26 July 2018

Mr Warwick Anderson
General Manager Networks Finance and Reporting
Australian Energy Regulator
GPO Box 520
MELBOURNE VIC 3001

Via email: TaxReview2018@aer.gov.au

Dear Warwick

**AER Initial Report –Review of regulatory tax approach**

SA Power Networks, Australian Gas Infrastructure Group, CitiPower, United Energy and Powercor (**the Businesses**) are pleased to provide this submission in response to AER's Initial report- Review of regulatory tax approach, dated June 2018 (**Initial Report**).

The Businesses endorse the Energy Networks Australia submission in response to the Initial Report and this submission emphasizes key issues for consideration in the remainder of this review process.

**Focus of the Review**

As noted by the AER in the Initial Report, the general consensus from stakeholders (and experts) is that incentive based regulation should be maintained and that an approach where actual tax costs are passed through to customers has significant difficulties and costs, without corresponding benefits for consumers.[1]

The Businesses strongly support the maintenance of the incentive based regime. The achievement of the national electricity and gas objectives are maximized by this approach because service providers are incentivized to act efficiently and improve on the benchmark allowances. The Businesses agree with the AER's approach of assessing whether a better benchmark for tax costs can be achieved, which is consistent with the incentive regulation framework.

In particular, we consider the key focus in this Review should be to determine whether the current approach to estimating the corporate tax building block still results in an efficient tax allowance for the benchmark efficient entity. The Businesses acknowledge that it is appropriate and consistent with the incentive framework for the regulatory approach to be reviewed, at appropriate times, to determine whether it remains consistent with a benchmark efficient approach. In undertaking this task, the AER should take the following steps:

1. We should expect differences between allowances and actuals in an incentive-based regime. Drivers which are relevant to estimating benchmark efficient tax costs (ie- within the regulatory framework) need to be identified and those that are not relevant (because they are outside of the regulatory framework) should be excluded from the consideration.

[1] AER Initial Report, pages 45-47.

2. The AER should determine the benchmark efficient approach to corporate tax by reference to the practice commonly applied by regulated networks, and the legal obligations faced by the benchmark efficient entity, acting prudently under the requirements of tax legislation. Any changes to the current approach to estimating corporate tax should only be made if there is evidence that a different approach will result in a better estimate of benchmark efficient tax costs.
3. Having identified the current benchmark efficient approach, any changes to the way in which the corporate tax building block is estimated should be developed. Importantly, any changes must be forward looking and not retrospective (consistent with the maintenance of an incentive based regime) and there must be consistency in the approach. That is, a cost and the tax effect of that cost must be treated the same, so that either both are taken account of in the regulatory framework, or both are excluded.

The Businesses acknowledge that the above process will require an analysis of the tax paid by networks and predominant industry approaches, and we are supportive of the AER doing such analysis, guided by relevant external expertise. The information required for the analysis is not readily available and the issuing of regulatory information notices (**RINs**) is likely the best way for the AER to gather such industry-wide information. The scope of the RINs and the process of development is addressed further below.

**Possible responses identified so far**

We believe that evidence on the nature and drivers of "discrepancies" should precede consideration of potential responses. In the Initial Paper the AER identifies a range of possible responses to the apparent discrepancy between tax paid and regulatory tax allowance, including changes to the treatment of tax depreciation and changes to tax asset bases.[2]

The Businesses support the enquiry by the AER into whether the benchmark efficient approach should incorporate diminishing value depreciation. However, consideration needs to be given to the extent to which each network uses diminishing value depreciation, and the assets and rates used to apply that approach. If there is strong evidence that diminishing value depreciation is relevant and considered an efficient approach, the Businesses would support its incorporation into the benchmark efficient approach. However, the evidence would need to be convincing and a number of implementation issues would need to be addressed (as set out in the Energy Networks Australia submission). The adoption of such an approach would also need to be prospective, and could not apply to existing assets.

We do not think there is scope for changing tax asset values (the other proposal put by the AER's expert Lally), unless changes are also made to the RAB so that consumers also pay the full costs (in, for example, interest expenses) which give rise to the lower tax allowances that comes with the higher TAB. We note that this would result in higher prices, and we do not think it fits with the incentive framework of regulation.

In relation to refurbishment costs, the Businesses submit that the current approach where refurbishments and replacements are treated consistently should be maintained. This approach encourages efficient investment, consistent with the achievement of the national electricity and national

[2] AER Initial Report, page 38.

gas objectives. As illustrated in the Energy Networks Australia submission, an approach where refurbishment costs are treated as expenses immediately deductible, may result in inefficient investment incentives if not treated consistently in the regulatory framework.

In relation to the other potential responses identified in the Initial Report, we refer to and rely on the Energy Networks Australia submission.

**RINs**

In developing the RINs, care will need to be taken to ensure the information provided to the AER is tailored to be relevant and to enable the AER to undertake the type of assessment summarized earlier in this submission. It is also important to ensure the scope of the RINs is crafted having regard to the costs and complexity of the collation and preparation of the information, and the short timeframes proposed for compliance with RINs. The Businesses will work closely with the AER to seek to ensure the RINs achieve the intended purpose in the timeframes required. We support the submission of Energy Networks Australia in relation to the principles to be adopted, and the appointment of a working group to guide this process.

**The Rate of Return Review- Value of Imputation Credits**

The AER's draft Rate of Return Guidelines published earlier this month propose to set the value of imputation credits to 0.5. If this proposed value is maintained in the final Guidelines, this will have the effect of reducing the cost of corporate tax building block by approximately 20%. Other elements of the rate of return allowance will also be reduced. This would have a significant impact on networks' regulatory tax allowance and if maintained, must be considered by the AER as part of this review.

Please contact Patrick Makinson on [redacted] if you would like to discuss this submission further.

Yours sincerely


| Patrick Makinson | Renate Vogt | Craig de Laine |
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| Company Secretary | General Manager Regulation | General Manager Strategy and Regulation |