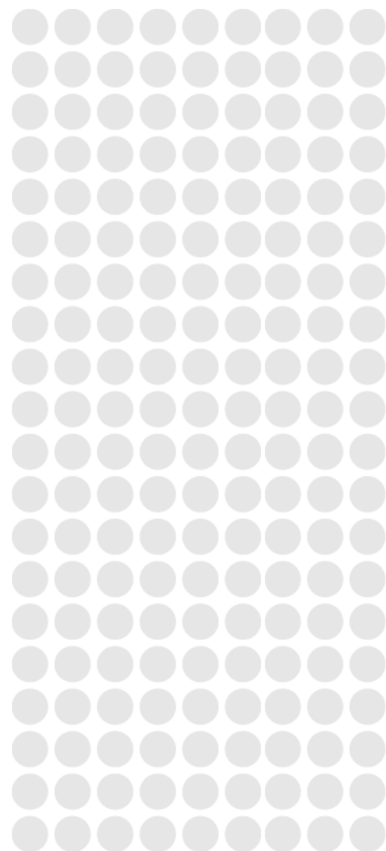
November 2018

AER review of regulatory tax approach

APA response to AER discussion paper



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1 framework

The purpose of this review is to ascertain whether the AER's approach for determining the amount of the regulatory tax allowance is reasonable. This is relevant because, if the AER's approach leads to an allowance in excess of a reasonable amount, then prices charged to consumers will be greater than efficient levels. Conversely, if the allowance is less than a reasonable amount, tax allowance shortfalls will need to be made up through reduced returns to investors, which runs the risk of a chilling effect on investment. Getting the allowance right will be a delicate balance, but getting it right is clearly in the long term interests of consumers.

It is in this context of ongoing improvements to the regulatory framework that APA supports the AER's review of the approach to calculating the regulatory tax allowance.

Different stakeholders will hold different views as to whether the tax allowance is reasonable, excessive, or insufficient, based on their differing perspectives. This review will need to find a way to address these differing perspectives.

APA considers that this assessment must be conducted in the context of the regulatory regime in which it applies. In particular, attempts at a direct comparison of the regulatory tax allowance against the amount of cash tax paid to the ATO disregard the fundamental differences in these two special purpose financial reporting regimes.

It is critical, in APA's view, for any assessment of the reasonableness of the regulatory tax allowance to be conducted in the context of the regulatory regime in order to preserve the internal integrity of the regulatory regime.

This submission discusses the key issues in this context. A key theme of this discussion is that it will be critical, in order to maintain the internal integrity of the regulatory framework, to apply consistent benchmarks between the calculation of the allowed revenue requirements and the allowance for tax based on that allowed revenue requirement. Applying inconsistent benchmarks to different aspects of the regime could reduce the confidence that both consumers and investors place on the outcomes. This reduction in confidence would clearly not be in the long term interests of consumers.

2 tax vs regulatory reporting frameworks

Figure 1 below provides a side-by-side comparison of the calculation of tax payable and the regulatory tax allowance. This analysis is consistent with the format in which APA replied to the AER's tax information RIN.

Figure 1: Tax payable vs regulatory tax allowance

ATO Statement of Taxable Income:		Tax allowance in a Regulatory context:
EBIT per statutory accounts		EBIT per statutory accounts
	→	+/- Regulatory incentives
- Book interest expense	↔	- Regulatory cost of debt
+ Permanent additions		+ Permanent additions
+ Timing additions: Accounting depreciation	↔	+ Timing additions: Straight line RAB depreciation
- Permanent deductions		- Permanent deductions: Indexation of the capital base
- Timing deductions: Tax depreciation	↔	- Timing deductions: RegTax depreciation
= Taxable Income		= Regulatory Taxable Income
x 30% tax rate		x 30% tax rate
= Cash tax payable		= Regulatory Tax Allowance

This analysis exposes a number of key features that are discussed in more detail in this submission:

- the tax regime has no regard to the incentive features embraced in the regulatory regime;[1]
- in sharp contrast to the tax regime, the regulatory framework provides for indexation of the capital base;[2]

[1] The tax regime includes its own suite of incentives, such as accelerated depreciation to promote investment in target industries. Importantly, the objectives of the tax regime's incentive framework differ from those of the AER's economic regulatory regime.

[2] The PwC review of overseas practice does not address that the US regulatory model uses historical cost as the calculation of the regulatory asset base. In contrast, Australia started with a relatively recent independent revaluation of the network assets (in the Hilmer era) and

- the regulatory regime features a return on debt based on a benchmark level of gearing on the indexed capital base, multiplied by an externally-determined AER-allowed cost of debt; and
- a total of *four* different measures of depreciation.

These key differences, and their relevance to an analysis of the regulatory allowance, are the subjects of this submission.

2.1 incentive mechanisms

While not relevant to the *ex ante* calculation of the regulatory tax allowance, APA considers that any analysis comparing the cash tax payable to the regulatory tax allowance must consider the revenue impacts of any applicable regulatory incentive mechanisms.

As in its previous submission, APA submits that this recognition must include not only the AER's formal incentive mechanisms (STPIS, EBSS, CESS), but must also include the incentive mechanisms inherent in the regulatory regime.

Particularly as it relates to the pipeline industry, APA submits that any revenue impacts associated with volumetric or service outperformance in a price cap regime must be reflected in any comparative analysis. The information provided by APA in response to the AER's tax information RIN includes these impacts in the analysis.

has applied indexation since. This makes any comparison of the regulatory tax allowance against tax paid difficult.

3 key issues

3.1 benchmark corporate structure

The PwC report identified that there is a range of corporate structures under which investment in network businesses are held. Some of these structures reflect foreign ownership interests, trust structures, etc.

APA considers that the actual form of the corporate structure holding the network assets has some scope to be fluid as either 1) assets are traded in the international marketplace; or 2) tax laws, either in Australia or overseas, change to favour one form of corporate structure over another.

In this respect, it would be difficult for a stable regulatory regime to apply an actual corporate structure in the calculation of any of its building blocks – the actual corporate structure could well change, either within or between regulatory periods. This leads the regulatory framework to prefer a benchmark over an actual corporate structure.

In terms of the impact on the regulatory tax allowance, the PwC analysis (Figure 1) indicated that over 70% of regulated asset holders pay tax at a 30% tax rate.[3] Any corporate structure featuring the same tax rate would therefore serve as a reasonable benchmark.

In this regard, APA supports the AER's decision to retain the Australian corporate benchmark entity structure.

3.2 asset revaluations

Acknowledging that there is a global trade in regulated network assets, it is important that consumers have confidence that prices will not increase by virtue of any upward asset valuation caused by the purchase of assets over time. The fact that regulated asset values are not adjusted on acquisition is an important feature underpinning the stability and predictability of the regulatory regime.

[3] While APA is structured as a stapled security it pays tax at a corporate rate (a "Division 6C public trading trust" – see PwC p40).

APA therefore supports the AER's position that the regulatory tax allowance should not be affected by the value reflected in any acquisition of the business. Indeed this should apply consistently to both upward and downward revaluations.

However, APA has identified inconsistency in arguments that:

1. tax depreciation applied in the calculation of the regulatory tax allowance should be adjusted to reflect any upward asset revaluations; and
2. interest expense applied in the calculation of the regulatory tax allowance should reflect the amount of debt financing held by the parent following an acquisition of a network business where the "actual" interest expense is greater than the regulatory cost of debt.[4]

APA considers that either of these positions is fundamentally inconsistent with the principle that consumers should not be impacted by asset revaluations occurring on changes of ownership.

APA therefore supports the AER's position to refrain from adjusting the regulatory tax depreciation or the regulatory tax deduction for interest expense to reflect the impact of any business acquisitions.

3.3 actual vs benchmark debt and gearing

The impact of business acquisitions on interest expense was discussed immediately above. This addressed the *amount* of debt considered to be outstanding in calculating the interest expense deduction in the AER tax allowance calculation.

The other component in calculating the interest expense deduction is the cost of debt applied to the outstanding amount.

As previously advised, as a multi-asset holder, APA raises capital at the corporate level. It does not allocate any particular debt issue to any particular operating business. As APA manages a portfolio of debt issues, it is

[4] Actual interest expense might be greater than the regulatory cost of debt where the parent either 1) financed an acquisition at a gearing level higher than the AER's benchmark, 2) acquired an asset for a value greater than the regulated RAB, or 3) both.

not possible to determine the "actual" cost of debt applicable to any particular pipeline or regulated asset. Any attempts to allocate debt or interest expense from the corporate entity to any operating business would be arbitrary.

Moreover, APA notes that the AER has just undertaken an intensive process to determine the appropriate cost of debt through its review of the Rate of Return Guideline. It would be difficult to imagine a more relevant estimate of the cost of debt for tax interest expense purposes than that just determined by the AER itself.

The AER requested information on actual debt issues and the related cost of debt for each issue, as part of its tax information RIN. While APA provided this information as required by the RIN, APA considers that this information is not relevant to the question of the reasonableness of the regulatory tax allowance. Moreover, reflection of such actual costs would mark a profound departure from the economic foundations of the framework.

Consistent with the views of other stakeholders, APA has been concerned with the compressed time frame in which this review has been undertaken. This abbreviated time frame has not allowed for consultation on, and considered analysis of, the implications of reflecting actual interests costs in the tax allowance calculation. Should the AER conclude that of actual debt costs have a role in the regulatory framework, this fundamental change to the fabric of the incentive regulation regime must be examined through a broader consultation and analysis process.

Finally, we should note that Table 8.1 of the AER Discussion Paper presumes that "actual" interest expense (ie interest tax deduction) is greater than the AER allowed cost of debt. While this may be the case (particularly considering the low allowed cost of debt in the AER's Rate of Return Guideline), it is entirely possible that the "actual" interest expense is lower than the AER's allowed cost of debt.

This may be driven by lower gearing than the AER benchmark, or by the business being able to secure debt funding at a lower rate than the AER cost of debt. In this case, applying the "actual" cost of debt would result in a lower interest expense deduction and consequently a greater tax allowance building block.

3.4 depreciation

There are three issues discussed surrounding depreciation, each of which is discussed below.

3.4.1 immediate expensing of refurbishment

APA accepts that, where a business undertakes refurbishment expenditure which is immediately deductible for tax purposes, prudent tax management practices would see the refurbishment expenditure claimed as an immediate tax deduction. This presents a timing difference between the tax and regulatory regimes.

From a regulatory perspective, the issues are twofold:

1. ensuring consistency between the return on and of capital building blocks and the regulatory tax allowance; and
2. estimating the proportion of expenditure that is refurbishment, rather than capital, in nature – whether such an estimate should be a business-specific forecast, considering the scope for volatility in annual refurbishment expenditure, or the subject of an industry benchmark.

These are difficult questions, that require broader consideration and analysis, to ensure that other unintended consequences (and opportunities for gaming) are not created.

While the AER will consider the magnitude of the issue by reference to the RIN information provided, APA considers that this is one area in which a change to the regulatory tax approach should be approached with great caution.

3.4.2 move to declining balance tax depreciation

The AER's Post Tax Revenue Model applies straight line depreciation of the Tax Asset Base for the purposes of calculating the regulatory tax allowance.

The tax information RIN should provide the AER with detailed information on the extent to which businesses currently apply prime cost (ie, straight line) or diminishing value depreciation for tax purposes.

With this information in hand, the AER should be in a position to assess the magnitude of any change to the assumed method of depreciation for tax purposes.

To the extent the AER finds that a move to diminishing balance depreciation would result in an improvement in the regulatory framework in the long term interests of consumers (acknowledging any intergeneration equity impacts), APA is generally supportive. However, APA is concerned with the modelling complexity and resultant reduction in transparency and understandability of the framework, and so believes that any such change should be approached with caution.

Noting that a business is not allowed to change methodologies for tax purposes once a particular approach is embarked upon, APA submits that any such change should be made prospectively.

3.4.3 aligning gas tax asset lives

Table 6.3 of the AER's Discussion Paper addresses a concern that the gas network businesses are allowed to depreciate their pipeline assets over 20 years for tax purposes while the regulatory tax allowance is based on a longer assumed tax life. This, in the AER's view, is giving rise to a discrepancy between the tax allowance and the amount of cash tax paid.

As outlined at the public forum, all the AER's regulated gas transmission service provider access arrangements feature a 20 year depreciable life for the Tax Asset Base for pipeline assets. This proposed amendment is therefore not required for the gas transmission sector.