AER Tax Review 2018 - Addendum

Expert Advice

Australian Energy Regulator

10 December 2018

pwc

Ben Stonehouse
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10 December 2018

Dear Ben

Addendum to the AER Tax Review 2018 - Expert Advice

Enclosed is the Addendum to the AER Tax Review 2018 - Expert Advice (**Addendum**) prepared by Vaughan Lindfield and Michael Davidson.

This Addendum has been prepared following our AER Tax Review 2018 Report dated 26 October 2018 (**Report**) at the request of the Australian Energy Regulator (**AER**) pursuant to the Order of Services with a commencement date of 9 July 2018. Our Addendum has been provided in two schedules as follows:

Schedule 1: Additional findings and recommendations in respect of RIN responses

The purpose of Schedule 1 of this Addendum is to:

- Report on the information provided by the Network Service Providers (**NSPs**) in response to the formal regulatory information notices (**RINs**);
- Confirm whether any of the information received in response to the RINs impacts on the recommendations made in our Report; and
- Consider and comment on potential drivers which could not be addressed in our Report due to the need for RIN responses to perform an appropriate analysis (including interest expense).

Schedule 2: Response to submissions

The purpose of Schedule 2 of this Addendum is to respond to public submissions regarding the tax technical aspects of our Report. Our Addendum does not address matters raised in submissions which are of a policy nature (refer the AER's accompanying discussion paper in this regard).

Schedule 1 and Schedule 2 of this Addendum is to be read together with our Report.

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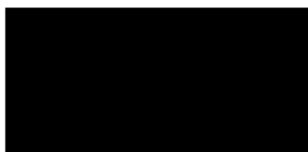
Yours sincerely



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1 Introduction

We, Vaughan Lindfield and Michael Davidson, are partners of PricewaterhouseCoopers (**PwC**) working in the tax practice.

The background to the preparation of the Report and this Addendum are set out in section 1.1 of our Report.

1.1 Scope of work

This Addendum has been prepared at the request of the AER following the publication of our Report, and should be read together with the Report.

Specifically, and in accordance with the Order of Services, we have been engaged to:

1. Report on the information provided by the NSPs in response to the formal RINs;

2. Confirm whether any of the information received in response to the RINs impacts on the recommendations made in our Report;

3. Consider and comment on potential drivers which could not be addressed in our Report due to the need for RIN responses to perform an appropriate analysis (including interest expense); and

4. Respond to public submissions on our Report.

The limitations on our scope of work are set out in section 1.3.2 below.

1.2 Declaration regarding conflicts of interest

PwC is Australia's largest professional services firm and provides 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. In particular:

- Vaughan Lindfield is based in Western Australia (which does not include any network assets which are regulated by the AER) and does not, or has not, advised any of the NSPs which are subject to this review, or their investors; and

- Michael Davidson is based in New South Wales. Michael provides tax advice to Spark Infrastructure and APA. In addition, he has historically been involved in the annual audit of TransGrid's financial statements from a tax perspective. Accordingly, Michael has not been involved in the review or assessment of any information relating to Spark Infrastructure, APA or TransGrid.

1.3 Information reliance

1.3.1 Information reviewed

As noted in our Report, certain information was requested from the NSPs by the AER for the purposes of our investigations. These requests for information were made in the form of voluntary information requests and formal RINs.

Our Report considered the responses received in respect of the voluntary information requests. This Addendum considers the responses received in respect of the formal RINs. A copy of RINs issued by the AER was included in Appendix C of our Report.

In addition to the information reviewed, we have also undertaken investigations into approaches taken in relation to financing costs by utility regulators in foreign jurisdictions (where appropriate).

1.3.2 Limitations

No independent verification of information

We have not conducted an audit or other verification of any information supplied to us. We have assumed that the information supplied to us is accurately stated, true and accurate. Of relevance, an officer of each NSP has provided a statutory declaration declaring that best endeavours have been made, to the best of their information, knowledge and belief, to ensure that the information provided in response to the RINs is in accordance with the requirements of the RINs as well as true and accurate.

We do not warrant the accuracy or reliability of any of the information supplied.

Restrictions on available information

Notwithstanding the AER's information gathering powers, we note the following restrictions in respect of the information that was made available to us for the conduct of our review:

- As noted in our Report, information relevant to the tax position of the upstream equity investors in flow through entities has been requested in the RINs on a "best endeavours" basis. Accordingly, limited information has been received in this regard.

- Not all NSPs were able to respond to all RIN questions. A summary of the explanations provided by the relevant NSP for not providing the relevant information is as follows:

  – Information was requested for years prior to a change of ownership (e.g. privatisation) whereby the information relating to the previous owners could not be sought within the timeframe; or

  – The information requested had not yet been prepared for the purposes of ATO lodgement (relevant only for one of the 17 NSPs).

- Where limitations on information exist, in most instances the non-responding entities have been excluded from our findings.

Where relevant, we have noted limitations in the information to give context to our findings.

Confidentiality

Information provided by the NSPs in response to the RINs are subject to declarations of confidentiality, such that the information cannot be replicated in this Addendum. As such, our findings have been aggregated or sanitised to ensure confidentiality is maintained.

Timeframe

The formal RINs were issued by the AER on 9 October 2018 with the deadline for the NSPs to respond being 26 October 2018. The first of the RIN responses was received on 24 October 2018, albeit in some instances further information was requested from the NSPs where the RIN responses were not initially complete. The last information was received from the NSPs on 5 December 2018.

Submissions on the AER's discussion paper dated 2 November 2018 were received by the AER from 21 November 2018 to 4 December 2018.

1.4 Qualifications

This Addendum has been based on the relevant taxation legislation, applicable case law and published ATO rulings, determinations and statements of administrative practice at the date of this Addendum. The opinions in this Addendum 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 Addendum. We are not responsible for updating this Addendum for changes in the law or its interpretation.

If this Addendum 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 Addendum as our original opinions may no longer be applicable or appropriate in such circumstances.

1.5 Reliance on this Addendum

This Addendum has been prepared, and may be relied on, solely for the purposes set out in the Order of Services. This Addendum has been prepared specifically for the AER. Neither we nor PwC accept responsibility to anyone other than the AER if they use the Addendum 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 Addendum contrary to the Order of Services.

1.6 Assistance by colleagues

In order to arrive at our observations and recommendations on this matter, we have selected colleagues to assist us. Our colleagues carried out the work that we decided they should perform. We have reviewed their work and original documents to the extent we considered necessary to form our opinions. The opinions expressed in this Addendum are ours.

1.7 Conduct of this engagement

We have been instructed that the Addendum is to be prepared in a form which satisfies the requirements of the guidelines for expert witnesses in proceedings in the Federal Court of Australia. These guidelines are set out in Federal Court of Australia's Expert Evidence Practice Note (GPN-EXPT).

We confirm that the Addendum is prepared in a form which is consistent with the Practice Note, subject to the qualifications stated in this Addendum. Documents used to support our findings have been identified throughout the Addendum. We have made all inquiries which we believe are desirable and appropriate for the purpose of responding to the AER's request, but provide no assurance that all such information has been identified. No matters of significance that we regard as relevant to our opinion have, to our knowledge, been withheld.

1.8 Classification of regulated entities

Our Report and this Addendum refers to both “NSPs” and “regulated entities”. Initial comments on our Report indicated that a reconciliation of these terms would assist interpretation of our Report.

For the purpose of our Report and this Addendum, the term NSP generally refers to each respective broader commercial group which may include a number of regulated and unregulated entities, under common ownership. There are 17 NSPs which are subject to our investigations.

The term “regulated entities” generally refers to each discrete separate regulated entity within a broader commercial group for which a Determination will be issued by the AER. There are 32 regulated entities which are subject to our investigations. Certain NSPs own more than one regulated entity, and in one case up to five.

A table which discloses the NSPs and regulated entities subject to this review has been attached as Appendix B.

Schedule 1: Additional findings and recommendations in respect of RIN responses

2 Key observations and recommendations

2.1 Financing

2.1.1 Observations

The ATO Note identified "deductions for interest expense" as a driver for the differential between actual tax paid and the regulatory forecast of tax costs. Accordingly, based on the information provided, we have considered any discrepancies between actual interest expense claimed by the NSPs and the 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 in the return of debt building block).

Prima facie, we would expect the actual interest expense claimed by the NSPs to exceed the regulatory cost of debt calculated by the AER. This could be due to the following:

- Where a NSP has been subject to M&A activity (e.g. privatisations), the actual quantum of debt assumed by the NSP will be reflective of the market value of the regulated assets at the time of acquisition (at an appropriate gearing ratio). In contrast the regulatory cost of debt is applied to the RAB (representing depreciated cost adjusted for inflation) for the purpose of determining the interest expected for regulatory purposes; and

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

Accordingly, we would expect there to be a natural and explainable difference between actual interest deductions of the NSPs and the interest expense determined for regulatory purposes. Where such a difference is created by factors outside of the regulatory ring-fence (e.g. M&A costs and unregulated assets), we would not expect a change to the regulatory forecast of tax to occur, consistent with the broader regulatory principle that the tax allowance should be determined having regard to the forecast costs incurred in the "efficient operation" of the regulated network assets. Adjusting the interest expense within the regulatory forecast of tax for factors unrelated to efficient operation of the network assets (e.g. unrecoverable costs) would create inconsistency between the tax allowance and the other building blocks within the regulatory model.

As such, we have sought to understand how much of any differential observed in relation to interest expense relates to the "external" factors noted above (i.e. those outside of the regulatory ring-fence), against differences relating to gearing ratios and interest rates (i.e. those inside the regulatory ring-fence).

Due to limitations in the timeframe for response to the RINs and the AER's review, information has only been sought in respect of the actual financing arrangements of the NSPs as at 30 June 2018 (or the most recent year end of the NSP). Accordingly our findings below reflect the actual financing positions of the NSPs at a single point in time only, and should not be considered reflective of the actual positions of the NSPs over the timeframe considered in the ATO Note (e.g. 2013 to 2016).

This approach is considered appropriate due to the fact the AER's review is focused on improving the alignment between the regulatory forecast of tax cost and actual tax positions on a go forward basis. As such, any recommendations for change will be on a prospective basis. Further, in our view, 30 June 2018 (or the most recent financial year of the NSP) is an appropriate point in time to consider the financing arrangements of the NSPs. This is because, in particular, tax deductions relating to financing in past years may not be reflective

of future years due to expected changes in law, interpretational issues (including court decisions) relevant to deductibility of interest (as discussed in 3.1.4 below) and ATO activity in the area of debt financing.

Based on the information provided (as at 30 June 2018 or the most recent financial year), we have been able to compare the actual annual interest deductions which we expect will be claimed by the NSPs in respect of the disclosed financing arrangements and the annual interest deduction which is included in the regulatory forecast of tax costs for the equivalent year (refer Figure 2 in section 3.1.3 of this Schedule). Prima facie, this shows:

- **Private sector entities:** Actual aggregated annual interest deductions across all private sector NSPs of $2,708.11m, compared to aggregate annual interest deductions included in the regulatory model of $2,222.50m (an excess of $485.61m, or 21.8%); and

- **NTER entities:** Actual aggregated annual interest deductions across all NTER NSPs of $1,428.76m, compared to aggregate annual interest deductions included in the regulatory model of $1,371.16m (an excess of $57.60m, or 4.2%).

The observed interest deductions exclude debt deductions claimed by upstream investors in flow through vehicles.

Further, the observed interest deductions excludes the impact of foreign currency swaps for certain NSPs where this level of information was not provided in the RIN responses (this was received and included in our findings in respect of some, but not all, NSPs). The AER have advised us that the expected impact on actual tax deductions if all foreign currency swap arrangements were included in our findings would be an increase in the weighted average interest rate for all private sector NSPs of approx. 50 basis points, and therefore a greater discrepancy than that noted above.

Consistent with the ATO Note, these initial findings demonstrate that deductions relating to interest expense is a driver for the differential between actual tax and estimated tax for regulatory purposes (i.e. due to the fact actual interest incurred by the NSPs exceeds the interest expense included in the regulatory model). This differential may have been further exacerbated by deductions claimed by upstream investors, but we cannot verify this. As noted below we expect proposed legislative changes which are applicable from 1 July 2018 to substantially reduce deductions available to upstream investors.

However, it is important to consider how much of any observed differential relates to factors which would be reflected in the regulatory model (i.e. within the ring-fence) as opposed to those which would not (i.e. outside of the ring-fence). As such, we have re-calculated what the expected interest deduction would be for the NSPs if the actual gearing ratios (based on the financial statements of the NSPs, which is consistent with the requirements of the thin capitalisation safe harbour debt amount method) and interest rates observed in the information provided was applied to the RAB rather than the actual quantum of debt of each entity (effectively removing the impact of M&A and unregulated activity on the quantum of debt). This approach is consistent with the return on equity regulatory approach which does not factor in returns on market value transactions.

Once the impact of M&A and unregulated activity is removed, the information shows that the regulated annual aggregate interest expense is actually greater than the actual ring-fenced aggregate interest expense (in respect of the 2018 income year) for private sector entities (by $517.50m, refer to Figure 3 in section 3.1.3 for further details of this calculation). This differential can be explained by analysing the relevant underlying interest rates and gearing ratios as shows in the table below:

	Total RAB	Weighted Average Interest Rate[1]		Weighted Average Debt Percentage[2]	
		Regulated	Actual[3]	Regulated (based on MV)	Actual (based on book value)
Private	64,062,672,391	5.78%	4.23%	60%	65.01%
NTER	43,089,287,294	5.30%	4.77%	60%	76.09%
All Entities	107,151,959,685	5.59%	4.40%	60%	69.47%

We have sought to isolate and address the impact of differentials in interest rates and gearing ratios on the discrepancy between actual tax paid and the regulatory forecast of tax, as outlined below.

Differential in interest rate

The observed actual weighted interest rate as at 30 June 2018 across all NSPs is 1.19% less than the weighted average interest rate applied for regulatory purposes for the same period. This can be split into a 1.55% differential relating to private sector entities, and a 0.53% differential relating to NTER entities.

The AER have advised that this difference relates to the following factors:

1. The interest rate applied for regulatory purposes in the cost of debt calculation is determined on a 10 year trailing average basis, in accordance with the Rate of Return requirements, whereas our calculations are applied to the relevant rates at a specific point in time. Due to current low prevailing interest rates and the relatively significant proportion of recent transactions and re-financing (including the NSW privatisations), the weighted average interest rates observed as at 30 June 2018 (including related party debt, but excluding gearing by upstream investors) is approx. 1.19% lower than the 10 year trailing average across all entities. The AER estimates this accounts for approximately one third of the differential;

2. The impact of foreign currency swaps as noted above which the AER advised us accounts for an approx. 50 basis points differential. The AUD equivalent actual interest rate of debt originally sourced in foreign currencies has been disclosed in some on the RIN responses, but not all. The AER estimates this factor also accounts for approximately one third of the differential;

3. The impact of actual debt terms (in years) compared to the 10 year benchmark applied in the rate of return guidelines (noting this is currently being reconsidered by the AER). In some instances the actual term of the financing arrangements is less than 10 years, which can lead to a lower interest rate. The AER estimates this accounts for approximately on quarter of the differential; and

4. The difference between actual and regulatory interest rates when compared on like-for-like averaging basis due to outperformance of the benchmark by the NSP. This is due to

[1] Weighted average of all interest rates (against actual quantum of debt) in respect of financing arrangements per RIN disclosures, including both internal (e.g. shareholder) and external funding arrangements.

[2] The RIN questions requested that gearing ratios were disclosed based on the debt and equity amounts disclosed in the entity's financial statements, which is generally consistent with the thin capitalisation requirements. It is important to note however that the benchmark gearing ratio applied by the AER is determined with reference to the benchmark equity value of the entities. Therefore these two measures are not a like for like comparison.

[3] Actual gearing has been determined by the NSPs having regard to debt and equity disclosed in the Financial Statements of the NSP.

the fact the regulatory cost of debt for each NSP is determined with reference to a benchmark credit rating of BBB, with the expectation that NSPs would be incentivised to operate on a more efficient basis, and potentially achieve a lower cost of debt in operating the network assets (in which case the benefit for the relevant year would be retained by the NSP). The AER estimates this accounts for approximately one tenth of the differential.

The reasons discussed above for the observed variances between the actual weighted interest rates and the regulatory weighted interest rates are a justified and expected part of the regulatory model.

Differential in gearing ratio

As outlined in the table above, we have also observed a difference in the actual percentage of debt gearing disclosed by the NSPs and the 60% benchmark gearing rate applied for regulatory purposes. When applying the actual weighted average gearing ratios disclosed by the NSPs to the RAB and the interest rate used in the cost of debt calculations for regulatory purposes, we can evidence the impact of gearing ratios as follows:

- **Private sector entities:** Aggregate annual notional interest deduction (applying actual gearing to regulatory interest rate and RAB) of $2,410.5m, compared to aggregate annual interest deductions included in the regulatory model of $2,222.5m (an excess of $188m, representing an average excess of $15.67m per NSP relating to gearing); and

- **NTER entities:** Aggregate annual notional interest deduction (applying actual gearing to regulatory interest rate and RAB) of $1,733.5m, compared to aggregate annual interest deductions included in the regulatory model of $1,371.2m (an excess of $362.3m, representing an average excess of $72.47m per NSP relating to gearing).

This differential demonstrates the impact of actual gearing ratios on the interest expense deduction for actual tax purposes as compared to the regulatory interest expense. Notwithstanding the fact that the gearing ratios disclosed in the RIN responses represent the aggregated gearing level of each NSP across broad commercial groups (consisting of regulated and unregulated assets), the observed higher debt gearing levels is, in our view, a relevant factor (i.e. inside the ring-fence) when considering the drivers for discrepancies between actual tax payments and the regulatory forecast of tax costs.

A key driver for this difference appears to be the approach taken by the AER in determining the benchmark gearing ratio within the Rate of Return Guidelines. We understand that for the purpose of the cost of debt calculation (and therefore interest expense reflected in the regulatory forecast of tax costs), the AER determine the benchmark gearing ratio having regard to the market value (rather than book value) of the relevant comparator businesses.

This differs to the approach taken for actual tax purposes whereby the 60% thin capitalisation safe harbour debt amount method is calculated having regarding to the debt and equity values recognised in the taxpayer's financial statements (e.g. book value). For example, the equity component of the denominator in the gearing ratio calculation which is considered relevant for actual tax purposes (e.g. total debt, divided by the sum of total debt plus total equity) is based on the equity reported in the entity's financial statements, whereas the denominator used in calculation of the AER's 60% benchmark ratio is the market value of the equity of the relevant comparative businesses. Alternatively, a taxpayer may be allowed a higher gearing ratio for actual tax purposes under either the arm's length debt test or the worldwide gearing test. This is discussed further in section 3.1.4 below.

Given the nature of the businesses reflected in the benchmark calculation, it is expected that the market values of those equities would generally be higher than the book value of the same equities. Accordingly, the gearing ratio used by the AER in the cost of debt calculations would naturally be expected to be less than the gearing ratio applied by the NSPs when calculating that metric based on the book values of the NSP's equity balances. We have not been able to quantify the expected impact of this difference for the purpose of our review.

Whilst this appears to provide a justifiable reason for an excess of actual gearing percentages ratios above the benchmark percentage applied for regulatory purposes, we have observed NSPs with an actual gearing percentages which are materially higher than the 60% benchmark percentage. Accordingly, whilst it is possible that the total weighted average gearing percentage at an industry level of 69.47% may not seem materially higher than the benchmark gearing levels applied for regulatory purposes after accounting for differences in market value and book values (noting this is unquantifiable at this stage), in some instances there may be a material difference on a stand-alone basis.

In considering potential adjustments to the regulatory model in respect of gearing ratios, we have had regard to approaches adopted by foreign regulators. Of relevance, we have noted the approach adopted by the Office of Gas and Electricity Markets (**Ofgem**) in the United Kingdom (**UK**) to apply a "claw back" mechanism which reduces the applicable tax allowance where excessive gearing occurs, which would otherwise result in greater actual interest deductions than calculated under the tax allowance. Whilst practical guidance can be taken from the Ofgem approach, we recommend further consideration is given to key differences in the Australian and UK regulatory and tax regimes which may impact the suitability of such a claw back mechanism in Australia. Further details regarding the Ofgem approach is included in Appendix C.

Upstream investors

As noted above, we have not been able to observe interest deductions claimed by upstream investors due to limitations in information provided. To the extent the NSP has debt funding up to thin capitalisation limits and additional interest has been claimed by upstream investors in flow through vehicles in the 30 June 2018 and prior income years (referred to as 'double gearing'), this would have historically resulted in an additional differential between tax ultimately paid on regulated profits and the regulatory forecast of tax costs (consistent with the observations in the ATO Note).

Of relevance is the draft legislation currently before Parliament (and expected to pass) which will remove the ability for foreign investors in flow through entities with an interest of 10% or greater in an Australian investment vehicle (e.g. trust) to apply double gearing in respect of those investments from 1 July 2018. Unlike the tax reform relating to staple structures discussed in our Report, there is no proposed grandfathering or transitional arrangements. Based on the RIN responses and publicly available information, we have not observed any specific upstream investors in flow through vehicles with an equity interest of less than 10% in the investment vehicle such that they may continue to apply double gearing following application of the proposed law.

Whilst it is possible for new investors with an interest of less than 10% to be introduced into the structures after 1 July 2018, we have not sought to speculate on whether this may occur. Accordingly, we do not expect interest deductions of upstream investors in flow through vehicles to cause a material discrepancy between actual tax paid and the regulatory forecast of tax costs from 1 July 2018 onwards. Therefore, we do not believe it is necessary to adjust the regulatory model in respect of upstream gearing in flow through vehicles, as there should be no misalignment in this regard going forward.

In addition, we expect recent tax law developments and ATO activity to further restrict actual interest deductions claimed in future years (refer our further comments in this regard in section 3.1.4 below).

2.1.2 Recommendations

The findings above demonstrate that differences in actual interest deductions and the estimated deductions included in the regulatory forecast of tax costs relate to:

1. Differences in quantum of debt attributable to M&A and unregulated assets;

2. Differences in interest rates applicable to the relevant year; and

3. Differences in gearing ratios.

The differences relating to item (1) are justifiable in accordance with the ring-fencing principles of the regulatory framework, whereby such costs are not considered recoverable for regulatory purposes and therefore any excess deductions attributable to those unrecoverable costs should also be excluded from the tax allowance calculation. Accordingly, we do not recommend any changes to the regulatory model in this regard.

The differences relating to item (2) can largely be explained by differences in the interest rates applicable to current debt and giving rise to current year actual debt deductions, and the 10 year trailing average method of determining weighted average interest rates for regulatory purposes. Based on the information received we have not identified any excessive deductions attributable solely to interest rates (on a weighted average per entity basis, e.g. including interest on related party debt), and therefore, do not recommend any changes to the regulatory model in respect of interest rates for tax purposes (noting interest rates are subject to the broader Rate of Return review).

Whilst differences relating to item (3) can also be explained in part by differences in the approach taken for determining the benchmark debt percentage for regulatory purposes to the determination of actual debt gearing percentages in determining actual interest deductions, we have also observed stand-alone NSPs with gearing which would be expected to exceed the regulatory benchmark after adjusting for these differences. To the extent the discrepancy observed in respect of item (3) is considered material, consideration could be given by the AER to contemplating an adjustment to the tax allowance model to adjust the interest expense included in calculation of the regulatory forecast of tax costs to reflect the actual gearing levels adopted by the NSPs. The approach applied by Ofgem in the UK could be considered further in this regard, however further research regarding the relevance of this model to the Australian regulatory framework would need to be undertaken.

We recommend the following considerations are addressed further prior to proceeding with an adjustment to the regulatory model to reflect actual gearing ratios in the regulatory forecast of tax costs:

- Impact of thin capitalisation restrictions: The regulatory model should recognise that where actual debt gearing exceeds debt levels which are allowed under Australia's thin capitalisation rules, only the amount allowed under the thin capitalisations rules should be included in the calculation of interest expense for the purposes of the regulatory forecast of tax costs. As noted below, three differing methods are available under which taxpayers may calculate their maximum allowable debt for thin capitalisation purposes, and decisions relating to which method to apply are not required until lodgement of the income tax return. Accordingly, complexities may arise in addressing the impact of thin capitalisation on the regulatory tax calculations.

- Interaction with other regulatory building blocks: We have noted above the general principle whereby consistency should be applied across different building blocks within the regulatory model. Accordingly, if higher gearing ratios were taken into account within the tax allowance, the AER should consider whether this is consistent with the other regulatory building blocks in light of the cost of debt building block and the rate of return review.

We do not recommend any changes are made to the regulatory model in respect of upstream gearing as this will be largely restricted from 1 July 2018 under proposed legislative reform.

2.2 Tax paid and stand-alone regulatory tax calculations

2.2.1 Observations

Following receipt of the RIN information we have been able to provide more complete findings regarding actual tax paid by the NSPs. In particular, we have included updated versions of the graphs originally included as Figures 2, 3, 4 and 5 of our Report in section 3.2.1 of this Schedule.

Further, in response to comments provided on our Report and following receipt of further RIN responses, we have also provided an analysis of the actual taxable profits of all private sector entities (including flow through entities) and NTER entities in comparison to the estimated taxable profits of the NSPs included in the regulatory forecast of tax costs (e.g. on a like-for-like basis). Whilst the taxable profit positon of each entity does not necessarily indicate the expected amount of actual tax to be paid (particularly in the case of flow through vehicles with upstream investors), it is a relevant comparison when considering the estimated taxable income of each NSP which is included in the calculation of the regulatory forecast of tax costs.

Whilst the additional income tax returns provided in the RIN responses disclose a greater amount of tax paid by the private sector entities (when compared to the information provided on a voluntary basis), the total amount of tax payments observed in respect of private sector entities are still materially less than the regulatory forecast of tax for those entities. In this regard, the RIN responses are consistent with the findings and recommendations outlined in our Report. Refer section 2.1 of our Report for a summary of our observations and recommendations in this regard.

In addition, the RIN responses have enabled us to observe the expected actual tax positions of the NSPs excluding income and expenses relating to unregulated activities (e.g. on a stand-alone regulated entity basis) in respect of the latest lodged income tax return. Our review of the information provided in this regard indicates that where the tax position of each regulated entity is considered by including only income and expenditure relating to the efficient operation of the regulated assets, but applying any choices or elections made for actual tax purposes in respect of those items, the regulated entities would be in a taxable income position purely in relation to the regulated activities and profits in respect of the income year considered. Limitations in the stand-alone tax calculations provided by the NSPs means that limited insights can be drawn when comparing our findings in respect of these calculations to the regulatory model for the forecast of tax costs. For example, the stand-alone tax calculations which reconcile to the income tax returns are generally based on accounting figures which may not reconcile to the income and expenditure items included within the ring-fence for the purpose of the regulatory model. Refer section 3.2.2 for our observations in this regard.

In all instances, the stand-alone position for each NSP reflects a taxable regulatory profits position (after accounting for the relevant tax adjustments). This demonstrates that, if the latest income year for which an income tax return has been lodged can be used as an accurate reflection of the standard annual tax position for these entities, we would expect all NSPs to be in a taxable profits position when factors outside of the regulatory ring-fence are excluded from the actual tax positions of each entity.

These findings exclude the expected impact of holding structures on tax rates (refer sections 2.2.1 and 3.2 of our Report for our findings in this regard) and also the impact of carried forward tax losses. As noted in our Report, we have been unable to reconcile the source of the carry forward tax losses reported by the relevant NSPs within the timeframe for review. That said, notwithstanding the stand-alone regulatory tax calculations reviewed have only been prepared in respect of a single (recent) income year, these calculations indicate that the NSPs may not have incurred material tax losses on a year-on-year basis solely in respect of operation of the regulated assets (but rather, the tax losses are expected to relate to

unregulated activities and M&A costs). Due to the limited nature of the information provided however, detailed reconciliations would need to be prepared in respect of past years (extending back significant periods in many cases) to definitively confirm this expectation. We have not sought to do this within the timeframe for the AER's review.

2.2.2 Recommendations

The additional RIN information supports the findings and recommendations outlined in section 2.1 and 2.2 of our Report. No additional recommendations are made in this section in respect of the information reviewed relating to tax paid and stand-alone tax positions.

2.3 Observations on other matters discussed in our Report

The additional RIN information has enabled us to further consider certain matters addressed in our Report. In particular, we note:

2.3.1 M&A activity and tax consolidations

Information was provided by the NSPs which quantified the impact of step ups in the tax depreciable cost base of regulated assets as a result of changes in ownership and M&A activity. As discussed in section 3.2 of our Report, of the 17 NSPs which are subject to this review, 7 of these entities are taxed as a company within the private sector (the remaining 10 NSPs are either NTER entities or flow through from a tax perspective). Of the 7 NSPs which are taxed as a company, all have elected to apply the tax consolidation regime, and therefore may be subject to a resetting of depreciable tax values in the event of a change of ownership or M&A activity. Of the 7 NSPs which are taxed as company, 4 have disclosed a resetting of the tax costs base of their depreciable regulated assets over the past 10 years.

Three of these NSPs reported step ups in the last 10 years. For these three entities, the average total increase in tax depreciable cost of assets across all years per NSP was $2.06b across all assets (e.g. over $6b in aggregate), or $1.98b excluding assets designated as unregulated.

One NSP reported a step down in asset values only (note, we have not reported the quantum of this step down to preserve confidentially, however consider the amount immaterial in comparison to the step ups).

This data shows that while the resetting of tax cost bases under the tax consolidations law is not widespread across all NSPs, in instances where it has occurred, the increase to depreciable tax bases has been significant.

Notwithstanding these findings, we have not changed our recommendation in relation to step ups, in that we do not recommend uplifted tax asset values are recognised in the regulatory forecast of tax costs on the basis (1) the costs are not recoverable to the NSPs under the regulatory framework, and (2) the costs should not be seen as a cost attributable to the efficient operation of the network assets.

2.3.2 Capital expenditure and depreciation deductions

A recommendation of our Report was that the AER should consider changing the regulatory tax allowance to treat refurbishment capital expenditure as immediately deductible, having regard to the potential non-tax commercial implications.

This recommendation was based on the information available to us at the date of the Report (provided on a voluntary basis), which indicated that, on average:

- $81.5m of the regulatory capex included in TAB was claimed as an immediate deduction by each regulated entity annually; and

- $108.7m was claimed by each NSP (as some NSPs hold multiple regulated entities) annually.

Our analysis of the information received in response to the RIN indicates that the average amount of immediately deducted capital expenditure is lower. On average:

- $48.9m of the regulatory capex included in TAB was claimed as an immediate deduction by each regulated entity annually; and

- $69.5m was claimed by each NSP (as some NSPs hold multiple regulated entities) annually.

The difference in the number is attributable to the fact that more NSPs responded to the RINs (as compared to the voluntary requests for information) and the quantum of immediately deducted capital expenditure for those NSPs was low (or nil).

Notwithstanding that the updated information shows that the amount of regulatory capex claimed as immediate deductions is lower than originally thought, we are of the view that the observed difference still gives rise to a material divergence in the timing of actual tax paid and the tax allowance determined under the existing regulatory approach. We therefore confirm our original recommendation that the immediate deductibility of some of these costs should be taken into consideration for the purposes of determining the estimated cost of taxation, subject to the AER assessing the commercial impact of this amendment.

The RIN responses have not led to any other changes in our findings or recommendations relating to capital allowances (per section 3.3 of our Report) on the basis tax fixed asset register information had largely already been provided on a voluntary basis.

2.3.3 Research & Development tax incentive

Section 3.3.3 of this Schedule outlines our updated findings following receipt of information relating to R&D tax incentive claims for all NSPs.

Consistent with the findings in section 3.6.2 of our Report, the observed R&D tax incentive claims in respect of regulated activities is immaterial (less than $5m tax offsets claimed per year in aggregate across the NSPs over the last 5 years). Accordingly, our findings and recommendation in respect of R&D as summarised in section 2.2.5 of our Report remain unchanged.

3 Detailed analysis

This section sets out detailed commentary of the findings from our review of the formal RIN responses which form the basis for our recommendations.

3.1 Financing

As outlined in section 3.1.2 of our Report, the regulatory forecast of tax costs is calculated broadly by having regard to the estimated income tax payable by a business based on the regulated revenue, operating expenses, financing costs and tax-specific depreciation profile, which determines the estimated taxable income of an entity, and assumes income tax will be payable on that amount at the corporate tax rate of 30%. Financing costs were not considered in our Report as the responses to the formal RINs had not been received at that time.

The ATO Note identified interest expense as a driver for the discrepancy between the regulatory forecast cost of tax and actual tax paid by the NSPs. In particular, the ATO have observed that the average gearing of certain entities was greater than that assumed by the AER in the tax allowance building blocks, and that interest expense deductions claimed by taxpayers appeared larger than the interest expense allowance in the regulatory models in respect of the period of review (2013 to 2016).

Due to time constraints within the AER's review, we have not sought to reconcile actual interest deductions to the estimated interest expense included in the regulatory model in respect of prior years (e.g. the period of review covered by the ATO Note). Rather, the RINs have requested information relating to the actual financing arrangements of the NSPs as at 30 June 2018 (or the latest financial year end).

This approach is considered appropriate due to the fact the AER's review is focused on improving the alignment between the regulatory forecast of tax cost and actual tax positions on a go forward basis. As such, any recommendations for change will be on a prospective basis. In addition, we note that changing tax laws and practices will mean that prior deductions in respect of financing arrangements may not be an accurate indicator of expected future deductions (for the reasons discussed further below). As such, we have sought to assess the issues for consideration based on the most recent financing information available for the NSPs.

The financing information provided by the NSPs has been used to firstly determine whether interest expenses are expected to create a discrepancy between actual tax paid and the regulatory forecast of tax costs for the 2018 year, and secondly, consider the drivers for any such discrepancy.

Consistent with our Report, our review of the financing information has had regard to the ring-fencing principles inherent in the regulatory model. As such, in assessing the drivers for discrepancies, we have sought to identify the impact of M&A activity on financing arrangements of the NSP and related deductions for interest expense, given this would generally be expected to result in additional interest costs which would not be recoverable for regulatory purposes (e.g. outside of the ring-fence). Where regulated network assets are acquired at market values above the RAB, it would be expected that actual interest expense would exceed the assumed interest expense in the regulatory model. This is on the basis the assumed interest expense for regulatory purposes is generally based on 60% of the RAB (calculated based on the depreciated cost of the regulated assets, adjusted for inflation), whereas actual interest expense for the NSP following acquisition of regulated assets would be based on the actual gearing ratio adopted in respect of the acquisition of the assets.

Accordingly, there may be justifiable reasons for differences in the quantum of actual interest expense (to the extent this relates to M&A or unregulated assets) as compared to the

regulatory interest expense. In contrast, any differences between the actual gearing ratios and interest rates incurred by the NSPs, and the gearing ratios and interests rates assumed for the purpose of the regulatory forecast of tax costs, should be considered in further detail.

As such, this section considers the AER's methodology for determining financing costs as part of the tax allowance and compares this to the actual financing costs incurred by the NSPs for the 2018 income year to determine whether this results in a differential between the regulatory forecast of tax costs and the actual tax paid in respect of financing costs only. We have therefore sought to quantify where any excess of actual interest expense as compared to regulatory interest expense appears to relate to M&A activity rather than the gearing ratios and interest rates applied.

3.1.1 Regulatory approach to interest expense in the tax allowance

The current approach applied for regulatory purposes is to provide the regulated entities with an estimated interest deduction for the purpose of the forecast of tax costs which is equal to the cost of debt which is included in return on capital provided to the entity (that is, there is alignment between the approach taken for tax purposes to the approach taken in the revenue forecast more broadly).

The AER's discussion paper dated 2 November 2018 referred to recent commentary of the Independent Panel Review of the AER's Rate of Return Draft Guidelines (dated 7 September 2018) which briefly referenced the expected consistency between the cost of debt in the rate of return model and interest expense in the tax allowance as follows:

> *The only significant interaction of the gearing ratio with other building blocks is with the taxation component. Because interest costs are tax deductible, consistency requires the same gearing ratio to be used in the rate of return and taxation building blocks.*

The comments above are consistent with the general principles of the regulatory approach to tax allowances whereby costs to be included in the regulatory forecast of tax costs are based on a benchmark efficient entity approach having regard to the estimated efficient costs of operation of the network assets.

In other words the calculations of the tax allowance should only take into account revenue and expenditure which is included in the other building blocks within the regulatory model.

The cost of debt for each NSP is determined by the AER on a benchmark basis, having regard to a benchmark credit rating (BBB), term (10 years) and yields. These benchmark factors are used by the AER to determine the allowed return of debt using a 10 year trailing average portfolio approach on an annual basis. In arriving at the annual interest expense amount, the current return on debt framework assumes a gearing level equal to 60% of the RAB balance.

The annualised interest expense which is determined under the return on debt framework is applied in the tax building blocks in determining the allowable tax deduction for interest expense required to arrive at the forecast cost of tax for regulatory purposes. Consistent with the AER's regulatory tax approach, no adjustment is made to the tax allowance on an ex-post basis.

3.1.2 Summary of information requested

In order to investigate the impact of financing deductions on the discrepancy between actual tax paid and the regulatory forecast of tax, the following information was requested in the RINs:

> *2.1 Provide the debt to equity ratio (including external and internal/related party debt) of the [distribution/transmission] network service provider and any related stapled entities holding direct interests in the network assets (e.g. Asset Trust and/or Partnership), any of its downstream associated entities or any of its*

upstream equity participants (the latter on a best endeavours basis) as at 30 June 2018 (or its most recent financial year end).

2.2 Provide the following details for all financing arrangements (except those classified as equity for income tax purposes) of the [distribution/transmission] network service provider and any related stapled entities that hold direct interests in the network assets, e.g. the Asset Trust/Partnership) and any of its downstream associated entities which were in place in at 30 June 2018 (or its most recent financial year end), including:

(a) Outstanding principal in respect of each arrangement and the interest rate as set out in the agreement(s) for the arrangement thereon, and

(b) Counterparties to the arrangement where they are associates as defined in section 318 of the Income Tax Assessment Act 1936 (ITAA 1936).

2.3 To the extent the [distribution/transmission] network service provider and any related stapled entities that hold a direct interest in the network assets (e.g. the Asset Trust/Partnership) are treated as a transparent vehicle for tax purposes (e.g. partnership or flow through trust) provide details requested in item 2.2 of this schedule, where practically possible on a best endeavours basis, of all financing arrangements (except those classified as equity for income tax purposes) for upstream equity participants in those vehicles.

2.4 Identify and list those entities in the group structure referred to in item 1.1 of this schedule that were inward or outward investors for the purpose of the thin capitalisation regime in Division 820 of the Income Tax Assessment Act 1997 (ITAA 1997), as at the end of the latest income year for which a tax return has been lodged.

2.5 For those entities listed in response to item 2.4 of this schedule, confirm the following to the extent the information is not already disclosed in the latest tax return (including international dealings schedule) lodged as provided in response to item 3.1 of this schedule:

(a) Whether any exemption from the thin capitalisation rules apply in respect of the latest lodged tax return.

(b) What method was chosen in determining maximum allowable debt (e.g. safe harbour, arms-length debt or worldwide gearing) in the latest lodged tax return?

(c) The maximum allowable debt amount and adjusted average debt amount as defined under Division 820 of the ITAA 1997 and as disclosed in the latest lodged tax return.

Responses were received from all NSPs in respect of these questions relating to financing arrangements entered into by the NSP. Very limited information was received in respect of financing arrangements entered into by upstream equity investors where NSPs were in a flow through entity (both for domestic and foreign investors).

Ignoring in the first instance any potential upstream debt deductions, we have been able to perform our investigations having regard to the actual financing profiles of the NSP's, in comparison to the estimated financing profile used in the cost of debt calculations for regulatory purposes.

To the extent material deductions have been taken at an upstream level this would have resulted in an additional divergence over what has been observed at a NSP level. We have not been able to observe this even in respect of the 2018 income year given the lack of information about financing arrangements provided by private sector upstream investors in a flow through structure.

Proposed amendments to the tax legislation will remove the ability for upstream foreign investors to 'double gear' investments in the relevant project vehicles from 1 July 2018. These proposed changes will deny any interest deductions for upstream investors with an interest of 10% or more in a flow through vehicle where the NSP is already geared up to the allowable thin capitalisation levels (with no grandfathering or transitional arrangement).

Note, we have not identified any specific investors in flow through vehicles with an interest of less than 10% in that vehicle who could continue to benefit through doubling gearing after 1 July 2018. Accordingly, historical variances in respect of upstream gearing may not be relevant in considering any changes to the regulatory model which are to be applied on a prospective basis.

Whilst the ATO's Note considered the impact of interest expense over the 2013 to 2016 income years, we have only sought to address the actual financing arrangements (and interest deductions) in place as at 30 June 2018 (or the most recent year end). This is due to the timeframe available for the AER's review, the need for any recommendations to be prospective in nature (meaning that the most recent income year should be the most relevant to our review).

3.1.3 Findings

The following information has been obtained from the RIN responses (supplemented by regulatory determination information provided by the AER where applicable) in respect of each NSP for the purpose of our investigations (as at 30 June 2018 or the most recent financial year end):

Actual

- Actual gearing ratios
- Actual weighted average interest rate on financing arrangements
- Actual quantum of external debt
- Actual quantum of internal debt (e.g. shareholder loans)[4]
- Income tax return disclosures (including the International Dealings Schedule) where available and relevant

Regulatory

- Benchmark gearing ratio applied for regulatory purposes (60% of RAB)
- Estimated cost of debt applied for regulatory purposes

Using this information, we have sought to compare the actual annual interest deductions for the NSPs to the interest expense which is included as a tax deduction in the regulatory forecast of tax costs. It is expected that any differences between these amounts would relate to the following:

- **M&A activity:** Where the NSP has been subject to M&A activity, the quantum of debt issued would be based on the market value of the NSP at the time of the transaction, as opposed to the RAB. This will create a difference in interest costs as the regulatory cost of debt is calculated assuming a benchmark 60% gearing percentage applied to the RAB. This factor is considered outside of the regulatory ring-fence (as the additional interest costs are not recoverable for regulatory purposes) and therefore a justified difference.
- **Existence of unregulated assets:** Interest expense incurred by the NSPs may relate to financing of unregulated assets. This factor is considered outside of the regulatory ring-fence and therefore a justified difference.

[4] Excluding debt issued by upstream equity investors.

- **Differences in interest rates:** To the extent actual interest rates applicable to the NSP's financing arrangements are greater or less than the interest rate used in the regulatory cost of debt calculation, this will create a relevant difference for the purpose of our review. The impact of any differences in interest rates should be considered further.

- **Differences in gearing ratios:** To the extent actual gearing ratios adopted by the NSPs are higher than the benchmark gearing ratio adopted in the regulatory cost of debt calculation, this will create a relevant difference for the purpose of our review. The impact of any difference in gearing levels should be considered further.

Accordingly, to the extent any discrepancy is observed in respect of interest rates and gearing ratios, we have considered whether changes are required to provide better alignment between actual tax and the regulatory forecast of tax costs.

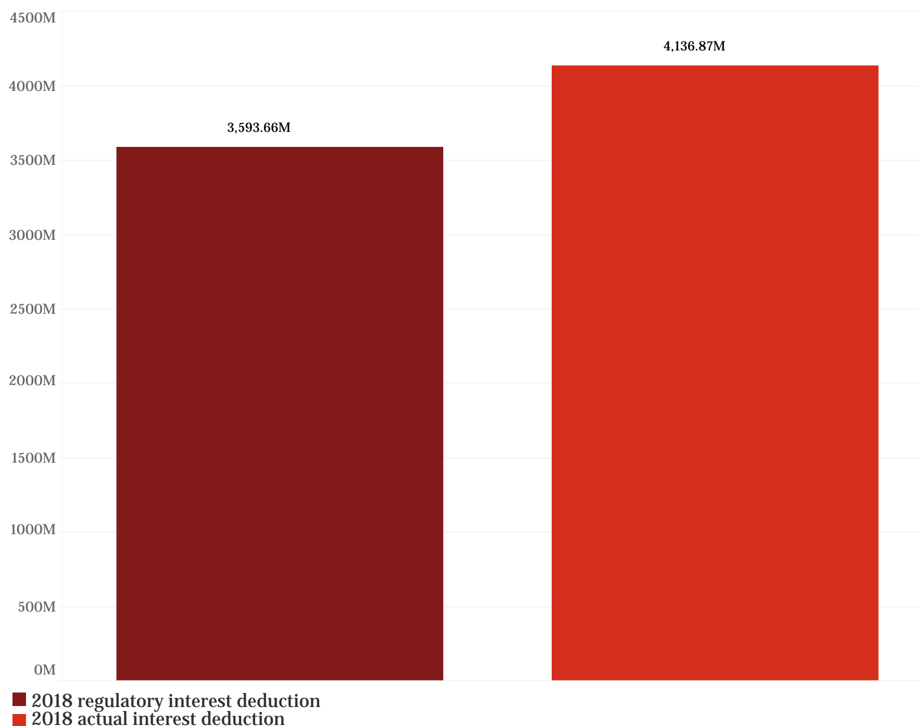
Based on the information provided, we have compared:

1. the expected annual interest deduction for each NSP (based on quantum of debt disclosed in the RIN responses and weighted average interest rates); and

2. the annual deduction for interest expense provided to each NSP under the regulatory forecast of tax costs (based on the cost of debt provided to each NSP under the relevant determination, applied to the RAB at the estimated 60% gearing ratio).

Our findings in this regard are outlined in Figure 1 below (disclosed on an aggregated basis to preserve confidentiality).

Figure 1: Comparison of annual interest deduction



Notes relevant to interpretation of information:

- The aggregate 2018 regulatory interest deduction has been determined based on cost of debt information provided by the AER.

- The aggregate 2018 actual interest deduction has been determined having regard to RIN responses relating to total quantum of financing arrangements (including external and internal dealings) and

actual applicable interest rates. To verify this approach, we have, where possible, compared the assumed 2018 deduction which has been calculated based on this methodology for each NSP to the income tax return disclosures relating to actual interest deductions claimed in the 2017 income year for those entities (being the latest year for which an income tax return has generally been prepared), and have only noted at net 2.34% variance in these amounts.

- This approach does not account for thin capitalisation denial, however based on the income tax return we have only observed denied interest deductions for thin capitalisation purposes (using the 2017 income year as a proxy) equal to 0.037% of the total annual assumed interest deduction for 2018.

- The interest rates applicable to a number of financing arrangements disclosed in the RIN responses were presented based on a margin on top of BBSW/BBSY (e.g. on a floating basis). Given the floating nature of these arrangements we have applied the 3 month BBSW/BBSY rate for the 2018 income year in determining the interest rate applicable for the purpose of our review.

- The actual annualised interest deductions disclosed above do not include any deductions which have been claimed by upstream investors in flow through vehicles, due to limitations in information provided in the RIN responses.[5]

- The actual annualised interest deductions do not include the impact of some foreign currency swaps as these have not been disclosed in the RIN responses. Refer our comments below in this regard.

Figure 1 demonstrates that the annual actual interest deductions across all responding NSPs on an aggregate basis exceeds the estimated annual interest expense for regulatory purposes for the same entities by at least $543.21m (or 15.1%).[6]

It is important to note, that many financing arrangements entered into by the private sector NSPs are originally denominated in foreign currencies, but then converted to AUD through derivative arrangements. Where both the foreign currency and AUD amounts have been noted in the RIN responses, the AUD amounts have been used for the purpose of our analysis. In some instances however, foreign currencies information only has been provided. The AER have advised that this has resulted in an under-statement of the interest deductions for actual tax purposes as disclosed in the graphs in this section, as the AUD equivalent interest rate is generally higher. The AER have reviewed the AUD equivalent interest rate of NSPs which have only responded in the foreign currency terms (based on rate of return information), and advised that the expected impact of this is an approx. 50 basis point understatement of the total aggregate weighted interest rates observed by us across all private sector NSPs. This will have the effect of increasing the expected actual interest deduction for the 2018 income year as disclosed in Figures 1 to 4 in this section. We have not been able to separately quantify the aggregate dollar amount of this increase.

Figure 2 immediately below provides a comparison of the same information, split between private sector and NTER entities.

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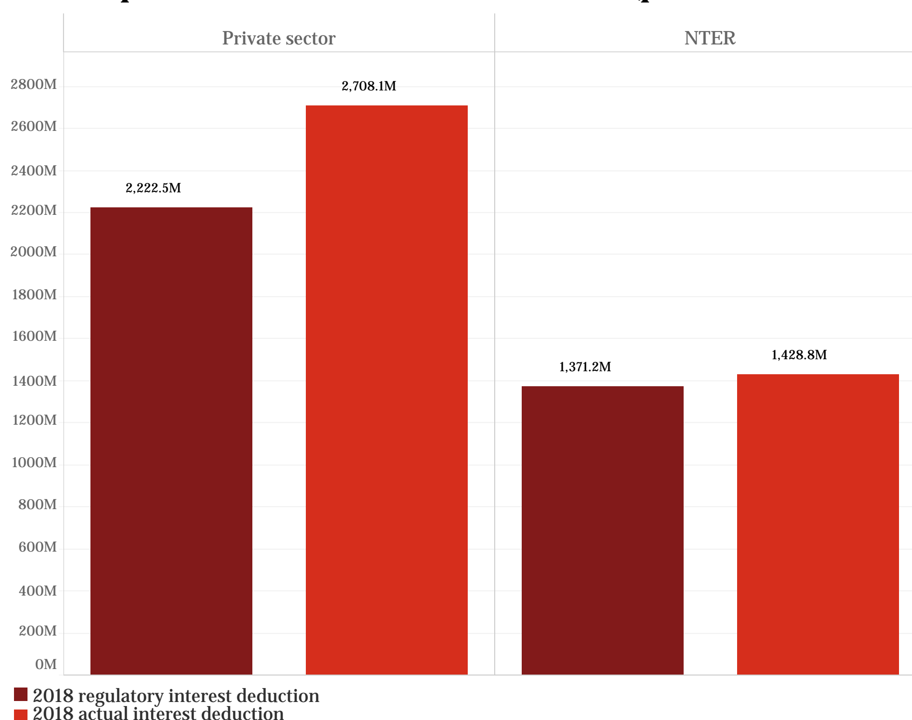
[5] As noted in section 3.1.4, debt deductions of upstream investors in flow through vehicles will be restricted for any investors with an interest of 10% or more form 1 July 2018 under proposed legislation. No specific investors with an interest of less than 10% in the flow through NSPs have been observed.

[6] This excludes any deductions which may have been claimed by upstream investors.

Figure 2: Comparison of annual interest deduction (private sector v NTER)



**Refer interpretation notes in respect of Figure 1 above*

We note the following in respect of Figure 2:

- When considered with respect to private sector entities only, the actual annual aggregate interest deduction is at least approx. $485.6m greater than the estimated annual aggregate interest expense for regulatory purposes. As noted above, this is to be expected given the impact of M&A activity and unregulated assets on the financing arrangements of the private sector NSPs.

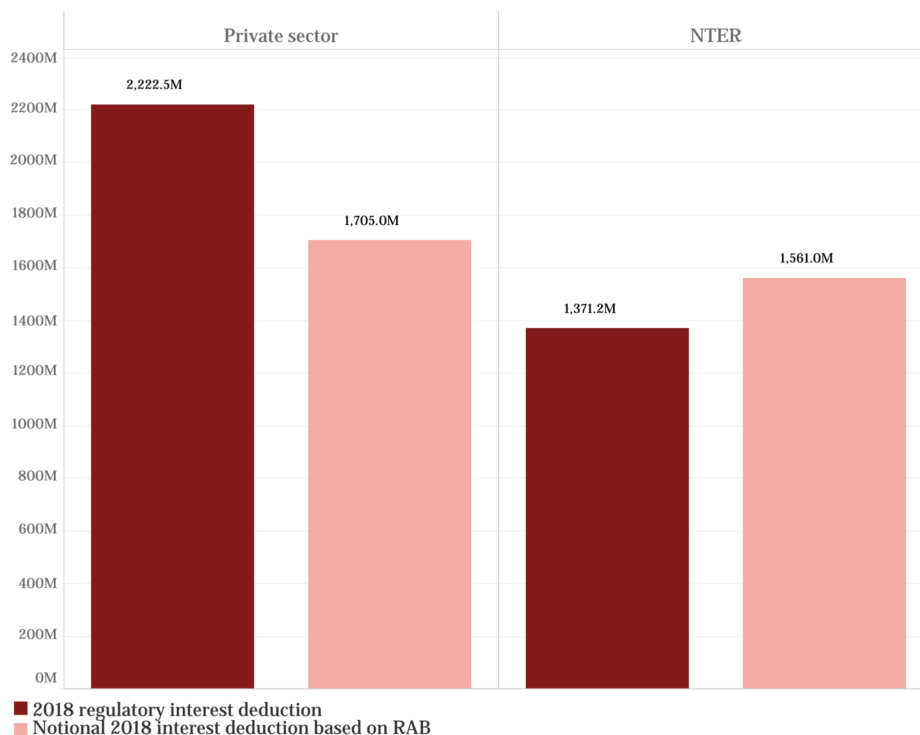
- Notwithstanding we have only used financing arrangements as at 30 June 2018 (or the most recent financial year end of the NSP) as a proxy for the annual deduction, this appears to support the ATO's view that interest expense is likely to be a driver for the differences between actual tax paid and the regulatory forecast of tax costs.

- When considered with respect to NTER entities only, the actual annual aggregate interest deduction is also more than the estimated annual aggregate interest expense for regulatory purposes, by $57.6m.

The observed interest deductions exclude debt deductions claimed by upstream investors in flow through vehicles. As noted below we do not expect material deductions to be available to upstream investors going forward as a consequence of proposed legislative changes which are applicable from 1 July 2018.

As noted, it is important to consider how much of any differential relates to factors which should be reflected in the regulatory model (i.e. within the ring-fence) as opposed to those which would not (i.e. outside of the ring-fence). As such, we have re-calculated what the expected interest deduction would be for the NSPs if the actual gearing ratios and interest rates observed in the information provided was applied to the RAB (akin to the approach adopted for the purposes of the regulatory return on debt) rather than the actual quantum of debt of each entity.

Figure 3: Notional actual deduction based on RAB (e.g. excluding M&A and unregulated assets)



Notes relevant to interpretation of information:

- The notional deduction presented above has been calculated as the applicable aggregate tax deduction if the actual weighted average interest rates and actual gearing ratios observed in the RIN responses for each entity were applied to the RAB of each entity. This presents the aggregate tax deduction which would be claimed by the NSPs if any uplift in quantum of debt attributable to M&A activity or unregulated assets was eliminated.

- The notional annualised interest deductions do not include the impact of some foreign currency swaps as these have not been disclosed in the RIN responses. Refer our comments above in this regard.

In respect of private sector entities (e.g. those subject to M&A activity), the results of this calculation shows an excess of the aggregate annual interest deductions included in the regulatory model over the re-calculated notional actual interest deductions (applying actual gearing and interest rates to RAB) of $517.5m (on an aggregate basis across all private sector NSPs). This amount can be seen as the incremental deductions which would be applicable to increased quantum of debt issued by the NSPs relating to M&A activity (e.g. excess of market value over RAB) and unregulated assets.

An opposite differential exists for NTER entities whereby the notional aggregate interest deduction exceeds the aggregate forecast regulatory deduction by $189.8m.

As the impact of M&A and unregulated assets has been excluded, the drivers for this differential should only relate to gearing ratios and interest rate, as observed in the following table:

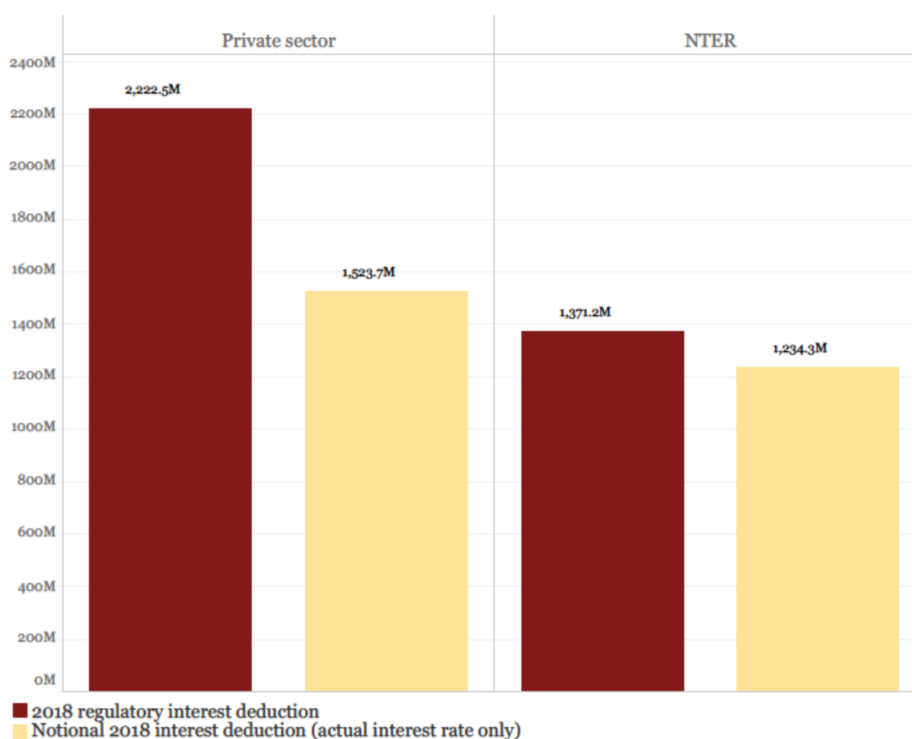
	Total RAB	Weighted Average Interest Rate[7]		Weighted Average Debt Percentage[8]	
		Regulated	Actual[9]	Regulated	Actual
Private	64,062,672,391	5.78%	4.23%	60%	65.01%
NTER	43,089,287,294	5.30%	4.77%	60%	76.09%
All Entities	107,151,959,685	5.59%	4.40%	60%	69.47%

The impact of differentials between interest rate and gearing ratios for actual tax and regulatory purposes are discussed further below.

Relevant factor 1: Interest rate

The impact of differences in interest rates giving rise to a divergence between actual tax deductions and the interest expense included in the regulatory model has been demonstrated in Figure 4 below. Figure 4 compares a notional interest deduction calculated by applying the actual interest rates observed across the NSPs to the benchmark gearing ratio of 60% against the RAB for all entities. This isolates any differences applicable in interest rate for actual tax and regulatory purposes.

Figure 4: Notional actual deduction applying actual interest rates to RAB and regulatory gearing



[7] Weighted average of all interest rates (against actual quantum of debt) in respect of financing arrangements per RIN disclosures, including both internal (e.g. shareholder) and external funding arrangements.

[8] The RIN questions requested that gearing ratios were disclosed based on the debt and equity amounts disclosed in the entity's financial statements, which is generally consistent with the thin capitalisation requirements. It is important to note however that the benchmark gearing ratio applied by the AER is determined with reference to the benchmark equity value of the entities. Therefore these two measures are not a like for like comparison.

[9] Actual gearing has been determined by the NSPs having regard to debt and equity disclosed in the Financial Statements of the NSP. This excludes the impact of some foreign currency swaps as noted on page 21.

Notes relevant to interpretation of information:

- The notional deduction presented above has been calculated as the applicable aggregate tax deduction if the actual weighted average interest rates was applied to the RAB at the regulatory benchmark gearing percentage of 60%. The differential between the regulatory interest deduction and this notional deduction can be seen as purely driven by interest rate differentials for actual and regulatory purposes.

- The notional annualised interest deductions do not include the impact of some foreign currency swaps as these have not been disclosed in the RIN responses. Refer our comments above in this regard.

This demonstrates a material difference in respect of private sector entities whereby the average weighted interest rate applied for regulatory purposes for 2018 income year was 5.78% and the actual average weighted interest rate disclosed in the RIN responses (which includes related party debt) was 4.23%, demonstrating a differential in interest deductions applicable to interest rate differences of $698.8m.

The AER have advised that this difference relates to the following factors:

1. The interest rate applied for regulatory purposes in the cost of debt calculation is determined on a 10 year trailing average basis, in accordance with the Rate of Return requirements, whereas our calculations are applied to the relevant rates at a specific point in time. Due to current low prevailing interest rates and the relatively significant proportion of recent transactions and re-financing (including the NSW privatisations), the weighted average interest rates observed as at 30 June 2018 (including related party debt, but excluding gearing by upstream investors) is approx. 1.19% lower than the 10 year trailing average across all entities. The AER estimates this accounts for approximately one third of the differential;

2. The impact of foreign currency swaps as noted on page 21 above. The AUD equivalent actual interest rate of debt originally sourced in foreign currencies has been disclosed in some on the RIN responses, but not all. The AER estimates this factor also accounts for approximately one third of the differential;

3. The impact of actual debt terms (in years) compared to the 10 year benchmark applied in the rate of return guidelines (noting this is currently being reconsidered by the AER). In some instances the actual term of the financing arrangements is less than 10 years, which can lead to a lower interest rate. The AER estimates this accounts for approximately on quarter of the differential; and

4. The difference between actual and regulatory interest rates when compared on like-for-like averaging basis due to outperformance of the benchmark by the NSP. This is due to the fact the regulatory cost of debt for each NSP is determined with reference to a benchmark credit rating of BBB, with the expectation that NSPs would be incentivised to operate on a more efficient basis, and potentially achieve a lower cost of debt in operating the network assets (in which case the benefit for the relevant year would be retained by the NSP). The AER estimates this accounts for approximately one tenth of the differential.

In addition, we have compared the actual weighted average interest rates to the regulatory interest rates for each NSP on a stand-alone basis and have not observed any individual NSPs where the actual weighted average interest rate (which includes internal gearing) was greater than 50 basis points higher than the regulatory interest rate. In all but two instances the regulatory interest rate was higher than the actual weighted average interest rate (likely for the reason discussed above).

Reasons (1), (3) and (4) discussed above for the observed variances between the actual weighted interest rates and the regulatory weighted interest rates are a justified and expected part of the benchmark efficient regulatory model. Reason (2) relates to the absence of

certain information in the RIN responses received, and therefore would be eliminated based on a like for like comparison.

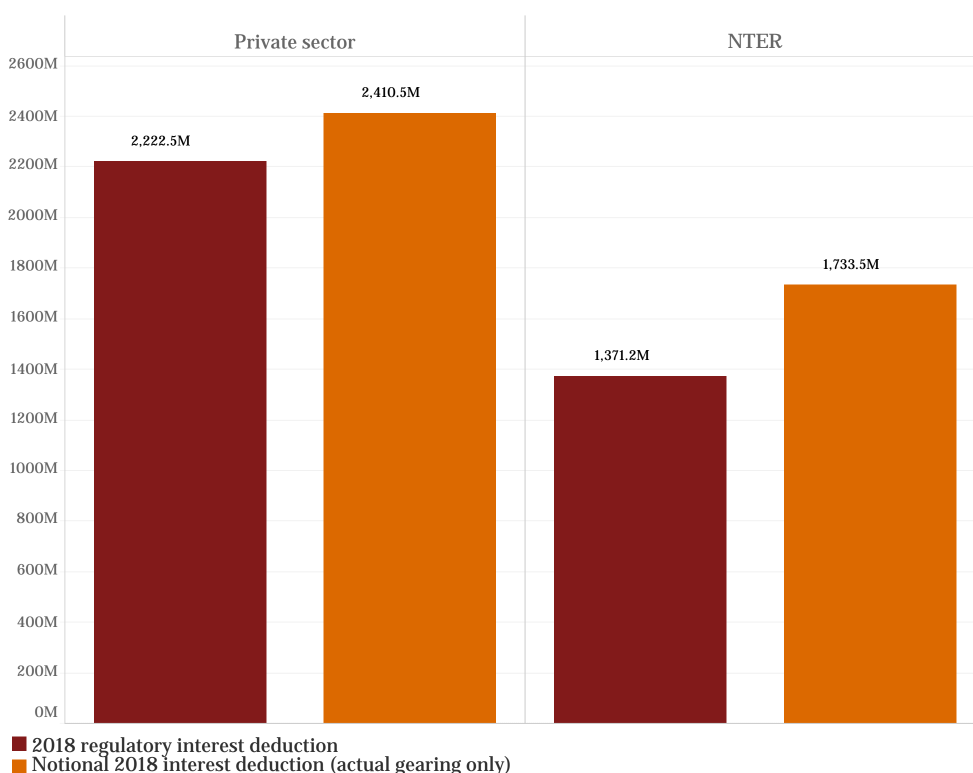
Accordingly, we believe any difference between actual tax and the regulatory forecast of tax costs relating to interest rates of themselves is justifiable and does not result in a misalignment that would require modifications to be made to the existing benchmark model.

Relevant factor 2: Gearing ratios

As outlined in the table above, we have observed a difference in the actual percentage of debt gearing disclosed by the NSPs and the 60% benchmark gearing rate applied for regulatory purposes.

The impact of differences in gearing ratios giving rise to a divergence in actual tax deductions and the interest expense included in the regulatory model has been demonstrated in Figure 5 below. Figure 5 compares a notional interest deduction calculation by applying the actual gearing ratios observed across the NSPs to the RAB, at the interest rates used for the purposes of the cost of debt calculation (e.g. the regulatory interest rates). This isolates any difference which is specific to gearing levels within the model.

Figure 5: Notional actual deduction applying actual gearing rates to RAB and regulatory interest rates



Notes relevant to interpretation of information:

- The notional deduction presented above has been calculated as the applicable aggregate tax deduction if the actual gearing ratios observed in the RIN responses were applied to the RAB and the regulatory weighed interest rates applied in the cost of debt calculation. The differential between the regulatory interest deduction and this notional deduction can be seen as purely driven by gearing ratio differentials for actual and regulatory purposes.

- The gearing ratios disclosed in the RINs were based on the financial statements of the NSPs (consistent with the thin capitalisation safe harbour debt amount method).

When applying the actual weighted average gearing ratios disclosed by the NSPs to the RAB and the interest rate used in the cost of debt calculations for regulatory purposes, we can evidence the impact of gearing ratios as follows:

- **Private sector entities:** Aggregate annual notional interest deduction (applying actual gearing to regulatory interest rate and RAB) of $2,410.5m, compared to aggregate annual interest deductions included in the regulatory model of $2,222.5m (an excess of $188m, representing an average excess of $15.67m per NSP relating to gearing); and

- **NTER entities:** Aggregate annual notional interest deduction (applying actual gearing to regulatory interest rate and RAB) of $1,733.5m, compared to aggregate annual interest deductions included in the regulatory model of $1,371.2m (an excess of $362.3m, representing an average excess of $72.4m per NSP relating to gearing).

This differential demonstrates the impact of actual gearing ratios on the interest expense deduction for actual tax purposes as compared to the regulatory interest expense. Notwithstanding the fact that the gearing ratios disclosed in the RIN responses represent the aggregated gearing level of each NSP across broad commercial groups (consisting of regulated and unregulated assets), the observed higher debt gearing levels is, in our view, a relevant factor (i.e. inside the ring-fence) when considering the drivers for discrepancies between actual tax payments and the regulatory forecast of tax costs.

A key driver for this difference appears to be the approach taken by the AER in determining the benchmark gearing ratio within the Rate of Return Guidelines. We understand that for the purpose of the cost of debt calculation (and therefore interest expense reflected in the regulatory forecast of tax costs), the AER determine the benchmark gearing ratio having regard to the market value (rather than book value) of the relevant comparator businesses.

This differs to the approach taken for actual tax purposes whereby the 60% thin capitalisation safe harbour debt amount method is calculated having regarding to the debt and equity values recognised in the taxpayer's financial statements (e.g. book value). For example, where the equity component of the denominator in the gearing ratio calculation which is considered relevant for actual tax purposes (e.g. total debt, divided by the sum of total debt plus total equity) is based on the equity reported in the entity's financial statements, the denominator used in calculation of the AER's 60% benchmark ratio is the market value of the equity of the relevant comparative businesses.

Given the nature of the businesses reflected in the benchmark calculation, it is expected that the market values of those equities would generally be higher than the book value of the same equities. Accordingly, the gearing ratio used by the AER in the cost of debt calculations would by nature be expected to be less than the gearing ratio applied by the NSPs when calculating that metric based on the book values of the NSP's equity balances. We have not been able to quantify the expected impact of this difference for the purpose of our review.

Whilst this appears to provide a justifiable reason for an excess of actual gearing percentages ratios above the benchmark percentage applied for regulatory purposes, we have observed NSPs with an actual gearing percentages which are materially higher than the 60% benchmark percentage (with percentages of greater than 80% observed in both the private sector and NTER entities in some instances). Accordingly, whilst the total weighted average gearing percentage at an industry level 69.47% may not seem materially higher than the benchmark gearing levels applied for regulatory purposes after accounting for differences in market value and book values (noting this is unquantifiable at this stage), in some instances there may be a material difference on a stand-alone basis.

In considering appropriate approaches to better align actual gearing practices with the gearing percentage adopted in the regulatory forecast of tax costs calculations, we have considered approaches taken by foreign jurisdictions. We have considered foreign regulators to determine any 'tax only' regulatory adjustments in respect of interest expense. The only relevant approach we have identified that adopted by Ofgem in the UK, whereby a clawback mechanism is applied to adjust the relevant tax allowance for regulated electricity and gas

providers in the event actual gearing levels exceed the benchmark estimated amount for regulatory purposes, which would otherwise result in higher actual interest deductions than the interest expense calculated in the regulatory model. A more detailed explanation of this model is attached as Appendix C to this Addendum.

Whilst the Ofgem approach to 'claw back' excessive deductions provides a practical example of how excessive deductions may be dealt with within a regulatory model, it is not yet clear how consistent the drivers for any such discrepancies are between the Australian and UK regulatory models. For example, whilst M&A transactions have led to a significant excess of debt (by quantum) issued by Australian NSPs in comparison to assumed regulatory debt levels, it is not apparent whether the same issue exists in the UK. In particular, discussions with regulatory specialists in the UK have indicated that strict debt ring-fencing and lending criteria may mean that quantum of debt issued by regulated entities is much more closely aligned with and attributable to the regulated assets. In contrast, if the same claw back mechanism was applied in Australia, we would expect a significant reduction in the tax allowance in respect of "excessive debt deductions" which do not actually form part of the regulatory ring-fence. This could lead to outcomes inconsistent with the ring-fencing principles within the Australian model and would therefore need to be considered in further detail.

As noted above, we have not been able to observe interest deductions claimed by upstream investor due to limitations in information provided. To the extent the NSP has debt funding up to thin capitalisation limits and additional interest has been claimed by upstream investors in flow through vehicles in the 30 June 2018 and prior income years (referred to as 'double gearing'), this would have historically resulted in an additional differential between tax ultimately paid on regulated profits and the regulatory forecast of tax costs (consistent with the observations in the ATO Note).

Of relevance is the draft legislation currently before Parliament (and expected to pass) which will remove the ability for investors in flow through entities with an interest of 10% or more to apply double gearing in respect of those investments from 1 July 2018. Unlike the tax reform relating to staple structures discussed in our Report, there is no proposed grandfathering or transitional arrangements. Based on the RIN responses and publicly available information, we have not observed any upstream investors in flow through vehicles with an equity interest of less than 10%.

Whilst it is possible for new investors with an interest of less than 10% could be introduced into the structures after 1 July 2018, we have not sought to speculate on whether this may occur. Accordingly, we do not expect interest deductions of upstream investors in flow through vehicles to cause a material discrepancy between actual tax paid and the regulatory forecast of tax costs from 1 July 2018 onwards. Therefore, we do not believe it is necessary to adjust the regulatory model in respect of upstream gearing in flow through vehicles, as there should be no material misalignment in this regard going forward.

In addition, we expect recent tax law developments and ATO activity to further restrict actual interest deductions claimed in future years (refer our further comments in this regard in section 3.1.4 below).

3.1.4 Recent tax law changes to financing

As noted, when having regard to any prospective changes to the current regulatory framework, it is important to consider any changes in tax law which may be relevant to the benchmark positions on a go forward basis. Relevant developments are discussed below.

Thin capitalisation

The thin capitalisation provisions contained in Division 820 of the ITAA 1997 were introduced in their current form in 2001. The intention of the thin capitalisation measures is to prevent multinational taxpayers allocating a disproportionate amount of debt to

Australian operations (to be "thinly capitalised") for the purpose of claiming excessive debt deductions in Australia.

The thin capitalisation rules in Division 820 broadly apply by denying a portion of an entity's deductions for interest and other related debt costs (referred to as "debt deductions") where the entity is "thinly capitalised" having regard to a number of statutory tests. Different tests will apply depending on the thin capitalisation classification of the entity.

The thin capitalisation rules do not apply to an entity that is an Australian resident with only Australian operations (i.e. it is not an “inward investor”) and which does not control foreign entities (i.e. it is not an “outward investor”).

For inward and outward investors, there are a number of exemptions from the thin capitalisation provisions available, including:

- the "de minimus" exemption, which applies where total debt deductions of the entity and all of its associate entities for the year are $2 million or less;
- the "Australian assets threshold", which applies to an outward investing entity that is not also an inward investing entity where, broadly, at least 90% of the total assets of the entity and its associates are Australian assets; and
- the exemption for special purpose entities established for the purpose of managing risk (e.g. securitisation vehicles).

For taxpayers that are subject to the thin capitalisation rules, and that are not classified as approved deposit-taking institutions (i.e. banks), a thin capitalisation exposure (i.e. where debt deductions are disallowed) will generally arise where the level of adjusted average debt exceeds maximum allowable debt. Broadly, the maximum allowable debt of an entity may be determined by three alternative methods:

- *The safe harbour debt amount* - limits the amount of debt capital on which debt deductions will be allowed to broadly 60% of Australian assets (note: this was reduced from 75% in 2014).
- *The arm's length debt amount* - broadly, the arm's length debt amount is the amount of debt:
  - that the Australian business would reasonably be expected to have during the year after taking into account prescribed factors and assumptions; and
  - which would have been provided to the Australian business by independent commercial lending institutions on arm's length terms and conditions.
- The *worldwide gearing debt amount* - permits certain entities to be geared up to the level of the entity's worldwide group.

Based on the RIN responses, we have observed all three methods being adopted by private sector entities across the past 5 years. We note that proposed legislative amendments discussed in section 3.1.4 may result in a reduction to the maximum allowable debt calculated under the arm's length debt method and worldwide debt method. We have also evidenced one instance of an NSP being denied debt deductions for exceeding the maximum allowable thin capitalisation debt levels in an income year (noting the total quantum of interest denied was less than $2m).

NTER entities are generally not subject to thin capitalisation restrictions as they would not be considered inward or outward investors.

Double gearing and unitholder debt

In 2017, the ATO published a draft of the “Privatisation and Infrastructure – Australian Federal Tax Framework” (**Framework Document**), which aims to provide general guidance on the ATO’s position on a range of infrastructure related tax issues.

In the Framework Document, the ATO identified two areas relating to gearing that it considers give rise to a high compliance risk. The first involves the use of debt in upstream investment vehicles to fund an investment into an infrastructure asset. The Framework Document describes this as typically occurring by way of the relevant special purpose vehicle borrowing funds from its parent, and injecting those funds as equity into the relevant holding vehicle (referred to in the Framework Document as “unitholder debt”). The ATO notes that taxpayers adopting a structure which involves unitholder debt should carefully consider the application of the transfer pricing rules in Division 815, the thin capitalisation rules in Division 820, and Part IVA.

The second area noted by the ATO involves the “fracturing of control interests” to facilitate “double gearing” – that is, multiple layers of flow-through entities (i.e. trusts and partnerships) each issuing debt against the same underlying asset.

Where an investor is an associate entity of a unit trust, the value of the equity interest in the unit trust would be excluded from that investor’s safe harbour debt calculation such that the investor has no further thin capitalisation ‘capacity’ against which to claim debt deductions in respect of that investment. “Associate entity” for these purposes is currently defined to mean an interest of 50% or more. As such, any investor holding a less than 50% equity interest in a flow through NSP could claim debt deductions against the value of their investment, in addition to debt deductions being claimed at the project level (e.g. double gearing).

Legislation is currently before Parliament which proposes to amend the thin capitalisation rules to prevent foreign investors from double gearing their investments. This legislation addresses what is described as an unintended legislative outcome and will apply for income years commencing on or after 1 July 2018. No grandfathering or transitional arrangements will apply (unlike the reforms relating to stapled structures discussed in section 3.2 of our Report).

The change will be implemented by reducing the threshold at which a flow through entity becomes an “associate entity” from ownership of 50% or more to 10% or more for the purposes of applying the thin capitalisation rules.

The legislation will also clarify that the thin capitalisation arm’s length debt test requires consideration of gearing against the underlying assets of an entity. This was considered a necessary response to the changes to the thin capitalisation associate entity provisions, as it was thought that investors may attempt to double gear by calculating a thin capitalisation arm’s length debt amount. To safeguard against investors attempting to double gear in this way, the arm’s length debt test will be amended to clarify that, for the purposes of determining the arm’s length debt amount, the debt to equity ratios of any entities in which the entity has a direct or indirect interest is a factor that must also be taken into account, to the extent the interest is relevant and material to the considerations of both a prudent independent borrower and a prudent independent lender.

Relevantly, this means that the ability of relevant investments of the entity to act as security (or asset backing) to support the entity's debt is determined taking into account the burden of any debt claims the investments already have against their underlying assets (whether held directly or indirectly through further interposed entities).

It is expected that, to the extent that any of the NSPs have unitholder debt or double gearing in their structures, the tax outcomes resulting from the use of these elements in their structure should be substantially neutralised from 1 July 2018 onwards.

We have not identified any specific investors with an interest of less than 10% in the flow-through NSPs subject to this review, which would be able to continue accessing double gearing following the change in law.

Worldwide gearing test

In addition to the changes to double gearing as noted above, it was announced in the 2018 Federal Budget that the thin capitalisation rules will be amended to ensure that foreign controlled Australian consolidated groups (including multiple entry consolidated groups) that control a foreign entity will be treated as both outward and inward investment vehicles. This changes addresses an anomaly under the thin capitalisation rules where these consolidated entities were deemed to be outward investment vehicles and therefore able to access the worldwide gearing test.

The proposed changes will apply for income years commencing on or after 1 July 2019 and will ensure that these entities cannot access the worldwide gearing test which was only intended to apply to outward investors.

Interest withholding tax

Interest paid by an Australian resident to a non-resident is generally subject to a final withholding tax at a rate of 10%, unless an exemption applies. Given the profile of investors in NSPs, it is relevant to note that certain exemptions are available to foreign pension funds and sovereign investors as discussed below.

Foreign pension funds

Foreign pension funds are currently exempt from Australian interest and dividend withholding tax.

Legislation is currently before Parliament which proposes to limit the foreign pension fund withholding tax exemption to portfolio investments (i.e. where a foreign pension fund investor holds ownership interests of less than 10% per cent and does not have influence over the entity's key decision making). This measure is proposed to take effect from 1 July 2019 and arrangements in existence at 27 March 2018 will have access to a seven year transitional period (to 1 July 2026).

We have not identified any foreign pension funds with an interest of less than 10% in an Australian vehicle which holds an interest in any of the NSPs through review of the group structures provided in response to the voluntary information requests and the RINs.

Sovereign immunity

Legislation is currently before Parliament which proposes to legislate a framework for sovereign immunity, which will continue to exempt sovereign investors where they hold less than 10% of an entity's ownership interest and do not influence an entity's key decision making. The codification of the sovereign immunity exemption is proposed to take effect from 1 July 2019. Investments in existence at 27 March 2018 will have access to a seven year transitional period (unless a tax ruling is in place which extends beyond the seven year period). At the end of the transitional period, only sovereign investors who satisfy the requirements of the codified exemption will be exempt from tax.

These legislative changes should have implications for shareholder loans made to NSPs by foreign pension fund and sovereign investors following the transition period.

We have not identified any sovereign wealth funds with an interest of less than 10% in an Australian vehicle which holds an interest in any of the NSPs through review of the group structures provided in response to the voluntary information requests and the RINs.

Debt pricing

Related party loans have been an area of focus for the ATO in recent years. The *Chevron* decision in 2017 clarified the application of transfer pricing provisions in Australian tax legislation.

The Chevron decision

In April 2017, the Full Federal Court in *Chevron Australia Holdings Pty Ltd v Commissioner of Taxation* [2017] FCAFC 62 (***Chevron***) unanimously found in favour of the Commissioner and dismissed the taxpayer's appeal against the Commissioner's decision to disallow deductions claimed by the taxpayer in respect of interest incurred on loans provided to the taxpayer by a related company resident in the United States.

The dispute centred on the Commissioner's application of the transfer pricing rules, and the Commissioner's view that the interest rate applying to the loan exceeded the arm's length rate, and thus the deductions claimed were excessive. The Full Federal Court held that, in the circumstances of the case, an independent borrower would have included security and operational and financial covenants in the loan terms, which would have resulted in a lower interest rate than that actually charged. In relation to cross-border guarantees, the Full Federal Court accepted that it may be reasonable to expect that a taxpayer would be required to pay a fee to a parent entity for any security provided.

Following *Chevron*, the ATO has also adopted a modified approach to compliance with respect to related party loan arrangements.

The *Chevron* case provides a good example of where difficulties could arise if an actual tax pass through approach was adopted by the AER. Following the Chevron case, the ATO is likely to review historic transfer pricing positions adopted in relation to interest.

Relevantly, transfer pricing adjustments to the tax position of an entity as a result of the application of the transfer pricing rules may be made up to seven years from the day on which the Commissioner gives notice of the assessment to the entity.[10] There is no time limit for the Commissioner to make consequential amendments (which may apply to the affected entity, or an entity that dealt with the affected entity). Further, a time limit does not apply to the Commissioner's ability to determine additional amounts of withholding tax payable because an ascertainment of withholding tax does not constitute an assessment.

It is unclear how a tax pass through regulatory model would account for court decisions or other changes which impact the interpretation of the legislation such as this. To the extent adjustments are made in respect of tax positions for prior periods, issues of inter-generational inequality may arise.

PCG 2017/4

In December 2017, the ATO published its Practical Compliance Guideline PCG 2017/4 (**PCG**) which deals with related party debt financing. The PCG sets out the framework used by the ATO to assess risk in relation to certain related party financing arrangements having regard to a combination of quantitative and qualitative indicators. The ATO uses this risk assessment to tailor its engagement with taxpayers according to the features of its related party financing arrangements, the profile of the parties to the arrangements and the choices and behaviours of the taxpayer.

[10] For income years commencing before 29 June 2013, the Commissioner had an unlimited period to make an assessment to give effect to a transfer pricing adjustment.

The PCG is not a public ruling, but rather provides guidance to taxpayers to understand where the ATO will allocate compliance resources to test the tax outcomes of related party financing arrangements. The ATO has been clear that the PCG does not constitute a "safe harbour", nor does it alter or affect in any way its interpretation of the relevant law.

As a result of these developments, it is expected that interest rates applicable to shareholder loans (and consequently interest deductions) obtained by some NSPs may be lower in the future as compared with historic interest rates.

Anti-hybrid rules

In August 2018, Federal Parliament passed legislation to give effect to the Organisation for Economic Co-operation and Development's (**OECD**) recommended hybrid mismatch rules, as originally announced by the Australian Government in May 2015. These rules will generally apply to income years starting on or after 1 January 2019.

Broadly, hybrid mismatches are differences in the tax treatment of an entity or instrument under the laws of two or more tax jurisdictions. If a mismatch arises, the hybrid mismatch rules operate to neutralise the mismatch by disallowing a deduction or including an amount in assessable income.

The hybrid mismatch rules also contain a targeted integrity provision that applies to certain deductible interest payments (or payments under a derivative), made to an interposed foreign entity where the rate of foreign income tax on the payment is 10% or less. It is noted that this integrity rule is a unilateral measure, first announced by the Treasurer in November 2017, and is a departure from OECD recommendations in relation to hybrid mismatch arrangements.

The introduction of the anti-hybrid rules should broadly mean that an NSP should only be entitled to claim a deduction for interest paid to a non-resident related party where the interest income is taxed at a rate of 10% or more in the foreign jurisdiction.

Due to limitations in accessing tax information relating to upstream investors, we are not able to provide any observation regarding the potential historic existence of hybrid financing arrangements between the NSPs and their investors.

General anti-avoidance provisions

In addition to the specific legislative changes that have been enacted with respect to debt financing (as discussed above), there have also been changes to the general anti-avoidance provision in order to strengthen the integrity of the Australian tax system. These are briefly outlined below.

Diverted profits tax

In 2017, the Australian Government introduced the diverted profits tax (**DPT**), which effected the biggest change in Australia's general anti-avoidance provisions since their introduction 35 years ago. The DPT imposes a penalty rate of tax (40%) in circumstances where the amount of Australian tax paid is reduced by diverting profits offshore through related-party arrangements.

The DPT applies to significant global entities (i.e. multinational groups with more than A$1bn global groupwide revenue) by imposing the 40% penalty tax rate to Australian tax benefits if it would be concluded that there was a principal purpose of obtaining an Australian tax benefit, or both to obtain an Australian tax benefit and reduce foreign tax liabilities. The DPT applies to tax benefits obtained in income years commencing on or after 1 July 2017 (even if the scheme commenced in prior periods).

It is noted that in relation to financing, where the thin capitalisation rules apply to taxpayers,

only the rate of interest (and not the quantum of debt) is taken into consideration in determining a DPT tax benefit. In addition, it is relevant to note that the DPT does not apply to MITs, certain foreign collective investment vehicles, entities owned by foreign governments, complying superannuation entities and foreign pension funds.

Multinational anti-avoidance law

The multinational anti-avoidance law (**MAAL**) was enacted in 2015 and introduced a targeted anti-avoidance law which applies to multinationals that supply goods or services to Australian customers and record the revenue from those sales overseas. The MAAL applied from 1 January 2016.

Where the MAAL applies, the foreign entity will be taxed as if it had made the sales through a deemed Australian permanent establishment (**PE**). This means it will be subject to Australian tax on the notional profits attributable to the deemed PE, as well as withholding taxes where royalty or interest expenses are attributable to the deemed PE. Penalties will also apply on top of these taxes, generally at a rate of 100%.

Unlike the general anti-avoidance rule, the MAAL applies a lower threshold "purpose" test, being "one or more of the principal purposes", and allows foreign tax purposes to be included in that consideration.

Taxpayer Alert TA 2017/1

On 31 January 2017, the Commissioner issued Taxpayer Alert TA 2017/1 (**TA 2017/1**), expressing his concern over arrangements that fragment integrated trading businesses (i.e. stapled structures) in order to re-characterise trading income into passive income which may be taxed more favourably.

TA 2017/1 identifies four types of stapled structures which the Commissioner is concerned with, namely a finance staple, synthetic equity staple, royalty staple, and rental staple. Of relevance to this Addendum is the finance staple arrangement, which broadly involves a structure where the Asset Trust receives equity funding which is on-lent to the Operating Trust (for a discussion of stapled structures generally, see section 3.2.2 of our Report). TA 2017/1 states that the alert does not extend to privatisations of land (or improvements to land) based assets.

In regards to the finance staple, the Commissioner is concerned that the Asset Trust may, through its cross staple loan, be able to control the operating entity for the purposes of trading trust rules in Division 6C and provides an example where the operating entity's continuation as a going concern is contingent on the Asset Trust not exercising a right it has to trigger the operating entity's insolvency. TA 2017/1 notes that even if such arrangements are effective under the substantive provisions, the Commissioner is concerned that these arrangements are being entered into or carried out for the dominant purpose of obtaining a tax benefit, which might attract the operation of the anti-avoidance rule in Part IVA of the ITAA 1936.

Based on the RIN responses in respect of the financial arrangements of the NSPs at 30 June 2018, we have not identified any arrangements which appear to be part of a finance staple (noting that it is possible that some NSPs were previously structured as such). Given the ATO's published position on the use of finance staples, we would not expect such a structure to be implemented going forward without approval by the ATO.

3.1.5 Recommendations

The findings above demonstrate that differences in actual interest deductions and the estimated deductions included in the regulatory forecast of tax costs relate to:

1. Differences in quantum of debt attributable to M&A and unregulated assets;

2. Differences in interest rates applicable to the relevant year; and

3. Differences in gearing ratios.

The differences relating to item (1) are justifiable in accordance with the ring-fencing principles of the regulatory framework, whereby such costs are not considered recoverable for regulatory purposes and therefore any excess deductions attributable to those unrecoverable costs should also be excluded from the tax allowance calculation. Accordingly we do not recommend any changes to the regulatory model in this regard.

The differences relating to item (2) can largely be explained by differences in the interest rates applicable to current debt and giving rise current year actual debt deductions, and the 10 year trailing average method of determining weighted average interest rates for regulatory purposes. Based on the information received we have not identified any excessive deductions attributable solely to interest rates (on a weighted average per entity basis, e.g. including interest on related party debt), and therefore, do not recommend any changes to the regulatory model in respect of interest rates for tax purposes (noting interest rates are subject to the broader Rate of Return review).

Whilst differences relating to item (3) can also be explained in part by differences in the approach taken for determining the benchmark debt percentage for regulatory purposes to the determination of actual debt gearing percentages in determining actual interest deductions, we have also observed stand-alone NSPs with gearing which would be expected to exceed the regulatory benchmark after adjusting for these differences. To the extent the discrepancy observed in respect of item (3) is considered material, consideration could be given by the AER to contemplating an adjustment to the tax allowance model to adjust the interest expense included in calculation of the regulatory forecast of tax costs to reflect the actual gearing levels adopted by the NSPs. The approach applied by Ofgem in the UK could be considered further in this regard, however further research regarding the relevance of this model to the Australian regulatory framework would need to be undertaken.

We recommend the following considerations are addressed further prior to proceeding with an adjustment to the regulatory model to reflect actual gearing ratios in the regulatory forecast of tax costs:

- Impact of thin capitalisation restrictions: The regulatory model should recognise that where actual debt gearing exceeds debt levels which are allowed under Australia's thin capitalisation rules, only the amount allowed under the thin capitalisations rules should be included in the calculation of interest expense for the purposes of the regulatory forecast of tax costs. As noted above, three differing methods are available under which taxpayers may calculate their maximum allowable debt for thin capitalisation purposes, and decisions relating to which method to apply are not required until lodgement of the income tax return. Accordingly, complexities may arise in addressing the impact of thin capitalisation on the regulatory tax calculations.

- Interaction with other regulatory building blocks: We have noted above the general principle whereby consistency should be applied across different building blocks within the regulatory model. Accordingly, if higher gearing ratios were taken into account within the tax allowance, the AER needs to consider whether this is consistent with the other regulatory building blocks in light of the cost of debt building block and the rate of return review.

3.2 Tax paid and stand-alone regulated tax positions

Section 3.1 of our Report discussed our findings in respect of actual tax paid by the regulated entities. Our findings in the Report were based on the tax payable amounts disclosed in the income tax returns provided by the NSPs on a voluntary basis. Further income tax returns have been received by the NSPs in response to the RINs. Accordingly, this section provides updated observations regarding the actual tax positions (and tax losses carried forward) after taking into account the additional information contained in the RIN responses.

In addition, question 3.2 and 3.5 of the RINs requested that the NSPs provide stand-alone tax calculations which are reflected of the regulated entity on a stand-alone basis. This information is relevant to our review given the regulated network assets on which the tax allowance is provided are generally held within structures which include regulated and non-regulated assets.

Accordingly, the actual tax positions of the NSPs reported in the observed income tax returns generally represent a blend of regulated and unregulated transactions, many of which are outside of the regulatory ring-fence which is relevant for the purpose of determining the regulatory forecast of tax (e.g. deductions relating to costs which are not incurred in respect of the efficient operation of the network assets). The information requested at questions 3.2 and 3.5 of the RINs assist to better understand what the tax position of each regulated entity would look like when only having regard to the revenue and expenditure associated with efficient operation of the network assets.

Our findings in respect of these items are outlined below.

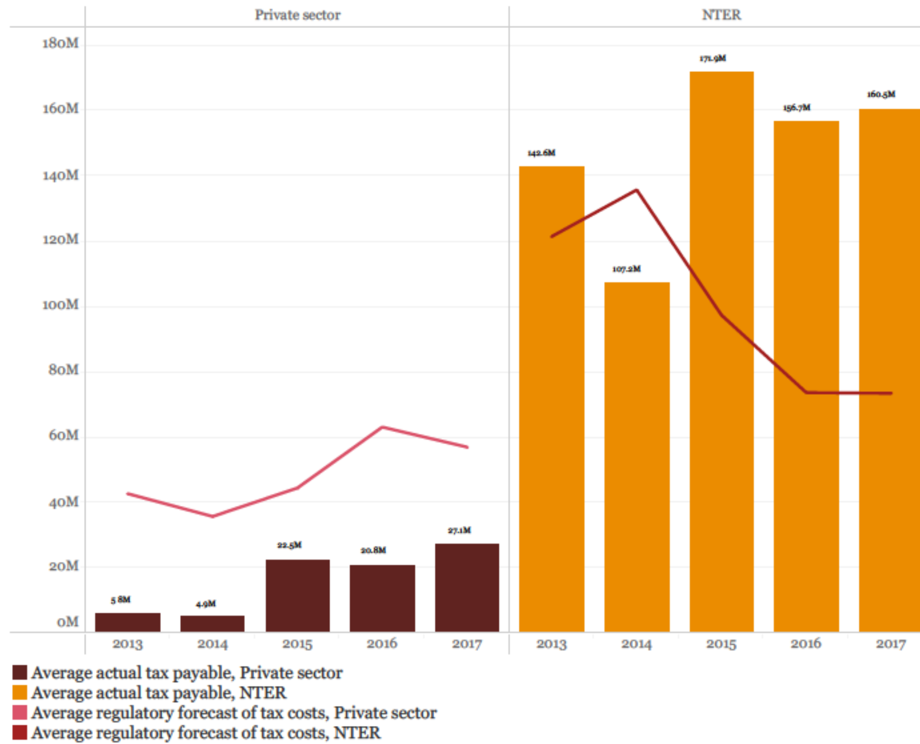
3.2.1 Tax paid – observations having regard to RIN responses

This section outlines our updated findings in relation to actual tax paid by the NSPs having regard to the RIN responses (noting our previous findings were based on information provided on a voluntary basis). Additional income tax returns and information regarding tax paid by the NSPs were received in the RINs subsequent to the issue of our Report.

Tax paid – updated diagram

Figure 2 on page 28 of our Report showed the average tax payable by NSPs which provided income tax returns on a voluntary basis, as disclosed in those returns. Further income tax returns have been receive in response to the RINs, and accordingly we have updated the same graph as Figure 6 immediately below for this additional information:

Figure 6: Tax paid based on RIN responses



Notes relevant to interpretation of information:

- The above graph shows the average actual tax payable by both NTER and private sector NSPs, as compared to the average regulatory forecast of tax costs.

- The average actual tax payable figures are determined based on actual tax payable reported in the tax returns provided by NSPs voluntarily and in response to the RINs. The average regulatory forecast of tax costs are determined based on the AER's modelled regulatory tax payable. To the extent regulatory information is not available, the equivalent tax return tax payable information has also been omitted. To the extent the actual tax payments only related to a part year (e.g. the regulated entity was acquired during the year or had a transitional period), the regulatory tax allowance applicable for the year was also pro-rated according to the same period.

- The number of NSPs that have provided income tax returns and have available tax allowance information, and are therefore reported above in the average tax payable amounts are as follows:

    - 2013: NTER: 3 / Private Sector: 3
    - 2014: NTER: 3 / Private Sector: 4
    - 2015: NTER: 4 / Private Sector: 5
    - 2016: NTER: 4 / Private Sector: 5
    - 2017: NTER: 4 / Private Sector: 5

We note the following in respect of Figure 6:

- Consistent with our Report, this graph only reflects entities which are taxed as a company, on the basis these entities are responsible for paying income tax in respect of the regulated activities. Entities taxed as companies (including NTER entities) represent 12 of the 17 NSPs which are subject to this review. For the 5 NSPs taxed on a flow through basis, responsibility for payment of income tax rests with the upstream investors, and accordingly, we have not been able to observe income tax paid by those investors (due to limitations in the ability to obtain information from upstream investors

as noted in section 1.3 above). The actual tax positions of the flow through entities is considered in further detail below.

- The tax paid information reflected in the updated graph continues to support our finding that private sector NSPs that are taxed as companies on average pay less income tax than the regulatory forecast of tax costs, and the NTER entities on average pay more.

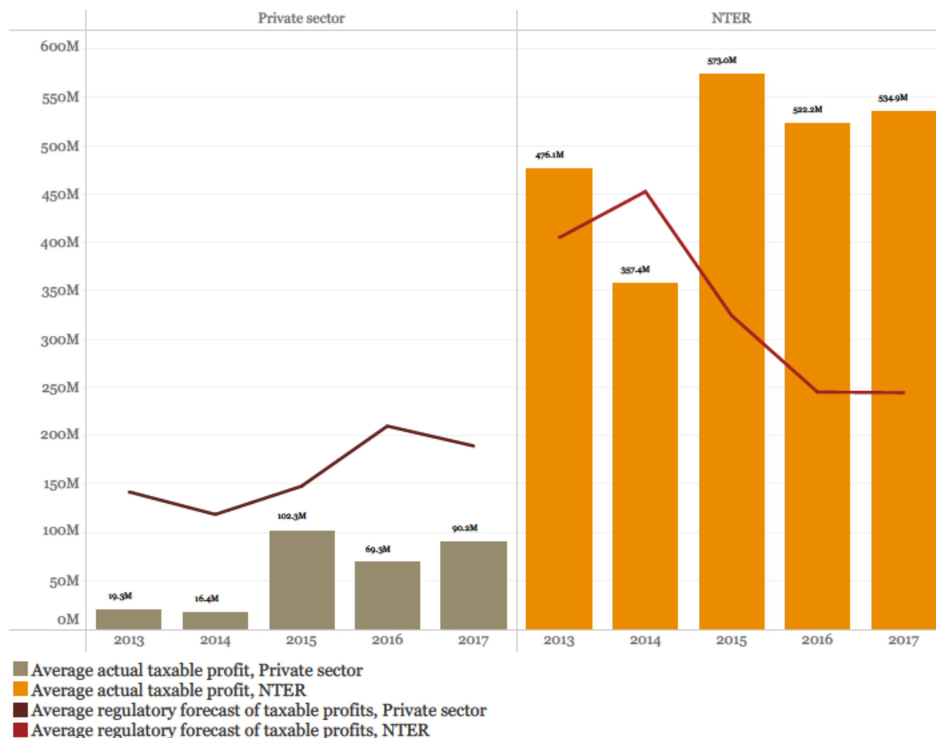
In response to comments provided on our Report, we have considered whether the information received relating to the tax position of the flow through NSPs could be integrated with the information received relating to the tax payable positions of the NSPs which are taxed as a company to provide a direct comparison of all NSPs which are subject to this review.

The NSPs which are taxed on a flow through basis have (where possible) provided either trust or partnership returns (as applicable) in response to question 3 of the voluntary information request and question 3.1 of the RINs. While the trust and partnership returns do not disclose tax payable (as income tax is not payable by a flow through entity, refer the discussion in section 3.2 of our Report for further information in this regard), the returns do disclose the taxable profits of the NSP which have been distributed to upstream investors to be taxed in the hands of those investors as appropriate (and subject to any other factors specific to those investors such as tax profile and available deductions), referred to as the 'net income' of the flow through entity.

Accordingly, a comparison of the taxable income of companies (prior to applying the 30% tax rate and any available offsets) to the net income or the trust or partnership appears to be a like for like comparison.

In order to be able to provide this comparison, we have first compared the taxable income of each NSP disclosed in Figure 6 above (e.g. those taxed as a company) to the regulatory forecast of tax costs before applying the 30% corporate tax rate. This is outlined in Figure 7 below.

Figure 7: Taxable profits based on RIN responses (Companies only)

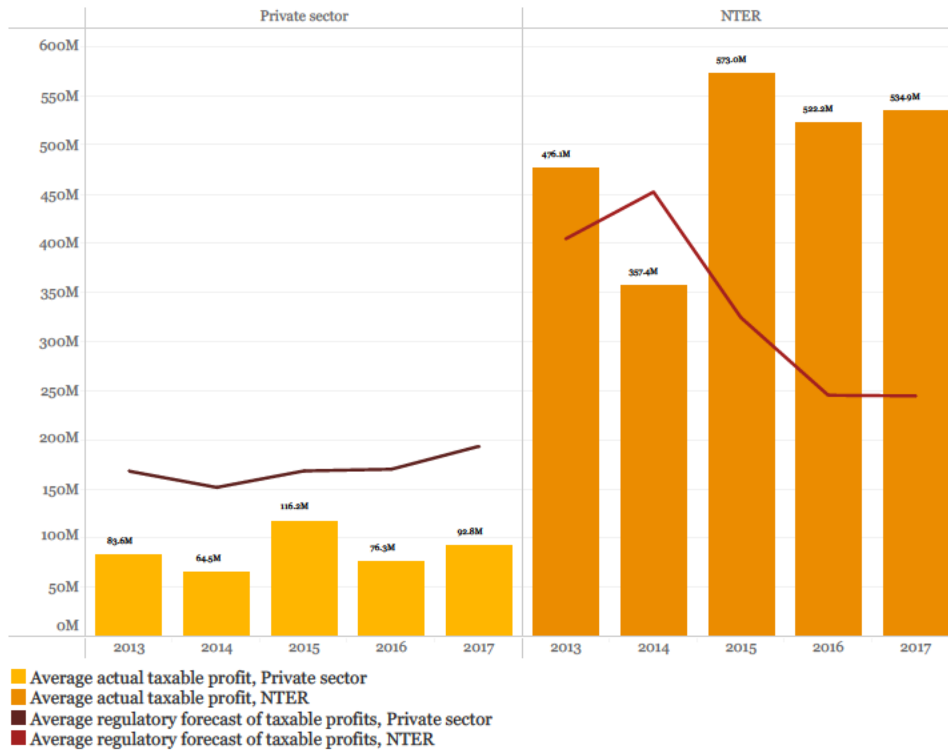


Notes relevant to interpretation of information:

- Refer noted in respect of Figure 6 above.

Next, we have included the net income of the flow through NSPs (e.g. partnership or trusts) in the private sector annual averages, in order to provide a comparison of taxable profits across all responding NSPs to the regulatory forecast of taxable profits for the same entities. This is outlined in Figure 8 below.

Figure 8: Taxable profits based on RIN responses



Notes relevant to interpretation of information:

- The above graph compares the average taxable profit of all NSPs, as compared to the average regulatory forecast of taxable profits.
- The average actual taxable profit figures have been determined based on actual taxable profits reported in the tax returns provided by NSPs voluntarily and in response to the RINs (e.g. taxable income for companies, and net income for partnerships and trusts).
- The average regulatory forecast of tax costs are determined based on the AER's modelled regulatory tax payable. The average regulator taxable profit figures have been determined by grossing up the AER's modelled regulatory tax payable by 30% (being the benchmark tax rate applied by the AER in all instances).
- To the extent regulatory tax allowance is not available, the equivalent NTER return tax payable information has also been omitted.
- The number of NSPs that have provided income tax returns and have available tax allowance information, and are therefore reported above in the average taxable profit amounts are as follows:
  - 2013: NTER: 3 / Private Sector: 5
  - 2014: NTER: 3 / Private Sector: 6
  - 2015: NTER: 4 / Private Sector: 7

- 2016: NTER: 4 / Private Sector: 8
- 2017: NTER: 4 / Private Sector: 9

We note the following in respect of Figure 8:

- This diagram provides a comparison of the forecasted taxable income on an annual average basis for regulatory purposes (e.g. before applying the benchmark tax rate of 30%) to the taxable income or net income (in the case of trusts and partnerships) as evidenced in the RIN responses (prior to any relevant tax offsets or upstream deductions). Whilst this is relevant in considering the appropriateness of the taxable income position of the NSPs as determined in the regulatory forecast of tax costs, the pre-tax positions of the entities should not be read as indicative of actual tax paid amounts. This is due to factors such as the existence of additional deductions attributable to upstream investors in flow through vehicles (noting the restrictions on debt deductions of upstream investors in flow through vehicles from 1 July 2018, as discussed in section 3.1.4 above) and availability of tax offsets (e.g. R&D).

- Consistent with the findings in section 3.1 of our Report, this graph demonstrates that private sector entities on average (including flow through vehicles), derive less taxable profits on an actual basis than that estimated for regulatory purposes. The divergence appears to be greater in the 2016 and 2017 years, which is not unexpected given the number of private sector entities has increased and as noted in section 3.6.1 of our Report, have generally claimed significant upfront deductions for stamp duty paid as a result of those privatisations (resulting in a decrease in the average taxable profits).

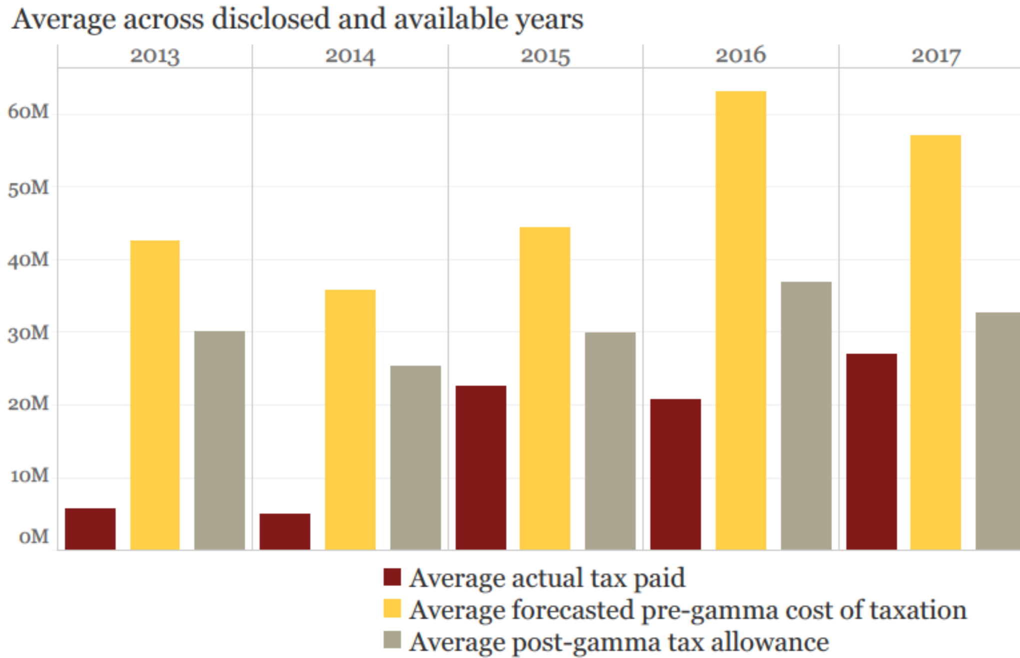
- Consistent with our findings in section 3.1 of our Report, NTER entities on average have reported greater taxable income than the forecast taxable income for regulatory purposes.

Update to actual tax paid v regulatory tax allowance graphs

We have updated Figure 3 and Figure 4 on pages 29-30 of our Report below at Figure 9 and Figure 10 to provide a more complete reflection of the tax paid comparison to the regulatory tax allowance (including post application of gamma) as reflected in our Report.

Where amounts disclosed have changed from our Report, this reflects new information obtained in the RIN responses, outcomes of appeal processes where these resulted in changes to the AER's revenue forecasts (which was not reflected in our Report), corrections to reflect gamma in each decision (including those determined by appeal processes) and annual debt updates not originally reflected in our initial findings.

Figure 9: Updated: Private sector entities – actual tax paid v regulatory tax allowance



Notes relevant to interpretation of information

- Of the 12 private sector NSPs subject to review, 7 are taxed as companies rather than on a flow through basis. Of these 7, 2 did not provide any tax returns in response to either the voluntary information request or the RINs. The remaining 5 who provided information are reflected above, in an annual year-on-year comparison of average actual tax paid against the average forecast of tax cost and related regulator tax allowance.

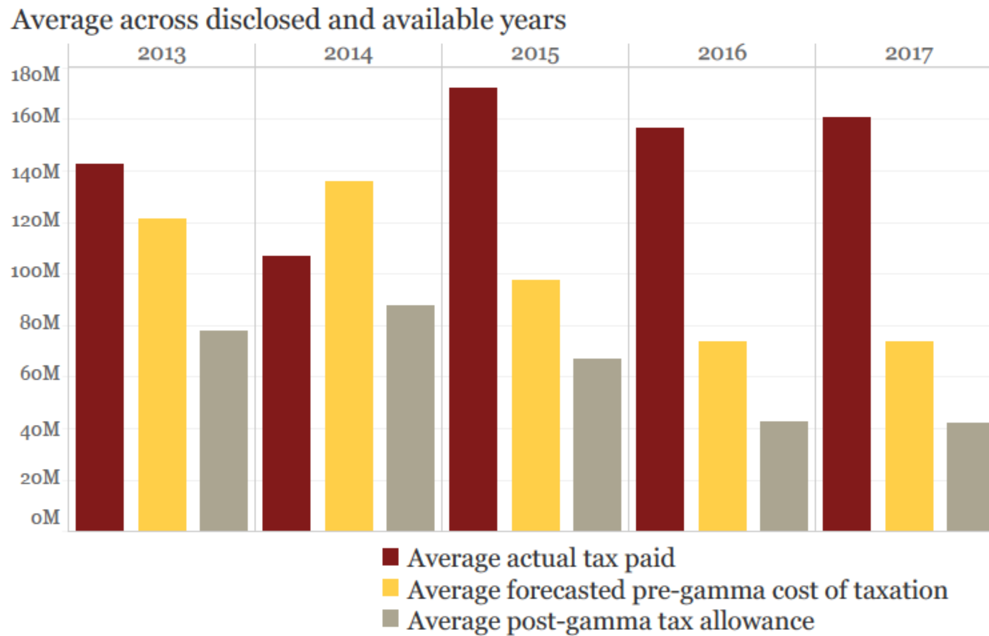
- To the extent the actual tax payments only related to a part year (e.g. the regulated entity was acquired during the year or had a transitional period), the regulatory tax allowance applicable for the year was also pro-rated according to the same period.

- The number of private sector NSPs (taxed as companies) that have provided income tax returns and are therefore reported above are as follows:

    - 2013: 3
    - 2014: 4
    - 2015: 5
    - 2016: 5
    - 2017: 5

- To the extent the actual tax payments only related to a part year (e.g. the regulated entity was acquired during the year or had a transitional period), the regulatory tax allowance applicable for the year was also pro-rated according to the same period.

Figure 10: Updated: NTER entities – actual tax paid v regulatory tax allowance



Notes relevant to interpretation of information

- The above graph compares the average tax payable by NTER entities (as reported in the NTER returns provided on a voluntary basis, and in response to the RINs) to the average forecast cost of tax and relating tax allowance for those same entities for regulatory purposes, on an annual basis.
- To the extent regulatory tax allowance is not available, the equivalent actual taxable profits information has also been omitted. To the extent the actual tax payments only related to a part year (e.g. the regulated entity was acquired during the year or had a transitional period), the regulatory tax allowance applicable for the year was also pro-rated according to the same period.
- The number of NTER NSPs that have provided income tax returns and have available tax allowance information for comparison, and are therefore reported above are as follows:
    - 2013: 3
    - 2014: 3
    - 2015: 4
    - 2016: 4
    - 2017: 4

We note the following in respect of Figures 9 and 10:

- Consistent with our comments in respect of Figure 6 above, the additional RIN information supports our finding that the average annual actual tax payments made by the observed private sector NSPs have been significantly lower than the average annual forecast cost of tax for the same entities for regulatory purposes.
- In respect of NTER entities, the updated RIN information and additional regulatory findings have led to a decrease in the observed differential between actual tax equivalent payments and the regulatory tax allowance in 2013, and an observed excess of forecasted tax costs over actual tax equivalent payments for the 2014 year. The findings in respect of the 2015, 2016 and 2017 report are consistent with that in our Report (subject to minor changes). Notwithstanding the updated information in respect of the 2013 and

2014 income years, this information confirms our findings in the Report that, generally, the NTER entities make significantly higher tax equivalent payments than the regulatory forecast of tax.

Tax losses – updated diagram

Due to the additional income tax return information provided in response to the RINs, we have also been able to update the tax loss diagram originally shown as Figure 5 on page 31 of our Report. The updated diagram is outlined as Figure 11 below.

Figure 11: Updated tax losses diagram

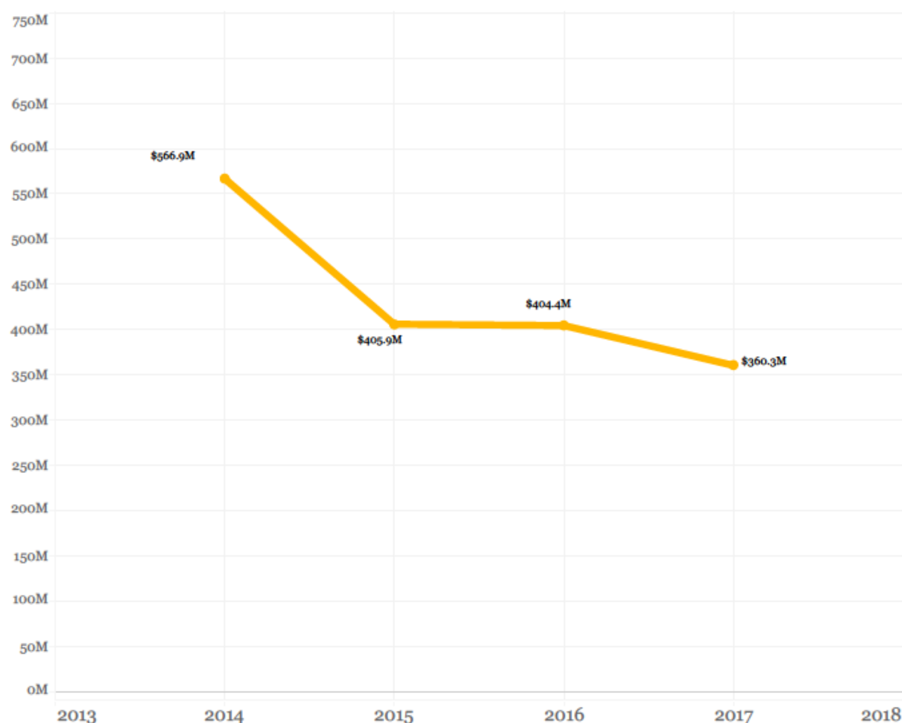


Figure 11 demonstrates a consistent finding with that discussed in our Report, in that the existence of tax losses for private sector corporate groups are considered to be a driver for the discrepancy between actual tax paid and the regulatory forecast of tax costs. We have been unable to reconcile the source of the tax losses reported within the timeframe and due to information constraints present for this review. Accordingly, we have been unable to conclude on whether the source of the tax losses reported relate to factors which are relevant or irrelevant to the regulatory tax allowance (e.g. in or outside of the regulatory ring-fence).

That said, information relating to the stand-alone regulated tax position of each NSP was requested in questions 3.2 and 3.5 of the NSP. In our view, the responses provided by the NSPs in respect of these questions represent the most relevant data source available to consider whether or not the NSPs actual tax obligations would differ from the regulatory forecast of tax if expenditure relating to unregulated activities was excluded for actual tax purposes. This is a relevant consideration in considering the appropriateness of the current regulatory approach to the tax allowance. Our findings in this regard are discussed in section 3.2.2 immediately below.

3.2.2 Stand-alone regulatory tax positions

As noted above, the vast majority of regulated assets are held by legal entities within a broader commercial group which is more often than not consolidated or otherwise aggregated with varying amounts of unregulated assets. Accordingly, whilst the findings in

section 3.1 of our Report and 3.2.1 of our Addendum (immediately above) address the actual tax positions of the NSPs, this does not provide a clear picture of the tax costs of NSPs which are attributable to efficient operation of the regulated network assets (e.g. within the ring-fence only).

In order to assist us to understand the potential actual tax positions of the NSPs Questions 3.2 and 3.5 of the RINs requested the following information:

> *3.2 Where the [distribution/transmission] network service provider is a member of a tax consolidated group provide tax calculations for the [distribution/transmission] network service provider on a stand-alone basis to the extent these calculations have already been prepared (e.g. these calculations already exist), which reconcile to the network service provider's net profit before tax and support the latest income tax return lodged by the Head Company of the tax consolidated group in the last 5 years or period of existence if less than 5 years.*
>
> *3.5 In respect of the latest income tax return lodged only, provide the statement of taxable income which shows all permanent and temporary tax adjustments including, opening and closing balances (and any working papers supporting the adjustments made with respect to capital expenditure for accounting or tax purposes) that reconciles taxable income to net profit before tax for the [distribution/transmission] network service provider (and any related stapled entities that hold a direct interest in the network assets) and any of its downstream associated entities.*

The approach taken in responding to the RIN questions outlined above varied between respondents. Some respondents provided itemised tax reconciliations which were specific to regulated income and expenses (e.g. regulated net profit before tax) only, whereas other respondents merely provided tax reconciliations split by legal entities within the NSP's broader group structures, which have required us to make certain assumptions regarding legal entities and regulated asset holders (having regard to the group structures provided). As question 3.5 only requests the detailed tax reconciliation in respect of the latest lodged income tax return, we have used this single income year as our analysis point for the purpose of this review.

Due to the variation in approaches taken by NSPs to respond to questions 3.2 and 3.5 of the RINs (e.g. differing methods to disaggregate regulated information from unregulated information), only limited reliance can be taken from our findings in respect of this information as aggregated industry level observations do not always include like for like responses between NSPs. Further, where NSPs have made assertions or disclosures relating to the quantum of profit before tax and subsequent tax reconciliation items relating to regulated income and expenditure, we have had to rely on the statements made by the NSPs in this regard as there is no practical way to verify these disclosures to the income tax returns or other relevant external information within the time frame allowed. As noted in section 1.3.2 above, we have not conducted an audit or other verification of any information supplied to us and have assumed that the information supplied to us is accurately stated, true and accurate (in accordance with the statutory declarations provided by the NSPs).

Accordingly, while our findings outlined in this section are relevant to the consideration of the appropriateness of the current approach to the regulatory forecast of tax costs having regard to regulated activities only, it should not be taken as definitive findings as to the nature and size of any variances between the actual tax paid and the regulatory forecast of tax costs.

Findings

In preparing stand-alone tax positions, the majority of responding entities provided a tax reconciliation which started with the regulated (or legally ring-fenced regulated entity) profit or loss before tax, and made certain adjustments for tax purposes to arrive at the (or legally ring-fenced regulated entity) taxable income position which supports the relevant lodged income tax return. This is a standard approach when determining the income tax position of

an entity, whereby 'tax adjustments' are made in respect of items which may be recognised on a different basis or at a different value (e.g. accounting and tax depreciation) such that a reconciliation between accounting net profit before tax and taxable income must be performed. As noted above, this information has been requested from the respondents in respect of the latest income year for which an income tax return has been lodged.

The starting point for this calculation, being regulatory accounting (or book) profit, has been determined solely by the NSP and cannot be verified as part of this review (due to the limitation in timeframe and availability of information noted above). Our expectation is that the NSPs have had regard to the accounting transactions relating solely to the efficient operation of the network assets in arriving at this amount.

Tax adjustments are then applied to arrive at a regulatory taxable profit position. Tax adjustments are normally explained as either 'temporary' (whereby whilst year on year adjustments are required, the total accounting and tax income or expense recognised should generally align over the long term, e.g. accruals or provisions adjustments), or 'permanent' (whereby account and tax adjustments will differ permanently, e.g. non-deductible entertainment and penalties, and R&D offsets).

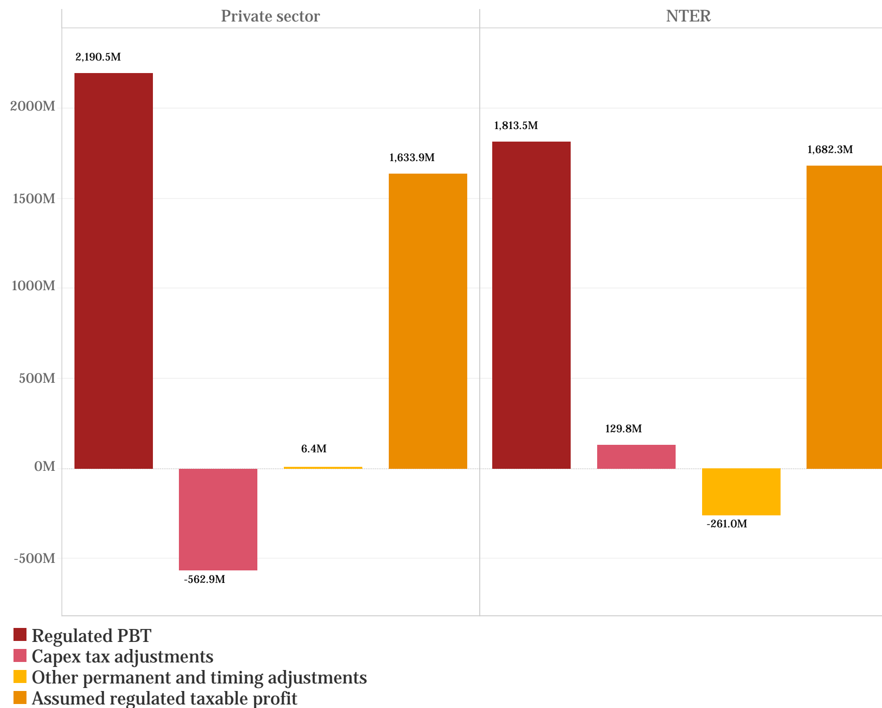
As noted in section 2.1 and 3.1 of our Report, the observed transactions entered into by the NSPs which are relevant to considering the efficient operation of the network assets (e.g. within the ring-fence) include:

- Opex (relating to regulated activities);
- Capex (relating to regulated activities); and
- Financing costs (to the extent the financing is attributable to the regulated assets).

As such, on review of the stand-alone tax reconciliations provided by the NSPs, we have sought to separate the relevant tax adjustments into categories which assist to understand how the stand-alone regulated tax position of the respondents may differ from the actual tax positions as reflected in the lodged income tax returns.

This may assist to understand the impact of 'tax only' adjustments which may cause the tax position of the participants to differ from that currently estimated for regulatory purposes. Due to restrictions in the level of information provided in respect of some tax reconciliation items, we have not been able to consistently separately identify adjustments relating to financing for each NSP as opposed to other timing or permanent tax adjustments. In all instances, tax adjustments relating to Capex have been separately identified. Accordingly, our aggregated findings in respect of the stand-alone regulated entity tax calculations are reflected in Figure 12 immediately below.

Figure 12: Estimated stand-alone regulated tax positions



Notes relevant to interpretation of information:

- The above graph represents the aggregated regulated accounting profit (before tax), tax adjustments, and regulated taxable profit (before applying the applicable tax rate and any relevant offsets) for all NSPs which have provided appropriate information, in respect of the latest year for which an income tax return has been lodged.
- All NSPs have responded to the RIN questions outlined above with reconciliations outlining stand-alone taxable profit positions. For one regulated entity (which is part of a broader NSP group), the regulated accounting profit could not be determined. Accordingly, this regulated entity has been excluded from the aggregated figures outlined above.
- Where tax reconciliations have been provided for a tax consolidated group (on an entity by entity basis), we have used judgement to determine which stand-alone legal entities should be included in the consolidated regulatory tax calculations based on the group structures provided.
- To arrive at the stand-alone taxable profit position, we have also used judgement to classify the relevant tax adjustments as relating to Capex, or “other timing and permanent adjustments”. To the extent any tax adjustments relate to factors outside of the regulatory ring-fence, these are not disclosed above (as the intention is to demonstrate a tax reconciliation purely for regulated activities).

Figure 12 demonstrates the following:

- On an aggregate basis, the regulated accounting profit positions disclosed by the NSPs are higher than the equivalent starting point for the tax calculation within the regulatory forecast of tax costs. We have not been able to reconcile this difference (as we have had to rely solely on the profit amount disclosed by the NSP for the purpose of responding to the specific RIN questions), however expect that this difference relates to different approaches in determining regulatory profit for financial reporting purposes to that adopted by the AER.
- The largest tax reconciliation adjustments made by private sector entities in respect of the regulated profit before tax relate to Capex (resulting in an aggregate $562.9m decrease in taxable profits across the responding entities as noted above). This can be compared to a positive increase of only $129.8m in relation to Capex adjustment for the NTER entities. This supports our findings in section 3.3 of our Report whereby it was

evidenced that private sector entities generally accelerate deductions relating to Capex (e.g. through use of the diminishing value method of tax depreciation) whereas for NTER entities Capex adjustments generally contribute to greater actual tax payable than the regulatory forecast of tax costs (as we evidenced a lower actual depreciable tax basis for NTERs than the TAB for those same entities in section 3.1 of our Report) .

- Other permanent and timing tax adjustments (including financing) do not have a material impact the difference between the stand-alone accounting profit positions and the stand-alone regulated taxable profit positions of the private sector NSPs on an aggregate basis.

- Other permanent and timing differences are material for the NTER entity, however this appears to relate largely to year end revenue recognition criteria, which would be expected to be only a short term timing difference, and therefore does not impact the findings from our review.

In addition to the above, we note that in all instances the stand-alone position for each NSP (when consolidating all discrete regulated entities) reflects a taxable regulatory profits position (after accounting for the relevant tax adjustments). This demonstrates that, if the latest income year for which an income tax return has been lodged can be used as an accurate reflect of the standard annual tax position for these entities, we would expect all NSPs to be in a taxable profits position when factors outside of the regulatory ring-fence are excluded from the actual tax positions of each entity.

These findings support the fact that the recommendations made in our Report regarding changes to the regulatory model assumptions relating to Capex will better align the actual taxable positions of the regulated entities to the forecast taxable position for regulatory purposes.

3.3 Observations on other matters discussed in our Report

This section outlines any specific matters which were discussed in our Report whereby the RIN responses have provided additional information relevant to our analysis.

3.3.1 M&A Activity and tax consolidation

Uplifts in depreciable tax bases

In section 2.2.3 of our Report, we recommended that the regulatory forecast of tax costs should not be adjusted to take into account uplifts in tax depreciable cost bases of assets due to M&A activity on the basis such costs are not recoverable by the NSPs under the regulatory model and should not be considered as incurred in the efficient operation of the regulated business. In particular, we noted:

- Neither the direct costs associated with the M&A activity nor the step up in the cost base of assets (generally as a consequence of acquisition proceeds over and above the existing base) are referable to the efficient operation of the regulatory assets. As a consequence these costs are not recoverable under the RAB.
- The step up in the tax cost base is generally (but not in all instances) matched by a tax cost to the seller (e.g. taxable gains can arise to the seller which recapture previous depreciation that had been claimed). Any adverse tax costs to the seller would arguably also need to be taken into account.
- The application of the tax consolidation rules especially around the resetting of the tax base of depreciable assets introduces substantial integrity risk not consistent with the regulatory regime. For example, the existence of liabilities and the cost of any equity at the date of the NSP joining a tax consolidated group which are unrelated to the regulated assets would be taken into account in resetting the tax cost base of the regulated assets. This introduces substantial integrity risks as liabilities associated with non-performing unregulated business assets could inappropriately skew value into the regulated depreciable assets and vice versa which would be not be acceptable.

In addition, Dr Martin Lally notes in his paper to the AER dated 25 October 2018 that the tax benefit of any tax cost base uplift resulting from a change of ownership should not be passed onto consumers on the basis "*acting otherwise would reduce the offer price in the purchase offer, thereby discouraging some changes of ownership from occurring, and this is not socially desirable.*"

At the time of writing our comments in our Report above, information relating the impact of uplifts in depreciable tax base on the actual tax position of the NSPs had not been received. In particular, questions 4.2 and 4.3 of the RINs requested the following:

> *4.2 If the [distribution/transmission] network service provider is a member of a tax consolidated group confirm whether there has been any reset of the tax cost base of regulated assets as a consequence of the tax consolidation rules during the last 10 years. Please state if either and/or both of the following has occurred:*
>
> *(a) Step up in tax value of assets*
>
> *(b) Step down in tax value of assets*
>
> *4.3 If either a step up and/or down in the tax value of regulated assets has occurred and is noted in response to item 4.2 of this schedule, quantify the total gross increase or decrease in the tax cost base of depreciable assets (where possible, split between regulated and unregulated assets). If there has been more than one event resulting in a resetting of the tax cost bases, please provide the total gross increase or decrease attributable to each separate event.*

We have now received responses to the RIN questions from all of the regulated businesses, and note the following in respect of the responses to questions 4.2 and 4.3:

- Question 4.2 is only relevant to the 7 NSPs which are taxed as a company. The 5 flow through vehicles are not subject to the tax consolidation regime and therefore would not experience a resetting of the tax depreciable cost base of assets on a change of ownership unless the assets were acquired directly which is unlikely to occur (unless a 100% acquisition occurred).
- As noted in our Report, all of the 7 NSPs which are taxed as a company have elected to apply the tax consolidations regime.
- Of these 7 NSPs, 4 have reported a reset of the tax cost base of regulated network assets at least once in the last 10 years. 3 of those respondents reported step ups in the tax depreciable cost of their regulated assets, and 1 respondent reported a step down only. Two of these respondents provided a split between the step up / step down attributable to regulated versus unregulated assets.
- Of the 3 NSPs which reported step ups in the last 10 years, the average total increase in tax depreciable cost of assets across all years per NSP was $2.06b across all assets, or $1.98b excluding assets designated as unregulated.
- One NSP reported a step down in asset values only (note, we have not reported the quantum of this step down to preserve confidentially, however consider the amount immaterial in comparison to the step ups).

This data shows that while the resetting of tax cost bases under the tax consolidations law is not widespread across the regulated entity, in instances where it has occurred, the increase to depreciable tax bases has been significant.

Notwithstanding these findings, we have not changed our recommendation in relation to step ups, in that we do not recommend uplifted tax asset values are recognised in the regulatory forecast of tax costs on the basis (1) the costs are not recoverable to the NSPs under the regulatory framework, and (2) the costs should not be seen as a cost attributable to the efficient operation of the network assets.

We have not provided any further commentary on the resetting of cost bases of depreciable assets which occurs on privatisation of assets under Division 58 of the ITAA 1997, as this has been addressed in detail in section 3.3.6 of our Report.

Stamp duty

In section 3.6.1 of our report we discussed the income tax treatment of stamp duty and the expected resulting discrepancy between actual tax paid and the regulatory forecast of tax costs. In particular, we noted that where privatisations have recently occurred by way of long term leases (e.g. NSW privatisations), it is expected that any stamp duty paid by the acquiring entity will be treated as immediately deductible in accordance with section 25-20 of the ITAA 1997.

Further, we noted that such costs should not be taken into account for the purposes of the regulatory forecast of tax costs on the basis that stamp duty is not recoverable by the NSPs for regulatory purposes (as it considered an M&A cost) and therefore inclusion within the tax allowance would create a misalignment between the tax allowance and the other building blocks within the regulatory model. At the time of our report however, we had not been able to quantify the expected impact of the relevant stamp duty deductions as not all entities had provided this information on a voluntary basis.

To assist us to quantify this impact, the following information was requested in question 6.1 of the RINs:

> *6.1 To the extent the [distribution/transmission] network service provider (and any related stapled entities) holds assets that have been privatised, please confirm the tax treatment of any stamp duty payable as a consequence of the privatisation (and the quantum of duty paid) by the [distribution/transmission] network service provider (and any related stapled entities that acquired a direct interest in the*

network assets) including but not limited to circumstances where any stamp duty payments have been:

(a) treated as immediately deductible pursuant to section 25-20 of the ITAA 1997, or

(b) added to the cost base of depreciable assets (directly or through application of the Allocable Cost Amount (ACA) calculation and allocation methodology).

We have now received responses to the RIN questions from all of the regulated businesses, and observe the following in respect of question 6.1:

- Recent privatisations have given rise to material stamp duty payments which either have, or are expected to be, treated as immediately deductible for income tax purposes.
- The average deductible stamp duty payment observed in respect of privatisations within the last 5 years is approx. $595.3m. As noted above, this is not a recoverable costs and therefore should not be taken into account in determining the regulatory forecast of tax costs. That said, it is a material (but justifiable) driver for the differential between actual tax payments and the regulatory forecast of tax costs in respect of the recently privatised entities.
- The average amount of stamp duty paid in respect of privatisations for which respondents have indicated those costs have been capitalised to the depreciable tax cost based of the network assets is considerably lower (an average of $17.5m per NSP which has disclosed capitalised stamp duty costs).

The findings above have confirmed our expectations in relation to the materiality of deductible stamp duty in respect of recent privatisations. Consistent with our recommendations in section 2.2.3 of our Report, we do not recommend any changes are made to the regulatory model in respect of deductible stamp duty costs on the basis these costs are not recoverable to the NSPs under the regulatory framework, and should not be seen as a cost attributable to the efficient operation of the network assets.

3.3.2 Capital expenditure and depreciation deductions

In sections 2.2.2 and 3.3.4 of our Report, we recommended that AER should consider changing the regulatory tax allowance to treat refurbishment capital expenditure as immediately deductible, having regard to the potential non-tax commercial implications.

This recommendation was based on the information available to us at the date of the Report, which indicated that, on average:

- $81.5m of the regulatory capex included in TAB was claimed as an immediate deduction by each regulated entity annually; and
- $108.7m was claimed by each NSP (as some NSPs hold multiple regulated entities) annually.

The RIN requested the following information (see question 5.4):

Provide a summary which identifies the total quantum of expenditure which is included in the regulatory fixed asset register (e.g. reported actual capex for regulatory purposes), but has been treated as immediately deductible for income tax purposes (e.g. refurbishments, overheads), in respect of income in the past 5 years, or period of existence if less than 5 years.

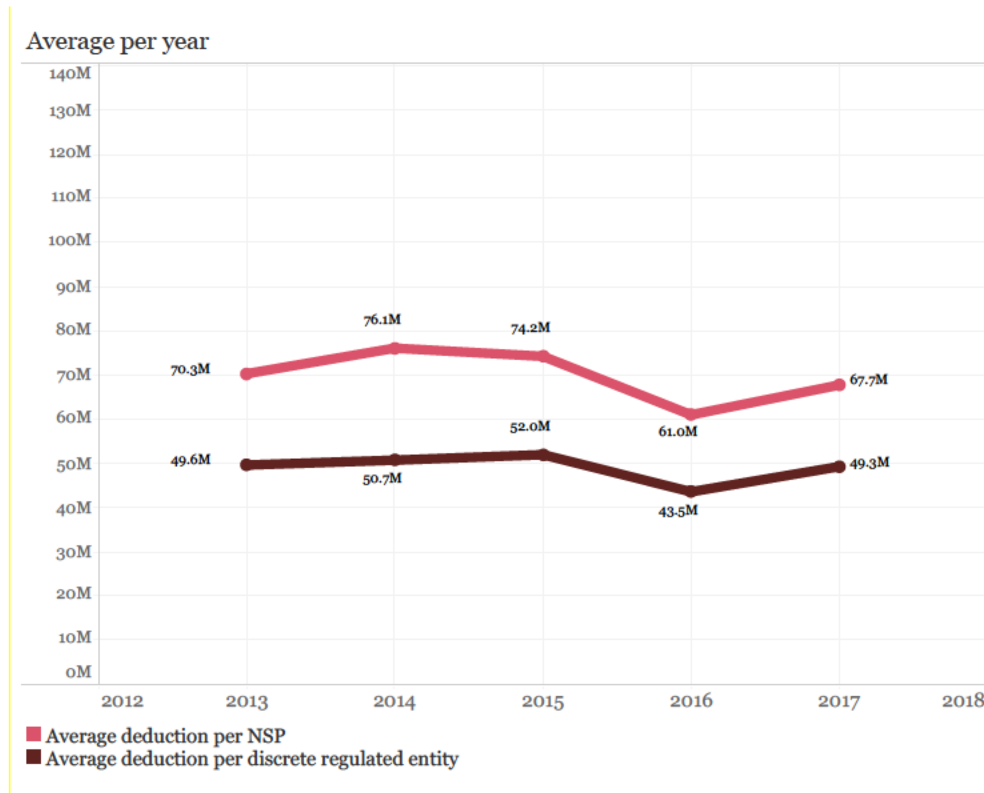
Our analysis of the information received in response to the RIN indicates that the average amount of immediately deducted capital expenditure is lower. On average:

- $48.9m of the regulatory capex included in TAB was claimed as an immediate deduction by each regulated entity annually; and
- $69.5m was claimed by each NSP (as some NSPs hold multiple regulated entities) annually.

The difference in the number is attributable to the fact that more NSPs responded to the RIN (as compared to the voluntary requests for information) and the quantum of immediately deducted capital expenditure for those NSPs was low (or nil).

The graphs below update Figure 15 of our Report, reflecting the information received in the RINs.

Figure 13: Average amount of Capex in the TAB immediately deducted annually for actual tax purposes (updated)



Notes relevant to interpretation of information:

- This graph shows the average quantum of regulated Capex which has been treated as immediately deductible annually for income tax purposes (per NSP, across NTER and private sector entities), based on the RIN responses. Amounts disclosed represent gross deductions claimed (not tax effected).
- There was considerable variation between entities. The range extended from less than $5 million to greater than $200m (calculated as the annually deductions for individual entities, averaged across the period), with standard deviation across all regulated entities of approx. $74.1m.

Notwithstanding that the updated information shows that the amount of regulatory capex claimed as immediate deductions is lower than originally thought, we are of the view that the observed difference still gives rise to a material divergence in the timing of actual tax paid and the tax allowance determined under the existing regulatory approach. We therefore confirm our original recommendation that the immediate deductibility of some of these costs should be taken into consideration for the purposes of determining the estimated cost of taxation, subject to the AER assessing the commercial impact of this amendment.

In respect of the findings in section 3.3 of our Report relating to capital allowances more broadly (e.g. depreciation methods and effective lives), additional tax fixed asset register information was only provided by one NSP as part of the RIN responses. This was due to the fact that where available, tax fixed asset register information had largely been provided by the NSPs on a voluntary basis. The additional tax fixed asset register information has had no material impact of the findings of our report (as this NSP represented less than 1% of the total regulated asset holders by TAB value). Accordingly, our findings and recommendations in respect of all other aspects of section 3.3 of our Report have not changed.

3.3.3 R&D tax incentive

For an overview of the R&D tax incentive, please refer to section 3.6.2 of our Report.

In sections 2.2.5 and 3.6.2 of our Report, we recommended that the AER tax allowance model should not be adjusted to take into account the impact of R&D tax incentives on the basis that they do not appear to have a material impact on the tax differential. In addition, the Report noted:

- The R&D tax incentive is designed to encourage companies to engage in R&D – adopting a forecast cost of tax for regulatory purposes which effectively removes this tax incentive would appear to be at odds with the intended outcome of the policy.
- Where the R&D expenditure is not recoverable under the regulated tariff, in our view any R&D tax concessions should in any case be excluded from the calculation of the tax allowance in line with the broader regulatory framework.
- Legislation proposing to amend the R&D tax incentive is currently before Parliament which, if passed, will mean the R&D tax incentive program will be more targeted and therefore harder to access.

At the date of our Report, limited information was available in relation to the R&D tax incentives claimed by the NSPs. The RIN requested the following information (see question 3.6):

> *Provide details of any Research & Development (R&D) tax incentive claims made by the [distribution network/transmission network /scheme pipeline] service provider and any related stapled entities in respect of expenditure incurred in respect of regulated assets for the last 5 years (or period of existence if less than 5 years), including a summary of the quantum of expenditure for each of the registered R&D activities, and a description of that activity.*

We have now received responses to the RIN and make the following observations.

The number of NSPS that claimed R&D tax incentives was as follows:

	2013	2014	2015	2016	2017
No. of NSPs that claimed R&D tax incentives	3	4	3	2	3

The total quantum of R&D tax incentives claimed by the NSPs was:

	2013	2014	2015	2016[11]	2017
R&D expenditure	$ 10,220,697	$ 12,031,993	$ 12,432,644	*	$ 7,428,912
R&D tax offset[12]	$ 4,088,279	$ 4,812,797	$ 4,973,058	*	$ 2,860,131

This data shows that the aggregate R&D tax offsets claimed by the NSPs was less than $5m in each of the last five years. This confirms the observation made in our Report, being that R&D tax offsets have not resulted in a material discrepancy between actual tax paid and the estimated cost of taxation for regulatory purposes.

In addition, and as discussed in section 3.6.2 of our Report, proposed legislative reforms is expected to substantially reduce R&D claims for NSPs going forward.

[11] 2016 R&D claim amounts not shown to preserve confidentiality (given only 2 NSPs included).

[12] Non-refundable carry forward offset of 40% for income years up to 30 June 2016 and 38.5% for income years from 30 June 2017 onwards for expenditure up to $100m.

Accordingly, we confirm our original recommendation that no change be made to the AER tax allowance model in respect of R&D tax incentives.

Schedule 2: Response to Submissions

This Schedule provides a response to the technical aspects of submissions on the AER's Discussion Paper which was released on 2 November 2018, along with PwC's Report dated 26 October 2018 and Dr Martin Lally's paper dated 25 October 2018 (the **Submissions**). Submissions were due on 23 November 2018 and 20 submissions were received from 21 November to 4 December 2018 (noting 4 were late).

This Schedule seeks to address the technical aspects of the Submissions only, and in particular where relating to the findings of our Report. Matters pertaining to policy decisions will be addressed by the AER.

1. Tax pass through method

Our Report recommended that the benchmark efficient entity approach to the tax allowance is maintained (as opposed to adopting an actual tax "pass through" approach) on the basis determining actual tax payable in respect of the regulatory assets only would be difficult and costly, and potentially lead to inequitable outcomes between different classes of investors.

The following has been noted in the Submissions in respect of the tax pass through approach:

- The Department of Environment and Energy (**DoEE**) supports consideration of an actual tax pass through approach due to the potentially material benefit to consumers.[13]

- No other submissions have supported a change to an actual tax pass through approach. In particular, the Consumer Challenge Panel (**CCP**) consider that it is appropriate to continue to apply the existing efficient entity benchmark approach, with an emphasis to progress towards a benchmark that better reflects the tax position of the benchmark entities.[14]

- Energy Consumers Australia (**ECA**) have noted there is "uniform agreement" that the inventive approach to tax allowances should continue, and then discusses ways in which any efficiency savings can be passed on to consumers.[15]

PwC response:

Section 3.1.4 of our Report considered there would not be merit in adopting a pass through of actual tax costs approach due to difficulties in:

- Determining actual tax costs in respect of the regulated assets within integrated and consolidated commercial groups;

- Identifying actual tax paid by upstream investors in flow through structures (both domestically and offshore);

[13] DoEE, Submission to the AER's Review of Regulatory Tax Approach, pages 5-6.

[14] CCP, Submission to the AER, page 34.

[15] ECA, Submission to Discussion Paper, page 2.

- Providing an equitable outcome to different investors with different tax profiles (e.g. the risk that a higher tax paying entity would be funding a lower tax paying entity);

- Ability to true up actual tax payments in respect of transactions relating consolidated groups, M&A activity, amendment of assessments of prior year tax positions, and changes in the application of interpretation of historic tax law; and

- The fact that actual "tax paid" is not a temporal concept given that amendments can be made by the taxpayer or the ATO to historical tax positions.

  As noted in section 3.1.4 of our Report we see challenges in determining "actual tax" under a tax pass through method. It is common for tax assessments for previous income years to be amended in future years (either within or beyond the 4 year statute of limitations), through either re-assessment by the taxpayer or as a result of ATO dispute, legislative change, or changes in interpretative issues. In some instances (such as transfer pricing and Part IVA) amendments may go back many years. An example of this is the recent Chevron Decision referred to in our Report.[16] In this regard, electricity and gas consumers will be subject to any settlements to resolve disputes between the ATO and NSPs (this raises inter-generational issues as raised in our Report).

  This would also potentially require consideration of the level of disclosure required around settlements (which are typically confidential) given it will directly impact on electricity and gas prices and therefore would need to have a level of transparency consistent with the other building blocks.

The DoEE submission does not provide any detailed suggestions as to how to overcome the complexities outlined above. We recommend detailed consideration is given to practical methods by which each of these issues can be addressed prior to proceeding with further consideration of an actual tax pass through approach.

Further if the benchmark approach is amended to be tax paid we would also make the following additional observations:

i. Actual tax paid has no regard to the regulatory ring fencing. This means that actual tax paid could take into account non regulatory expenditure and income which is completely inconsistent with the broader regulatory framework. This matter is also identified in the Supplementary Response prepared by ENA dated 4 December 2018.[17]

   This also has the risk that NSPs in groups with substantial non regulatory activities would therefore benefit from a recovery of taxes that have no reference to the efficient operation of the network assets. This would disadvantage specific customers based on the broader tax profiles associated with the NSP that services their region.

ii. Under such an approach private sector entities would have no motivation to act in a business-like manner in dealing with their tax affairs. In particular the adoption of an actual tax pass through which includes the tax implication of market transactions could see a substantial increase in tax paid. For example, the construct of the Tax Law currently creates a natural disincentive to taxpayers selling a direct interest in privatised assets (as opposed to the equity in the vehicle that holds the privatised assets) as it creates substantial taxable gains where Division 58 has originally applied to cap the tax basis of the assets

[16] *Chevron Australia Holdings v Commissioner of Taxation* [2017] FCAFC 62.

[17] ENA, Review of Regulatory Tax Approach: Supplementary Response, page 2.

below market value as noted in our Report. In effect this disincentive would effectively be removed by the adoption of an actual tax pass through model whereby the NSP would not bear the ultimate cost of any tax payable associated with selling a direct interest in the assets which could be passed on to consumers by increased costs.

iii. In this regard a change to an actual tax paid approach should recognise that the environment is dynamic and it would be reasonable to expect that NSPs will respond. In this regard any risks associated with the tax affairs of the taxpayer (including holding structure) would effectively move to the customer and there would be no benefit in the taxpayer choosing an interpretation of the tax law contrary to a position the ATO would take. Interpretation of the tax law is a central pillar of the Australian tax framework. In this regard the NSP would have no vested interest in adopting uncertain tax positions which are reasonably arguable given they would be exposed to the cost and resources and bore the risk of any interest and penalties whilst any benefit resided with the customer.

iv. It may also mean that any risk associated with disputes with the ATO would reside with the consumer. Where a tax paid approach is adopted the NSP would have no vested interest in spending time and resources (including money) trying to achieve an optimum outcome in settlement.

v. It is also unclear under an actual tax pass through approach how consumers would be protected from the tax impact of M&A activity. For example, if M&A costs such as stamp duty or uplifts in tax depreciable asset values are treated as deductible for the purposes of the tax allowance, then it is difficult to see how any subsequent taxable gains on disposal of assets through further M&A activity could not also be required to be reimbursed through the tax allowance. This is consistent with the comment regarding Division 58 noted above. Given the value of some transactions witnessed in the electricity and gas markets, this could have a significant impact on consumers.

vi. Further, an actual tax pass through approach may create iterative issues when determining the final tax liability. As the tax allowance forms part of the assessable income of a taxpayer and therefore their tax liability, a further tax liability would arise in respect of the tax allowance calculated on a pass through basis. This further tax liability would then be included in the tax allowance, further increasing revenue and the subsequent tax liability. This issue would need to be considered further under a pass through model to address this technical aspect.

Accordingly, having regard to the above matters, in our view there is a risk that tax costs over time could increase. In the first instances as noted above tax costs could increase regardless of NSP restructuring into a company and the adoption of an actual pass through approach would therefore need careful consideration. We expect that the concern raised by Dr Lally around the lack of incentives for NSPs to appropriately minimise tax relating to the observations noted above which in our view are a genuine risk associated with an actual pass through approach. None of the submissions have addressed any of these matters including how to mitigate the risk of increased tax costs. .

To the extent an actual tax pass through approach is adopted, this becomes specific to a taxpayer and then also raises the application of gamma where a foreign resident cannot utilise or benefit from the franking credits. Consideration of this issue becomes material

especially where the overall tax cost becomes higher than currently under the tax allowance.[18]

Of relevance is that the DoEE in its submission also states that "even if NSPs were to increase their tax payments by restructuring to an Australian company they would be subject to company tax. Consumers would be no worse off, and in addition receive a welfare benefit as revenue previously retained by investors will now be paid as tax".[19]

We agree that an actual tax paid flow through model will create a risk that NSPs held in flow through entities would consider restructuring into a company especially given that the tax concessional rates applying to foreign residents associated with these structures have a finite life. This would be more likely for operating trusts which would otherwise by subject to Division 6C. Such restructures would be complex and any costs associated with such a restructure (including any stamp duty) would need to be factored in by NSPs.

In this regard, it would seem that such an approach (i.e. to change the regulatory model prompting NSPs to consider restructuring to a company structure) would have the outcome of effectively unwinding the tax concessions afforded to foreign residents prior to the end of the proposed grandfathering concessions contained in *the Treasury Laws Amendment (Making Sure Foreign Investors Pay Their Fair Share of Tax in Australia and Other Measures) Bill 2018*. This seems to be at odds with the policy intent of the Federal Government of preserving these concessions for a stated period.

It is noted for completeness that the adoption by the NSP of a company structure would not impact on the after tax outcome for Australian superannuation funds.

Recommendation

Our review has focused on achieving a better alignment between calculating the regulatory tax cost with the actual tax practices adopted by NSPs in respect of the revenue and expenditure items within the regulatory building blocks. The proposed recommendations in our Report and the Addendum as they pertain to interest expense (in particular gearing ratios) are consistent with this approach having regard to the regulatory framework pursuant to our agreed scope of work.

Based on our work to date and having regard to the Submissions we remain of the view that an actual tax pass through approach is complex (as noted by the matters noted above) and does not align with the ring fencing associated with the broader regulatory framework. None of the submissions addressed any of the concerns noted above with respect to the risk of the tax affairs ultimately residing with consumers and how such risks could be managed from a policy perspective. Accordingly we have not changed our recommendation.

We note for completeness that a change in the broader policy framework is outside our scope of work.

The assumption that the benchmark efficient entity is an Australian company

The DoEE submission considers that an Australian company is not an appropriate benchmark entity for setting the tax allowance on the basis, amongst other things, "only 7 of the 17 NSPs are taxed as an Australian company".[20]

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[18] As instructed by the AER, our report has not considered the application of gamma, but rather any discrepancies arising between actual tax payments and the regulatory forecast of tax costs (e.g. prior to the application of gamma).

[19] DoEE, Submission to the AER's Review of Regulatory Tax Approach, pages 6.

[20] DoEE, Submission to the AER's Review of Regulatory Tax Approach, page 4.

This comment seems to overlook the fact that under the regulatory model the State/Territory Owned Enterprises which are subject to the NTER are considered to be taxed as a company (given that a tax equivalent liability is paid to the relevant State/Territory owners). When NTER entities are taken into account, 12 of the 17 NSPs are taxed as a company. Further, profits of 2 of the flow through entities flow directly and entirely to entities which are taxed as a company. On this basis, only profits of 3 of the 17 NSPs are taxed other than as a company.

In determining the appropriateness of the tax allowance, it is important to have regard to the classification of the State/Territory Owned Enterprises for the purpose of the National Gas and Electricity Rules. The Rules apply to NTER entities on the basis they are taxed as a company, and accordingly, in considering the appropriateness of the benchmark entity for the purpose of the tax allowance, it would appear inappropriate to consider NTER entities as anything other than a company.

Of significance is that COAG entered into the Competitive Principle Agreement (**CP Agreement**) on 11 April 1995 (as Amended to 13 April 2007).[21] The CP Agreement establishes a policy of competitive neutrality (**CN**). This requires government businesses operating in a market where there are actual or potential competitors should not enjoy any competitive advantages simply as a consequence of their public ownership. Not allowing State/Territory owned enterprises to recover tax equivalent payments would appear to disadvantage these entities, bringing into question whether this would be in breach of the CP Agreement and the concept of CN.

The objective of the policy is to eliminate potential resource allocation distortions arising from the public ownership of significant business activities in a contestable environment and to encourage fair and effective completion in the supply of goods and services. The ability of government owned business activities to compete unfairly can have significant economic efficiency and equity implications. As a consequence the application of CN requires payment of all relevant Commonwealth and State direct and indirect taxes or tax equivalents.

The DoEE submission does not expand on why the concepts and principles underpinning the CN should not be respected for the purposes of determining the tax allowance. In particular on what basis the tax equivalent payments being imposed at the company tax rate could be ignored in determining the percentage of entities taxed as a company.

Recommendation

As noted in our Report the recognition of the tax equivalent payments for the purposes of determining a benchmark efficient entity approach is ultimately a matter of policy. However, without any arguments advanced or specific direction by the AER instructing us to ignore the concepts of neutrality contained in the CP Agreement we are not in a position to change our recommendation based on the objective evidence. Specifically, based on objective evidence at least 72.3% of the regulated assets (by TAB value) are subject to tax at the company tax rate (including NTER entities) and as a consequence supports our original recommendation that the benchmark entity should remain a company for the previous reasons advanced.

2. Holding structures and tax rates

As noted above, our Report concluded that a corporate tax paying entity was an appropriate benchmark entity for the purposes of the regulatory forecast of tax cost, based on the observation that 72.3% of the regulated assets (by TAB value) are held by entities which are subject to the corporate tax rate.

[21] See https://www.coag.gov.au/sites/default/files/agreements/competition-principles-agreement-amended-2007.pdf

The following has been noted in the Submissions in respect of the appropriateness of the benchmark 30% corporate tax rate:

- The DoEE disagrees that a corporate tax paying company is an appropriate benchmark, noting in particular that only seven of the 17 NSPs are taxed as an Australian company (we note for clarity this number excludes the five NSPs which are subject to tax equivalent payments under the NTER), and that "no NSP is majority owned by Australian-resident companies whose shareholders are majority Australian".[22] Our response in this respect is addressed in section 1 of this Schedule above.

- The CCP recommends that the AER should consider applying two benchmark tax rates.[23] Specifically, a 30% tax rate for corporate tax paying entities, and a 15% tax rate for NSPs which are held in any structure other than a corporate taxpaying entity.[24]

- No other Submissions suggest a change from the current 30% corporate tax paying entity benchmark. Some have commented that no obvious alternative benchmark rate exists.

PwC response:

Submissions received from the DoEE and CCP in relation to tax rates have acknowledged the legislative reform[25] however commented that due to transitional periods and the potential for some investors to continue to receive concessional tax treatment, a material discrepancy will remain for a relevant period.

Due to the complexity associated with the tax reform relating to stapled arrangements and flow through vehicles, we have sought to clarify the impact of the proposed reform further in the table below. It is important to note that the proposed reform relating to tax rates is largely targeted at flow through vehicles within stapled structures. The reform is not expected to have any impact on the tax payable by the regulated entities which are taxed as companies, or the NTER entities.

The table below shows the expected impact of the proposed legislative reforms on the tax rate applicable to foreign investors in NSPs that are held in stapled structures.

It is noted that:

- The expected tax rates shown in this table are based on our experience with these types of structures as the responses to the RINs did not provide this level of information.

- The rates shown in the table assume that sovereign wealth fund investors will maintain their current ownership interest (i.e. they will not sell down to below 10%).

[22] DoEE, Submission to the AER's Review of Regulatory Tax Approach, page 4.

[23] CCP, Submission to the AER, page 17.

[24] Ibid.

[25] Treasury Laws Amendment (Making Sure Foreign Investors Pay Their Fair Share of Tax in Australia and Other Measures) Bill 2018.

	Current	01/07/19 – 30/06/26	01/07/26 – 30/06/34	From 01/07/34
Distributions of cross-staple rent from the asset entity	0%* / 15%^	0%* / 15% / 30% 15% rate applies to cross-staple rent that satisfies the integrity rules. Otherwise 30% rate applies.	15% / 30% 15% rate applies to cross-staple rent that satisfies the integrity rules. Otherwise 30% rate applies.	30% (depending on investor's tax profile – see below)
Distributions of income from the operating entity	0%* / 15%^	0%* / 15%^	30%	30%

* Applies to sovereign wealth fund investors who have qualify for the sovereign immunity exemption.
^ Assumes investors hold their interests via a MIT and are resident in an information exchange country.

Foreign companies investing directly into network assets via flow through structures would also expect to pay the 30% corporate tax rate on the basis all income distributed by the relevant trust or partnership would be Australian sourced.

Australian resident investors should not be impacted by the legislative reforms in respect of stapled structures. They will continue to be subject to tax at the applicable tax rate per the table below.

Investor tax profile	Current tax rate
NTER entity	30%
Australian company	30%
State / Territory (tax exempt, non-NTER)	N/A
Australian superannuation fund	15%

In addition to the above, and as discussed in detail in section 3.1 of Schedule 1 to this Addendum, the same legislation will restrict debt deductions which may be claimed by upstream investors in flow through vehicles with an interest of 10% or greater from 1 July 2018 onwards.

In noting the above, we respond to the following points made in Submissions:

- Page 6 of the DoEE submission states that "*PwC's Expert Advice notes that where a NSP is a flow-through entity, its actual cost of debt and equity may be lower when compared to a company*", referencing page 43 of our Report. This is not an accurate reflection of our comments. Page 43 of our Report notes that a flow-through vehicle "*can generally obtain a greater level of external debt funding (or a better rate). This is due to the fact that under a flow through structure the tax liability rests with the investor rather than the project vehicle (or investment vehicle)*". This comment explains the fact that flow through taxation may be perceived as more favourable from a debt financing perspective as the cash flows against which borrowings are sought are

determined on a pre-tax basis (which is a commercial driver for historical use of the structures). We would expect the impact of this on the NSP's cost of debt to be taken into account by the AER as a relevant Rate of Return consideration. Our comments in respect of any observed differences between actual interest payments and the regulatory interest expense are outlined in Schedule 1 to this Addendum.

- Page 9 of the DoEE submission outlines a number of reasons why the proposed legislative amendments may have less of an impact on future tax payments than indicated in the AER's discussion paper.[26] We respectfully make the following observations on the points raised by the DoEE:

  - The DoEE submission notes that foreign investors into flow through entities may have access to a 15% concessional MIT tax rate for 15 years in respect of certain new investments which are subject to Government approval.[27]

    We note that the rules referred to by DoEE are only applicable to new greenfields projects (which can include expansion capex to existing assets, albeit only the expansion capex would be eligible) which exceed $500 million and that are deemed by the Treasurer at that time to be "nationally significant". Given this criteria, we expect this will substantially exclude any already constructed brownfields assets (i.e. privatisations of existing assets). Accordingly, it is unclear how relevant this concession will be to the regulated electricity and gas networks.

    In addition, it is unclear when the Government will seek exercise its discretion to classify such investments as "nationally significant".

  - Previous stapled structures have only been effective from an income tax perspective where the ATO has entered into "tax deeds" with the relevant investors. The tax deed had the effect of confirming that the assets held by the asset trust constitute "land" such that the trust had certainty that it was not carrying on a trading business. Without the tax deeds, it is uncertain whether the asset trust (or a holding trust of an investor) would qualify as a MIT and therefore have access to the concessional 15% tax rate. It is unclear whether the ATO would be willing to enter into a tax deed in the current tax landscape.

  - The DoEE submission notes that differences between actual tax rates and the company tax rates will be retained as certain sovereign entities and foreign pension funds with an interest of less than 10% non-controlling interest will continue to be eligible for tax concessions.[28] We have reviewed the upstream investor profiles of all the flow through NSPs and have not identified any sovereign entities or foreign pension funds with an interest of less than 10% which would be eligible for the relevant tax concessions following implementation of the proposed changes to the tax laws. Accordingly, we do not consider this point relevant in the case of the existing NSPs subject to our review.

    Whilst some of the existing investors could sell down their existing equity interests to fall below the 10% threshold, this is speculative and also has to take into account that the equity interests disposed of by the sovereign entities could be acquired by an investor taxed as a company (thereby reducing the percentage of concessional tax entities observed in our Report).

[26] DoEE, Submission to the AER's Review of Regulatory Tax Approach, page 9.

[27] Ibid.

[28] Ibid.

- The DoEE submission notes that double gearing will still be available to upstream investors with an interest of less than 10% following 1 July 2018.[29] Similar to above, we have not noted any interests of less than 10% and therefore would not expect double gearing to be effective following 1 July 2018. Again, it would be speculative to consider whether this position could change as a result of disposals of interests by upstream investors.

The CCP suggest that a dual benchmark approach could be adopted whereby NSPs within a company structure are provided a tax rate of 30% for the purposes of the regulatory tax allowances, and NSPs held in any other structure are provided a tax rate of 15%.[30] We have concerns regarding the appropriateness of 15% as the benchmark tax rate on the basis that:

- 2 of the 5 NSPs which are held in flow through structures are wholly owned by companies which would be expected to pay income tax on any taxable distributions in respect of the network assets at the corporate tax rate of 30% (subject to the availability of any tax losses at the investor level).

- For the remaining 3 NSPs in flow through vehicles, we would expect the tax rates applicable to the upstream investors to vary. Accordingly, while some investors may pay 15% (e.g. superannuation funds and foreign investors in MITs), others may pay more or less. This will mean that investors with lower tax rates will benefit from the tax allowance provided in respect of investors with higher tax rates. It is unclear how this could be practically dealt with in light of the commercial arrangements between the relevant entities. As noted in our Report, tax is levied on an identified taxpayer and there is no basis within the tax legislation that allows an aggregation of tax between different taxpayers.

  As previously stated in our Report this is however ultimately a policy matter which is outside the scope of our review given it is a concept outside the tax legislative framework.

Additional matters raised in the DoEE Submission

We have addressed some further comments made in the DoEE submission below:

- The DoEE submission recommends that the impact of related party dealings is considered further by the AER.[31] The impact of financing arrangements (including related party financing) is considered in detail in Schedule 1 of this Addendum following the receipt of the RIN responses.

- Further, we have not evidenced any other related party dealings disclosed in Section A of the International Dealings Schedules attached to the income tax returns provided by the NSPs in response to the RINs which we would consider material for the purpose of this review (noting the requirement for taxpayers to disclose all related party dealings in this section).

  This is consistent with the ATO Note dated 10 April 2018 where under the heading 'Other Factors" the ATO state "There are a number of other technical factors that we consider are likely to be driving a difference between the ATO tax allowance and actual tax paid, however these factors appear not to be material".

- The DoEE submission raises a concern that "two large NSPs were, until recently, owned in a flow through structure".[32] The RINs requested group structures from the NSPs as at

[29] Ibid.

[30] CCP, Submission to the AER, page 17.

[31] DoEE, Submission to the AER's Review of Regulatory Tax Approach, page 8.

[32] Ibid, page 9.

30 June 2018 on the basis that only discrepancies between actual tax and the regulatory forecast of tax costs which are expected to apply in future income years are relevant for the purpose of this review. Accordingly, we have not sought information regarding historic group structures or tax practices which are not considered relevant in addressing opportunities for better alignment of actual tax practices and the regulatory model on a go forward basis.

- The DoEE Report questions the appropriateness of information gathered from the NSPs on the basis only eight of the 12 private NSPs provided information on a voluntary basis, and given none of the upstream investors provided their tax information.[33] We note that all entities have now responded to the RIN responses, subject to the limitations noted in section 1.3.2 of this Addendum. Schedule 1 of this Addendum addresses any areas whereby the RIN responses may impact the findings of our Report. Whilst information from upstream investors was requested on a best endeavours basis, we understand it was not practical to compel any further information in the timeframe allowed for this review.

- The DoEE Report questions the statement on page 53 of our Report that the zero percent tax rate is only expected to continue to apply to sovereign wealth fund investors until 2026, on the basis no information was provided by upstream investors, and in the DoEE's view, the zero percent rate will continue to be available in respect of certain funds and taxes beyond 2026.[34] We disagree with this statement. While no information has been provided by upstream investors, where sovereign wealth entities have invested in flow through vehicles it is our expectation that these entities would have sought tax exemption (under the principle of sovereign immunity) on acquisition of the interest. On the basis page 53 of our Report dealt with tax rates applicable to distributions of profit, we assume the DoEE are referring to sovereign wealth funds with an interest of less than 10% when they note that exemptions will be available after 2026. We have reviewed the profiles of all upstream investors in the flow through NSPs and have not identified any sovereign wealth funds with an interest of less than 10% which could continue to be treated as tax exempt under the proposed law from 1 July 2026 onwards. On this basis the comments made on page 53 of our Report are considered appropriate.

3. Immediate deductions for regulatory Capex

In our Report, we observed material immediate deductions claimed in respect of expenditure which was treated as Capex for regulatory purposes, and recommended the AER consider a change to the regulatory model to better align the model with actual tax practices in this regard (noting that regard should be given to the potential non-tax commercial implications of this).

Having regard only to information provided on a voluntary basis, our Report observed an annual average immediate deduction for regulatory Capex of $108.7m per NSP, or $81.5m per regulated entity. Following receipt of the RINs, we have now observed annual average immediate deductions across all NSPs of $69.5m per NSP, or $48.9m per regulated entity, as outlined in section 3.3.2 of Schedule 1 of this Addendum. The observed deductions have decreased due to a number of entities responded with nil or low amounts of immediate deductions, which had previously not responded on a voluntary basis.

The following has been noted in the Submissions in respect of a potential adjustment to the regulatory model in respect of immediately deductible regulatory capex:

- Submissions by the NSPs and the industry bodies (e.g. the ENA and NSG) have raised concerns regarding a change to the regulatory model in respect of immediately deductible regulatory Capex on the basis:

[33] Ibid.

[34] Ibid, pages 9-10.

  - The adjustment would create inconsistencies between the tax allowance and other building blocks (e.g. classification as expenditure as Capex or Opex for regulatory purposes);[35]
  - The adjustment would incentivise inefficient behaviour as costly replacements may be preferred to refurbishment, and create inter-generational inequality driven by short term spending decisions;[36] and
  - This may create inconsistencies with the incentive-based approach.[37]
- Many of these submissions have requested extensive consultation and modelling regarding the potential impact of a change, appropriate benchmarks and/or more limited examples of where an adjustments may arise.
- The CCP supports a change to recognise immediately deducted regulatory Capex in the tax allowance, with a preference to a benchmark proportion of Capex to the adjusted, also noting further work is required to operationalise this approach.[38]

PwC response:

The matters raised in the Submissions do not have regard to the technical aspects of our findings, but rather represent implementation, economic or policy focused suggestions. Accordingly, we have provided no further comment in this regard, given these matters of policy and implementation will be addressed by the AER.

4. Depreciation method

Our Report recommended that the diminishing value (**DV**) method of tax depreciation is adopted for all new depreciable assets, on the basis this would be the method expected to be adopted by a benchmark efficient entity. We have recommended that this method is applied on a prospective basis and only in respect of new assets, noting restrictions within the tax law regarding changes to the method of depreciation applied to an existing assets.

The following has been noted in the Submissions in respect of a potential change to the regulatory model in respect of depreciation methods:

- The regulated NSPs generally agree that there is a case for a change to DV on a prospective basis only,[39] however have noted concerns with complexities of adopting different methods (both across different registers and within the TAB). A number of submissions suggest that either the DV or prime cost (**PC**) method could be applied, on a case by case basis.[40]
- The CCP submission agrees with the proposed change to the DV method, and has suggested that serious consideration is given to the potential reset of the TAB where DV has been adopted for actual tax purposes in respect of existing assets.

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[35] See, eg, APA, AER Review of Regulatory Tax Approach, page 7.

[36] See, eg, Endeavour Energy, AER Review of Regulatory Tax Approach 2018, page 5; ENA, Review of Regulatory Tax Approach: Response to the AER Discussion Paper, page 25; TransGrid, AER's Discussion Paper on Review of Regulatory Tax Approach, page 1.

[37] See, eg, AusNet Services, AER Review of Regulatory Tax Approach: Response to Discussion Paper, page 1.

[38] DoEE, Submission to the AER's Review of Regulatory Tax Approach, page. 23.

[39] See, eg, APGA, Submission to the AER, pages 4-5; Jemena, Response to Discussion paper – Review of Regulatory Tax Approach, page 3; TransGrid, AER's Discussion Paper on Review of Regulatory Tax Approach, page 1.

[40] See, eg, AusNet, AER Review of Regulatory Tax Approach: Response to Discussion Paper, pages 3-4; Endeavour Energy, AER Review of Regulatory Tax Approach 2018, page 4.

PwC response:

There appears to be general consensus across stakeholders that a change to the tax depreciation methodology applied for the purpose of the TAB from PC to DV should be applied on a prospective basis in respect of new assets only. This is consistent with the requirements of the income tax law which prohibit a change to the depreciation methodology applied in respect of an asset over the course of its effective life.

Whilst our Report suggests that DV was the method which a benchmark efficient entity would adopt, we also see merit in adopted a case-by-case approach (e.g. applying the method which is adopted for actual tax purposes, for TAB purposes) where this can decrease complexities and compliance costs. A case-by-case approach would achieve the objective of greater aligning the actual tax position of the NSPs with the regulatory forecast of tax.

The CCP submission suggests that serious consideration is given to whether a change to the DV method and reset of the TAB should be performed where the entity has adopted the DV method for tax purposes in respect of existing assets, due to the potential for a "systemic mismatch between the allowed tax and the actual tax paid" otherwise.[41]

Notwithstanding our earlier comments regarding the inability to change depreciation methodology during the life of an asset for income tax purposes, we agree that serious consideration should be provided prior to proceeding with the CCP's suggestion in this regard. This is due to the potentially permanent loss of value to consumers where the TAB is reset following a change from SL to DV for regulatory purposes. By way of example, the resetting of the TAB would seek to re-establish the opening TAB value based on what the TAB would be had DV method always been applied by the NSP on respect of the relevant assets. This amount could be significantly lower than the current TAB value, due to the 200% uplift factor applied to depreciation under the DV method (or 150% for assets acquired prior to May 2006). This decrease in TAB would represent a permanent removal of depreciable tax basis which would otherwise reduce the regulatory forecast of tax costs over future income years. Accordingly, such an approach would have a cost to consumers over the remaining effective life of the asset.

In addition, and as noted in the CCP submission,[42] the resetting of the TAB would be a complex and potentially costly exercise. Whilst all NSPs maintain a tax fixed asset register which could provide a starting point for analysis of the reset tax cost base, where the NSP is part of a tax consolidated group, there is a chance the tax depreciable basis included in the tax fixed asset register has been reset under tax consolidations law and no longer is reflective of the nominal TAB values. A resetting exercise in this instance would involve the "stripping out" of the market value uplift (or decrease) attributable to the tax consolidation event.

Accordingly, it is clear that further detailed consideration would be required before considering any adjustment to the TAB value in respect of the proposed change to diminishing value methodology for regulatory purposes.

5. Capping of effective life for gas assets

Our Report recommended that the AER consider applying the 20 year statutory effect life cap to all gas transmission and distribution assets, in order to rectify the misalignment in effective lives for regulatory and actual tax purposes observed in respect of the gas sector as part of our review.

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[41] CCP. Submission to the AER, page 37.

[42] Ibid, page 41.

- Certain NSPs in the gas sector, and the ENA, have objected to our recommendations on the basis that taxpayer's have a choice as to whether to apply the 20 year statutory capped effective life for gas assets, or whether to self-assess a different (presumably longer) effective life. Reasons provided for a potentially higher effective life to be adopted include the desire to generate franking credits, the preservation of tax losses, and potential accounting issues with recoverability of tax losses.

PwC response:

We acknowledge that taxpayers have a choice as to whether to adopt the 20 year statutorily capped effective life or to self-assess a different effective life in accordance with the Capital Allowance provisions. In our view a taxpayer would only choose to apply a longer effective life over and above the 20 year capped life where it had material tax losses resulting in a more conservative approach to protect potential tax attributes as a consequence of M&A activity.

Accordingly, despite the reasons provided for the potential deferral of tax depreciation by selecting a longer effective life than 20 years, we remain with the view that a benchmark efficient entity would seek to legally minimise their year on year tax position where possible, and therefore would be expected to apply the 20 year statutorily capped effective life rather than choosing a different, longer effective life.

6. Interest expense

Matters related to interest expense were not addressed in our Report, but rather have been outlined in Schedule 1 above following receipt of the RIN responses. As such any comments in the Submissions relating to interest expense are in respect of the comments in the AER's discussion paper rather than our Report.

Our findings and recommendations relating to interest expense are outlined in sections 2.1 and 3.1 of Schedule 1 above.

Appendices

Appendix A Glossary

Abbreviation	Term
Addendum	This Addendum to the AER Tax Review 2018 – Expert Advice prepared by Vaughan Lindfield and Michael Davidson
AER	Australian Energy Regulator
ATO	Australian Taxation Office
ATO Note	Note issued by the ATO to the AER dated 10 April 2018 with the subject "Indicative comparative analysis of the AER electricity distribution tax allowance and tax payable"
Capex	Capital expenditure
CCP	Consumer Challenge Panel
CN	Competitive neutrality
CP Agreement	Competitive Principle Agreement
DoEE	Department of Environment and Energy
DPT	Diverted profits tax
DV	Diminishing value
Framework Document	Privatisation and Infrastructure – Australian Federal Tax Framework
ITAA 1936	*Income Tax Assessment Act 1936* (Cth)
ITAA 1997	*Income Tax Assessment Act 1997* (Cth)
MAAL	Multinational anti-avoidance law
M&A	Mergers and acquisitions
MIT	Managed Investment Trust
NSPs	Network Service Providers
NTER	National Tax Equivalent Regime
OECD	Organisation for Economic Cooperation and Development
Ofgem	Office of Gas and Electricity Markets
Ofwat	Office of Water Services
Opex	Operating expenditure
PC	Prime cost
PCFM	Price Control Financial Model

Abbreviation	Term
PCG	Practical Compliance Guideline
PE	Permanent establishment
PwC	PricewaterhouseCoopers
RAB	Regulated Asset Base
RAV	Regulatory Asset Value
R&D	Research and Development
Report	AER Tax Review 2018 Report dated 26 October 2018
RINs	Regulatory information notices
TAB	Tax Asset Base
TA 2017/1	Taxpayer Alert TA 2017/1
TGIE	Variable which Ofgem inputs into their Price Financial Control Model during the Annual Iteration Process
UK	United Kingdom

Appendix B List of entities

NSP	Regulated Entity	Sector	Segment	State
ActewAGL	ActewAGL Distribution Partnership	Electricity	Distribution	ACT
	ActewAGL Distribution Partnership	Gas	Distribution	ACT
AGIG	Australian Gas Networks (Albury) Ltd	Gas	Distribution	VIC
	Australian Gas Networks Ltd	Gas	Distribution	SA
	Australian Gas Networks (Vic) Pty Ltd	Gas	Distribution	VIC
	Australian Gas Networks (Qld) Ltd	Gas	Distribution	QLD
	Multinet Gas Distribution Partnership	Gas	Distribution	VIC
APA	APA GasNet Australia (Operations) Pty Ltd	Gas	Transmission	VIC
	APT Pipelines (NT) Pty Ltd (Amadeus)	Gas	Transmission	NT
	APT Petroleum Pipelines Pty Ltd	Gas	Transmission	QLD
Ausgrid	Ausgrid	Electricity	Distribution	NSW
AusNet	AusNet Electricity Services Pty Ltd	Electricity	Distribution	VIC

	AusNet Services (Transmission) Ltd	Electricity	Transmission	VIC
	AusNet Gas Services Pty Ltd	Gas	Distribution	VIC
Citipower Powercor United Energy	CitiPower Pty Ltd	Electricity	Distribution	VIC
	Powercor Australia Ltd	Electricity	Distribution	VIC
	United Energy Distribution Pty Ltd	Electricity	Distribution	VIC
EII	Directlink	Electricity	Distribution	Interconnector
	Murraylink Transmission Company Pty Ltd	Electricity	Distribution	Interconnector
ElectraNet	ElectraNet Pty Ltd	Electricity	Transmission	SA
Endeavour	Endeavour Energy	Electricity	Distribution	NSW
Energy Queensland	Energex Limited	Electricity	Distribution	QLD
	Ergon Energy	Electricity	Distribution	QLD
Essential	Essential Energy	Electricity	Distribution	NSW
Jemena	Jemena Electricity Networks (Vic) Ltd	Electricity	Distribution	VIC
	Jemena Gas Networks (NSW) Ltd	Gas	Distribution	NSW
Powerlink	Powerlink	Electricity	Transmission	QLD
PWC	Power Water Corporation	Electricity	Distribution	NT
SAPN	SA Power Networks	Electricity	Distribution	SA
TasNetworks	Tasmanian Networks Pty Ltd	Electricity	Transmission	TAS

	Tasmanian Networks Pty Ltd	Electricity	Distribution	TAS
TransGrid	TransGrid	Electricity	Transmission	NSW

Appendix C UK approach – excessive gearing clawback

As part of our review we have considered any comparative international regulatory systems whereby the impact of excessive debt deductions has been considered and is specifically adjusted for. The only relevant model identified in our review was the approach adopted by Ofgem in the UK. Ofgem applies a similar benchmark efficient entity incentive based approach to regulation of electricity and gas providers as applied in Australia, and therefore is a useful comparative for these purposes.

It is important to note that due to limitations in timeframe and availability of information we have been unable to perform a detailed reconciliation and verification of the factors between the AER and Ofgem models which may influence the appropriateness of such a claw back mechanism in Australia.

Regardless of this, the purpose of this Appendix is to provide a high level overview of the mechanics of the Ofgem approach in relation to excessive tax gearing.

Ofgem model

Ofgem regulates gas and electricity networks in accordance with their "RIIO" framework (Revenue = Incentives + Innovation + Outputs), a performance-based framework used to set the price controls. The RIIO is applied across a Price Control Period, providing licensees with an eight year period of settled price control arrangements, whilst also allowing comprehensive adjustments to be made to base revenue in respect of the licensee's network business each year.

Similar to Australia's benchmark efficient entity process, having regard to various elements of tax expense, Ofgem uses their Price Control Financial Model (**PCFM**) to set tax allowance for licensees to cover the costs of paying tax. The PCFM is applied at the outset of the Price Control Period to calculate the licensee's tax allowance for all years within the period, involves making modelling assumptions about (among other considerations) financing requirements, gearing levels and corporate debt costs for the licensee's business, and results in modelled levels of tax deductible interest costs and tax relief for the licensee for the Price Control Period.

Excessive gearing tax claw back mechanism

Noting that licensees may operate at different levels of gearing than that assumed for the purposes of determining modelled tax deductible interest costs, if a licensee operates at a higher level of gearing than the modelled level, it stands to benefit from the tax value of higher levels of interest deductibility. Ofgem's approach to such a discrepancy between actual and modelled deductible interest costs is to implement an ex post adjustment to "claw-back" any revenue benefit licensees obtain from lower tax costs that result from higher gearing. It should be noted that there is no provision to give additional tax allowances to a licensee if it chooses to operate at a level of gearing lower than the modelled on.

The claw-back mechanism involves adjusting the licensee's tax liability allowance during an annual review process, the PCFM Annual Iteration Process, which broadly involves inputting adjusted variables into the PCFM model in order to determine an adjusted tax allowance. Ofgem applies two tests to determine whether an adjustment will be made in respect of tax

deductible interest costs for the relevant year: the Gearing Level Test; and the Positive Tax Benefit Test.

Gearing Level Test:

Under the Gearing Level Test Ofgem determines whether the licensee's actual calculated gearing ratio is greater than the notional level of gearing. Notional gearing is between 60-65% as set out in Ofgem's Price Control Financial Handbooks, the handbook relevant to the licensee depends on whether the licensee is an electricity or gas network, transmission or distribution network.

The actual calculated gearing ratio is calculated as the licensee's indicative PCFM Regulatory Asset Value (**RAV**) balance (as at 31 March in the relevant year), divided by licensee's net debt figure (as at 31 March in the relevant year).

If actual calculated gearing is less than the notional level of gearing the positive tax benefit test is not to be performed and the benefit figure (referred to as TGIE) input into the PCFM is zero. If actual calculated gearing is greater than the notional level of gearing, then the positive tax benefit test will be performed to calculate the benefit figure (**TGIE**).

Positive Tax Benefit Test:

Under the Positive Tax Benefit Test Ofgem determines whether adjusted tax deductible interest payable (a figure reported by licensee in accordance with reporting requirements) (i.e. actual interest payable) is greater than the interest figure set out in the PCFM (i.e. notional interest).

If actual interest payable less notional interest produces a zero or negative amount (i.e. actual interest payable is less than notional interest), there is no positive tax benefit and the claw-back is not triggered. The benefit figure (TGIE) input into the PCFM is zero.

If actual interest payable less notional interest produces a positive amount (i.e. actual interest payable is greater than notional interest), then the claw-back has been triggered. The licensee's benefit figure (TGIE) is calculated by multiplying this positive amount by the corporation tax rate for the licensee, which is input into the PCFM.

In summary, if these tests reveal the licensee has a tax benefit from having higher gearing than the modelled gearing, the benefit figure (TGIE) will be input into the PCFM during the Annual Iteration Process. The mechanics of the PCFM will then produce a negative adjustment (i.e. a claw-back) to the licensee's tax allowance to account for this benefit.

If for any year the licensee has a claw-back but no modelled profits (notional profits) subject to tax, then the benefit figure calculated under the positive tax benefit test is added to the regulatory losses balance for the licensee. This will be utilised against future core taxable profit.

We note Ofgem is in the process of determining the structure of the price controls for the Price Control Period commencing in 2021 and is considering changes to the regulatory model. Following initial consultation with stakeholders, Ofgem is continuing to review the approach to setting tax allowance including the potential to expand clawback mechanisms for variances between tax allowance and tax paid. We have also had regard to the regulatory model employed by the United Kingdom's water services regulation authority, the Office of Water Services (**Ofwat**), however this has not provided any further relevant considerations.

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