AUSTRALIAN ENERGY REGULATOR

Meeting summary— 15 October 2019
Key Issues and Action Items

TO: Profitability Measures Review Working Group (PMRWG)

CC: Warwick Anderson

SUBJECT: Summary of outcomes from the PMRWG meeting 15 October 2019

The PMRWG met via teleconference on 15 October 2019 as part of its ongoing engagement to work through issues raised in response to the AER's draft position paper for the review into profitability measures that can be applied to electricity and gas network service providers (NSPs). The agenda was:

1. Opening remarks / update on work program
2. Applicable tax rates for NTER entities
3. Depreciation and RAB values for calculating the return on regulated equity measure
4. Next steps

For item 2, the discussion focussed on views put forward by one of the PMRWG via email. For item 3, AER staff (we) provided a discussion paper and put forward our own.

The following is a summary of the outcomes of this meeting.

Opening remarks / update on work program

We provided an update on the forward work plan and the key issues for discussion.

Applicable tax rates

We put forward to the working group the concerns raised by PMRWG members regarding our preliminary views that we would apply 0% tax rate which we proposed to apply to NSPs subject to the National Tax Equivalent Regime (NTER). (The application of the 0% tax rate was proposed at the 13 September 2019 PMRWG meeting).

The submission noted that although NTER entities pay the 30% equivalency payment to State Government Treasuries rather than the Australian Taxation Office (ATO), the liability is under Federal legislation. The State Governments cannot direct the NTER entities to make the payment and the NSPs could be penalised if they do not lodge a tax return and pay the State Government. The payment is not discretionary and is designed to make NTER entities competitively neutral. Therefore, the assumed tax rate should be 30%.

The submission also noted that while we proposed to provide the context of the equivalency payments in the explanatory material, this would not be sufficient to prevent misconstruction of a 0% tax rate by stakeholders of the NTER entities profitability.

AER staff view

We recognised that the treatment of NTER payments in profitability reporting is not straightforward as NTER payments can be viewed as more alike tax payments (in that they go to network owners rather than the ATO) or dividends (as there is no discretion on whether to pay NTER payments and the amount of NTER payments must be determined by reference to tax law). We are continuing to undertake analysis on this point to inform our final position.

As previously noted, the explanatory material to be provided when publishing the RORE will include commentary on the tax implications of ownership structures. Further, whichever interpretation is settled as the preferred interpretation, we noted we would explore the alternative interpretation in analysis to support the measure.

We acknowledged that the headline number reported will be important as this will be the prominent number. We sought the PMRWG views on our position and in particular the fundamental aspects/characteristics that should be taken into consideration in determining whether NTER payments are more akin to a tax or a return on equity.

PMRWG considerations

PMRWG members held a range of views on whether a 0% or 30% tax rate should be applied to the NTER entities. A number of PMRWG members acknowledged that they had generally recognised the basis for use of a 0% tax rate at the previous PMRWG meeting but had concerns about it being the basis of the headline reported number. Individual members put forward the range of following views:

- The key purpose of the review is to enable comparisons of profitability—actual returns compared to allowed returns—across NSPs.
- A reported headline number based on 0% tax rate would focus attention on a policy setting outside the control of the NSPs and regulatory institutions, in a context where either interpretation (0% or 30%) may be reasonable. This headline number will be focus of readers and not the detailed explanatory statement which sets out an alternative number based on a 30% tax rate.
- The AER should report on both interpretations. There should be an emphasis on consistency with the regulatory framework which ignores ownership structure when setting the allowance. Therefore, the headline rate should be based on a 30% tax rate to be consistent with the regulatory framework. But the AER should also report using a 0% tax rate to show the value of the NTER payments the governments received as revenue.
- The headline rate should be based on 0% tax rate. The effective tax rates for corporate entities are well below the 30% statutory tax rate. The NTER payments are levied by State and Territory Governments to appear equivalent to privately-owned NSPs and therefore be treated equally.
- The approach should reflect analysis of outcomes against the energy rules, and not the policy settings of Governments.
- There are reasons to apply either a 30% or 0% tax rate. Need to fundamentally consider how much flows back to the owners of the NSPs. In this instance, the owners are the state government and they get revenue from the NTER payment (tax or dividend). The area of focus should be: what do the owners of the assets receive when compared to what was allowed?

- How much goes back to the owners is important, however the ultimate objective of the profitability measures review is to quantify the efficiency of the NSPs. NSPs subject to the NTER do not have scope to move to more tax efficient structures.
- In terms of a return to equity holders, the NTER payments could be interpreted to preferred stock and not common stock. This would suggest that those returns might be better interpreted similarly to an interest payment, to be claimed before ordinary stock returns.

Action items

- It was decided that the PMRWG be given more time to provide feedback on the issue. We requested final input be provided via email by no later than 31 October 2019.

Depreciation and RAB values for calculating the return on regulated equity measure

We set out our updated view on the appropriate depreciation and RAB values to be used in calculating earnings before interest and tax (EBIT) and net profit after tax (NPAT). These are inputs to the return on assets, earnings per customer and return on regulatory equity measures.

We noted that nominal straight line depreciation has been used to calculate the EBIT for our reporting of return on assets (RoA) ratios, as previously agreed with the PMRWG. For the purposes of calculating our measures, we update nominal straight line depreciation to reflect actual indexation on the actual opening RABs. As set out in our draft position paper, RoA calculated on this basis should be compared against the *real* pre-tax WACC. However, we noted an alternative approach would be to calculate RoA using regulatory depreciation (nominal depreciation less actual inflation) which would be compared against the *nominal* pre-tax WACC.[1] We set out in our view that the difference between these approaches is presentational rather than substantive (i.e. it should not result in different implications about what the real rate of return *is*), and that we are aiming to present the comparison in the way which is most helpful for stakeholders.

We set out our workings which tested this comparison at the level of the return on regulated equity (RoRE). Specifically, we had calculated a RoRE 'output' using a PTRM and reconciled it to the allowed return on equity in the PTRM (these workings were provided to the PMRWG). Through this process we reached the view that:

- Option 1– Calculation of regulatory EBIT and NPAT using regulatory depreciation (calculated on the basis of actual rather than forecast inflation) allows for a simpler comparison against allowed returns (in this case, the nominal allowed return on equity)
- Option 2– Calculation of regulatory EBIT and NPAT using nominal straight line depreciation requires a series of further adjustments relating to indexation of the RAB to enable a direct comparison against the real post-tax return on equity.

We outlined that:

- In our view, both approaches are viable and the difference is mainly presentational. However, the choice is relevant to the objective of enabling a clear comparison between allowed and actual returns.

---

[1] We said on p. 19 of our draft position that: *Therefore, RoA should either be compared against the real pre-tax WACC, or the sum of RoA and outturn inflation should be compared against the nominal pre-tax WACC.*

- It is possible to 'step between', or reconcile, the two approaches, so there is the option of presenting an extended analysis based on both. However, we recognise that this becomes more complex.
- In our view, both approaches are consistent with our findings in the inflation review that networks expect to receive a real rate of return plus actual inflation under our framework.

A consequence of this approach would be that published RoA ratios and data would need to be recalculated and substitute in the nominal (rather than real) pre-tax WACC as the appropriate comparator.

We sought the PMRWG's views on the preferable way of presenting this information.

PMRWG considerations

Given the time constraints of the meeting, the PMRWG did not form any consensus on the proposed approach. The PMRWG requested more time to consider the issue. Individual members put forward the following initial views:

- Regulatory depreciation is a better representation on how a business would actually treat the asset outside the regulatory framework. In principle, if CPI is a good proxy for relevant changes in costs, indexation of the RAB is akin to a 'mark to market' of the asset value. Similar to the inflation of the RAB, accounting treatment recognises adjustment of asset values for changes in input prices reflecting inflation.

- It is important to account for the actual capital mix that drives actual interest expense, as higher gearing would—holding other things constant—increase interest expense (reducing RoRE) but also reduce the relevant 'actual' equity base (raising RoRE)

- There are parallels between the issues discussed here and issues being discussed between stakeholders and the AER in a separate process regarding inflation. Any approach we determine should be capable of accommodating any changes arising from that process.

Action items

- It was decided that the PMRWG need more time to work though the issue and provide feedback. The AER would provide the PMRWG with additional information to assist their considerations. We requested final input be provided via email by no later than 31 October 2019.

Next Steps

We noted this would be the last time the PMRWG would meet to discuss issues. We would be accepting feedback from the PMRWG on outstanding issues by no later than 31 October 2019.