulatory revenues; and
- An NSP may have an incentive to replace assets rather than re-furbish assets if immediate expensing of refurbishment assets reduces the regulated revenue in the short term.

These issues can only be overcome if an NSP is able to elect to immediately expense regulatory capital costs and, if it does so, those costs can be re-categorised as regulated operating expenditure.

We note that Lally and PwC support an approach that allows an NSP to elect whether to immediately expense capital items for tax purposes.[20] However, this will not address the efficiency issues which were also recognised by PwC; that immediately expensing refurbishment costs could lead to sub-optimal asset replacement decisions and policies by NSPs.[21]

6. Changes to assumptions that result in unregulated activities being captured by the regulatory framework

The AER is further considering the treatment of interest expense. We consider that the interest expense must remain a part of the incentive-based framework and must remain consistently determined with the regulatory estimates of the efficient cost of debt for a BEE. That is, if the efficient cost of debt is assumed to be based on a BBB+ rated entity securing debt on 60% of the regulated asset base (**RAB**) for a 10-year period, then the interest expense for tax purposes must adopt the same assumptions.

It is not clear how further information will assist the AER's consideration of this issue. There would appear to be three options:

1. Further information reveals that this issue is not material and so the AER does not consider it further.
2. The AER considers adopting a cost pass through approach in relation to interest expense. That is it adopts the individual NSP's assumptions regarding asset values, gearing and the cost of debt. The issues with this approach are the same as for a tax cost pass through approach rejected by the AER as being not in the long-term interests of consumers. This approach would need to consider an NSP specific asset value, gearing and cost of debt which could include the impact of re-valuations, acquisitions, unregulated services and activities as well as poor financing decisions.
3. The AER adopts a different benchmark cost of debt for tax purposes than for the purpose of determining regulatory revenue. This would require the AER to determine that there is a different efficient asset value, gearing and cost of debt to be applied for tax purposes than for revenue purposes, which would be inconsistent logic. In addition, the AER would be knowingly providing revenue that is lower (or higher) than it has determined is efficient, depending on whether higher (or lower) debt costs were considered more efficient for tax purposes than for regulatory revenue purposes. Further, the benchmark would also likely include a component of the impact of re-valuations, acquisitions, unregulated services and activities as well as poor financing decisions

We note that the current approach is supported by Lally and the Independent Panel. In particular, Lally agrees that the tax consequences of payments not included in regulated revenues should not be included in regulated revenues.[22]

[20] Lally, p. 21 and PwC, p 67.

[21] PwC, p. 20.

[22] Lally, p. 15.

Further, we note that interest expense cannot be considered independently of the consideration of the relevant asset value to be adopted for the regulatory approach to tax. In this regard, we agree with the AER and its experts that estimating the efficient cost of complying with tax obligations must be based on the RAB and TAB and not re-valuations or acquisition prices. To do so would conflate the value and service ascribed to unregulated services and activities, distorting markets and potentially leading to customers of regulated services subsidising or being subsidised by unregulated services or activities. As described by PwC:

> *"Privatisations and M&A activity may result in uplifts in the depreciable asset base for tax purposes. These uplifts are a permanent difference as there is no equivalent uplift to the tax base of those assets for the purposes of TAB and therefore in determining the forecast cost of tax for regulatory purposes.*
>
> *Specifically, the step up in the tax base of depreciable assets arises as a consequence of changes in ownership of the regulated assets. Generally, such step ups in this industry have typically arisen as a consequence of the buyer being a tax consolidated group.*
>
> *In addition, it is noted that recent privatisation transactions incurred significant stamp duty costs that were immediately deductible for tax purposes, however these costs are not recoverable to the NSP under the regulated return.*
>
> *In our view, it would be inconsistent with the regulatory framework to take such acquisition costs (including additional depreciation associated with a step up in the tax basis of depreciable assets) into account in determining the forecast cost of tax given such amounts:*
>
> 1. *cannot be recovered by the NSPs; and*
> 2. *are not cost incurred in the efficient operation of the regulated business (i.e. they are costs associated with the acquisition of the regulated business)."*[23]

And from Lally:

> *I agree with the proposition that the TBV uplift arising from a change of ownership at a higher price should remain with the buyer rather than be passed through to consumers, but not because of the consistency argument that has been advanced in many submissions. Instead, I agree with the proposition because acting otherwise would reduce the offer price in the purchase offer, thereby discouraging some changes of ownership from occurring, and this is not socially desirable."*[24]

[23] PwC, p. 21.

[24] Lally, p. 3.