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Australian Energy Regulator: Profitability Measures Review

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Advice on the allocation of interest and tax expense

pwc

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Dear Paul

AER Profitability measures for electricity and gas network businesses - Allocation of Interest and Income Tax Expense

We outline below our advice regarding the principles and methodologies which we recommend could be applied in allocating interest and income tax expense for the purpose of determining Return on Regulatory Equity as part of the profitability measures which the Australian Energy Regulator (**AER**) propose the regulated network businesses will be required to report.

This report has been prepared at the request of the AER in accordance with our Order for Services with a commencement date of 27 May 2019 (**Order for Services**) and our procedures were limited to those described in that Order for Services.

In accordance with the Order for Services, we have been engaged to produce a written report on the key principles and recommended methodologies used to allocate interest expense and tax expense for the purposes of reporting net profit after tax (**NPAT**) of network service providers (**NSPs**) on a regulatory accounting basis, which sets out specifically:

- the various entity structures associated with the regulated business and how these impact upon how tax expense and interest expense should be allocated to the regulated business entity;
- the key principles that should be applied to allocate tax expense and interest expense to the regulated entity;
- the methodologies that could be used to allocate tax expense and interest expense to the regulated entity and in turn to the core regulated service, what circumstances they relate to and their advantages and disadvantages;
- a recommendation as to what methodologies would be best applied in what circumstances; and
- whether the allocation methodologies would differ if we were trying to produce statutory accounting information (tax and interest expenses) for the regulated business entity rather than regulatory accounting information.

Our findings in this regard are outlined below.

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1. *Overview and purpose of this Report*

The AER is currently assessing the profitability measures which regulated electricity and gas network businesses may be required to report on an ongoing basis. The intention of the AER in requiring the reporting of profitability measures is to increase the level of transparency relating to the profits of the regulated network businesses, including the drivers of those profits, for the interest of stakeholders in line with achievement of the National Electricity Objective (**NEO**) and National Gas Objective (**NGO**).

The AER's current position regarding the range of profitability measures to be released, along with practical considerations in requiring NSPs to determine and report these measures is outlined in the AER's draft position paper "Profitability measures for electricity and gas network businesses" dated April 2018 (**Draft AER Position Paper**).

As noted in section 1.4 of the Draft AER Position Paper, the objective of the review of profitability measures is to identify measures which will allow comparison of:

- expected returns of a service provider to its actual returns;
- returns between service providers in the same sector; and
- returns between the service providers and other regulated/unregulated industries.

The measures which are currently recommended by the AER for reporting by the NSPs are outlined in Figure 1 below.

Figure 1: AER's draft position on profitability measures

Proposed measure	Calculation
1. Return on Assets (Regulatory)	Regulatory Earnings Before Interest and Tax (**EBIT**) / Regulatory Asset Base (**RAB**), where Regulatory EBIT is for core regulated services and the RAB for core regulated services.
2. Return on Assets (Statutory)	Statutory EBIT for the Service Provider / Statutory Total Assets for the Service Provider.
3. Return on Equity (Statutory)	Statutory NPAT for the service provider / Statutory Equity for the service provider.
4. Return on Equity (Regulatory)	Regulatory NPAT / Regulated Equity, where Regulatory NPAT is for core regulated services, and Regulatory equity is determined by applying the benchmark gearing ratio to the RAB for core regulated services.
5. EBIT / customers numbers (Regulatory)	Regulatory EBIT / Total customer or connections, where Regulatory EBIT and customer or connection numbers are for core regulated services.
6. RAB multiples	Enterprise Value / RAB, where Enterprise Value is the total market value of the business as determined by reference to a sale value or based on the value of the company's shares (if listed).

Stakeholder submissions provided to the AER have expressed concerns with measures which are based on NPAT. In particular, whilst cost allocation guidelines are available to assist businesses in determining regulatory EBIT, the calculation of regulatory NPAT will require an allocation of interest and tax expense of a network business to the core regulated services of that business. Particular concerns raised in this regard include:

- development of the assumptions required to produce the NPAT level data may differ between businesses both increasing regulatory burden and resulting in reported data that may not be comparable;[1]
- using measures which require actual tax and interest payments to be extracted (for example, NPAT) may be problematic on the basis that some NSP's tax and financing arrangements are undertaken for the business as a whole. Often debt is raised at a group level and is not separately allocated to the core regulated services of the business, and existing tax at the NSP level is calculated on EBIT;[2] and
- for the reasons above, additional costs may be incurred by the businesses in determining the appropriate allocation of interest and income tax expense for the purpose of the profitability measures relating to Regulatory NPAT.

Whilst the AER acknowledge the challenges which may exist for some of the businesses in performing an appropriate allocation of interest and tax expenses across the regulated network assets, the AER's view is that the additional cost of performing the analysis will be outweighed by the benefit to stakeholders of reporting the Return on Regulatory Equity information.

Accordingly, we have been requested to assist the AER in preparing guidance for the NSPs on how tax and interest expenses could be allocated to the regulated entity level for the purpose of calculating NPAT and subsequently the calculation of the return on regulated equity.

Disclaimers

PwC is Australia's largest professional services firm and provides material taxation, financial and consulting services to the NSPs which are subject to this review across various lines of service.

Due to the specialised nature of the corporate and income tax matters relevant to this review, the tax experts have significant experience in advising businesses, investors and the public sector in respect of the ownership and operation of electricity and gas network assets.

In accepting the engagement to assist the AER on this matter, we have undertaken an assessment of any potential conflicts arising, and applied safeguards where relevant to ensure an independent assessment of the matters can be achieved.

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[1] Ausnet Services, Submission 8 December 2017, https://www.aer.gov.au/system/files/AusNet%20Services%20-%20profitability%20measures%20submission.pdf

[2] Jemena, Submission 30 May 2018, https://www.aer.gov.au/system/files/Jemena%20-%20Profitability%20Measures%20Draft%20Position%20Paper%20submission_Redacted.pdf; TransGrid, Submission 30 May 2018, https://www.aer.gov.au/system/files/TransGrid%20-%20Profitability%20Measures%20Draft%20Position%20Paper%20submission_Redacted.pdf

This Report has been based on the relevant taxation legislation, applicable case law and published Australian Taxation Office (**ATO**) rulings, determinations and statements of administrative practice at the date of this Report. The opinions in this Report may alter if there is a change to the legislation, or a change of interpretation of the legislation by the courts or the ATO, after the date of this Report. We are not responsible for updating this Report for changes in the law or its interpretation.

If this Report is to be relied upon in the future or in any other context other than this specific engagement, it is important you ask us to review this Report as our original opinions may no longer be applicable or appropriate in such circumstances.

This Report has been prepared, and may be relied on, solely for the purposes of this engagement. This Report has been prepared specifically for the AER. Neither we nor PwC accept responsibility to anyone other than the AER if they use the Report for some other purpose.

Neither we nor PwC assume any responsibility for liability for any losses suffered as a result of the circulation, publication, reproduction or other use of this Report contrary to the Order for Services.

2. *Summary of recommendations*

We summarise below the recommendations which are made as a result of the detailed analysis in section 3 of this Report.

Recommendation 1 – Tax allocation for entities which are taxed as a company

Due to the proposed regulatory reporting requirements which network businesses will be subject to (refer Figure 3 below), and the fact that only "permanent" tax adjustments will impact the income tax expense of an entity in accordance with AASB 112, determination of the regulatory income tax expense for entities which are taxed as a company does not require a separate tax calculation to be prepared, but can be leveraged to a large extent from the information which is already proposed to be disclosed as per Figure 3 below.

Specifically, network businesses should be able to report income tax expense on a regulatory basis by multiplying the Profit Before Tax (**PBT**) reported in Figure 3 by the corporate tax rate of 30%, subject to specific adjustments for:

- The impact of any permanent differences relating to depreciation for regulatory and actual tax purposes (e.g. depreciation attributable to indexation of the RAB);
- Increases to income tax expense in relation to any interest expense included in the regulatory PBT which is treated as non-deductible for income tax purposes in accordance with the thin capitalisation, hybrid mismatch or transfer pricing regimes, or where accounting and tax classification (e.g. debt v equity) differs; and
- Amendments to prior year income tax return assessments (e.g. following ATO dispute or a change in law) which results in a permanent tax adjustment for income or expenditure which is within the regulatory ring-fence.

Recommendation 2 – Tax allocation for "flow through" entities

Network businesses which are held within a flow through structure should self-assess a "blended" tax rate which would be applicable to distributed taxable profits, having regard to the nature of the project vehicle (e.g. Managed Investment Trust (**MIT**), Division 6C trust) and the profile of investors.

For stapled structures, it is not expected that this blended rate would currently be higher than 19.5%[3] (and may be lower in some cases), however the rate is expected to increase to 30% following the cessation of the grandfathering (e.g. transitional) period in respect of the staple reforms on 1 July 2034.

Consideration should be given by the AER to the tax rate applicable to interests in flow through vehicles held by State/Territory owners which are not subject to the National Tax Equivalent Regime (**NTER**).

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[3] The blended tax rate of 19.5% assumes a 70/30 split between the Asset Trust and the Operating Trust, with a rate of 15% applicable to the Asset Trust distributions (e.g. the MIT rate) and a rate of 30% applicable to the Operating trust distributions (e.g. the non-resident trust distribution withholding rate).

Recommendation 3 – Allocation of interest expense

The following allocation methodologies may be considered in determining the optimal allocation of interest expense between regulated and unregulated activities for the purpose of determining Regulatory NPAT and Return on Equity:

1. Allocation based on regulatory EBIT / statutory EBIT

    - Advantage: Simplicity and ease of interpretation
    - Disadvantage: Lack of comparability where profitability of regulated assets is materially different to profitability of unregulated assets

2. Allocation based on RAB / Statutory Non-Current Assets (excluding DTAs)

    - Advantage: Simplicity and ease of interpretation. Relevance of assets as a driver of financing costs.
    - Disadvantage: Allocation may be skewed by indexation of RAB and/or revaluations of assets for statutory reporting purposes

3. Specific allocation having regard to use of funds

    - Advantage: Accuracy
    - Disadvantage: Complexity and cost of administration if information not readily available to businesses.

On the basis method 3 (specific allocation) will result in the most accurate interest expense allocation, we recommend network businesses endeavour to perform the interest allocation on this basis in the first instance. We acknowledge however that some businesses may face difficulties in performing a specific allocation due to a lack of traceability in funding sources.

As such, where complexities would otherwise arise in performing a specific allocation, either method 1 (regulatory EBIT / statutory EBIT) or method 2 (RAB / Statutory Non-Current Assets, excluding DTAs) may be considered as alternatives. The appropriateness of each of these alternative methods should be considered in light of the circumstances of the relevant network business and the disadvantages outlined above (being the potential for unregulated businesses with materially different profitability measures to skew method 1, and the potential for RAB indexation or revaluations of statutory assets to skew method 2). We would also recommend that Network businesses should be required to report the method adopted for transparency.

3. Detailed analysis

As discussed in section 1.4 of the AER's Draft Position Paper, the objectives of the AER's review into profitability reporting measures for electricity and gas network businesses are to identify measures which allow comparison of (1) expected returns of a service provider to its actual returns and (2) returns of a service provider to other service providers in the same sector and other regulated/unregulated industries.

Accordingly, the measures which have regard to NPAT (i.e. Return on Equity) should only be reported where that information, including the reporting of interest and tax expense, assists in these objectives.

3.1 Ring-Fencing Principles

In 2018, PwC assisted the AER with a detailed review of the tax attributes of the NSPs as part of the tax allowance review. As part of this review we were requested to consider whether the regulated entities were paying more or less tax than provided for within the regulatory tax allowance, the reasons for any discrepancies, and provide recommendations for any changes to the regulatory model to reduce these discrepancies.[4]

In our corresponding Report dated 26 October 2018 (**Tax Allowance Report**)[5] and the Addendum dated 10 December 2018 (**Addendum**)[6], our analysis of any discrepancies between actual tax paid by regulated entities and the estimated cost of tax for regulatory purposes (calculated tax allowance) had regard to which items fall inside and outside of the regulatory ring-fence. For the purposes of determining the estimated cost of taxation for regulatory purposes, we concluded that only regulated income and expenditure should be taken into account (i.e. no income or expenditure that falls outside the regulatory framework should be taken into account) in determining the tax allowance.

Similarly, in considering NPAT as a profitability measure intended to meet the AER's objectives of comparability between expected and actual returns and between returns of regulated service providers and unregulated businesses, the appropriate approach is to apply the regulatory ring-fence in determining NPAT. Thus in determining interest and tax expense for the purpose of reporting Regulatory NPAT, the ring-fencing principles should apply in that interest and tax expense should be appropriately allocated to the regulated business and unregulated business (including any expenditure relating to M&A activities that is not recoverable) in the same manner as revenues and other costs.

This approach accords with the AER's ring-fencing principles which provide for the identification and separation of a service provider's regulated business activities, costs and revenues from those

[4] The Tax Allowance Review performed by PwC was subject to strict confidentiality requirements and accordingly none of the information provided by the NSPs for the purpose of that review has been used or referenced in preparing this report. That said, many of our findings from the review were generic in nature and therefore published in our Report and Addendum. Where relevant, we have referred to these generic findings below in considering the appropriate allocation methodologies for the purpose of the AER's proposed profitability measures.

[5] Refer "PwC - AER tax review 2018 expert advice - 26 October 2018", https://www.aer.gov.au/system/files/PwC%20-%20AER%20tax%20review%202018%20expert%20advice%20-%2026%20October%202018_0.pdf

[6] Refer "PwC - AER Tax review - Addendum to Expert advice – 10 December 2018", https://www.aer.gov.au/system/files/PwC%20-%20AER%20Tax%20review%20-%20Addendum%20to%20Expert%20advice%20-%20PUBLIC%20VERSION.pdf

associated with provision of unregulated services in a contestable market.[7] Given the returns of regulated network businesses are only determined having regard to the efficient costs of operation of the regulated network assets (e.g. costs within the regulatory ring-fence), it is critical that any allocation of interest and tax for regulatory purposes only has regard to interest and tax costs which are incurred in the efficient operation of the regulated network. The broader income and expenses (and therefore profitability) of the regulated network businesses will be taken into account in the statutory profitability reporting measures which are proposed to be adopted by the AER.

Our Tax Allowance Report and Addendum concluded that the following factors were relevant in identifying any differences in the actual tax paid by regulated entities in respect of their regulated assets, and the regulatory tax allowance (e.g. related to costs within the regulatory ring-fence):

1. Holding structures
2. Financing costs
3. Capital expenditure (**Capex**) related adjustments

Whilst some other factors were considered as part of our Tax Allowance Report, these were not considered material or relevant when considering the regulatory ring-fence. In particular, it was noted that tax deductions attributable to acquisitions of network businesses (such as upfront stamp duty deductions or step ups in the tax depreciable cost base of assets) should not be taken into account when determining the regulatory cost of taxation on the basis such Mergers and Acquisitions (**M&A**) related costs (e.g. stamp duty or the excess of purchase price over RAB/Regulated Tax Asset Base (**TAB**) values) cannot be recovered by the NSPs under the regulatory model and such costs are not considered to be incurred in the efficient operation of the regulated business (rather, they are costs incurred in relation to acquisition of the business).[8]

The factors relevant to the consideration of interest and tax expense for the purpose of the profitability measures are discussed further below.

3.2 Holding structures

The alternative holding structures used by owners of regulated network business which were identified in our Tax Allowance Report and Addendum were:

- Private sector corporate groups (which generally apply tax consolidation to report all companies within a wholly owned group as a single entity for income tax purposes), which pay income tax federally at a rate equal to 30% of taxable profits;[9]

- State owned enterprises which are subject to the corporate income tax regime under the NTER. These entities are required to make a "tax equivalent" payment equal to 30% of taxable profits to their State shareholders under the NTER; and

[7] AER, Ring-fencing Guideline Electricity Distribution, Version 2, October 2017, https://www.aer.gov.au/system/files/AER%20-%20Ring-fencing%20Guideline%20Version%202%20-%20Clean%20-%20October%202017.pdf

[8] Tax Allowance Report section 2.2.3

[9] This includes any Public Trading Trusts which are taxed as a company for income tax purposes in accordance with Division 6C of the Income Tax Assessment Act 1936 (**ITAA 1936**).

- "Flow through" vehicles (e.g. stapled structures and partnerships). These structures are generally used by investment consortiums or partnerships between the government and private sector participants, whereby taxable profits "flow through" to the upstream investors and are taxed in the hands of those investors.

Our Tax Allowance Report found that at 30 June 2018, **66.21%** of regulated assets (by TAB value) were held within legal structures which were taxed as a company (e.g. at a 30% tax rate, including NTER entities), whereas **33.79%** of regulated assets (by TAB value) were held in "flow through" vehicles whereby any income tax liability is payable at the investor level.

Businesses which are taxed as a company

All regulated business which are taxed as a company would be subject to the 30% tax rate which applies to corporate groups with turnover of greater than $50m, either under the Federal income tax regime or under the NTER. We outline below a number of considerations which are relevant to the allocation of income tax expense to the regulated businesses within these corporate groups, for the purpose of determining regulated NPAT / Return on Regulatory Equity as a profitability measure.

Consistent with our comments in section 3.1 above regarding the ring-fencing principles applicable to the determination of regulatory income tax expense, and our comments in section 3.2.2 of the Addendum to our Tax Allowance Report, in the event a network business was required to perform a calculation of income tax expense in relation to its regulated assets for any one income year, we would expect the calculation to be largely limited to the factors outlined in the following example calculation:

Figure 2: Calculation of income tax in respect of regulated assets

Factor	***Calculation***
	Assessable income:
A	Actual regulated revenue
	Less: Allowable deductions
B	Actual regulatory operating expenditure (**Opex**)
C	Deductions relating to Capex (e.g. tax depreciation and immediately deductible Capex)
D	Deductible interest expense
	Equals: Regulatory taxable income
E	Multiplied by tax rate (30%)
	Equals: Regulatory income tax payable

The AER currently propose to require all regulated network businesses to prepare a stand-alone regulatory Income Statement for the purpose of the profitability measures (refer section 4.1 of the AER Draft Position Paper). The AER have provided a template Income Statement at Appendix B of its Draft Position Paper, which is outlined below:

Figure 3: AER's proposed reporting template - income statement

Income Statement

	Regulatory Year			
	Statutory Basis		Regulatory Basis	
	Service Provider	Adjustments	Service Provider	Core Regulated Services
	$0's, nominal			
REVENUE				
Service Revenue				
Contributions				
Interest income				
Profit from sale of fixed assets				
Other Revenue				
Total revenue	-	-	-	-
Cost of Goods Sold expenditure				
Total Gross Profit	-	-	-	-
OPERATING EXPENSES				
Maintenance expenditure				
Operating expenditure excluding maintenance expenditure				
Impairment losses				
Loss from disposal of fixed assets				
Loss from sale of fixed assets				
Other non depreciation and finance charges expenses				
Total Operating Expenses	-	-	-	-
Total Earnings before Interest, Tax, Depreciation & Amortisation (EBITDA)	-	-	-	-
Depreciation and Amortisation				
Total Earnings before Interest & Tax (EBIT)	-	-	-	-
INTEREST AND TAX EXPENSE				
Interest Expense				
Profit before tax				
Income tax expenses (/ benefit)				
Profit after tax				

As such, the ability of businesses to complete a regulatory tax calculation as outlined in Figure 2 above can be considered in light of the information which the businesses would be required to prepare and report in order to comply with the requirements of the regulatory income statement outlined in Figure 3 above.

In our Tax Allowance Report we noted that all of the private sector regulated businesses which are taxed as a company have elected to apply tax consolidation for income tax purposes. Accordingly, the actual income tax position for any private sector entity is likely to reflect the aggregate tax position of a large group of companies, which may include a variety of businesses, regulated and unregulated. On the basis the network businesses will be required to report their revenue and expenses on a Regulatory Basis in accordance with the Income Statement outlined in Figure 3, we do not expect the application of tax consolidation to give rise to any complexities for the businesses in reporting the information above. Just as the businesses are expected to provide disaggregated statutory and regulatory information, the disaggregated regulatory revenue and expenditure information should also reflect the stand-alone regulatory tax revenue and expenditure, subject to the considerations relating to Capex and financing costs discussed below.

In light of this, we make the following comments in respect of the factors of the income tax calculation outlined in Figure 2:

- **A. Regulated revenue:** In all instances we would expect the regulated revenue to be the same for the purpose of the regulatory income statement and the regulatory tax calculation. While there could potentially be differences in the timing of recognition of income for tax and regulatory reporting purposes, for the reasons discussed further below this should not give rise to any practical implications for the purpose of the relevant tax reporting requirements.

- **B. Regulatory Opex:** We would also expect the quantum of Regulatory Opex to align for the purpose of the regulatory income statement and the regulatory tax calculation (subject to timing differences, discussed further below).

- **C. Deductions relating to Capex:** There may be differences between tax depreciation for the purpose of the regulatory income statement and the regulatory tax calculation. This is because depreciation within the regulatory income statement has regard to the RAB (which is subject to indexation), whereas tax depreciation within the regulatory tax calculation is calculated with reference to the actual tax fixed asset register of the business. Timing differences (e.g. immediately deductible Capex and differences in depreciation methodology) are also discussed further below. [10]

- **D. Deductible interest expense**: Prima facie, the interest expense recognised for regulatory purposes should equal the deductible interest expense for the purpose of the income tax calculation (subject to any specifically denied interest deductions as discussed below). Our recommendations regarding the allocation of interest expense to the regulatory NPAT calculation are outlined in section 3.3 below however the deductible interest expense should broadly reflect the actual cost of debt which is attributable to RAB, excluding the impact of any M&A transactions or step ups in the tax value of assets. A difference may also arise between the regulatory income statement and the regulatory tax calculation where interest deductions are specifically denied for income tax purposes (e.g. deductions in excess of thin capitalisation, as a consequence of the anti-hybrid rules or transfer pricing restrictions).

- **E. Tax rate**: This should be 30% for all regulated businesses which are taxed as a company. Tax rates applicable to flow through structures are discussed further below.

Whilst other potential tax adjustments were considered as part of our tax allowance review (such as tax offsets, including the Research & Development (**R&D**) incentive), we did not identify any other material factors which should be taken into account in the calculation above. In particular, whilst some stakeholders raised the R&D tax offset as a potential driver for differences in actual tax paid in the regulatory forecast of tax costs, we noted in our review that a small portion of NSPs were evidenced as having made R&D claims over the period to 30 June 2017. Further, proposed reforms

[10] Refer section 3.3.4 of our Tax Allowance Report regarding immediately deductible regulatory capex

to the R&D tax incentive, if passed, will significantly reduce the ability of the NSPs to benefit from this incentive.[11] Accordingly, we have not identified any other factors which are considered relevant in determining income tax expense for regulatory purposes.

Our Tax Allowance Report also considered whether tax losses should be taken into account in determining the appropriate regulatory cost of tax (or in comparing that estimate to the actual tax payments of a business). Our Report concluded that tax losses were likely to be attributable to factors outside of the regulatory ring-fence (e.g. M&A costs or unregulated losses). If stand-alone regulatory tax calculations were prepared by the NSPs on an annual basis, our expectation is that each entity would be in a taxable income position for regulatory purposes.

Impact of temporary differences

As noted above, "income tax expense" for the purpose of the Return on Regulatory Equity and NPAT calculations should be determined in accordance with ordinary accounting principles, in order to comply with comparability goals of such measures (e.g. such that comparisons to equivalent ratios from listed accounts will be appropriate). In accordance with AASB 112, "income tax expense" will not only include the income tax payable in respect of the relevant current income year (referred to as "current tax expense") but will also include the tax impact of any movements in Deferred Tax Assets and Liabilities of the reporting entity (referred to as "deferred tax expense"). What this means in practice, is that any tax adjustments which only relate to the timing of a deduction (referred to as "temporary differences"), will not only impact the current tax expense, but will generally have an equal and opposite effect on deferred tax expense. Accordingly, temporary differences will not have an impact on the effective income tax rate of a reporting entity and the income tax expense recognised in the income statement, but rather will result in a shift between current tax payable and Deferred Tax Asset (**DTA**) / Deferred Tax Liability (**DTL**) accounts in the balance sheet.

As it is not currently proposed that regulatory balance sheets are reported for the purpose of the AER's profitability measures, it does not appear that temporary differences will have an impact on the profitability measures reported by the entities (as current tax payable and DTA/DTL balances will not be disclosed or relevant to the proposed profitability measures).

As such, in the event the only book to tax adjustments which were to be recognised by a business for regulatory purposes were temporary in nature, an appropriate income tax expense could be recognised for regulatory reporting purposes simply by multiplying the profit before tax (**PBT**) figure which is determined in Figure 2 above by the applicable tax rate (e.g. 30% for a company or a blended tax rate for a flow-through vehicle).

Adjustments which may be required

In practice however regard will need to be had to any tax adjustments that will not unwind over time due to differences in measurement requirements between accounting and tax (referred to as "permanent differences") which are required in determining the actual regulatory tax position of an entity. Based on our understanding of the regulated businesses the only material permanent differences which we would expect to be relevant to the determination of regulatory tax expense are:

[11] Note the proposed R&D reforms were introduced into Parliament in the *Treasury Laws Amendment (Making Sure Multinationals Pay Their Fair Share of Tax in Australia and Other Measures) Bill 2018,* however this Bill lapsed before being passed when Parliament was prorogued on 11 April 2019 prior to the Federal Election. We expect the Government will look to reintroduce this legislation in coming months.

- **Permanent Capex adjustments:** As RAB asset values are indexed, and actual tax fixed asset register are not, a permanent difference is likely to arise between Capex for Regulatory and tax purposes equal to the tax effect of the additional RAB depreciation attributable to inflation which is not depreciable for income tax purposes.

  The potential distortionary impact of RAB inflation on the comparability of regulatory profitability measures is discussed in section 2.5 of the Draft AER Position Paper. The AER have considered the option to require businesses to report regulatory depreciation (e.g. return of capital) after having adjusted for or removed the impact of indexation of the RAB for this reason, however note that "these adjustments would be complex, would need to be made for each service provider and would likely remain open to criticism". Accordingly, the AER have recommended inclusion of statutory profitability measures to allow comparability between the regulated network businesses and firms operating in the broader economy, rather than requiring businesses to adjust for specific factors such as indexation.

  We note for completeness that in the event businesses were required to report the regulatory PBT outlined in Figure 2 above by adjusting depreciation to remove the impact of RAB inflation, no adjustments would be required to the Regulatory tax expense calculation in respect of Capex, as any other differences arising (such as differences in effective lives, depreciation methods, or relating to immediately deductible capex) would be expected to be timing in nature and therefore have no impact on income tax expense when combining current and deferred tax expense for reporting purposes under AASB 112.

  On the basis of the AER's current recommendations however, an adjustment will be required to the income tax expense line in Figure 3 above to increase the tax expense by an amount equal to 30% of any RAB depreciation expense attributable to indexation of the RAB.

  Ideally, network businesses and the AER would be able to identify the impact of indexation on current year regulatory depreciation, or at least, apply a formula which provides a reasonable approximation of what this amount would be (e.g. Nominal Straight-Line Depreciation for regulatory purposes – (total RAB indexation x average depreciation rate applied across all RAB assets)).[12] We recommend the AER give further consideration as to whether such an apportionment could be achieved.

  In the event the indexation component of Nominal Straight-Line Depreciation for regulatory purposes (or a reasonable estimation of this amount) cannot be identified, we have considered whether there is an alternative method whereby business networks could determine the current tax and deferred tax adjustments which may arise for regulatory tax purposes, and apply this adjustment to the income tax recognised for regulatory NPAT purposes.

  This would require identification of all current tax adjustments relating to the RAB, and identification of all movements in deferred tax expense which are attributable to the RAB. Adjustment of both current and deferred tax expense movements is required to ensure that the adjustment to income tax expense is consistent with AASB112. The resulting net income

[12] For this purpose of this paper, we have assumed that the depreciation expense attributable to the regulated assets which will be disclosed in the Income Statement proposed to be reported by the network businesses for the purpose of the reporting of profitability measures (e.g. as per Appendix B of the Draft AER Position Paper) will be the Nominal Straight-line Depreciation recognized within the Return of Capital allowance for regulatory purposes. For completeness, we note that AER define Return of Capital (or 'Regulatory Depreciation') as equal to Nominal Straight-line Depreciation less Actual Inflation. This is on the basis an inflation adjustment is required to the Return of Capital formula to ensure no double counting arises, given inflation is also factored into the WACC aspect of the Return on Capital allowance.

tax expense impact (e.g. current tax expense movement less deferred tax expense movement) could then be applied to the prima facie tax expense (e.g. 30% of regulatory EBIT) in order to account for the impact of permanent differences relating to Capex.

The adjustments which would need to be taken into account when applying this approach to determine an appropriate adjustment to income tax expense in accordance with AASB 112 would include:

Depreciation tax adjustments (current tax):

- Add back: Annual Nominal Straight-Line Depreciation recognised for regulatory purposes
- Subtract: Annual actual tax depreciation in respect of regulated assets
- Subtract: Immediately deductible Capex incurred in the year
- Add back: Customer contributions or gifted assets (which are recognised for TAB and actual tax purposes).

The net effect of the above items is to reflect the total increase / decrease in the regulatory income tax expense of a network business which is attributable to current tax adjustments

Depreciation tax adjustments (deferred tax):

- Add back: RAB Closing Balance (excluding indexation) less RAB Opening Balance (excluding indexation)
- Subtract: Actual tax fixed asset register closing balance (regulated assets only) minus actual tax fixed asset register opening balance (regulated assets only), excluding the impact of any current year market value adjustments (e.g. resetting under tax consolidation) to the tax fixed asset register.[13,14]

The net effect of the above items is to reflect the total movement in deferred tax (e.g. net DTA/DTL) which is attributable to the regulatory assets. Indexation is required to be removed from the RAB on the basis inclusion of indexation would otherwise create a permanent difference for tax effect accounting purposes.

The net total of the current tax and deferred tax adjustments outlined above would then be multiplied by the applicable tax rate (e.g. 30% for entities which are taxed as a company, or a blended rate for flow-through entities, as discussed further below) to determine the

[13] These balances are expected to include any gifted assets or assets funded by customer contributions which have been recognized as assessable for income tax purposes. Refer section 3.3.6 of our Tax Allowance Report for further discussion regarding the income tax treatment of gifted assets and customer contributions.

[14] Any increase or decrease to the tax fixed asset register balance under tax consolidation principles in the income year for which profitability is being measures could potentially distort this formula by creating a deferred income tax expense/benefit, with no offsetting current tax adjustment. Therefore, current year tax resets should be excluded from the tax fixed asset register balance (e.g. the tax base). In the year following the reset, the uplifted/decreased balance should be included in the opening balance of the tax fixed asset register, and therefore no further distortion should arise.

adjustment required to the income tax expense line within the regulatory income statement in relation to Capex.

- **Non-deductible interest expense:** Another permanent difference may arise whereby interest expense is treated as non-deductible for income tax purposes. This may occur where the debt levels of a business exceed the maximum allowable debt as determined under Australia's thin capitalisation regime, where interest payable to international related parties of the Australian network business exceed an amount which is considered to be of an arm's length nature in accordance with Australia's transfer pricing regime, or where the hybrid mismatch rules apply to deny a debt deduction which gives rise to a hybrid outcome (e.g. interest is otherwise deductible in Australia, but not assessable on receipt in another jurisdiction) . In these scenarios the regulatory income tax expense of the business will need to be increased by an amount equal to 30% (for a corporate entity) of the non-deductible interest expense, to the extent that interest expense is allocable to the regulated network (refer our comments in section 3.3 below in this regard).

  Refer section 3.1.4 of the Addendum to our Tax Allowance Report for a detailed analysis of the income tax laws which may impact the ability of the network businesses to claim interest deductions in respect of financing attributable to the regulated assets. Consistent with the preceding item, our recommendation is that entities which are subject to denials of interest deductions self-report the impact of the denied deductions on the income tax expense reported for the purpose of the profitability measures.

  In addition, a permanent adjustment may also arise where the accounting and tax classification of an instrument differs (e.g. debt v equity). An example of this may be a preference share which is partially accounted for as debt for reporting purpose (and therefore any returns would be recognised for reporting purposes as a financing/interest expense), but are classified as equity for income tax purposes (and therefore any returns would be considered a non-deductible dividend payment for income tax purposes).

  The allocation methodology applicable to interest expense for the purpose of regulatory PBT (and the corresponding impact on interest deductions recognised for regulatory tax purposes) is discussed further at section 3.3 below.

- **Adjustments to prior year returns:** Permanent differences may also arise where prior year income tax assessments for regulated businesses are amended following dispute with the ATO or a change in law (such as a Court judgement). Consistent with our comments above, such adjustments should only impact regulatory tax expense where the income or expense in question is within the regulatory ring-fence, and the adjustment is permanent in nature (e.g. the permanent denial of deductions).

Other approaches considered

McGrathNicol suggested that when considering allocation of tax to the service provider level a reasonable assumption might include that the tax payable by a service provider is based on the group's effective tax rate applied to the service provider's net PBT.[15]

[15] McGrathNicol, *Response to submissions on profitability measures*, 23 April 2018, page 11.

We consider that an allocation method relying on such an assumption, requiring the application of the effective tax rate of a service provider's broader corporate group (determined on a statutory basis) to a NSP's regulatory PBT would not be an appropriate method of allocating tax expense to the NSP level. This essentially combines a statutory measure (effective tax) with a regulatory measure (regulatory PBT) which would produce a distortionary result as no regard can be given as to whether the factors which have impacted effective tax rate for the business are within or outside of the regulatory ring-fence. Further, this method does not allow the required adjustments to the tax calculation (as outlined above) to be made and additionally this method would not produce a comparable profitability measure which meets the AER's objectives.

Further, we have also considered whether allocating the actual tax paid by a group to the respective regulated and unregulated businesses would be feasible. Allocation of actual tax to the regulated/unregulated businesses could potentially be made with regard to some relevant driver, in a similar manner to allocation of interest expense, as discussed above. This would firstly require identification of an appropriate driver on which to base this allocation of actual tax paid.

However, even if an appropriate driver could be identified, we consider this method would not be effective on the basis that actual tax does not have regard to the AER's ring-fencing principles. For example, actual tax is calculated having regard to items such as the reset tax cost bases of assets, that is any step-ups attained from M&A activities, as well as M&A costs more broadly. Therefore, as actual tax is not reflective of the regulatory position, any allocation of actual tax to regulated/unregulated businesses based on a relevant driver would require further adjustment to strip out items which are not within the regulatory ring-fence which we consider would require significant efforts.

Furthermore, starting with actual tax would not satisfy the AER's requirement to report NPAT as determined under accounting standards for consistency and comparability between NSPs as actual tax is not reflective of income tax expense under AASB 112, only taking into account current tax not deferred tax.

This method would also not be appropriate where regulated businesses are held in a flow through structure as it would not be possible to determine the actual tax paid by investors on the taxable profits of the flow through structure to begin with.

Recommendations

Based on the above, we make the following recommendation in respect of allocation methodologies for income tax expense in relation to network businesses which are taxed as a company:

Recommendation 1

Due to the proposed regulatory reporting requirements which network businesses will be subject to (refer Figure 3 above), and the fact that only "permanent" tax adjustments will impact the income tax expense of an entity in accordance with AASB 112, determination of the regulatory income tax expense for entities which are taxed as a company does not require a separate tax calculation to be prepared, but can be leveraged to a large extent from the information which is already proposed to be disclosed as per Figure 3 above.

Specifically, network businesses should be able to report income tax expense on a regulatory basis by multiplying the PBT reported in Figure 3 by the corporate tax rate of 30%, subject to specific adjustments for:

- The impact of any permanent differences relating to depreciation for regulatory and actual tax purposes (e.g. depreciation attributable to indexation of the RAB);
- Increases to income tax expense in relation to any interest expense included in the regulatory PBT which is treated as non-deductible for income tax purposes in accordance with the thin capitalisation, hybrid mismatch or transfer pricing regimes, or where accounting and tax classification (e.g. debt v equity) differs; and
- Amendments to prior year income tax return assessments (e.g. following ATO dispute or a change in law) which results in a permanent tax adjustment for income or expenditure which is within the regulatory ring-fence.

Additional considerations for "flow through" entities

As noted above, our Tax Allowance Report observed that 33.79% of regulated assets by TAB value (at 30 June 2018) are held in structures which are considered "flow through" for income tax purposes (e.g. partnerships and stapled structures). The types of flow through vehicles (including stapled structures) and the taxation of investors in flow through vehicles are discussed in detail in section 3.2.2 of our Tax Allowance Report.[16]

Flow through vehicles are treated as transparent for income tax purposes, such that the income tax burden attributable to the regulated network assets is primarily taxed in the hands of the investors in the holding vehicles, rather than at the level of the holding vehicle itself (as would be the case with a corporate structure). This creates complexity in the calculation of Return on Regulatory Equity and NPAT on the basis that the "flow through" network businesses do not actually pay income tax, but rather, it is paid by their investors.

Whilst this prima facie may indicate that the regulated profits attributable to flow through structures should not report any income tax, this would significantly detract from the comparability of the relevant metrics (e.g. Return on Regulatory Equity and NPAT) for the purpose of profitability reporting by the AER. Further, this would not in all instances be an accurate reflection of the true tax cost attributable to the assets on the basis the investors in flow through vehicles may incur an

[16] For the purpose of this report, flow through vehicles are legal structures which are treated as 'transparent' for income tax purposes, and include partnerships, trusts (other than Public Trading Trusts which are taxed as companies under Division 6C of the ITAA 1997) and stapled structures.

additional income tax cost which would not be attributable to investors in corporate entities, as investors in the corporate entities would generally receive a tax offset by way of franking credit applicable to any returns paid to them out of previously taxed profits (whereby investors in flow through vehicles do not).

As such, we recommend that the income tax expense of upstream investors in flow through vehicles which are directly attributable to the taxable profits of the regulated network business are included in the income tax expense line of the regulatory income statement outlined in Figure 3, to allow comparability of Return on Regulatory Equity and NPAT on a like for like basis between the regulated network businesses, regardless of holding structure.[17]

The considerations associated with ascertaining the taxable profits of flow through vehicles are identical to the considerations outlined above in respect of corporate entities, with the exception of the tax rate which is applicable to those taxable profits. For corporate entities, a tax rate of 30% will apply, however difficulties arise in respect of flow through vehicles in that tax rates will vary across different investors in any one investment vehicle. For all other purposes relevant to the determination of taxable income having regard to the regulatory ring-fence, the principles relating to assessability of income and deductibility of expenses are generally the same for corporate and flow through entities.

As noted above the tax implications associated with flow through vehicles is discussed in detail in section 3.3.2 of our Tax Allowance Report. In addition, section 3.2.3 of our Tax Allowance Report discusses recent reforms to the tax laws relating to stapled structures and the MIT rules which will have a significant impact on the tax payable by investors in regulated assets which are currently held under stapled structures. We summarise the relevant aspects of these rules and reforms for the purpose of this paper below:

- Flow through investment vehicles are a common structure used globally in the managed funds and institutional investment sectors, in part due to the preference of institutional investors to receive profits from passive investments on a pre-tax basis.

- The Australian Government introduced the MIT regime in 2008 in order to increase Australia's international competitiveness in attracting investment capital for "eligible investment businesses" (which includes businesses which invest in land or items affixed to land for the purpose of deriving rent). The MIT regime broadly provides a concessional income tax rate of 15% to distributions of taxable income to investors from Exchange of Information (**EoI**) countries where all relevant MIT criteria is satisfied by the investment vehicle. If the investor is not resident in an EoI country, then the rate increases to 30%.

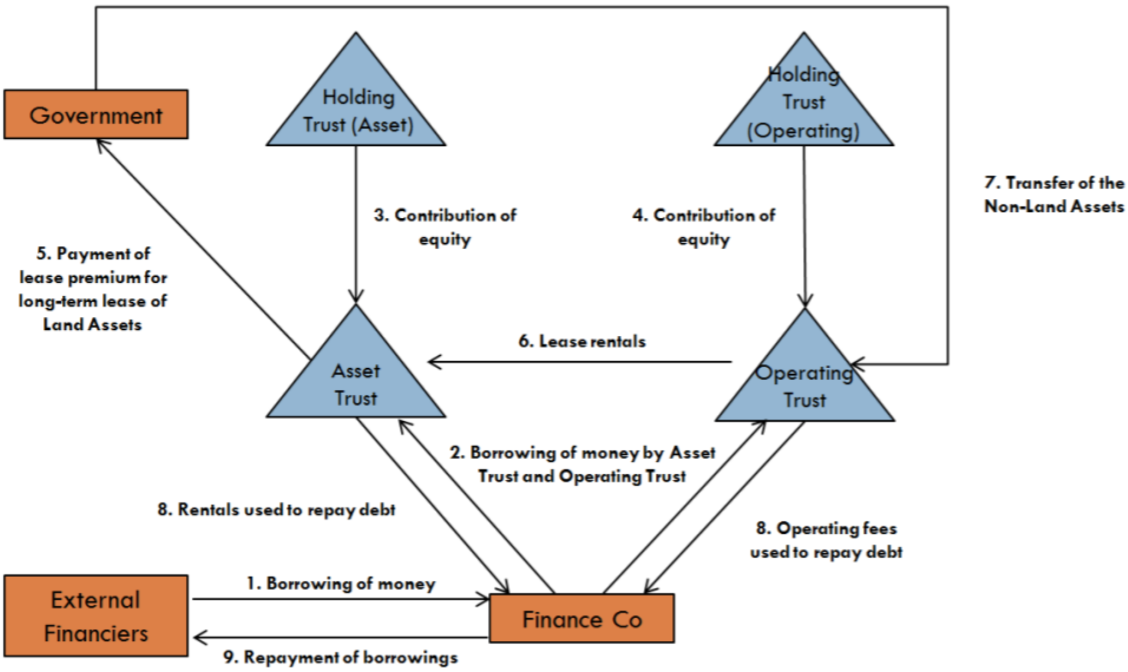
- Privatisations of Australian regulated electricity networks have occurred under both partnerships and stapled structures, which are treated as flow through for income tax purposes. In particular, partnerships have been used in privatisations where the relevant State government seeks to retain an ownership interest in the regulated assets post privatisation.

- Under a typical stapled structure, the "land" assets (including items affixed to land) are held by the "Asset Trust" whereas the operating licence and customer contracts are entered into by the

[17] For the purpose of this Report, the term "income tax" generally covers both income tax levied under Australian income tax law, and withholding taxes levied on distributions to non-resident investors (e.g. MIT and non-resident withholding).

"Operating Trust".[18] The operating trust makes a rental payment to the asset trust for use of the relevant land based assets. A generic stapled structure is depicted in the diagram below:

Figure 4: Example stapled structure (as per ATO draft privatisation tax framework)[19]



- Under the stapled structure, the Holding Trust (Asset) (depicted above) will generally be considered eligible for MIT status and therefore entitle investors from EoI countries to the concessional 15% tax rate in respect of profits. Further, entities which attract concessional tax rates will be taxed at those lower rates (e.g. 15% for complying superannuation funds or 0% in some cases for Sovereign Wealth Funds).

- The Operating Trust will not conduct an "eligible investment business" and therefore the Holding Trust (Operating) may attract the application of Division 6C of the ITAA 1936, which broadly seeks to treat a widely held (Public) trust which does not carry on an eligible investment business (Trading) as a company for income tax purposes (referred to as a Public Trading Trust), and subject the Division 6C trust to a 30% tax rate at the trust level. In the

[18] We note that under some stapled structures the operating assets may be held by a company. Whether the operating assets are held by a trust or a company should not make any material difference for the purpose of this paper.

[19] Extracted from page 48 of the "*Privatisation and Infrastructure – Australian Federal Tax Framework*" (January 2017 Draft) released by the ATO

event the Holding Trust (Operating) is not considered subject to Division 6C, the trust will remain flow through in nature however any distributions to non-residents may be subject to a 30% non-final withholding tax rate noting the potential 7 year transitional relief applying to MIT Trading trust income which may potentially be applicable in some circumstances.

- Section 3.2.4 of our Tax Allowance Report observed the following investor categories and expected tax rates in respect of all regulated assets (including entities taxed as a company, whereby the company or NTER entity is considered the relevant holder of the regulated assets):

Figure 5: Investor tax profiles and tax rates – 30 June 2018 (by TAB value)

Investor tax profile	% of TAB	Expected tax rate
1. NTER entity	**40.00%**	30%
2. Australian company	**29.98%**	30%
3. Australian States or Territories (tax exempt, non-NTER)	**11.10%**	N/A
4. Australian managed investment fund[20,21]	**7.86%**	15%-30%
5. Australian superannuation funds	**3.79%**	15%
6. Foreign Sovereign Wealth Funds[22]	**2.90%**	0%-30%
7. Foreign pension funds[23]	**2.07%**	15%-30%
8. Foreign companies	**2.30%**	30%

[20] The MIT concessional tax rate of 15% for investors in EoI countries will only remain available for the flow through entities holding regulated assets through stapled arrangements until 30 June 2034, after which point a 30% tax rate will apply. Profits attributable to the operating side of a staple will not be eligible for MIT status and therefore subject to 30% non-resident withholding subject to the 7 year transitional relief for MIT trading trust income which may be applicable in some circumstances.

[21] Due to the lack of information available in respect of tax profiles for investors in managed investment funds, we are unable to confirm the expected tax rate for these investors. In many cases, we would expect the concessional MIT rate of 15% to be available for certain foreign investors resident in an EOI country. Likewise, investments by superannuation funds in the managed investment funds would also attract a tax rate of 15%. In other cases, the corporate rate of 30% may apply.

[22] Sovereign wealth funds may be treated as tax exempt on certain passive classes of income, which is generally confirmed through a ruling request with the ATO. Sovereign wealth funds with an interest of 10% or more will pay withholding tax of 30% on Australian profits from energy businesses for any new investments post 27 March 2018 or from 2026 for assets acquired before that date. Sovereign wealth funds with an interest of less than 10% (and no influence over the NSP) will remain exempt.

[23] Foreign pension funds would generally access the 15% MIT concession (subject to reform of law and transitional arrangements) on the asset side of a staple, and be subject to 30% withholding tax in respect of the operating side of the staple

- Based on the above:
  - 16.62% of regulated assets (by TAB value, at 30 June 2018) were held directly by investors in flow through vehicles which may attract concessional tax rates in respect of the regulated assets (e.g. below 30%).
  - 72.28% of regulated assets (by TAB value, at 30 June 2018) were held directly by entities which are taxed as a company and subject to the corporate tax rate of 30% (including NTER entities);
  - 11.1% of regulated assets (by TAB value, at 30 June 2018) were held by Australian States or Territories which are exempt from income tax.
- As discussed in section 3.2.3 of our Tax Allowance Report, the tax rules applicable to stapled structures have recently been subject to significant reform following introduction of *Treasury Laws Amendment (Making Sure Foreign Investors Pay Their Fair Share of Tax in Australia and Other Measures) Bill 2019*. In particular:
  - Any MIT which is in receipt of a cross-staple rent payment will be subject to 30% tax on taxable profits (rather than 15% under the MIT regime) from 1 July 2034 onwards (or new stapled structures which are introduced after 27 March 2018). This is expected to apply from that date to all regulated network businesses which are held in a stapled structure;
  - Any distributions received by a MIT in respect of an interest in a Trading Trust (e.g. the Operating Trust or Holding Trust (Operating)) will be subject to the corporate tax rate of 30%, subject to a 7 year grandfathering period (ending 30 June 2026) for interests which were held at 27 March 2018;
  - Concessional tax rates and exemptions which are currently available to Sovereign Wealth Funds and foreign pension funds with a 10% or greater interest in an Australian infrastructure investment will be removed from 1 July 2026 onwards, after which the 30% corporate tax rate will apply in respect of distributions of taxable profits received by those entities (unless the investor's tax exemption has been confirmed through a Private Binding Ruling with the ATO which covers a period beyond that date, in which case the exemptions apply until the end of the ruling period); and
  - The ability of investors in the relevant holding trusts with a greater than 10% equity interest to claim interest deductions for gearing against the investment in the trust whereby the trust is already fully geared for thin capitalisation purposes (e.g. double gearing) has been removed from 1 July 2018.

Accordingly, whilst there may currently be discrepancies between the tax rates applicable to investors in flow through vehicles and the standard 30% tax rate applicable to corporate entities, these discrepancies will largely disappear from 1 July 2034 onwards after which most investors will be subject to a 30% tax rate (with the exception of certain investors such as sovereign wealth funds with a non-controlling interest of less than 10% in the project vehicle).[24]

In order to determine the appropriate tax rate for a network business which is subject to flow through taxation, we are of the view that this can only be achieved through the determination of a "blended" tax rate which represents the average Australian income tax rate which will apply to profits of the regulated business in this hands of the initial recipients of those profits. This calculation should not include any foreign taxes which may apply to those investors, as this would not achieve the comparability requirements of the profitability measures as investors in corporate vehicles may in some (albeit limited) instances also be subject to foreign taxes in respect of dividends received from the relevant company.

We would expect that network businesses can seek to identify the potential tax rate applicable to investor distributions on a best endeavours basis, or to the extent that specific tax rates cannot be confirmed, apply a reasonable estimate based on expected tax profile of the relevant investors.

As outlined in Figure 5 above, the categories of tax rates which may be applicable to investors in stapled structures in particular (prior the removal of concessional tax rates in 2026 and 2034, as may be applicable) are:

Asset Trust:

- MIT investor from EoI country – 15%
- Australian complying superannuation fund – 15%
- Sovereign Wealth Fund[25] – 0%
- Other investors – 30%

Operating Trust:

- Public Trading Trusts[26] – 30%[27]
- Non-Public Trading Trusts
    - MIT investor from EoI country – 15%[28]

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[24] Note, our Tax Allowance Report did not evidence any investors in flow through vehicles with an interest of less than 10% as at 30 June 2018.

[25] The exemption from income tax under the Principle of Sovereign Immunity would generally be confirmed by a sovereign investor by way of ATO private binding ruling.

[26] Public Trading Trusts are taxed as a company in accordance with Division 6C of the ITAA 1936. A trust is generally classified as a Public Trading Trust if it is (1) a Public Unit Trust – being either listed, having greater than 50 investors, or greater than 20% held by exempt entities, and (2) a Trading Trust – being a trust which carries on a business other than an Eligible Investment Business. Refer section 3.2.2 of our Tax Allowance Report for further information relating to the potential application of Division 6C in respect of regulated network businesses.

[27] We note that investors in complying Australian superannuation funds would be entitled to refundable franking credit offsets in respect of income tax paid at the investment level in excess of 15%.

- Australian complying superannuation fund – 15%
- Other investors – 30%

As can be seen from the tax rates above, further complications arise in respect of stapled structures in that it is possible for the tax rates applicable to individual investors to differ across their interests in the Asset Trust (which is generally eligible for MIT status) and their interest in the Operating Trust (which would only be eligible for the concessional MIT rate if the MIT held a non-controlling interest in the operating trust and the trust was not considered to be Public Unit Trust (e.g. not widely held)). The general practice of the ATO in recent years has been to accept an allocation of value to the assets of the Asset Trust of no greater than 70% than the total value of the regulated network business (and accordingly, the distributable profits of the Asset Trust should not represent greater than 70% of the total distributable profits of the regulated network business).[29] Whilst this may not be an accurate reflection of the true value of the assets of the Asset Trust as compared to the Operating Trust, based on publicly available comments it is not expected that the ATO would have accepted a valuation allocation of greater than 70% to the Asset Trust in respect of previously privatised assets (note, this has not been confirmed by us, but is rather based on general public commentary within the industry). Accordingly, when applying a weighted average tax rate to the taxable profits of a stapled structure, a 70:30 split attributable to the Asset Trust and Operating Trust would appear to be a reasonable assumption for comparative purposes.

Further, as noted in the table in Figure 5 above, 11.1% of regulated network assets (by TAB value as at 30 June 2018) are held directly (through flow through structures) by Australian States/Territories in vehicles which are not subject to the NTER, and therefore do not pay income tax. We recommend the AER consider from a policy perspective whether an assumed income tax rate of 30% should be applied in respect of interests held by tax exempt State/Territory owned entities (e.g. akin to the tax rate applicable to NTER entities). This consideration should take into account the objective of comparability in respect of the profitability measures and also the broader concept of competitive neutrality which seeks to eliminate any competitive advantage which may be enjoyed by a government owned business that is operating in a commercially competitive environment.[30]

If a "base case" assumption was to be applied in respect of stapled structures (prior to the phasing out of concessional MIT treatment for infrastructure assets from 1 July 2034) it may have regard to a 70:30 split in respect of the profits attributable to the Asset and Operating Trusts, with a 15% tax rate applicable to the Asset Trust (e.g. MIT rate) and a 30% tax rate applicable to the Operating Trust (e.g. Division 6C rate). This would achieve a blended income tax rate for a stapled structure of 19.5%. In reality, the blended tax rate applicable to the regulated network businesses which are held within stapled structures are likely to be lower due to the existence of concessionally taxed entities (e.g. superannuation funds, Sovereign Wealth Funds and State/Territory owners), or in respect of non-controlling MIT interests in Trading Trusts (e.g. non-Division 6C trusts) prior to 30 June 2026.

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[28] As noted above, MITs which hold an interest in a Trading Trust will be subject to 30% tax from 1 July 2026 onwards as part of the Staples reform measures (for interests held before 27 March 2018. Interests acquired after that date will be subject to a 30% tax rate from the date of acquisition).

[29] Refer Example 3 in the ATO's Law Companion Ruling (**LCR**) 2015/15 and Taxation Institute of Australia (**TIA**) paper: *Knight, W: Stapled Securities: Where are we up to and what is the future for infrastructure? March 2018, page 12*

[30] Refer OECD publication: *Competitive Neutrality: Maintaining a level playing field between public and private business*, published 30 August 2012.

The base case blended tax rate also assumes that debt funding is allocated across the Operating Trust and Asset Trust in accordance with the 70:30 ratio discussed above, consistent with the ATO's comments in the *Privatisation and Infrastructure – Australian Federal Tax Framework* (January 2017 Draft), whereby the ATO raised concerns with "unequal levels of gearing" across stapled structures.

We note that in some instances investor bases and tax profiles may change over the course of a reporting year. In this instance, the average rate over the relevant reporting period should be applied.

Recommendations

Accordingly, we recommend the regulated network businesses which are held within flow through structures self-assess a blended tax rate having regard to their investor profiles and the tax status of the project vehicles (e.g. MIT status in respect of an Asset Trust or Division 6C status in respect of an Operating Trust). This should not be a costly or complicated exercise for the businesses, and information could be sought from investors on a 'best endeavours' basis if necessary. To the extent that the blended tax rate is materially different to what would be expected by the AER having regard to the guidance above, further supporting calculations in respect of the estimated blended tax rate could be sought.

Recommendation 2

Network businesses which are held within a flow through structure should self-assess a "blended" tax rate which would be applicable to distributed taxable profits, having regard to the nature of the project vehicle (e.g. MIT, Division 6C trust) and the profile of investors.

For stapled structures, it is not expected that this blended rate would currently be higher than 19.5% (and may be significantly lower in some cases), however the rate is expected to increase to 30% following the cessation of the grandfathering (e.g. transitional) period in respect of the staples reforms on 1 July 2034).

Consideration should be given by the AER to the tax rate applicable to interests in flow through vehicles held by State/Territory owners which are not subject to the NTER.

3.3 Allocation of interest expense

The allocation of interest expense from statutory accounts to regulatory accounts has been identified as a key issue which may cause inconsistency in profitability measures reported by the NSPs. Service providers in a corporate group typically raise finance at a group level, consisting of both regulated and non-regulated businesses. Without clear guidance for the allocation of amounts to their regulated and non-regulated activities, the NPAT cannot be isolated to regulatory activity and hence regulatory NPAT cannot be determined.

The Addendum to our Tax Allowance Report addressed discrepancies between actual interest expense claimed by the NSPs and notional interest expense determined by the AER for the purpose of calculation of the regulatory forecast of tax costs (which is equal to the regulatory cost of debt provided to the regulated entities return on debt building block). Prima facie, we expected the actual interest expense claimed by the NSPs to exceed the regulatory cost of debt calculated by the AER due to the following factors:

- M&A activity (e.g. privatisations), where the quantum of actual debt assumed by the NSP will be based on the market value of the regulated assets at the time of acquisition (at an appropriate gearing ratio); and

- Actual interest expense of the NSPs reflecting debt used to fund acquisition or construction of both regulated and unregulated assets.

Accordingly, providing comparable profitability measures to the AER requires a ring-fencing apportionment approach, which must be applied consistently to interest expense to remove the impact of the above factors.

McGrathNicol suggests that a reasonable assumptions to allocate interest includes an allocation based on a "relevant driver".[31] The total interest expense of the regulated network businesses will be disclosed to the AER in accordance with the "statutory basis" interest expense disclosure within the reporting template outlined in Figure 3 above. We agree that this interest expense should be allocated on a regulatory basis having regard to an appropriate factor.

To assist in consideration of an appropriate apportionment methodology for interest, we have summarised some relevant allocation principles from a tax and accounting perspective below.

Interest expense for tax purposes

For Australian tax purposes and under s 8-1 and Division 230 of the *Income Tax Assessment Act 1997* (**ITAA 1997**), interest is generally deductible to the extent to which it is incurred in gaining or producing assessable income or in carrying on a business for that purpose, and is not of a capital, private or domestic nature. No deduction will be available for borrowings relating to the production of exempt income.[32]

Under Tax Determination (**TD**) 93/13,[33] apportionment of this interest expense is required for tax purposes in the following circumstances:

- Where the borrowing is partly for income producing and partly for other purposes; and
- Where the borrowing has been taken out by two or more taxpayers.

The courts adopt both a subjective and objective purpose approach towards characterising outgoings to determine the apportionment of interest expense.[34] The appropriate method of apportionment is

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[31] McGrathNicol, *Response to submissions on profitability measures*, 23 April 2018, page 11.

[32] Case Y5 91 ATC 120; Case Z33 92 ATC 308.

[33] Tax Determination 93/13: Deductibility of interest on a loan used to acquire income producing property where non-income producing property is used as security

[34] *Ronpibon Tin NL* v *FC of T* (1949) 8 ATD 431; (1949) 78 CLR 4

dependent on the facts of each case and must be “fair and reasonable” to the extent of the outlay in relation to assessable income.[35]

A suitable method of apportionment on the basis of percentage of income producing assets to total assets was utilised in the *Reliance Finance Corporation Pty Ltd v Federal Commissioner of Taxation,*[36] where only a proportion of assets funded by the principal loan amount were deemed income producing. The interest expense deductible for tax purposes was determined by apportioning the interest expense on the principal loan amount by the percentage of assets that were determined to have derived income.

Taxation Ruling (**TR**) 2011/6[37] which deals with section 40-880 of the ITAA 1997 also provides for apportionment in some instances. Under section 40-880 taxpayers are entitled to write off certain types of business related capital expenditure by taking a deduction of the cost over a five-year period, where no other provision takes the expenditure into account or denies a deduction. Such expenditure may include the costs of raising equity and defending against takeovers, as well as expenses incurred in establishing, converting or winding up a business structure.

TR 2011/6 provides that expenditure which relates to more than one business or purpose may be apportioned on a fair and reasonable basis, which will depend on the facts and circumstances unique to that case. Further, expenditure incurred partly for a taxable purpose and partly for a purpose which is not a taxable purpose should be apportioned. No particular methodology is set out in the legislation or extrinsic materials to determine the extent to which a business is carried on for a taxable purpose, however as a general rule, the extent to which a business is carried on for a taxable purpose or not may be determined by comparing the amount of any exempt income and non-assessable non-exempt income the business has derived with total income (that is, assessable income plus exempt income plus non-assessable non-exempt income), and applying this percentage to the amount of expenditure to reduce the deduction.

The allocation of interest expense for tax purposes is also consistent with the OECD’s revised guidance on the Application of the Transactional Profit Split Method[38]. This guidance addresses the use of a transactional profit split method is used to allocate the relevant profits between associated entities on an economically valid basis, where a split would approximate the division of profits that would have been obtained at arm’s length between the parties.

The strength of this method is that it offers a solution for cases where operations are highly integrated and various parties to a transaction make unique and valuable contributions. Contributions are determined by reference to the relative values of their respective functions, assets and risks.

Profit splitting factors based on assets or capital (e.g. operating assets, fixed assets, and intangibles) may be used where there is a strong correlation between the assets and creation of value in the

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[35] *Fletcher & Ors* v *FC of T* 92 ATC 2045

[36] *Reliance Finance Corporation Pty Ltd* v *Federal Commissioner of Taxation* 87 ATC 4146

[37] Taxation Ruling 2011/6: Income Tax: business related capital expenditure – section 40-880 of the *Income Tax Assessment Act 1997* core issues

[38] Revised Guidance on the Application of the Transactional Profit Split Method – Inclusive Framework on BEPS: Action 10 (June 2018).

context of the controlled transaction. However, this is to the extent that assets can be measured reliably and can capture the relative contributions being split.

In respect of the NSPs, the assets are a key driver for various economic measures including derived revenue, depreciation expense and interest deductions claimed. Each NSP is also required to maintain consistent record keeping of assets to the extent that they can be reliably measured and distinguished between regulated and non-regulated assets. Hence, the application of the profit split method based on the assets held by the NSPs should be considered.

Interest expense for accounting purposes

For Australian accounting purposes and under AASB 123, borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset form part of the cost of the asset and are capitalised. An entity shall recognise other borrowing costs as an expense in the period in which they are incurred. Among others, AASB 123 recognises power generation facilities and intangible assets as qualifying assets.

AASB 123 recognises the difficulty in identifying a direct relationship between particular borrowings and a qualifying asset and to determine the borrowings that could otherwise have been avoided. Guidance is provided where an entity borrows funds generally and uses a portion for the purpose of obtaining a qualifying asset. The borrowing costs eligible for capitalisation are determined by applying a capitalisation rate to the expenditures on the asset, where the capitalisation rate is the weighted average of the borrowing costs applicable to the borrowings, other than borrowings made specifically for the purpose of obtaining the qualifying asset.

In general practice, the borrowing costs that are attributable to a specific qualifying asset are determined by apportioning the principal loan amount by the percentage of qualifying assets over the entire asset pool.

Aside from the allocation of interest to determine capitalisation of borrowing costs, accounting standards do not generally prescribe a method of allocation for reporting purposes. Interest expense is recognised in the legal entity that holds the relevant loan and is only on-charged to other group entities if there is a legal arrangement in place to do so. Additionally, there is no requirement to allocate interest expense for segment reporting in financial statements unless such an allocation is performed for internal management reporting purposes.

Allocation of interest expense for regulatory purposes

We agree that it would be “fair and reasonable” to allocate a percentage of the actual (statutory) interest expense of the network businesses to the regulatory activities having regard to a “relevant driver”. In considering appropriate drivers, we have considered whether interest can be allocated based on either of the following approaches:

1. Allocation based on regulatory EBIT / statutory EBIT
2. Allocation based on RAB / Statutory Total Assets
3. Specific allocation having regard to use of funds

Each of these potential allocation methodologies is considered in further detail below.

Allocation method 1: Regulatory EBIT / Statutory EBIT

An allocation methodology for interest expense having regard to EBIT appears to be the least complex approach given the availability of this information and the general acceptance of stakeholders that EBIT should be used as an appropriate comparable measure of the profitability of the network businesses.

In particular, regulatory EBIT is intrinsically linked to the funding profile of the network businesses, given the relevance of each businesses' cost of debt and equity in the determination of gross revenue. Whilst the return of capital component of the regulatory tariff structure (e.g. depreciation of RAB) may not have a direct correlation to the quantum of cost of debt funding (and therefore allocation of interest) for the network businesses, this should not detract from the use of EBIT as an allocation method given the RAB depreciation component is recognised as both a component of revenue and an expense in determining regulatory EBIT.

The Addendum to our Tax Allowance Report (specifically section 3.1) discussed the importance of having regard to the regulatory ring-fence (e.g. the costs which regulated businesses are able to receive a return in respect of) in determining the appropriate forecast of tax costs (including financing) for regulatory purposes. This is particularly important in respect of debt funding given the acquisition of network businesses as multiples of RAB over recent years may mean that actual debt funding and interest expense of network owners may significantly exceed the cost of debt provided to those businesses for regulatory purposes. The Addendum to our Tax Allowance Report found that after removing the impact of market value adjustments to debt (e.g. M&A activity), the actual weighted average interest rates and gearing ratios of the network businesses were relatively consistent with the benchmark measures applied by the AER (noting our recommendation that regard should be had to outliers from a gearing ratio perspective).

Consistent with these findings, we believe it is important that any allocation method accurately reflects the ring-fenced cost of debt funding when allocating interest expense for the purpose of determining regulatory NPAT for the profitability measures.

Given the regulated return on debt which is a component of regulatory revenue derived by the business networks is based on the ring-fenced costs of debt, we believe that regulatory EBIT / statutory EBIT should appropriately adjust the interest rate expense to reflect the ring-fenced quantum of debt.

That said, where significant unregulated assets exist within the statutory reporting group with profitability levels which are materially different to the regulated assets, there is a risk that the unregulated EBIT will skew the allocation of interest expense either away from the regulated assets if unregulated assets are more profitable, or towards the regulated assets if the unregulated assets are less profitable. As unregulated assets are likely to attract greater risk profiles, the profitability levels of those assets may be greater or lower than the regulated assets depending on performance.

The issues associated with statutory reporting figures for the network businesses have been considered in detail throughout the AER's consultation process on this project to date, and are summarised in section 2.5 in the Draft AER Position Paper. Whilst the AER acknowledge that statutory reporting measures (e.g. statutory EBIT) are influenced by a number of factors and adjustments (e.g. revaluations of assets or amortisation of intangible assets) which are not relevant for regulatory purposes, their current view is this downside is outweighed by the benefits of a measure which is comparable not just across the regulated entities but across businesses in the broader economy in general.

In a similar manner, whilst there is a risk that an interest allocation having regard to EBIT may be skewed where EBIT is influenced by factors not relating to the regulatory ring-fence (e.g. profitability levels of unregulated assets), the advantage of this allocation measure is simplicity in reporting and ease of interpretation for users of the profitability measures.

Allocation method 2: RAB / Statutory Non-Current Assets (excluding DTAs)

In considering drivers which are relevant to the allocation of interest and provide a 'fair and reasonable' basis, an allocation methodology having regard to RAB should be considered on the basis the regulatory profit position of the entities is largely determined having regard to the RAB, and the underlying regulated assets represent the assets against which the external debt of the businesses is expected to be secured.

In order to apply this driver to apportion the statutory (e.g. actual) interest expense of a regulated network operator, we must consider the appropriate basis (e.g. denominator) over which the RAB can be applied to achieve apportionment of the interest expense. To enable consistency within this formula, a relevant statutory measure would be Non-Current Statutory Assets (excluding DTAs) which are recognised by the network businesses for statutory reporting purposes. While it may be arguable that all assets of a network service provider could be subject to gearing, it is possible that the working capital levels, and approaches to debt funding in respect of current assets, may differ significantly across the different network businesses. Accordingly, we recommend the denominator in this allocation method is limited to Statutory Non-Current Assets, excluding tax balances (as DTAs would not attract debt funding). This is on the basis Non-Current Statutory Assets (excluding DTA) is likely to represent the gross value of assets across all regulated and unregulated activities against the debt raised by a network business may be applied.

The use of assets (rather than earnings) as a basis for the apportionment of interest expense for regulatory purpose is consistent with the preferred allocation methodologies outlined above from a tax and accounting perspective.

Whilst an advantage of this method is the centrality of RAB as the relevant driver, a disadvantage is the potential risk that Statutory Non-Current Assets will not give an appropriate point of comparison against RAB on the basis:

- RAB is indexed whereas Statutory Assets are not. For example, where a network business includes only regulated assets, an allocation factor of greater than 1 may arise due to inflation of the RAB. Whilst in such an instance we would recommend the factor would be capped at 1, this illustrates a broader issue about the potentially distortionary impact of RAB indexation; and

- Statutory Assets may be subject to revaluations, which may therefore not give a true reflection of the actual value of the underlying assets at the time the relevant debt funding was sourced.

Similar to Allocation Method 1, RAB / Statutory Non-Current Assets (excluding DTAs)is a relatively uncomplicated measure, and therefore achieves the goals of simplicity and ease of interpretation for users of the profitability measures.

Allocation method 3: Specific allocation having regard to use of funds

The third potential allocation methodology which we have identified is to apply a similar approach adopted in AASB 123 (Borrowing Costs), as discussed above. Under AASB 123, where debt funding has been sourced specifically for acquisition, construction or production of a specific asset, the borrowing costs attributable to that debt will be allocated directly to the relevant debt funded assets for accounting purposes. In the event no specific purpose can be identified in respect of a debt instrument (e.g. a corporate facility), then the borrowing costs attributable to that facility are allocated across qualifying assets of the entity having regarding to proportion of total assets.

In a similar manner, to the extent that network businesses are able to identify a specific debt facility which has been used to fund acquisition or construction of regulated assets, then the interest expense attributable to this debt should be allocated to the regulated operations for the purpose of the NPAT calculation.

It is important to note that this approach should still respect the ring-fencing principles discussed above and in section 3.1 of the Addendum to our Tax Allowance Report, in that any portion of a debt facility which was used to fund costs which do not generate a return to the network businesses for regulatory purposes (e.g. M&A costs such as stamp duty, and goodwill), should not be allocated to the regulatory basis for the purpose of determining regulatory NPAT. This would require dissection of debt facilities having regard to funding decisions and allocations on acquisition of assets (e.g. privatisations) which can be evidenced by the owners of the regulated network assets.

Likewise, interest expense which is directly attributable to debt used to fund acquisition or construction on unregulated assets should be allocated directly to those assets.

To the extent that remaining debt facilities cannot be attributed to acquisition or construction of a specific asset, the interest expense attributable to that debt should allocated between the regulated assets and unregulated assets (excluding those assets which have already been allocated interest expense based on a specific application of debt), having regard to the proportion each remaining assets represents of total remaining assets of the regulated entity (e.g. also excluding assets already allocated to).

This allocation methodology is considered to be the most accurate of the three potential methodologies considered. Given the level of accuracy, this method also achieves the objective of enabling comparability between entities and businesses in the broader economy.

The downside of this methodology is complexity. This method will require network business to determine and substantiate appropriate allocations of specific and general debt facilities having regard to the purpose for which each instrument was entered into. Whilst we would generally expect this information to be available, some network businesses may have greater difficulty or costs than others in complying with these requirements.

In recommending consideration of methodologies which promote simplicity in calculations (e.g. reduce compliance costs for network businesses) we have considered the use of the allocation methodology in light of the objectives of the reporting of profitability measures by the AER (i.e. increasing transparency for stakeholders). This is in contrast to our recommendations as part of the Tax Allowance Report whereby the objective of the AER was to align the tax allowance provided to taxpayers to actual tax payable in respect of the regulatory activities (in which case simplicity was not considered a relevant criteria).

Finally, we note that interest expense to be reflected in the tax calculation discussed at 3.2 of this Report should be determined on a consistent basis with interest expense for regulatory purposes. The result is that no further tax adjustments should be required, other than where deductions specifically denied under the thin capitalisation or transfer pricing rules (as discussed above).

Recommendation 3

The following allocation methodologies may be considered in determining the optimal allocation of interest expense between regulated and unregulated activities for the purpose of determining Regulatory NPAT and Return on Equity:

1. Allocation based on regulatory EBIT / statutory EBIT
   - Advantage: Simplicity and ease of interpretation
   - Disadvantage: Lack of comparability where profitability of regulated assets is materially different to profitability of unregulated assets
2. Allocation based on RAB / Statutory Non-Current Assets (excluding DTAs)
   - Advantage: Simplicity and ease of interpretation. Relevance of assets as a driver of financing costs.
   - Disadvantage: Allocation may be skewed by inflation of RAB and/or revaluations of assets for statutory reporting purposes
3. Specific allocation having regard to use of funds
   - Advantage: Accuracy
   - Disadvantage: Complexity and cost of administration if information not readily available to businesses.

On the basis method 3 (specific allocation) will result in the most accurate interest expense allocation, we recommend network businesses endeavour to perform the interest allocation on this basis in the first instance. We acknowledge however that some businesses may face difficulties in performing a specific allocation due to a lack of traceability in funding sources.

As such, where complexities would otherwise arise in performing a specific allocation, either method 1 (regulatory EBIT / statutory EBIT) or method 2 (RAB / Statutory Non-Current Assets, excluding DTAs) may be considered as alternatives. The appropriateness of each of these alternative methods should be considered in light of the circumstances of the relevant network business and the disadvantages outlines above (being the potential for unregulated businesses with materially different profitability measures to skew method 1, and the potential for RAB indexation or revaluations of statutory assets to skew method 2).

We would also recommend that Network businesses should be required to report the method adopted for transparency.

3.4 Additional considerations

Overseas examples

We have had regard to the approaches taken by the United Kingdom (**UK**) and Canada (Ontario) in calculating return on equity for the purposes of assessing financial performance of electricity distributors in those jurisdictions.

- The Office of Gas and Electricy Markets (**Ofgem**), the UK's regulator, requires electricity and gas licencees to report their regulatory financial performance annually as part of their regulatory model. This involves calculating Return on Regulatory Equity (**RORE**), which is used to compare the performance of different network companies and the performance at different price controls. Ofgem has produced instructions and guidance, together with a comprehensive spreadsheet template for calculating RORE. Ofgem's approach is to take actual tax liability as the starting point and provides for adjustments to be made to remove the non-regulated tax liability. Licencees should provide a judgment on the tax liability amount that relates to their regulated and non-regulated business in making this adjustment.

- The Ontario Energy Board (**OEB**) also imposes record keeping and reporting requirements on electricity providers, and keeps "scorecards" of provider's performance measures, one of which is return on equity. Electricity providers are required to calculate Return on Regulatory Equity in accordance with guidelines and a spreadsheet template. The guidance provided in this regard is not clear on how income tax should be allocated to the regulatory earnings.

- Thus both jurisdictions essentially require the completion of specific templates to calculate Return on Regulatory Equity, with adjustments to be made according to their respective laws. Our understanding of the approaches taken by these jurisdictions has not had further impact upon our recommendations.

How would our findings differ if the goal was to prepare statutory information for the regulated business?

Australian Accounting Standards are predominantly applied to either individual legal entities (be they companies, trust or unincorporated joint ventures and partnerships) or to groups of such entities.

As noted previously, the holding structures of regulated businesses can vary significantly. In some cases they are held in their own legal entity, but in many cases they are within entities with non-regulated businesses or potentially split between several legal entities (such as in 'flow through' structures).

These differences can make it challenging to provide information on the regulated business that would be compliant with accounting standards and/or that would provide meaningful information to users. In particular, accounting standards do not provide guidance on preparing information on a 'carve-out' basis and there is therefore a risk of diversity in application.

We summarise below some of the challenges that could potentially arise specifically in relation to interest and tax.

Interest

For statutory purposes, interest expense is recognised by the entity that has a legal obligation to pay it. There is no ability to allocate interest to another entity unless a legal contract is in place to charge that interest. Therefore, if the regulated business is in one legal entity and another group entity has borrowed funds then (unless there was a formal contract in place between the entities) no interest expense would be recognised by the regulated business.

There is also no guidance provided in accounting standards about how to allocate interest expense within an entity (if the regulated business forms part of a larger entity). For example, the allocation of interest expense is not required for segment reporting. Given this, preparing a statutory 'carve out' of the regulated business would also require some sort of allocation methodology to be determined and disclosed by the preparer.

Taxation

Accounting for taxation on a statutory basis carries similar challenges to those discussed in the rest of this report – being the impact of the holding structure and the impact of allocating within an entity or group (particularly a tax consolidated group).

Accounting standards require the tax rate to be applied in preparing statutory information to be the tax rate applicable to that entity. Flow-through entities would therefore recognise a 0% tax rate, if they themselves were not taxable.

Where companies are part of a tax consolidated group or the regulated business is part of a larger entity then an allocation methodology will need to be applied.

Australian Accounting Standards provide detailed guidance on how to allocate taxes between entities in a tax consolidated group within Interpretation 1052 *Tax Consolidation Accounting*. This standard allows for three different approaches to be applied:

(i) The ***standalone taxpayer*** approach, where each entity determines its tax expense and balances as though it was paying tax itself;

(ii) The ***separate taxpayer within group*** approach, consistent with the stand-alone taxpayer approach except that the entity would exclude the impact of transaction occurring within the tax consolidated group (i.e. intercompany transactions); and

(iii) The ***group allocation*** approach, in which the entity would be allocated its share of the Group's current and deferred tax balances in a systematic manner.

Applying accounting standards could therefore still lead to potentially significant differences in application between entities, depending on their specific circumstances and which approach they chose to apply.

*   *   *   *   *   *

Please do not hesitate to contact Vaughan Lindfield or Michael Davidson if you would like to discuss our findings in this report in further detail.

Yours sincerely

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