AER Review of regulatory tax approach

Public forum on discussion paper

7 November 2018

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Outline

- Process and aims
- Drivers and responses

Outline – Process and aims

- Aims of the review
- Information gathering
- Role of the discussion paper
- Current approach

Aims of the Review

- Examine the tax difference
  - What is the extent of the difference?
  - What is driving the difference? Past and future?
- Consider changes in response
  - Reducing the tax difference is not an end point
  - Identifying possible changes that might reduce the tax difference, but only where to do so helps ensure customers pay efficient costs over the long term
- Rule and model changes

Information gathering

- Public forum (July):
  - Collect detailed tax information from NSPs
  - Stakeholder concerns around scope
- Voluntary information (August)
  - Extensive stakeholder engagement
  - Letters 17 August, due 31 August
- Formal Information gathering (October)
  - Consultation on draft RINs in September
  - RINs issued 9 October, due 26 October

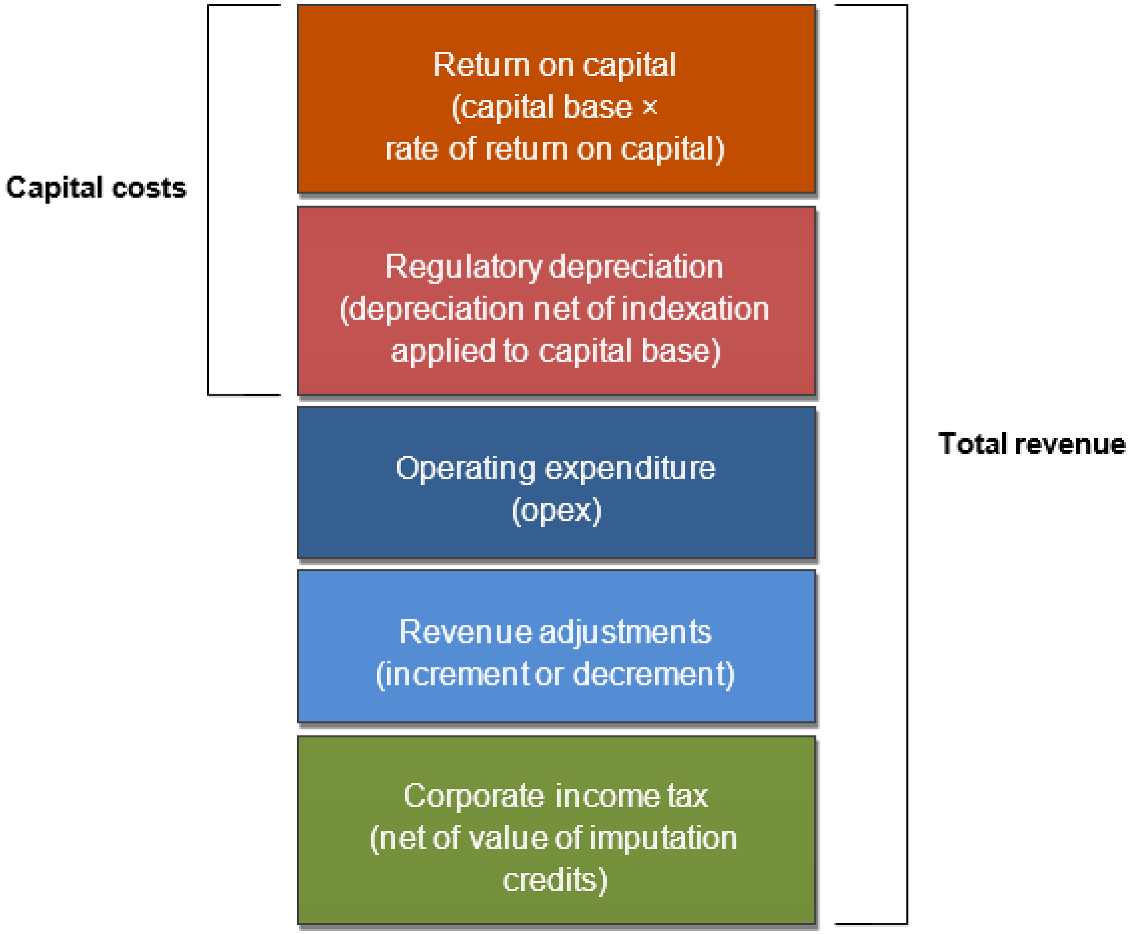
Role of discussion paper (1)

- Limited information available
  - Based on voluntary information only
  - Uneven data set – some areas have good coverage
- Reflects advice and submissions
  - Expert tax advisors (PwC and ex-ATO)
  - Economic advice (Lally)
- Discussion paper, not decision
  - Process ongoing with further consultation
  - Substantive new material expected in some areas

Current approach (1)

- Current regulatory framework
  - Building block incentive approach
  - Incentive for efficiency gains for business
  - Gains shared with consumers over long term

Current approach (2)



Outline – Drivers and responses

- ATO Note
  - Drivers of the tax difference
- Responses to drivers
  - Entity ownership and structure
  - Depreciation
  - Interest
  - Tax pass through

ATO note – Tax difference

- Tax difference varies based on ownership
  - Private entities' actual tax paid is <u>less</u> than the regulatory forecast of tax costs
  - NTER entities' actual tax paid is <u>more</u> than the regulatory forecast of tax costs

ATO note – Drivers (private sector)

- Entity structure
  - Tax payable at investor level not the entity level
- Interest expense
  - Gearing above AER gearing level
- Available tax losses
  - Significant losses not entered into AER model
- Depreciation
  - Several drivers - diminishing value depreciation, self assessed asset lives, low value pools

ATO note – Drivers (private sector)

ATO driver	Chapter	Major issues
Entity structure	5. Entity structure and ownership	Benchmark tax rate
Accrued tax losses		
Depreciation	6. Depreciation - Timing effects	Immediate expensing
		Diminishing value
		Gas asset lives
	7. Depreciation - Value effects	TAB revaluation
Interest expense	8. Interest expense	Interest expense
	9. Incentive regulation vs tax pass through	Tax pass through

Entity structure and ownership

- Chain of ownership
  - Flow-through structures where tax obligation passes up the chain
  - No observed tax payments at the initial level
- Aggregation of ownership
  - Tax only dealt with at consolidated level
  - Regulated activities may only be a small component
- Accrued tax losses
  - No observed tax as previous tax losses used up
  - Secondary effect (why were tax losses present?)

Key issue – Benchmark tax rate

- We propose no change is warranted
  - ✓ Reflect more ‘efficient’ ownership with material impact
  - × Most networks appear to pay 30% rate, after tracing ownership chain (applies both overall and only considering private sector entities)
  - × Windfall gains/losses for existing owners
  - × Not achievable for all owners (or at significant cost)
  - × Legislative changes cause concessional tax rates to increase towards standard 30% rate
  - ? Options: Choice of alternative rate (0%, 15%, other?)

Depreciation

- Timing effect
  - Earlier depreciation relative to the AER approach (ATO makes no time value of money adjustment).
  - Lower tax payments now worth more than lower tax payments later (may be decades later)
- Value effect
  - More depreciation available than under the AER approach, which means more tax expense, which means lower tax payments
- Several ATO note drivers not material

Key issue – Immediate expensing

- We consider this a possible change
  - ✓ Achievable, reflects common practice by NSPs under current tax legislation
  - ✓ Efficient practice (lower cost because of NPV effect)
  - ✓ Material driver of tax difference (in aggregate)
  - × Not material for some NSPs (varied impact)
  - × Assessment (forecasts and actuals) difficult and this this affects either implementation option
  - × Potential negative capex incentives
  - ? Options: NSPs specific or benchmark percentage

Key issue – Diminishing value

- We consider this a possible change
  - ✓ Achievable, reflects most common practice adopted by private sector networks (but not NTER)
  - ✓ Efficient practice (lower cost because of NPV effect)
  - ✓ Material over the longer term
  - × Tax legislation prevents switching midstream, so may not be achievable for all networks
  - × Implementation options raise concerns over materiality or modelling complexity or NSP selection
  - ? Options: Scope of application (new or existing assets)

Key issue – Gas asset lives

- We consider this a possible change
  - ✓ Achievable, reflects common practice by SPs and current tax legislation
  - ✓ Efficient practice (lower cost because of NPV effect)
  - ✓ Material driver, but only for those affected gas SPs
  - × Implementation options raise concerns over materiality or achievability or retrospectivity
  - ? Options: Scope of application (new or existing assets, and on method for adjusting existing assets)

Key issue – TAB revaluation

- We consider no change is warranted
  - ✓ Targets a material driver of underlying discrepancy
  - ✓ Reflects current tax legislation treatment of M&A
  - × Would mean RAB/TAB valuation no longer insulated from changes in market value
  - × Assessment of new values difficult (disaggregation), may include non-regulatory costs in TAB
  - × Discourage transactions (Lally)
  - ? Options: Basis for calculating new TAB

Key issue – Interest expense

- Insufficient information at present
  - ✓ More ‘accurate’ interest expense
  - × Difficult to determine the appropriate adjustment
  - × Difficult to ensure consistency with overall compensation package (and rate of return)
  - ? Options: Unclear because underling driver not known
  - ? Adjust gearing (for tax only)
  - ? Adjust debt to market value (for tax only)
  - ? Adjust interest expense
  - ? Adjust treatment of hybrid securities

Framework - Tax pass through

- Benchmark approach aims to harness efficiency gains for consumer benefit
  - Regulatory review important for passing those benefits through to consumers
  - We observe achievable tax practice, but do not determine what does/does not comply with tax practice.
- Tax pass through reduces tax discrepancy, but does it mean consumers pay more than efficient costs?

Key issue – Tax pass through

- We propose no change is warranted
  - ✓ Directly targets tax discrepancy
  - × In long term, possible increase in tax costs above efficient level as firms have no incentive to minimise
  - × In short term, possible increase in tax costs because of timing effects (where tax depreciation exhausted)
  - × Practical implementation, monitoring, ring fencing concerns
  - ? Options: Full or capped pass through, incentive mechanism

Invite submissions

- Next steps outlined in paper
- Seven summary tables for comment
  - Include possible pros/cons
  - Include multiple implementation options
- Recap - role of discussion paper
  - Changes in long term interest of consumers
  - Limited information set currently
  - Describes possible changes, pros and cons
  - Part of ongoing process