AER Review of regulatory tax approach

A presentation from the Network Shareholders Group –

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The NSG supports the current approach to setting the tax allowance for an NSP

- The current rules provide for an NSP to have an opportunity to recover its efficient costs and comply with obligations
  - Ensuring lowest cost, reliable and sustainable services to customers
- The current rules require the AER to apply the statutory income tax rate to the taxable income of the benchmark entity
  - Ensuring NSPs can comply with obligations
- The AER's current approach that assumes the BEE is an Australian Company that pays tax at the corporate tax rate under Australian tax law
  - Insulates customers from decisions taken by owners that increase the tax paid by an NSP
  - No additional compliance and process costs
  - Is simple and understood
  - Provides ongoing incentives to improve efficiency and invest
  - Does not increase uncertainty for future investment

Passing through tax costs is not in the long term interests of customers

- Significant costs associated with capturing, and reporting information, compliance and enforcement will be passed through to customers
- Customers bear 100% of changes in tax payments due to the behaviour of owners
  - Changes in ownership or portfolio of ownership
  - Purchase price
  - Corporate or capital structure
  - Intercompany loans
  - Related party activities
  - Unregulated services
- Price volatility of actual tax profile
- Benefits to customers of lower costs are off-set by higher tax payments
- Unnecessarily introduces complexity and uncertainty impacting on incentives and costs of investment
- Implementation and transition issues
  - How is tax paid defined and captured (by gov entities, at investor level)?
  - Increased risk of cost recovery for NSPs
  - Circularity
  - Treatment of past payments and losses

Two tasks for the AER

1. Is there a difference between the tax allowance and tax paid for NSPs?
2. What is the appropriate regulatory allowance for NSPs?

Backward looking

Task 1: Is there a difference between the tax allowance and tax paid for NSPs?

- Yes
  - There is no expectation that the regulatory allowance will equal actual tax paid by an individual NSP
- This task will require:
  - Collection of data over a long period of time for all NSPs
  - Capture all tax paid on the revenue received by the NSP regardless of which entity or shareholder pays tax
  - Appropriately allocate and attribute tax paid to the NSP (rather than related parties) for regulated services only
- Is there any benefit from completing this task?
  - Only where it can inform the appropriate forward looking benchmark
  - Must be best practice not average practice
  - Require a framework for assessing efficiency (and best practice) to guide information to be collected

Should customers pay for variations between the regulatory allowance and actual tax paid?

- Customers would pay more or less in each year as a result of:
  - A different (or change in) corporate structure or ownership portfolio
  - Variations between forecast and actual capex and opex
  - Variations in the value of assets (not just the cost of assets)
  - Variations in revenue
  - Variations in tax depreciation (method, lives, timing)
  - Variations in capital contributions
  - Rewards and penalties under financial incentive schemes (EBSS, CESS, STPIS, F factor, DMIS)
  - Actual debt costs (actual gearing, credit rating, intercompany loans)

Forward looking

Task 2: What is the appropriate regulatory allowance?

- The efficient cost of complying with the tax obligation applying to the benchmark entity
- Paying tax is an obligation of an NSP or its shareholders
  - It would not be appropriate to provide an NSP with revenue that is less than the efficient costs of complying with obligations
  - It would not be appropriate to assume that the efficient cost of complying with tax obligations is to pay less (or more) than the obligation
- Therefore, the task requires two questions to be addressed
  1. What is the efficient structure and practice for a benchmark NSP?
  2. What is the tax obligation of an NSP with an efficient tax structure, receiving the revenue consistent with the determination and incurring the efficient tax expenses?

Australian tax law	AER Current approach	Option 1: Change benchmark entity	Option 2: Change benchmark practices	Option 3: Change tax rate
Applicable entity	Australian Company	Trust, Partnership, Government corporation, foreign or Australian owned?	Australian Company	Australian Company
Taxable income includes ex-post revenue from all sources including financial incentive schemes	Taxable income = ex-ante PTRM revenue less tax expense less tax loss carried forward	Taxable income = PTRM revenue less ex-ante tax expense less tax loss carried forward	Taxable income = PTRM revenue including revenue from financial incentives less ex-ante tax expense less tax loss carried forward	Taxable income = PTRM revenue less ex-ante tax expense less tax loss carried forward
Tax expenses includes ex-post expenses reflecting statutory financial information	Ex-ante tax expenses = forecast opex + tax depreciation + interest on 60% of RAB + revenue from incentive schemes	Ex-ante tax expenses = forecast opex + tax depreciation + interest + revenue from incentive schemes	Ex-ante tax expenses = forecast opex + tax depreciation + interest	Taxable expenses = forecast opex + tax depreciation + interest + revenue from incentive schemes
Tax depreciation can be either straight line or diminishing value, asset lives assessed	Tax depreciation = straight line applied to TAB with asset lives proposed by NSP	Tax depreciation = straight line applied to TAB with asset lives proposed by NSP	Tax depreciation = diminishing value applied to TAB with asset lives proposed by the NSP	Tax depreciation = straight line applied to TAB with asset lives proposed by NSP
Tax rate = applicable legal obligation (imputation credits applied consistent with law)	Tax rate = applicable legal obligation less AER value of imputation credits	Tax rate = applicable legal obligation (and consistent value of imputation credits)	Tax rate = applicable legal obligation less AER value of imputation credits	Tax rate = alternative tax rate reflecting a combination of obligations (require reassessment of imputation credits)

No expectation that these will be equal – one reflects actual financial information, the other reflects regulatory and benchmark assumptions

Should customers pay more or less as a result of ownership or structure (or a change in ownership or structure)?

How is efficient practice assessed?

How is the alternative rate determined (linked to obligation and recognise tax life cycle)?

Question 1: What is the efficient structure and practice for a benchmark NSP?

- Structure
  - Australian Company
  - Partnership
  - Trust
  - Government corporation
- Ownership
  - Private or government
  - Australian or foreign
  - Superannuation fund
- Taxable income and taxable expenses
  - Consistent with law or regulatory assumptions (or a combination)
- Time period
  - Average each year or modelled over the life of investment

What is the benchmark entity?

- Not apparent from current information
  - No clear evidence of a preferred structure or ownership
  - Highly dependent on private or public ownership
  - Challenges comparing tax expense to tax allowance
  - Many issues that have implications for tax are under review by the ATO and the Australian Government
  - No framework for assessing efficient structure or ownership
- Should customers pay more or less because of ownership?
  - The AER and Lally agree that customers should pay no more or less as a result of ownership
  - If ownership matters, need to determine what constitutes tax paid?
    - Government entities – tax paid to itself
    - Private entities – tax paid at the entity and investor level

Question 2: What is the tax obligation for the benchmark entity?

- The applicable tax rate under Australian Taxation Law
  - Reflect the assumed structure and ownership
    - Single or combination of structures
    - Single or portfolio ownership
  - Reflect assumptions
    - Taxable income
    - Taxable expenses
    - Tax losses
    - Tax profile

Principles

- Any changes must be capable of being adopted by the NSP under tax law and applied prospectively
- The benefits of any change should consider life cycle costs, not simply push costs in to a future period, or ignore past costs
- A Change in the benchmark structure must be informed by total tax paid on revenue received by the NSP including NTER payments and tax paid at entity and investor level
- A change in tax depreciation must not impose windfall gains or losses as a result of being at a particular point in the tax cycle (noting these changes impact on timing, not value)
- Information requirements should be targeted at monitoring benchmark structure and practices and the costs and benefits of collecting the information