Appendix A – High level publishable summary

Review of the Network Service Provider's (NSP) Response to the Australian Energy Regulator's (AER) Profitability Measures Information Request

30 June 2021

Purpose of this summary report

This Appendix provides a summary of the findings of PwC's review of the NSP responses to the AER's Profitability Measures Information Request, in accordance with our Order for Services from the AER dated 9 April 2021.

In accordance with the Order for Services, PwC has been engaged to assist the AER in considering the reasonableness of the responses provided by the NSPs in relation to the allocation of tax and interest expense for the purpose of determining Regulated Return on Equity (**RoRE**) as part of the AER's ongoing review of these measures.

Our assistance has consisted of review of the information provided by the NSPs, discussions with the AER regarding further information requests which may be required, preparation of a detailed confidential (non-publishable) report outlining the findings of our review, and preparation of this (publishable) summary of our findings.

In accordance with the Order for Services, our review has been limited to the electricity service providers due to the timeframe of responses and the AER's review process. Our review focuses solely on the appropriateness of the NSP responses relating to the allocation of tax and interest expense to Regulatory Net Profit After Tax (**NPAT**) for the purpose of determining RoRE within the AER's reporting profitability measures, for responses provided by the electricity network operators only (on the basis this information is being released prior to the profitability measures relating to the gas network operators) for the 2014 to 2019 reporting periods (**Review Period**).

Disclaimers

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

In accepting this engagement to assist the AER on this matter, we have undertaken as assessment of any potential conflicts arising, and applied safeguards where relevant to ensure that an

PricewaterhouseCoopers, ABN 52 780 433 757
Brookfield Place, 125 St Georges Terrace, PERTH WA 6000, GPO Box D198, PERTH WA 6840
T: +61 8 9238 3000, F: +61 8 9238 3999, www.pwc.com.au

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independent assessment of the matters can be achieved.

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

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Summary of findings

Allocation of tax expense

As recommended in our previous advice to the AER regarding allocation methodologies for tax and interest expense to regulated businesses for the purpose of the profitability measures reporting dated 28 June 2019[1] (**PwC Allocation Advice**), the calculation of tax expense for the purpose of determining Regulatory NPAT should be consistent with the principles for determining income tax expense in accordance with AASB 112: Income Tax Expense, to ensure comparability and understandability of responses. As such, Regulatory Profit Before Tax (**PBT**) should be used as the starting point for determining tax expense allocable to the regulated businesses, with adjustments made in respect of any "permanent" tax adjustments, which will impact the effective tax rate of the business. Tax adjustments which are timing in nature should not impact income tax expense for these purposes, due to the deferred tax accounting methodology stipulated in AASB 112. Further information in this regard is outlined in the PwC Allocation Advice.

From our perspective, the tax adjustments which are likely to have a material permanent impact on income tax expense for the regulated businesses and therefore should be included in the determination of Regulatory NPAT are limited to:

- Adjustments to remove the impact of indexation on depreciation of the Regulated Asset Base (**RAB**);
- Adjustments relating to interest expense which is allocable to the regulated business but treated as non-deductible for income tax purposes;

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[1] PwC, Australian Energy Regulator: Profitability measures review – Advice on the allocation of interest and tax expense, 28 June 2019.

- Amendments to prior year income tax assessments following an ATO dispute or change in law which are permanent in nature; and
- Differences in tax rate attributable to the ownership structure of the regulated business (e.g. where the applicable tax rate differs from the benchmark rate for regulatory purposes of 30%).

The AER released its final view in relation to the information requirements for the purpose of determining Regulatory NPAT in its Final Position Paper on the Profitability Measures for Electricity and Gas Networks dated December 2019[2] (**Final Position Paper**), which broadly accepted the recommendations from the PwC Allocation Advice, with some adjustments to information requirements resulting from consultation with the industry and the AER's own experience. The AER subsequently provided information requests to each NSP in respect of the allocation of tax and interest expense for the purpose of Regulatory NPAT. Responses were received by the NSPs by way of completed Profitability Measures Workbooks and supporting Basis of Preparation (**BoP**) documentation.

We outline our findings from review of the information received by the AER from regulated electricity businesses (on a summarised and confidential basis) below.

Permanent adjustments to tax expense

In accordance with the AER's information request, the Profitability Measures Workbooks prepared by the NSPs contain adjustments to income tax expense in relation to the following areas.

*Permanent adjustments relating to capital expenditure (**Capex**)*

The key issue in determining permanent adjustments relating to Capex is the identification of the impact of historic indexation on RAB depreciation. This difficulty was acknowledged in the PwC Allocation Advice, noting complex formulas may be required to determine the correct adjustments. Following further consultation, the AER's Final Position Paper has determined that an appropriate approach to this adjustment is to remove the RAB depreciation and include the Regulatory Tax Asset Base (**TAB**) depreciation in the tax adjustment section of the Profitability Measures Workbook for each year.

While this approach will eliminate the impact of indexation of the RAB, there is a risk that adjustments to income tax expense will also be made for differences between RAB and TAB depreciation which are timing in nature only. This would be inconsistent with the principles of AASB 112 and lead to a lack of comparability of the measures.

Based on our review, the most material timing difference which may impact income tax expense for these purposes during the Review Period relates to customer contributions and gifted assets. While such assets are not included for the purpose of the RAB, certain receipts of customer contributions or gifted assets are treated as assessable income for the purpose of determining the tax allowance included in the regulatory framework, and subsequently depreciated within the TAB. Any such

[2] AER, Final position: Profitability measures for regulated electricity and gas network businesses, December 2019.

depreciation would generally represent a timing difference (given recognition of upfront assessable income would generate a Deferred Tax Asset (**DTA**) under AASB 112) and therefore should not impact the effective tax rate of each business. This is consistent with the intention of the accounting standards to smooth the recognition of tax expense relating to transactions which have a temporal nature.

Further, based on our discussions with the AER, we understand that in some instances the useful life applied may differ for RAB and TAB purposes. Where this is the case, it is likely that these timing differences (between RAB and TAB) will impact the annual income tax expense calculated for the purpose of determining regulated NPAT under the profitability measures, which is inconsistent with the approach generally adopted in determining income tax expense under AASB 112. We note however, given all regulated businesses will be subject to the same approach, this may not have an adverse impact on comparability of the results.

While other timing differences may also factor into the difference between RAB and TAB depreciation, these are not expected to be material over the Review Period on the basis:

- The same depreciation methodology has historically generally been applied for RAB and TAB purposes by the electricity network owners (being the straight line / prime cost method), for the majority of the Review Period; and
- The impact of immediate deductions attributable to Capex (e.g. capitalised repairs or other deductible costs) has not historically been reflected in the TABs for the majority of the Review Period

We note that following the AER's Review of the Regulatory Tax Approach in 2018 (and as outlined in the AER's Final Report dated December 2018[3]), adjustments are expected to be made for TAB purposes in relation to the areas noted above in regulatory decisions from as early as 2019 onwards. While this period may overlap slightly with the Review Period, the impact of these adjustments are not expected to have a significant impact on the RoRE reported in the current profitability measures, but adjustments to the AER's approach should be taken into account going forward.[4]

Having regard to the above, we note that the average impact of the adjustments relating to Capex in the Profitability Measures Workbook is an average decrease to RoRE of 0.59% p.a. for all NSPs on an aggregated basis over the Review Period. While a portion of this would relate to the removal of indexation from RAB depreciation, there is a risk that some of the adjustment also relates to timing differences attributable to customer contributions and gifted assets (discussed further below).

[3] AER – Final Report: Review of regulatory tax approach, December 2018.

[4] Further consideration will also need to be given on a go forward basis to the impact of the Temporary Full Expensing measures which have been introduced by the Federal Government as a COVID-19 support incentive. Depending on satisfaction of eligibility requirements, these rules may allow NSPs to immediately deduct Capex which is (broadly) incurred after 6 October 2020 and relates to assets first used or installed ready for use by 30 June 2023.

Recognition of income from customer contributions and gifted assets

The Profitability Measures Workbook also provides for a tax adjustment to Regulatory NPAT to recognise the impact of assessable income arising from receipts of customer contributions and gifted assets. This income is generally recognised for TAB and actual tax purposes (subject to our comments below in respect of gifted assets), but not otherwise recognised as income for regulatory purposes. It appears this adjustment has been included in the Profitability Measures Workbook to counter the impact of TAB depreciation on such assets as discussed above.

Adjustments relating to assessable income arising from customer contributions and gifted assets should generally be considered timing in nature for income tax purposes (as a DTA will be created, which will unwind over time as the underlying asset is depreciation), and therefore should not impact the year on year income tax expense which is a component of Regulatory NPAT.

From the NSPs which have responded to the information request, 11 of the 18 NSPs have included assessable income relating to customer contributions and gifted assets. The NSPs which have not reported assessable income relating to customer contributions or gifted assets are generally transmission network owners, which in our experience are less likely to make such adjustments. The average impact of the adjustments relating to customer contributions and gifted assets is an average decrease to RoRE across the entities reporting an adjustment of 0.73%

For completeness, we note the actual tax treatment (and therefore the TAB treatment) of gifted assets is likely to be revisited by some NSPs in light of the Full Federal Court's decision in *Victoria Power Networks Pty Ltd v Commissioner of Taxation 2020 ATC 20-768* (**VPN case**). In the VPN case, the Full Federal Court found that while customer contributions paid to the electricity distributor to construct connections which would otherwise be considered uneconomic were assessable for income tax purposes as ordinary income, assets which were constructed by customers and "gifted" to the distributor would only represent assessable income under section 21A of the Income Tax Assessment Act 1936 (**ITAA 1936**) to the extent of the rebate provided to the customer (e.g. the economic value of the asset) rather than to the extent of the construction costs. This was on the basis the economic value of the asset to the distributor represented the "arm's length value" under section 21A of the ITAA 1936.

This decision differs from the way the ATO has previously sought to administer the tax law in relation to gifted assets, and therefore we expect some NSPs are likely to reconsider the recognition of assessable income in relation to gifted assets for Federal tax (including potentially making prior year adjustments for the over payment of tax).

Permanent differences due to disallowed interest expense

The PwC Allocation Advice noted that permanent denials of interest expense for tax purposes may arise where:

- Debt levels attributable to the regulated assets exceed allowable thin capitalisation thresholds;
- Interest payments to related parties exceed an arm's length price under transfer pricing principles;

- The hybrid mismatch rules deny deductions on payments which give rise to hybrid outcomes; or
- The debt/equity classification of an instrument differs for reporting and tax purposes.

The majority of NSPs did not report disallowed interest deductions in relation to the factors above. This is consistent with the findings of our previous Tax Allowance Report[5] (including Addendum[6]) which found that NSPs did not as a general rule exceed maximum allowable gearing levels (under the thin capitalisation rules) for actual tax purposes. The average impact of the adjustments relating to disallowed interest expense is an average decrease to RoRE across the 6 entities reporting an adjustment of 0.18% (noting in some instances it is difficult to determine whether these adjustments relate to interest expense attributable to the regulatory ringfence).

Permanent differences due to adjustments to prior year returns

Prior year income tax assessments may be amended following disputes with the ATO or a change in law. Where this results in adjustments that are within the regulatory ring-fence and permanent in nature, regulatory tax expense will be impacted. Any adjustments related to interest expense would likely be disclosed in the responses discussed above, and therefore this item should capture any other amendments relating to the regulatory ringfence which would be permanent in nature.

Only 4 of the 18 NSPs reported adjustments to prior year returns over the Review Period. The average impact of these adjustments is an average increase to RoRE across the entities reporting an adjustment of 0.03%.

Carried forward tax losses

We would generally not expect tax losses to be relevant when considering income tax allocable to the regulatory ring-fence, on the basis it is unlikely a regulated network would generate material tax losses on a stand-alone basis. This is consistent with the findings of PwC's Tax Allowance Report, whereby it was noted that tax losses observed were generally generated by transactions outside of the regulatory ring-fence. No further recommendations were made in respect of tax losses in the AER's Final Position Paper.

Notwithstanding, the Profitability Measures Workbooks distributed to NSPs provided an ability for NSPs to adjust the regulated NPAT for the effect of any carried forward tax losses attributable to the regulated business.

Only 3 of the 18 NSPs reported adjustments relating to carried forward tax losses over the Review Period. The average impact of these adjustments is average increase to RoRE across the entities reporting an adjustment of 0.18%.

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[5] PwC, AER Tax Review – Expert Advice, 26 October 2018.

[6] PwC, AER Tax Review – (Addendum) Expert Advice, 10 December 2018.

Differences in tax rate attributable to ownership structure

As noted above, an adjustment is required to the effective tax rate of the NSPs in determining Regulatory NPAT to reflect the tax rate applicable to each business in light of the various ownership structures which arise in practice.

The PwC Allocation Advice noted the following recommendations in respect of the tax rate for the purpose of Regulated NPAT and RoRE:

- NSPs which are taxed as a company and NTER entities should apply the corporate tax rate of 30%; and
- NSPs which are taxed on a flow-through basis should self-assess the blended tax rate which would be applicable to taxable profits of the regulated network assets having regard to investor profiles. For stapled structures, the PwC Allocation Advice noted the blended tax rate would not be expected to be any higher than 19.5%[7] (and may be lower in some cases), however would likely increase to 30% as the grandfathering period in relation to the recent tax reforms relating to stapled structures ceases on 30 June 2034.

The AER's Final Position Paper agreed with the observations above, and in addition, noted that profitability measures for NTER entities and also state owners of regulated assets which are not subject to the NTER would be reported such that stakeholders can understand profitability both where a 30% tax rate applies, and also a 0% tax rate (e.g. assuming NTER tax equivalent payments are akin to a dividend to the State).

In relation to the electricity NSPs which responded to the AER's information request, we note the following characteristics of respondents:

- NSPs taxed as company: 7 entities, representing 20.20% of the total TAB;
- NTER entities: 9 entities, representing 58.56% of the total TAB;
- NSPs taxed on a flow through basis: 5 entities, representing 21.24% of the total TAB.

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

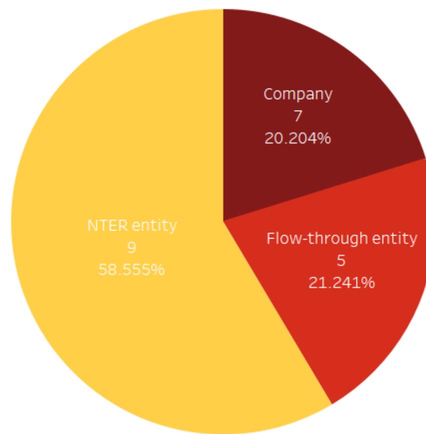

Figure 1: Ownership structure proportion of TAB

Our general observations in relation to the approaches adopted by the NSPs in determining the appropriate tax rate is as follows:

- Companies and entities subject to the NTER have appropriately adopted the 30% corporate tax rate (albeit we note the AER may report the profitability measures for these entities both under 30% and 0% assumptions as noted above).
- NSPs which are held via flow through structures with corporate or NTER investors only have appropriately adopted the 30% corporate tax rate.
- NSPs which are held via flow through structures with a range of investor profiles have generally been unable to determine the actual tax profile of investors, and therefore have opted for the blended tax rate of 19.5%. This approach is consistent with our expectations and experience in dealing with such structures, and is based on the 70:30 split of value between the asset holding and operating arms of the stapled structures which aligns to the ATO's views on value allocation for these purposes.[8] The concessional MIT tax rate of 15% for foreign investors in exchange of information countries (which applies in relation to the asset holding arm of the staple) is expected to be available in relation to qualifying structures until the end of the transitional period for the staple structure tax reforms, which ends on 30 June 2034.
- In many instances, businesses are unable to identify the exact tax profiles of upstream investors which hold an interest through managed funds or other "flow through" collective investment vehicles. As such, the blended tax rate of 19.5% appears to be the most appropriate approach in the absence of more specific information.

[8] Law Companion Ruling 2015/15, example 3.

Allocation of interest expense

Consistent with the recommendations the PwC Allocation Advice, the AER has recommended in its Final Position Paper that NSPs adopt the following self-assessment approach in allocating interest expense to the regulated businesses for the purpose of determining Regulatory NPAT:

- Identify debt instruments which can be specifically identified as having been used to fund the acquisition or construction of regulated assets ("specific debt"), and allocate interest attributable to this debt to the regulated assets;

- For other debt interests of the corporate group which are not directly traceable to funding the acquisition or construction of regulated assets ("general debt"), perform an appropriate allocation of interest expense across the regulated and unregulated aspects of the business based on an appropriate methodology, to be determined by each business having regard to factors which the NSP deems appropriate.

We have reviewed the information provided by the NSPs in relation to the allocation of interest expense both in the Profitability Measures Workbook and the BoP documents, and note that each NSP has generally taken a tailored approach to the allocation of interest expense in relation to their regulated assets having regard to their specific debt funding and asset profile. This is consistent with the AER's views that self-assessment of the allocation of interest by NSPs will result in the most accurate allocations, as the AER notes on page 49 of the Final Position Paper:

> *"We consider self-allocation of interest expense is most likely to achieve our objectives of a meaningful and accurate allocation, as the NSP is best position to make judgments about its use of funds, having regard to its individual circumstances."*

We make the following observations from our review of the approaches adopted by the NSPs in allocating interest expense for the purpose of determining Regulated NPAT:

- Very few NSPs have identified specific debt and performed allocations on that basis, but rather, the general approach has been to allocate general debt of each group based on an allocation methodology which each NSP has determined to be appropriate.

- The allocation methods applied in relation to general debt have generally been based on a formula having regard to regulated assets in comparison to book assets, or regulated revenue in comparison to group revenue. In all instances except one (discussed in the following point), the explanations provided by the NSPs to support the allocation methodology in the BoP responses appear reasonable and have resulted in allocated gearing levels broadly consistent with the 60% benchmark gearing ratio applied for regulatory purposes. Where gearing ratios depart from the 60% benchmark rate, we expect this is reflective of the differential in the actual gearing levels adopted by relevant NSP in relation to the regulated assets.

- The majority of NSPs have excluded the impact of goodwill on debt funding (e.g. where debt has been sought having regard to the market value of assets, rather than construction costs, such as on privatisation or as a result of other M&A activity). One NSP has allocated interest expense having regard to actual interest expense which is based on the full value of debt geared against assets acquired at market value (e.g. including goodwill). The AER may

want to consider engaging further with that particular NSP to potentially alter the allocation methodology adopted to ensure a consistent approach across all entities.

- We have observed a general consistency of effective interest rates applicable to the debt allocated to the regulated assets across the private sector respondents, and across the NTER entity respondents.
- In accordance with the Information Request, each NSP has also been requested to disclose interest expense attributable to related party debt in the Profitability Measures Workbooks. Private sector entities have generally not included interest on shareholder loans in the interest expense allocable to the regulated assets, on the basis such loans are not recognised as debt within the regulatory model.

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

Yours sincerely

Vaughan Lindfield Partner Tax & Legal	Michael Davidson Partner Tax & Legal