Review of regulatory tax approach

Preliminary Response to the AER Discussion Paper

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Preliminary views

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Consumer Challenge Panel

Overview - 1

- Preliminary high level view – generally supportive of AER's overall approach and recommendation – noting details to be determined
  - Support changes to immediate expensing of capex, using DV, reducing tax asset lives for gas
  - Support no change to asset revaluations, self-assessment of asset lives, TAB asset revaluation, low value pools
  - Question though about entity structure and ownership recommendation
- Disappointing about the lack of time to consider the issues given the Minister's timetable
- Accept the criteria used to evaluate possible changes in tax calculation - but suggest more detail on the definition of "material" would be helpful
- Key issues relate to how the AER assesses taxable i
  - eg depreciation, "refurbishment" capex expensing etc

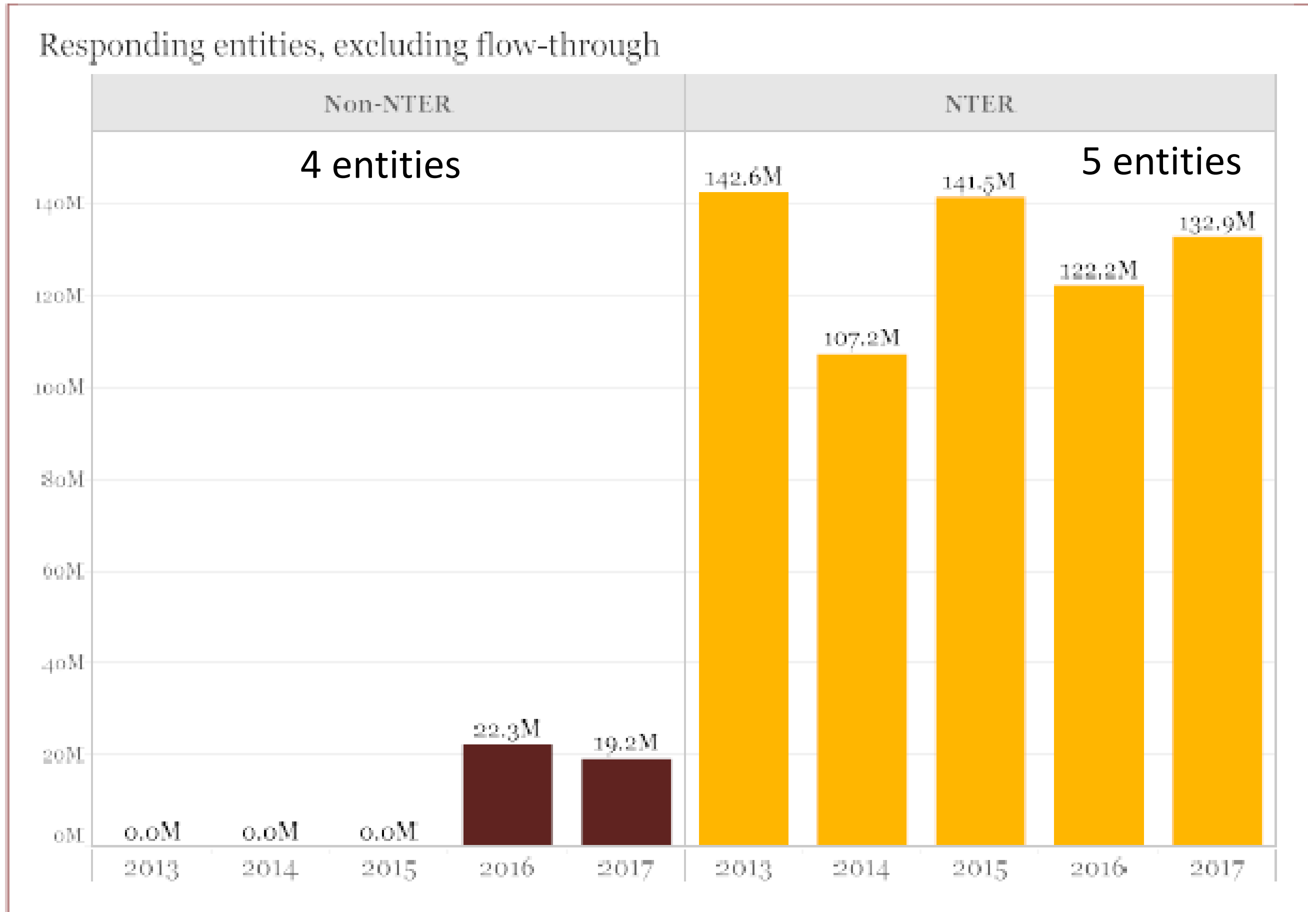
Preliminary views

Overview -2

- We agree with the objective of better matching the tax allowed with the typical tax position of a privately owned network
  - And note that this may impact on the time profile of prices consumers pay over the asset life
- So we agree with the use of data to determine the efficient benchmark to achieve this outcome, but significant issues remain around how it is defined
  - We comment on possible different approaches
  - Is there a case for consumers sharing the benefits/costs of different tax management practices?
- Look forward to the RiN data - esp interest payments
  - More consultation needed on December report
- Consumers are looking for the AER to:
  - significantly narrow the gap by changes applying from April 2019 decisions
  - Continue ongoing data gathering and analysis of remaining issues
  - Commitment to regular tax benchmark review completed well prior to the next rate of return review

Preliminary Views

The pub test for consumers - 1



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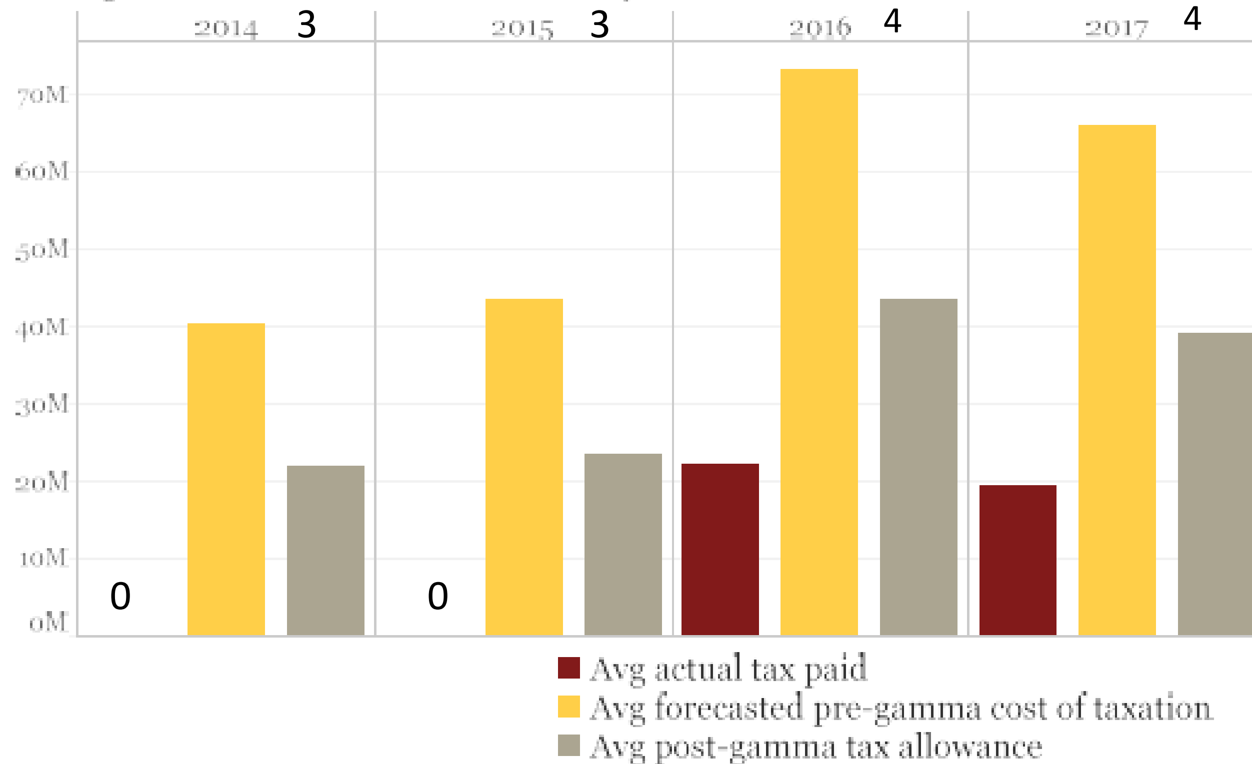
The pub test for consumers - 2



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We generally accept the AER's evaluation criteria

- Does it reflect efficient costs of operating the regulated network?
  - We agree with its importance when assessing intergenerational equity issues around depreciation
- It is material?
  - AER does not provide any specific guidance – just makes judgements about materiality
  - Agree with considering implementation costs but networks can overstate these costs eg RiT for replacement capex
- Is it an achievable tax practice?
  - Should consumers share the benefits/costs of a network choosing to depart from the benchmark?
- Is it a broader tax issue and hence best left to the ATO?
  - AER should base tax calculations on existing legislation and rules practice?
  - So why not base the structure on what is current situation rather that what will happen in 15 years? (noting future privatisations can qualify for this 15 yr exemption (from date of privatisation?)
  - Why should consumers pay the "transitional costs" associated with th transitional rules on stapled security structures?

Preliminary views

AER's conclusions (1)

Issue	AER's conclusion	CCP Response
Pass through vs benchmark approach	Not moving to pass through	Agree subject to robust benchmarks for each component
Entity structure & ownership	No change- applicable to only a limited number of firms and they will change under recent announced changes to tax law and ATO decisions	Benchmark based on actual practice today; why should consumers pay transitional costs for eg 15 years?
Asset revaluations	No change - continue current approach, ie not adjust the TAB/RAB for market transactions.	Agree with AER's position

AER's conclusions (2)

Issue	AER's position	CCP's Response
Recognise immediate expensing of capex	Change - Implemented in DNSP proposal? Or Benchmark allowance?	Agree in principle - need more clarity on the options and definition of 'refurbishment'
Use DV approach	Change - adopt DV but for new assets only, or for all existing and new assets in the TAB?	Agree in principle but option of two benchmarks given ATO switching rules
Reducing tax asset lives for gas	Change - recognises ATO legislation on 20-year cap, but new capex or all existing capex in the TAB?	Agree in principle - prefer to apply to all gas assets but need to understand extent of issue
Treatment of interest expenses	Still under consideration awaiting RiN data	Important issue – implemented for April '19? In principle, we consider AER should adjust its approach given different definitions of debt for regulatory and tax purposes.

Our understanding of AER's position

Issue	Benchmark?
Structure and ownership	• Yes - Set privately owned benchmark based on "achievable tax practice"
Statutory tax rate	• Yes – 30%
Expensing of refurbishment capex	• Yes – the principle of expensing reflecting benchmark firm in the current tax environment • No – application to be network specific reflecting actual values given wide disparity among networks
Move to diminishing value as tax depreciation method	• Yes – the principle reflects actual tax practice of privately owned networks and should be applied to all networks • Yes – apply prospectively to networks who currently use straight line • ?? – what assets should it cover?

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What do we mean by the benchmark approach?

- Agree with AER approach based on private sector ownership for competitive neutrality (p. 24)
  - So the tax situation of government owned entities is irrelevant for this discussion
- But detailed implementation in the LTIC may mean:
  - Multiple benchmarks and/or
  - network specific benchmarks rather than network approach eg expensing of refurbishment capex
- Benchmarks will change over time as tax practice changes and this needs to be monitored by the AER

Preliminary views

Specific Issues – immediate expensing of capex

- Current AER approach of zero expensed not current practice
  - Variety of approaches to expensing depending on asset life and different interpretations of the ATO's position
- We understand the benefits of the AER suggested network specific approach to expensing capex but prefer a benchmark if possible
  i. Getting business to provide estimate
     - may introduce gaming underestimate expensing in proposal from actual level
     - can it be addressed by true-up based on actual expensing and obviate need for CESS style incentive scheme

  ii. AER sets a conservative % benchmark – start conservative and monitor
- Examine need for the AER to develop a clearer definition of refurbishment for the revenue determination process
  - How to ensure not inconsistent with ATO's definition – given it is not precise?
- Agree with the AER that NPV=0 impact needs to be assessed over the asset life, not a single reset period – just as with the expected inflation analysis

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Specific Issues – depreciation

- Support the move to using diminishing value as the tax depreciation benchmark
  - Consistent with current practice of privately owned networks
- Complexity arises because of tax rulings that both DV and SL methods are valid and that a business cannot change approach over life of the assets
  - Preference is to apply DV approach for all assets for all businesses
  - But recognise that this may be problematic for some – need to understand extent of this however.
  - Is there a middle way – two 'benchmarks':
    - If historically used DV – continue
    - If historically used SL – apply DV for new assets

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Specific Issues – interest expense

- CCP considers this a very important issues and we are concerned that there will be insufficient time to properly consider the matter.
- Not bound by 60/40 ratio used in determining WACC
- Our basic issue is that there is clearly a difference in the debt/equity ratio (60/40) used for:
  - the above the line AER revenue determination (including assessment of regulatory taxable income), and
  - the ratio NSP's use for tax purposes.
- We understand this arises from eg:
  - Different definitions of debt and equity for regulatory and tax purposes
  - Differences in market vs regulatory valuation
- Conclude that AER should endeavor to establish a benchmark approach for industry and apply that in tax calculation

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Looking for more clarity on how changes will be achieved

Possible change	How it is achieved?
Immediate expensing of refurbishment capex	• Model amendment (p.48) • CESS type incentive scheme to remove incentives if applying a NSP specific approach "…would likely require a rule change" (p. 58)
Using diminishing value rather than straight line	Model amendment (p.49)
Gas pipeline asset life	Seems to be a model change (p.50)
Gearing ratio/interest expense	"May require a rule change to implement" (p.88)

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Preliminary conclusions, next steps

- We are in broad agreement with the AER's approach and recommendations at this stage
- The tight timetable has created issues around how to fully consider the issues
- Given the importance of the debt issue, we think there should be another round of consultation on the December report incorporating RiN data
- Consumers are looking for the AER to:
  - significantly narrow the gap by April 2019 decisions
  - Continue ongoing data gathering and analysis of remaining issues
  - Commit to regular tax benchmark reviews completed well prior to the next rate of return review

Preliminary views