26 July 2018

Mr Warwick Anderson
General Manager, Network Finance and Reporting
Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601

Via email: taxreview2018@aer.gov.au

Dear Mr Anderson,

Submission to the AER's Initial Report Paper on the review of regulatory tax approach

We have come together as a group of private investors in the sector to facilitate contributions to energy and regulatory policy issues. We represent major investors in Network Service Providers **(NSPs)** and funds that are the custodians of the retirement and general savings for millions of Australians – Spark Infrastructure, Morrison & Co, AustralianSuper, IFM Investors, Macquarie Infrastructure and Real Assets and AMP Capital (the Network Shareholder Group (**NSG**)).

As providers of long-term capital to support the provision of reliable energy network services to customers, we seek a regulatory regime that provides ongoing confidence to invest efficiently through stable and transparent processes and outcomes, and importantly with confidence and certainty across multiple regulatory periods and resets. This ensures that risk remains consistent with investor expectations, reduces the cost of new capital to NSPs and delivers lower prices to customers.

The importance of future investment in the energy network was highlighted in the Integrated System Plan (**ISP**) released by the Australian Energy Market Operator (**AEMO**) in July 2018. AEMO estimated that the additional investment proposed in the ISP would conservatively deliver NPV savings of around $1.2 billion to consumers and that without further network development, consumers would pay more for energy.[1]

We provided a submission to the AER's issues paper for this review on 1 June 2018. That submission supported the AER's current approach to estimating the tax allowance. We have reviewed the AER's Initial Report and participated in the AER's forum held on 18 July 2018. We have also appreciated the opportunity to meet separately with the AER's Consumer Challenge Panel (**CCP**) and members of the AER's tax review team.

We remain of the view that the AER's current approach to determining the regulatory tax allowance is the approach that achieves the National Electricity Objective (**NEO**), the National Gas Objective (**NGO**) and the Revenue and Pricing Principles (**RPPs**) contained in the National Energy Laws to the greatest degree.

It is critical that the review does not diminish the fundamentals of the incentive based economic regulatory framework that applies to regulated NSPs in Australia. The reference to the benchmark efficient entity (**BEE**) ensures that only the efficient costs of financing and tax are included in the revenue allowance so that customers do not pay for inefficient decisions and NSPs have an incentive to outperform the benchmark.

This review should also be contained to ensuring that the current assumptions about the efficient practices of the BEE remain appropriate. The review should not stray in to the policy and legal issues associated with the tax treatment of different structures or ownership. The Australian tax law, and federal policy objectives delivered through the tax system, are the domain of the Commonwealth government and should not be driven or distorted by economic regulation of energy networks.

A shift to a cost pass through approach is a fundamental change to the regulatory regime. It would require changes to the National Energy Laws and Rules, introduce complexity, uncertainty and price volatility, and impose

[1] AEMO, *Integrated System Plan*, July 2018, p. 6.

significant process and compliance costs on customers. Importantly, the legal and ownership structure of each network will impose different costs on different customers (and in different regions), resulting in volatile prices based on structure and ownership over efficiency. This is fundamentally wrong as network customers should be indifferent to the structure and ownership of the NSPs and instead only pay for the efficient costs of the provision of regulated energy network services.

We urge the AER to retain the incentive-based framework under the National Energy Law and Rules and consider the cost-benefit trade-off of any potential amendments in undertaking this review. It is also appropriate to consider whether any changes to the regulatory tax allowance - particularly where those amendments require changes to the National Energy Law and Rules or the AER's models - will change the expected risk profile and return for the BEE. Impacts from changes in approaches and to regulatory parameters do not work in isolation, i.e. a change in the risk profile must be taken into account in the forward estimates under the AER's review of the rate of return guideline (**RORG**).

We have attached to this letter our response to the questions raised by the AER in the Issues Paper. Please contact Sally McMahon, Economic Regulatory Advisor with Spark Infrastructure [redacted] for further discussion or questions.

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

Attachment: Response to the AER's Initial Report on the regulatory tax approach

Key Messages

- We support the AER's current approach to estimating the tax allowance. That is, by calculating the tax liability based on an ex-ante forecast of the allowed revenue and efficient costs of an NSP and the statutory tax rate applying to the benchmark efficient entity.
- Ownership structures do not change the obligation to pay tax, they just change where tax is paid and by who. Taxes paid are at rates ranging from 0% - 47%.
- The key benefits of the benchmark efficient entity approach are:
  - It is agnostic to actual legal structure;
  - It ignores who the owners of the NSP are, the location of the NSP, and how much was paid to acquire the NSP;
  - Volatility of actual tax payments are ignored; and
  - It allows the tax allowance to be calculated over a regulatory period without having to look at the life of the business as a whole and the long-term timing differences that eventuate over the business cycle.
- The current approach ensures the lowest cost, reliable and sustainable services to customers and ensure that an NSP can comply with its relevant obligations without introducing unnecessary costs and risks.
- The Australian tax law, and federal policy objectives delivered through the tax system, are the domain of the Commonwealth government and should not be driven or distorted by economic regulation of energy networks.
- We do not support a tax pass through approach as this would:
  - Require each NSP to be considered separately, and for the approach to be carried out accurately, tax will need to be assessed at various levels in the ownership structure;
  - Result in outcomes for customers wholly dependent on structure and ownership rather than efficiency; and
  - Require significant costs associated with producing and reviewing information, and compliance and enforcement to be recovered from customers.

1. Introduction

Under an incentive-based approach to regulation it is important that the benchmark costs are reviewed to ensure that changes in efficient costs of an NSP providing regulated services because of changes in market conditions or practices are captured. This ensures that any reduction in efficient costs are passed through to customers and any increases in efficient costs can be recovered by the NSP.

However, we are concerned that the timelines applied to this review do not recognise the complexity and difficulties involved and will not allow proper consideration of the information being requested. For example, the type of information sought by the AER is significant, held by hundreds, if not thousands, of institutional and retail investors. Such investors are subject to various tax arrangements, confidentiality arrangements and disclosure processes. We are concerned that the information may not be readily available in the form required within such a short timeframe. Producing, collecting and providing this information will take much longer than the time allowed for in this review. However, not all this information will be useful to the AER and so we seek an opportunity to collaborate to determine what data might be readily available that might assist the AER.

We strongly support the AER's appointment of a tax advisor in this review. The tax system and information is complex and extensive. Any request for information must consider the ability of an NSP or related party to comply and the cost and benefit of compliance.

Should the AER be unable to collect or properly assess the information, there is significant risk that it will be forced to implement an outcome that has unintended negative consequences on the wider economy, deliberate broader policy objectives, and ultimately prices for Australian consumers.

The ATO should be the regulatory entity tasked with focussing on policing tax positions taken by NSPs. The AER should not be putting itself in a position where tax positions of entities become an issue due to the AER taking a different position on tax policy in its regulatory regime.

The remainder of this submission will address the issues raised in the AER's Initial Report and provides comments on possible changes outlined by the AER.

2. Cost pass through vs incentive based regulatory approach

We support maintaining an incentive-based approach to determining the revenue provided to NSPs to cover the efficient cost of tax liabilities under the current post tax revenue approach. A change to this approach so that the cost of actual tax paid is passed through to customers would require a rule change and is unlikely to be consistent with the NEO, NGO and RPPs contained in the national energy laws. A cost pass through approach would:

- Require the production, collection, collation, review and analysis of a significant amount of information provided by NSPs and multiple related parties – these costs would need to be recovered from customers;
- Require the development of guidelines to allocate and attribute tax payments so that they reflect the efficient costs incurred only by the NSP and only in the provision of regulated services and so that the information can provide an 'apples with apples' comparison across time, NSPs, structures and owners – increasing the process and compliance costs;
- Introduce additional volatility in prices over time as variations between the allowance and actual tax paid due to differences in activities, behaviours and tax cycles are passed through;
- Reduces the strength of efficiency incentives on operating and capital expenditures by reducing the financial benefit by the off-setting tax payment;
- Introduce complexity and uncertainty that reduces incentives to invest in the provision of regulated network services; and
- Result in customers paying more (or less) for regulated services due to decisions made by owners for a portfolio of investments about corporate and capital structure, acquisition and purchase price, related party activities, unregulated services and tax litigation.

There are also significant implementation and transition issues which will need to be taken in to account and may put at risk the ability to effectively implement the approach. These include:

- Identifying all entities and individual investors that are liable to pay tax on the revenue received by the NSP;
- Defining the scope of tax payable such as by government entities and individual investors;
- The process for reviewing the variation in the tax payments to be passed through that ensure that any assessment is symmetrically applied;
- Increased circularity associated with tax payments because of increasing revenue to cover higher tax payments;
- Constant reviews due to frequent changes in tax policy;
- The treatment of tax disputes; and
- Ensuring that windfall gains and losses are not created merely because of the timing of tax cycles.

In contrast, the current incentive-based approach to providing a revenue allowance to recover the efficient costs of the forecast tax liability is simple, understood, provides continual incentives to reduce costs across all building block cost elements and ensures that the price to customers for regulated services relate only to the efficient cost of those services rather than extraneous activities or decisions. This approach ensures the lowest cost, reliable and sustainable services to customers, that the NSP can comply with its obligations, and does not introduce unnecessary uncertainty and risk that could reduce the incentives for future investment or increase the cost of future capital.

3. Task to be undertaken

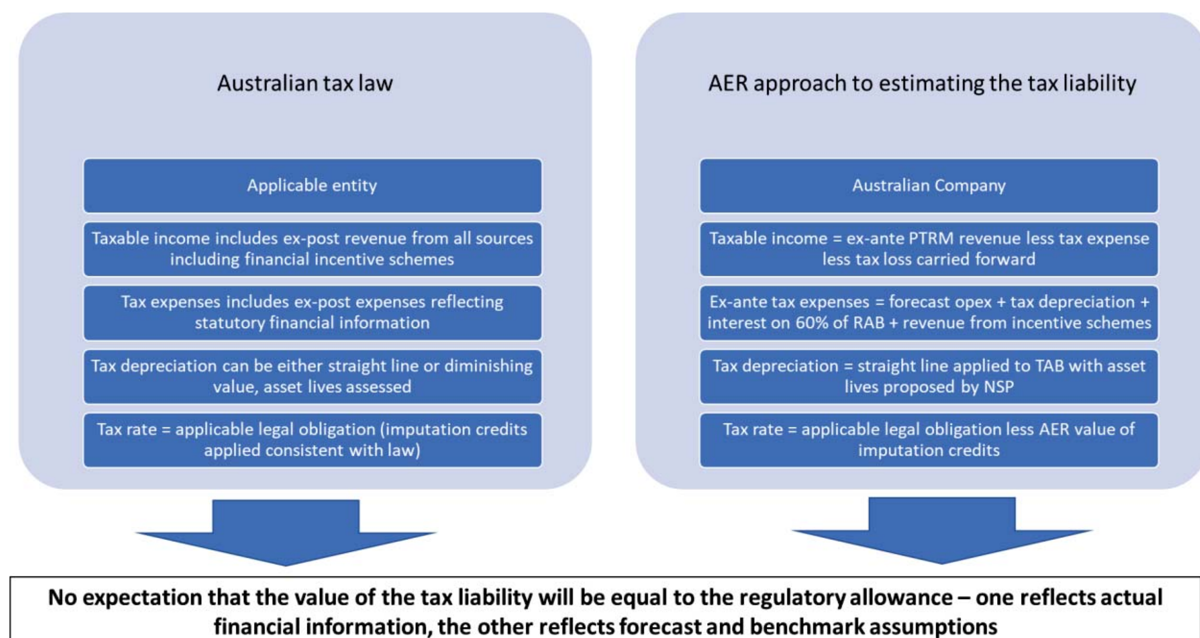
The regulatory allowance for the tax liability is estimated ex-ante based on the forecast efficient costs and revenue allowance reflecting assumptions adopted for economic regulation. Whereas the tax paid is calculated ex-post based on the actual profile of costs incurred, revenue received, and tax depreciation expenses reflect tax law and guidance. These two values will never be identical and are not expected to be.

The value of calculating the difference between the allowance and the tax paid is limited. Instead there is greater value to customers of focusing on the reasons for the discrepancy and the extent to which the discrepancy is driven by a change in the characteristics of the BEE that lead to a lower estimate of the efficient cost of complying with its tax obligations. Under the incentive-based approach where a more efficient BEE is identified and the cost of complying with tax obligations are lower, the lower costs are passed through to customers, and where the changes in the characteristics of the BEE are found to result in higher costs of complying with obligations, the higher costs are passed through to the customers.

The AER's current approach is to assume that the BEE is an Australian company that is subject to the statutory corporate tax rate (currently 30%). The AER does not specify a composition of ownership (although there is an explicit assumption about this in the AER's approach to deducting the value of imputation credits) and adopts tax treatment practices that, in the main, reflect the requirements of the Australian tax law. Key differences include the mandating of straight line depreciation for tax purposes (the tax law provides an entity with a choice albeit with rules about changes) and treating revenue from financial incentive mechanisms as a tax expense (the tax law treats this revenue as income).

The following diagram illustrates the relevant features of Australian tax law as they relate to the calculation of the tax liability compared with the AER's current approach to estimating the revenue allowance to cover the efficient costs of a BEE for complying with Australian tax law.

Diagram 1: Comparison of Australian tax law with the AER's current estimation of tax liability

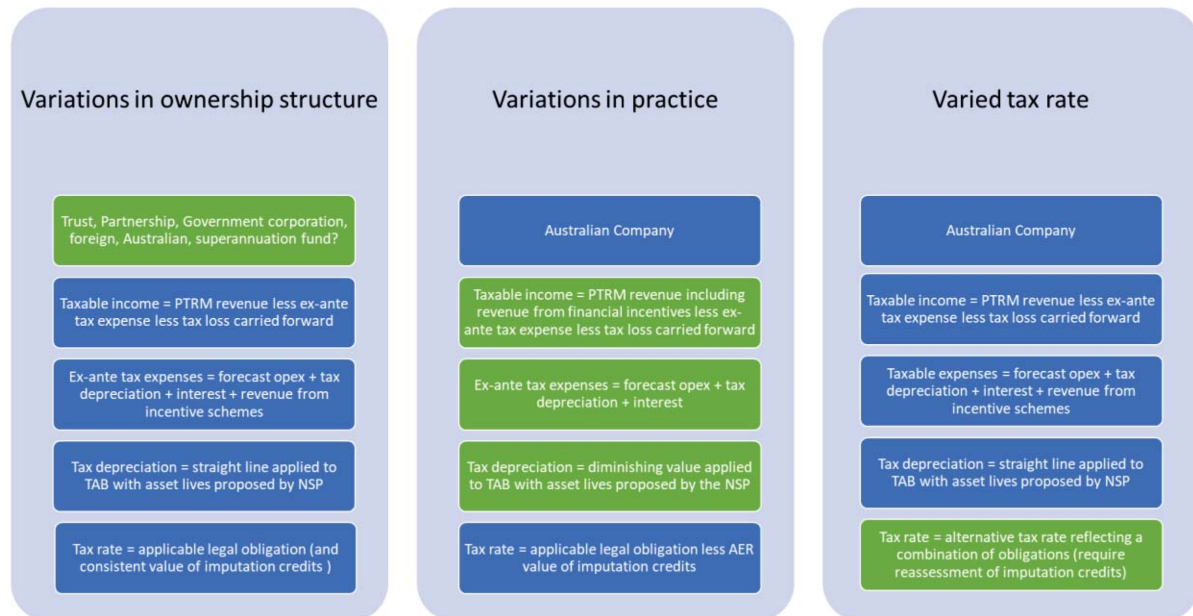


3.1. The characteristics of the BEE

Using this model as a guide, the variations in assumptions about the BEE might include ownership structure, and tax management practices and the tax rate. The ownership structure could affect the relevant statutory tax rate.

The following diagram illustrates the various assumptions of the BEE and how these relate to the estimation of the revenue required to cover the tax liability.

Diagram 2: The characteristics of the BEE



3.2. Ownership structure

The NSG supports retaining the current assumption that a BEE is an Australian Company and that the owners of the Australian company pay tax at the corporate statutory tax rate. Although, there are other structures currently adopted for NSPs, these structures do not remove the obligation to pay tax, they just alter where the tax is paid. Further, the information presented by the AER and the McGrath Nichol report does not lead to any clear conclusion about a preferred ownership structure, or the efficiency of different ownership structures. In any event, the variations in structures have, in some cases, been established or required by State Governments, and in all cases, been reviewed and approved by Treasury, the ATO, FIRB.

Where a network has been established in a partnership or in trust structure, there will be no tax payments by the NSP, rather, tax will be paid outside of the asset structure (which will be a "flow through" structure for tax purposes) at the investor level. One key reason is because they provide for individual investors to pay tax at their own investment level and manage their tax position across their portfolio of investments. The tax rate that applies to different classes of investors may differ, so flow through structures enable investors pay tax at the statutory tax rate according to the tax rules that apply to them specifically.

These entities could be owned by government, private Australian or foreign investors or a superannuation fund. For example, Australian Superannuation funds are taxed at concessional rates and sovereign offshore investors benefit from sovereign investment concessions. Both stimulate investment into Australia, creating jobs and contributing towards the creating of an energy network that facilitates entry of new low-cost energy sources, lowering costs for consumers in the medium and longer term, as highlighted by the recently released AEMO Integrated System Plan. Applicable statutory tax rates can vary from 0% - 47% and recently announced tax law changes will increase the tax rates for many investors in the future.

The tax rate must reflect the obligation under tax law. It is not appropriate to change the tax rate unless it follows a change to the assumptions about the structure and ownership composition of a BEE as this would not allow an NSP an opportunity to comply with its obligations to pay tax. Further, this would assume that the efficient cost of complying with tax obligations is to pay less (or more) than that determined by Australian tax law.

The AER has previously considered ownership should not be taken in to account when considering the rate of return or cost of debt. However, it has made implicit assumptions about who owns an NSP by estimating and deducting the value of imputation credits from the estimated tax liability. If the AER were to change the assumed structure of the BEE or specify the ownership composition, the value of imputation credits would need to be revised.

For the reasons outlined above, we do not consider that a change in the assumptions about the ownership structure can be supported on an efficiency basis, and indeed, consider that a change in these assumptions could have detrimental effects on broader economic policies adopted by the Australian Government.

3.3. Tax treatment practices

We consider that the review should be contained to the tax management practices of the BEE. That is, to consider the efficient tax treatment practices of the BEE in relation to taxable income and taxable expenses. The AER's current approach assumes that the tax treatment of income and expenses is consistent with the Australian tax law except for a few examples where it mandates an approach where the tax law provides for a choice and treats revenue from financial incentives as a tax expense.

There may be circumstances where the NSP exercises its choice under Australian tax law to differ from the AER's treatment. Where this is widely spread and reflects a more efficient treatment, the AER may seek to alter its assumptions to be more consistent with the NSP (and related party) treatment. However, we caution against mandating practices where a choice is available and encourage proper assessment of whether the practice is efficient and implementable. That is:

- Does the change deliver lower costs to customers over the tax life cycle and not simply push costs in to future years or ignore past costs? and
- Can the change in approach be adopted under Australian tax law by the NSP?

The framework for assessing whether or not there should be a change to the approach to providing an allowance for the efficient cost of complying with tax obligations must reflect the NEO, NGO and RPPs. It is inadequate to simply determine that the majority of NSPs undertake the practice. Instead, the framework must consider whether the approach reflects the efficient costs and provides incentives to achieve efficiencies and undertake efficient investment. This requires an assessment of not simply what will deliver the lowest cost in a given year, but whether the approach will deliver the lowest cost of providing services over the long term without risking the reliability and security of services, or future investment.

4. Information required

We note that information on actual tax paid by NSPs or their investors that relates solely to the regulated businesses will be very difficult to obtain within the timeframe proposed. Even for NSPs that are companies, it is unlikely that they will be able to easily or accurately split their tax payments between regulated and unregulated business activities. For NSPs that are not companies and have flow through status (where tax is paid by the investors) there will be the added difficulty of getting information from investors, who may also invest via pooled, diversified infrastructure funds which do not split distributions by underlying investments.

We strongly support the AER's engagement of specialist tax advisors and consider that this will greatly assist the AER in identifying the information required to make its assessment and seek information that can be provided in a consistent manner across NSPs within the timeframes. The NSG would like to work collaboratively to determine what data is available that will assist the AER.

5. AER possible changes

Chapter 6 of the AER's Initial Report outlines a range of possible responses to the apparent tax discrepancy. These include:

1. Changes to the treatment of tax depreciation in the regulatory models
2. Changes to other aspects of the tax approach that would require a change in the rules (NGR and NER)
3. Changes focussed on adjusting tax allowances to reflect actual tax payments by energy networks.

We address each of these below.

5.1. Changes to the treatment of tax depreciation in the regulatory models

The AER has identified a number of changes to the treatment of tax depreciation in the regulatory models that do not require a change in the rules. The AER also recognises that given that assets can only be depreciated once, these changes could affect the profile of tax payments but will not affect the overall cost of the tax payments.

Therefore, a change in treatment that delivers a lower price in the short term (and it is not clear to the NSG that these changes would do so) may result in higher prices in the medium term. This will depend on the tax life-cycle of the asset affected.

We also note that under Australian tax law, once a method of depreciation has been chosen for an asset, it cannot be changed. Any change can only apply to new assets. This was acknowledged by tax practitioners and Professor Lally in the AER's tax review forum held on 18 July 2018.

Any changes to asset lives used for tax depreciation purposes (including low-value asset pools) or the immediate expensing of refurbishment should be informed by current practice, maintain an NPV=0 approach to the life cycle tax liability costs and take in to account any distortionary effects on the incentive to expense or capitalise costs, for example, as presented by the ENA at the AER's tax forum on 18 July 2018 in relation to the immediate expensing of refurbishment assets.

5.2. Changes that require rule changes (and consequential changes to the AER's models)

The options identified by the AER in this category include changes to the statutory tax rate to reflect ownership structures commonly used by regulated businesses, using a different debt gearing for tax purposes than that used in the rate of return, recognising expenses that do not relate to the provision of regulated services, revaluation of the regulated asset base used to calculate tax depreciation (**TAB**) and adjusting for prior tax losses not previously accounted for.

The NSG does not support a change to the assumed ownership structure and consequential changes to the statutory tax rate for the reasons outlined above.

The NSG does not consider that the option to use a different gearing ratio for tax expense compared to that used for estimating the rate of return is valid. The AER has thoroughly assessed the appropriate gearing level for an NSP providing regulated services as part of the rate of return guideline review. The assessment included ensuring that observations affected by ownership structures and the provision of unregulated services are adjusted to reflect only the NSP providing regulated services. These adjustments are also required for the gearing relevant for the purposes of tax deductibility of interest payments.

The proposal to recognise the tax benefit of expenses that are not required for the provision of regulated services would result in a subsidy between the competitive activities which the AER has applied considerable effort to ensure does not occur due to the AER's Ring Fencing Guideline. Symmetrical application of this approach would also result in customers of regulated services subsidising competitive services.

The proposal to apply revaluations adopted by the ATO to the TAB has the same effect as the inconsistent treatment of expense and tax liability outlined above. The ATO only adopts revaluation because of an entity demonstrating that the revaluation complies with the tax law. This could not be interpreted to include the revaluation of the assets used to provide regulated services. Therefore, it would represent a subsidy from competitive services to regulated services. The adjustment for tax losses not attributable to regulated services would again constitute a subsidy between regulated and competitive services.

If such a subsidy is required to achieve affordability objectives, it should be paid for by the relevant government and not borne by private investors.

5.3. Pass through of actual tax payments

We have outlined earlier in section 2 of this submission that we do not support the pass through of variations between the regulatory allowance for tax and the actual tax paid and provided reasons. This view and the reasons apply equally to any individual items that might attract a tax liability or generate a tax loss. We are in strong agreement with Professor Lally on this point.

6. Principles to be applied

When assessing whether any change should be applied, in addition to considering the NEO, NGO and RPPs, the NSG considers that the AER should have regard to the following principles that will ensure the long-term impacts on consumers are properly assessed and the change in approach is able to be implemented:

- Any changes must be capable of being adopted by the NSP under tax law and applied prospectively;
- The benefits of any change should consider life cycle costs, not simply push costs into a future period, or ignore past costs;
- The calculation of a difference between the tax allowance and tax paid must include the total tax paid on revenue received by the NSP including NTER payments and tax paid at entity and investor level, and should take into consideration tax depreciation generated by revaluations of assets that are valid under tax legislation;
- A change in tax depreciation must not impose windfall gains or losses as a result of being at a particular point in the tax cycle;
- Information requirements should be targeted and take account of the costs and benefits of collecting the information;
- There must be consistency between the assumptions of a BEE for tax and rate of return; and
- Changes to assumptions must not result in a subsidy between regulated and unregulated services from attributing a tax benefit or payment associated with unregulated services to regulated services (or vice versa).

7. Implementation

The AER considers that any new approach should be applied to the determinations where final decisions are due in April 2019 (the NSW, ACT, Tas and NT DNSPs). The NSG considers that this will only be possible if the AER continues with the current incentive-based approach and does not seek to implement a cost pass through approach. The rule change and RIN processes are likely to be controversial and complex.

If the review, and the information requirements, are contained to understanding the current structure, ownership and practices of the NSPs, and utilising this information to assess the characteristics of the BEE for the purposes of estimating the efficient cost of complying with tax obligations, it may be possible to implement any changes prior to April 2019. However, if the AER determines that the assumptions about the ownership structure of the BEE and relevant statutory tax rate should change, this will need to be incorporated in to the AER's review of the Rate of Return Guideline so that the values attributed to the various risk parameters can be properly assessed on a forward-looking basis and the value of imputation credits can be estimated consistent with the tax obligations of the BEE.