31 May 2018

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

Via email: TaxReview2018@aer.gov.au

Dear Warwick

**AER Issues Paper –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 Issues paper- Review of regulatory tax approach (**Issues Paper**).

The Businesses endorse the Energy Networks Australia submission in response to the Issues Paper including the responses to the AER's specific questions. The Energy Networks Australia submission is very detailed and we do not intend to repeat the positions put, in this document. Rather, we emphasise the matters that we consider should be the central focus in this review.

**Why regulatory tax allowances differ from actual tax paid**

Under the incentive regulatory framework in Australia, a service provider's allowed revenue is set by reference to the efficient costs of a benchmark efficient entity, rather than of the service provider itself. An allowance for tax costs is one of the building blocks making up allowed revenue and it is estimated to reflect efficient tax costs of the benchmark efficient entity. It is not based on the expected actual tax costs of the service provider.

A key benefit of this approach is that consumers pay no more for network services than the amount the regulator determines reflects efficient costs and if actual costs of the service provider exceed the allowance, there is no change in prices. Further, service providers are incentivised to conduct their businesses more efficiently and improve on the benchmark allowances. This also benefits consumers who share in any out-performance.

Importantly, and particularly relevant to the ATO's findings relating to tax paid by privatised networks, when there is a change in ownership of a service provider, there is no change to the regulatory allowances and consumers are protected from any costs associated with those transactions. Nor is there any re-valuing of the regulatory asset base, even where the purchaser pays more for the asset than its RAB. Similarly, any changes to the tax position of the network or its owners are not passed through to consumers.

Actual costs of the service provider, including tax costs, will necessarily differ from the benchmark efficient allowances estimated by the regulator. It is therefore not surprising, and to be expected, that actual tax observed to be paid by the ATO (noting the limitations of the ATO's conclusions in any event) differs from regulatory tax allowances. Under the incentive regime, every cost will differ from the regulatory allowance, and tax costs are no exception. The fact that there is a difference, even if material, does not indicate that there is a problem that needs to be addressed. Rather, as the Energy Networks Australia submission explains, it is necessary to understand what is causing the difference before determining whether any changes need to be made.

The ATO and the AER identify a number of drivers for the difference, including higher interest expenses, higher depreciation expenses, differences in gearing, tax losses carried forward and tax structures. The majority of the reasons for the difference between actual tax paid and benchmark tax allowances relate to payments made by (or tax deductions available to) network owners, which are outside of the benchmark efficient tax allowance and are uncompensated in the revenue allowance.

To take a simple example, the AER's current gearing assumption is that the benchmark efficient entity is financed 60% by debt funding and 40% equity. However a network owner may in reality have a higher gearing ratio (and it is free to do so) which would give rise to higher interests costs than allowed in the regulatory allowance. The higher interest costs will give rise to tax deductions which will result in actual tax paid being lower than the regulatory tax allowance. Just as the higher interest expense and risk is borne entirely by the network owner, the tax effect (higher tax deduction) also rests with the network owner and is not taken into account in setting the benchmark tax allowance.

**Do the differences indicate there is a problem?**

As set out in the Energy Networks Australia submission, the key issue is not that there are differences between actual tax paid and regulatory tax allowances, but what is causing the difference and if it relates to a matter that is relevant to and within the benchmark framework.

Where the differences arise from costs that networks (or their owners) incur which are outside of the costs compensated through the regulatory framework, then this is reflective of the incentive framework in operation and there is no need to make any adjustments.

However, if is identified that the difference is the result of the regulatory tax allowance being different from what are considered to be benchmark efficient tax costs, this indicates there may be an issue with how the tax allowance is being estimated, or the assumptions underlying it. Further investigation would be appropriate. This is discussed in more detail in the Energy Networks Australia submission.

The Businesses submit that this review should be focused on identifying any matters that suggest there is a departure between what is considered to reflect benchmark efficient tax costs and the regulatory allowance under the current Rules, and the reasons for it. This is likely to be a fairly narrow scope, which is perhaps appropriate given the tight time frame and complexity of issues involved.

**Next steps**

The Issues Paper states that the tax review will consider whether changes to the regulatory tax approach are appropriate, with the purpose of ensuring that energy consumers pay no more than necessary for the safe and reliable delivery of electricity and gas services.

As set out above, the Businesses submit that the incentive framework is already set up in way that ensures consumers do not pay any more than necessary for the provision of regulated services and consumers are protected from the majority of costs that are driving the difference in actual tax paid and regulatory allowances.

The relevant question is whether the regulatory tax allowance under the current approach is consistent with the tax that would be paid by the benchmark efficient entity, taking into account the dynamic nature of the tax system, and we submit that should be the focus of this review.

However any change in the approach to setting the regulatory tax allowance should only be made if there is strong evidence that the current approach gives rise to tax allowances which differ from the benchmark efficient cost of tax.

Please contact Patrick Makinson on (08) 8404 5865 if you would like to discuss this submission further.

Yours sincerely

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