21 November 2018

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

Email: TaxReview2018@aer.gov.au

Dear Mr Anderson

RE: Review of regulatory tax approach

Origin Energy appreciates the opportunity to provide a submission to the Australian Energy Regulator's (AER) review of regulatory tax approach.

We recognise that it is not the intent of this AER review to reduce the tax allowance, rather to ensure that its method models efficient tax management practices. Based on the information it has received to date, the AER concluded that a change to the method of calculating benchmark regulatory tax is not warranted but that improvements could be made to aspects of its calculation.

We support the continued application of an incentive based method as we consider that this is consistent with incentive based regulation and the intent of the national electricity and gas objectives. We also support the AER's approach to defer decisions on certain matters subject to receipt of its completed information request to enable it to make an informed decision.

Origin's responses to specific issues raised by the AER are set out below.

Entity structure and ownership

The AER's analysis identified around 81 per cent of regulated networks are owned by either state and territory governments or Australian companies, both of which pay an effective tax rate at the standard corporate rate of 30 per cent. The AER also noted that Australian super funds, sovereign wealth funds and foreign pension funds own around 10 per cent.

We agree that the current ownership structures have likely had little effect on the underlying tax difference and, for this reason, a change from the standard corporate rate is not warranted at this point in time. However, we consider that if the makeup of ownership changes to the extent that the achievability criteria is no longer relevant, then the AER should revisit this issue.

Accrued tax losses

The AER identified that the networks have built up large tax losses that they are able to carry forward against future taxable income.

The AER considered that it was necessary to consider the underlying primary drivers of the tax difference; including timing differences around depreciation, and tax management practices permitted under different ownership structures.

The AER considered that even on a prospective basis the entity ownership structure does not appear to be a material driver. It did note that timing differences around depreciation naturally reverse so that tax losses that build up in the first portion of an asset's life will be drawn down in the later portion.

We believe that a fuller understanding of the nature of tax losses carried forward will have a material bearing on how other elements such as depreciation are considered. For this reason, we believe that any decision should be subject to an assessment of the completed information requests.

Immediate expensing of capex

The AER noted that certain types of capital expenditure relating to the refurbishment of an asset are capitalised into the asset base for regulatory purposes but may be immediately deductable expenses for tax purposes.

We recognise that replacement assets such as repairs, improvements to an existing asset, or a separate new depreciating asset are a contentious area of the law and the appropriate tax treatment is situation and fact specific. However, we believe that to the extent that the Australian Tax Office (ATO) has treated an expense in a particular way, then where practicable there should be consistency with the regulatory treatment.

For this reason, we support the AER's view for certain capex to be included in the regulatory asset base but to be expensed immediately for regulatory tax purposes.

To achieve this, we believe that the 'specific approach' which requires each network to include a forecast of immediately deductible capex as part of the determination process should be adopted.

Using the diminishing value approach

Origin considers that the diminishing value approach is a more appropriate depreciation method that better reflects the efficient tax management practices adopted by non-regulated industry.

However, we consider that it would be problematic to change the benchmark allowance to this method for existing assets as this would require a complex retrospective analysis to remove the prospect of any permanent uplift in the tax asset base. For this reason, we support the adoption of a diminishing value approach for new assets.

Cap gas asset lives

The AER noted that there is a current statutory cap of 20 years for the effective lives of gas transmission and distribution assets. The AER considered that the effective lives are significantly higher, which it has used for regulatory purposes.

As stated, we believe that where practicable the regulatory and statutory treatment of tax should align. For this reason, we support the adoption of a 20 year cap. We also consider that this is best achieved by applying this to all new capex rather than existing assets to remove the potential to create a permanent uplift in the depreciable asset base for tax purposes.

Tax asset base revaluation

The AER's current approach to value its tax asset base is the historic cost base of the tax assets. The AER does not recognise the sale of assets or transaction costs arising from a change in ownership which fall outside of the regulatory framework.

The AER recognised that the effect of market transactions can increase or decrease the tax cost based recognised by the ATO. This can result in a higher or lower depreciation expense in subsequent years when compared to regulatory depreciation. Until such time that further information is available, we support the view not to adjust the tax asset base in response to market transactions for regulated assets. We agree that it is appropriate to preserve a consistent regulatory approach that insulates consumers from changes in market valuations, both on the regulatory asset base and the tax asset base.

Interest expense

The AER determine interest expense by reference to a benchmark gearing ratio of 60 per cent and a benchmark cost of debt. We support consistency between the different building block components; in this case the determination of the WACC; interest costs and tax deductibility. We agree that the same value of debt and gearing should be adopted for both regulatory and tax calculations.

Change method to tax pass-through

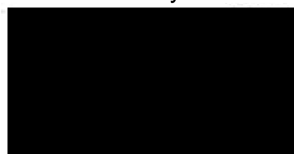
We support the position of the AER that while the pass-through method may achieve short-term reductions in the tax component of the networks' revenue allowance, it is unlikely to deliver long-term efficient tax management. Furthermore, we believe it is inconsistent with the principles of incentive regulation, and to treat one of the revenue building block components different to the remaining elements creates a potential risk of internal inconsistency and perverse outcomes.

Closing

We support the AER approach to maintain its current method to calculate the tax building block component as an incentive based cost but to identify areas where the calculation of this benchmark which may be out of step with efficient tax management practices.

If you have any questions regarding this submission, please contact me on .

Yours sincerely



Sean Greenup
Group Manager Regulatory Policy
sean.greenup@originenergy.com.au