

1 June 2018

Mr Warwick Anderson
General Manager, Network Finance and Reporting
Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601

Via email: taxreview2018@aer.gov.au

Dear Mr Anderson,

Submission to the AER's Issues Paper on the review of regulatory tax approach from the Network Shareholder Group (NSG)

We have come together as a group of private investors in the sector to facilitate contributions to energy and regulatory policy issues. As providers of long-term capital to support the provision of reliable energy network services to customers, we seek a regulatory regime that provides ongoing enduring confidence to invest efficiently through stability and transparency of process and outcomes, and importantly with confidence and certainty across multiple regulatory periods and resets. This ensures that risk remains consistent with investor expectations, reduces the cost of new capital to Network Service Providers (NSPs) and delivers lower prices to customers.

We support the AER's current approach to estimating the tax allowance. This approach is based on the efficient costs of providing services and recognises that the benchmark efficient entity (BEE) has an obligation to pay tax at the company tax rate. This approach ensures that customers pay no more than the efficient cost and share in the benefits of greater efficiencies over time through lower prices.

Key Messages

- We support the AER's current approach to estimating the tax allowance based on the efficient costs of the NSP including a benchmark approach to estimating the tax allowance.
- The benchmark approach to estimating the tax allowance is consistent and aligned to the BEE construct which underpins the Rate of Return (ROR). The tax and ROR benchmark constructs should remain aligned, i.e. they are interdependent not independent variables. If the benchmark approach to tax was removed, an upward adjustment to ROR reflecting increased uncertainty and decreased predictability would follow.
- The task of measuring a variation in the regulatory tax allowance and the actual tax paid on income received by NSPs is not straightforward and would require significant data to be provided, including by entities other than the NSPs.
- The major driver of the difference between expected tax and actual tax paid exists across the economy and therefore is better examined by the Commonwealth Treasury or through the Australian Tax Office (ATO), and not addressed through changes to the economic regulatory framework applying to energy NSPs.
- This review could impose additional costs on customers that are unlikely to be outweighed by any outcome of this review.

We represent major investors in NSPs and funds that are the custodians of the retirement and general savings for many millions of individual Australians – Spark Infrastructure, Hastings Funds Management, AustralianSuper, IFM Investors, Macquarie Infrastructure and Real Assets and AMP Capital (the Network Shareholder Group (**NSG**)).

Collectively, we have provided more than \$12 billion in capital to the following electricity transmission and distribution network businesses: Ausgrid, Endeavour Energy and TransGrid in NSW; SA Power Networks and ElectraNet in South Australia; and CitiPower and Powercor in Victoria.

It is critical that the review does not diminish the fundamentals of the incentive based economic regulatory framework that applies to regulated NSPs in Australia. This framework is established in the Australian energy laws, supported by the Australian energy rules and independently tested over time through merits and judicial reviews. Under this framework, customers pay no more than the efficient cost of providing services and benefit from strong incentives for network businesses to achieve efficiencies that are shared with customers over time through lower prices.

The National Electricity Objective (**NEO**) and the National Gas Objective (**NGO**) explicitly seek the promotion of efficient investment in, and efficient operation and use of, energy for the long-term interests of consumers with respect to:

- price, quality, safety, reliability and security of services; and
- the reliability, safety and security of the national energy systems.

Further, the Revenue and Pricing Principles (**RPPs**) contained in the National Energy Laws outline that an NSP must:

- Have a reasonable opportunity to recover at least the efficient costs of providing services and complying with obligations; and
- Be provided with effective incentives in order to promote economic efficiency.

The framework also requires that regard should be had to the economic costs and risk of over or under investment or under or over utilisation.

A detailed review of the difference between the regulatory allowance for tax and tax paid is likely to be irrelevant to the task of estimating the efficient tax allowance for the BEE. Instead, this review will merely highlight issues that are already known. That is, the differences arise from:

- Legal structural differences between the BEE corporate for regulatory purposes versus the actual legal structure adopted by each NSP (including utilisation of tax consolidated groups);
- Differences between the tax and regulatory treatment of income and expenses; and
- Most NSPs conducting more activities than purely regulated business.

A comprehensive review of each of these categories and the underlying drivers behind them will require significant information from NSPs as well as entities other than the NSPs.

The AER has highlighted the regulatory tax allowances represent 4 per cent of revenue allowances. We expect the cost of the review will outweigh any benefits of the review. The review will be complex, time intensive, resource consuming and is likely to increase the costs to customers. The initiation of the review by the Hon Josh Frydenberg MP introduces additional sovereign and regulatory risk that dampens investment incentives and increases the cost of capital (both equity and debt) as investors and lenders expect a higher premium to cover increased risk. This risk will be further exacerbated if the outcomes of the review undermine the fundamental principles of the incentive-based regulatory regime by, for example, departing from the BEE concept. The impact of uncertainty is likely to stifle investments in innovation and new technology, slowing the pace of transformation to a lower cost, low emission, reliable and secure energy supply system. This is a key area of concern for the Energy Market Transformation Project Team (**EMTPT**) supporting the COAG Energy Council.¹

¹ As outlined in the Bulletin released on 18 April 2018 – see <http://www.coagenergycouncil.gov.au/publications/optimising-network-incentives-report>

In addition, we expect that:

- The costs of the review itself are significant. This review draws on considerable resources of stakeholders and taxpayer funded entities such as the ATO, the AER and the Australian Energy Market Commission (AEMC). These costs include the costs associated with consequential reviews of regulatory information notices (RINs), the AER's post tax revenue model (PTRM) and the roll-forward model (RFM) and rule change processes. These costs will be paid by taxpayers.
- To the extent that the review results in any changes to the AER's current approach, NSPs will incur transition and implementation costs, as well as ongoing costs associated with incremental collection, review and analysis of tax data. These costs will be passed through to customers.

The AER's review should focus on differences between the regulatory treatment of income and expenses rather than issues that are not related to regulated services or are due to structural differences that affect the whole economy. The major driver of the difference is likely to be due to structural issues which are better examined by the Commonwealth Treasury or ATO and not addressed through changes to the economic regulatory framework applying to energy NSPs.

We urge the AER to consider the incentive-based framework under the National Energy Law and Rules and the cost-benefit trade-off of any potential changes in undertaking this review. It is also appropriate to consider whether any changes to the regulatory tax allowance - particularly where those changes require changes to the national energy rules or the AER's models - will change the expected risk profile. A change in the risk profile must be taken into account in the AER's review of the rate of return guideline (RORG).

We have attached to this letter our response to the questions raised by the AER in the Issues Paper. Please contact Sally McMahon, Economic Regulatory Advisor with Spark Infrastructure (phone: 0421 057 821) for further discussion or questions.

Yours sincerely,

Rick Francis
Managing Director & CEO
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Andrew Faber
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Attachment: Response to the AER's questions in the Issues Paper on the regulatory tax approach

Incentive based regulation and the BEE

The concept of the BEE is a critical element of the incentive framework and establishing the regulated rate of return (**ROR**). The opportunity to outperform (or underperform) the benchmark and realise a ROR greater than (or less than) the regulated ROR is a necessary component of attracting investment to the sector and encouraging NSPs and their owners to take a prudent level of risk, run the business as efficiently as possible and critically identify and foster innovation in future service delivery. Any changes to the benchmark will not only risk an adverse change in behaviour but also break a fundamental principle behind the entire incentive based regulatory framework.

We support the AER's approach to modelling tax for a NSP based on the BEE. That is, to model the expected revenue for the NSP through the post-tax revenue model (**PTRM**) (which includes benchmark efficient operating and capital expenditure, benchmark gearing and credit ratings and depreciation based on the regulated asset base (**RAB**) and regulatory inflation) and apply the corporate tax rate to taxable income, with an adjustment for the valuation of imputation credits.

This approach ensures that an NSP has an opportunity to recover its efficient costs, including the efficient cost of complying with obligations, and customers pay no more than the efficient costs of services received regardless of corporate decisions about structure, ownership or debt.

Further, the benchmark approach to estimating the tax allowance is consistent and aligned to the BEE construct which underpins the Rate of Return (ROR). The tax and ROR benchmark constructs should remain aligned, i.e. they are interdependent not independent variables. If the benchmark approach to tax was removed, an upward adjustment to ROR reflecting increased uncertainty and decreased predictability would follow.

Q1. Are there other publicly available sources that provide tax data for the regulated networks?

We are not aware of any other publicly available sources that provide tax data for the regulated networks. Further, any tax data available is very rarely likely to reflect the tax paid on income received by the NSP as very few NSPs themselves are tax paying entities and income tax is payable at the shareholder level.

Q2. Of the available data sources, which are the most appropriate for the purposes of the AER's review?

For the purpose of identifying the difference between the regulatory allowance for tax and the tax payable, none of the available data sources relied on by the ATO and the AER are appropriate due to a significant level of adjustment, exclusion and manipulation of data required. The ATO outlined that there were assumptions and exclusions incorporated in the analysis due to limitations in the data available and the AER has indicated that the data examined was scarce and conflicting.²

More importantly, the data does not appear to recognise that the tax payable on income earned by the NSP is not confined to the NSP. Over the years, NSP's which have been privatised have been structured in several ways, including; companies, partnerships, dual trust structures and dual partnership structures.

The impact of this is that in most structures other than companies, the liability for tax will be outside of the NSP itself. This could result in tax imposed at an Australian Superannuation Fund level, withholding taxes where the ultimate investor is non-resident, tax at a corporate securityholder level or tax in the hands of investors who have an indirect investment in a NSP via a listed or unlisted fund vehicle. It is therefore too simplistic to simply compare the regulatory tax allowance with the actual tax paid by a NSP and is likely to significantly under-represent total tax paid in relation to the income received by a NSP.

Even setting aside the structural differences, looking at the overall impost of Australian tax for each NSP will be very much dependent on who the investors are. For example, State and Territory owned NSPs do not pay

² AER, Issues Paper, Review of regulatory tax approach, May 2018, p. 1.

Australian income tax, the tax rate for superannuation fund investors will be dependent on whether the investment is allocated to the accumulation or pension phase of that individual super fund, also where listed and unlisted funds own indirect investments in NSPs, those fund investors will be subject to tax at their own tax rate depending on their status. Therefore, the total impost and effective tax rate will vary. These differences are not unique to energy network businesses. This is recognised in the ATO's note to the AER.³ However, it is not clear how the ATO has taken this into account.

Other information that would be required includes:

- Revenue and expenses that might be earned by related parties or unregulated services within the same tax paying entity (as they may impact on the tax revenue and tax expenses attributed to the NSP).
- The timing of tax payments over the life of the regulated assets or the long-term lease of the NSP assets with government.

The collection of this data would be a significant administrative task, the cost of which would be borne by taxpayers, NSPs, their shareholders and ultimately the customer increasing prices and volatility because of timing, change in ownership, different corporate structures, tax rulings or litigation. We do not consider that this exercise will be useful for considering the tax allowance for the BEE.

Looking forward, this investigation will also need to take into account the proposed legislation for the tax treatment of stapled structures and certain classes of investors in the infrastructure sector, as such proposed changes will have a direct and significant impact on how much and where tax is paid on income received by the NSP. In this example, a change in tax cost reflected in tariffs charged to customers is an anomalous outcome based purely on a change in ownership, and potentially above the NSP level.

Q3. What information would the AER need to obtain on actual tax payments in order to inform this review and any potential adjustments to the regulatory treatment of taxation?

As noted in response to Q2, the AER would need to obtain tax payment information for all structures and all investors over the life of the asset to properly recognise the tax paid, noting that tax law and investors will change over time (for example because of privatisation). For completeness, this might also need to include information on the value of imputation credits to individual investors.

Q4. Are there other potential drivers that could cause the difference (between expected tax costs and actual tax paid) identified in the ATO note?

We agree with the drivers identified by the ATO and the AER for the difference between the amount of tax paid and the tax allowance.⁴ We also note that many of these drivers result from decisions of owners rather than the NSPs and may have no bearing on the efficient cost of providing services. These variances are currently appropriately borne by owners. For example, there is no compensation in the regulated revenues if a credit rating of an entity is downgraded due to privatisation and perceived loss of parental support or when investors pay a higher price for the assets compared to Regulated Asset Base (**RAB**) value.

A change to the calculation or treatment of tax allowance would require consideration of other elements of the building blocks to ensure internal consistency. It is not clear whether such changes would decrease or increase the costs recovered from customers. These include:

- NSPs are not provided with an allowance for the tax liability on revenue received through financial incentive schemes despite this revenue being included in taxable income under the Australian tax system.
- Newly privatised assets tend to generate tax losses for several years before becoming tax payable.
- Tax paying entities include taxable income generated by unregulated services, and these activities may grow over time, contributing more to taxable income and increasing the tax paid by the entity in the future.

³ ATO, ATO Note, Indicative comparative analysis of the AER electricity distribution tax allowance and tax payable, 10 April 2018, p. 2.

⁴ AER, Issues Paper, Review of regulatory tax approach, May 2018, p. 16-17.

The AER should consider how any change made today will impact NSP allowances in the future.

Q5. How should we assess materiality of the potential drivers?

The materiality of the drivers will differ for each NSP over time and will depend on whether the materiality is being assessed for regulated NSPs or more generally across the economy. We consider that the materiality of a driver for an NSP should be compared with the materiality of the driver across the economy. If the driver has the same proportionate impact economy wide as on NSPs, then that driver is likely best addressed on an economy wide basis. Whereas, if the driver has a disproportionate effect on NSPs, the driver may warrant more attention at an industry level. However, as outlined earlier, if the driver has no impact on the efficient costs of the NSP or the expected tax to be paid by a BEE, but rather is driven by ownership or structure, there is limited merit in exposing energy customers to these impacts. These issues or changes in tax treatment should not be addressed through the regulatory framework. It is also likely to be inefficient for the AER to focus on issues that are already under review by the Commonwealth Treasury, for example, stapled structures.

Q6. Which of these potential drivers should be the focus for the AER's review?

The AER should focus on the holistic methodology for setting the tax allowance and maintaining its interrelationship with other parts of the regulatory framework. We reiterate our view that the current methodology remains appropriate and that the key driver for the difference is more appropriately dealt at the economy-wide level.