APGA
50 YEARS 1968–2018

Submission to the AER

Issues Paper: Review of regulatory tax approach

31/05/2018

Introduction

The Australian Pipelines and Gas Association (APGA) welcomes the opportunity to provide commentary to the AER's review on regulatory taxation. We understand that this review is being conducted under Ministerial direction, following an ATO examination of tax paid by electricity distribution businesses.

APGA is the peak body representing Australia's pipeline infrastructure, with a focus on gas transmission, but also including transportation of other products. Our members include owners, operators, constructors, advisers, engineering companies and suppliers of pipeline products and services. APGA's members build, own and operate the gas transmission infrastructure connecting the disparate gas supply basins and demand centres of Australia, offering a wide range of services to gas producers, retailers and users. The replacement value of Australia's gas transmission infrastructure is estimated to be $50 billion.

Although we appreciate the need to examine the issue from the perspective of the whole industry, we note that the AER's estimates of tax paid (Table 1 of the Issues Paper) suggests that the entire gas industry represents only seven percent of tax payable, and gas transmission (APGA membership) slightly less than one percent. The Issues Paper notes further that tax allowances are roughly four percent of allowed revenues. To the extent that timing is tight, and information about tax is complex, the AER may find merit in focussing its resources where any solutions might deliver the largest benefits for consumers.

We divide our submission into two parts; we firstly address the questions that the AER has put in respect of information about tax, and about drivers of potential differences between allowances and actual tax paid. We then turn to some broader issues in respect of the treatment of tax. We realise that this will form part of future stages of the review process, but we think it is useful to bring forward some of these issues now, such that they might better inform the developing debate which, we appreciate, is being driven to a shorter timeframe than any stakeholders (or the AER) would consider ideal.

The AER's questions

The AER's questions are divided into two components; information about tax and drivers of tax behaviour. The first three concern information:

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

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

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?

We are not aware of publicly-available sources of information that might assist the AER in examining how much tax is actually paid. The AER does have, of course, the option of either requesting, or using its information gathering powers to obtain the actual tax returns of the businesses, and then examining these. This would provide the AER with data, but it is not clear that it would provide the AER with much information, because interpretation of the results requires considerable analysis. We consider that there may be considerable advantages if the AER were to work with the relevant businesses on any information it obtains from them, rather than in isolation.

In particular, there are almost no stand-alone assets within the AER's regulatory scope, and most assets are owned by larger companies, which rarely assess tax on the basis of individual assets, requiring considerable "unscrambling" of a corporate tax return to try and understand how much of the overall corporate tax bill can be attributed to a given asset. Moreover, such unscrambling is inter-temporal in nature, because tax paid (or not paid in the case of tax losses) in one year can affect tax paid in the next. This makes the process very complex.

In its recent work on actual debt costs, the AER has worked with businesses to gain a proper understanding of what the data mean in terms of meaningful information, and we think this has worked well. We would suggest that debt is very simple compared with tax, meaning such interaction is all the more important in respect of tax.

However, even if the AER works with business to understand information in tax returns, and this information is well-understood, it will be incomplete. To the extent that a business has foreign ownership and pays tax overseas via the various tax treaties that Australia has, information about tax paid in Australia will necessarily be incomplete. Not only does the AER have no power to request information beyond Australia's shores, but the businesses in Australia may not be in a position to provide useful information to the AER voluntarily where the parent of such a business had different global interests which offset taxes.

Even with domestic ownership, the use of structures like partnerships or stapled securities where the profits generated by a business are paid by investors at their marginal tax rate not only add layers of complexity, but also mean that the businesses with whom the AER interacts may have no way of providing information about the full value of tax paid that is associated with their business activities.[1]

Turning now to the drivers, the AER has three further questions:

Q4. Are there other potential drivers that could cause the difference (between expected tax costs and actual tax paid) identified in the ATO note?
Q5. How should we assess materiality of the potential drivers?
Q6. Which of these potential drivers should be the focus for the AER's review?

The AER has outlined several possible drivers and has asked stakeholders to provide a view as to their importance. There are two views of importance; the actual dollar size of the given driver in explaining differences between tax allowances and taxes paid (dollar importance) and the importance of the driver in the context of indicating something needs to be done (policy importance). The two are not correlated. For example, a big reason why tax paid might be less than tax allowances might be the prices paid for the assets (see below), but this has no policy implications at all because the regulatory regime only provides revenues based upon RAB, not actual values. We rate importance on both issues on a scale of one to five with one being the least and five the most important.

Table 1: The importance of drivers

AER Driver	Dollar importance	Policy importance	Notes
Ownership structure	4	4	see points below
Gearing	3	1	Actual gearing can differ from allowed, but AER data suggests small differences. The issue is also connected to prices paid for assets (see below).
Diminishing value	4	1	It seems likely that depreciation schedules for tax will differ from the allowance, but this will lead to a temporary issue only (see below)
Self-assessed asset lives	2	1	as above
Low value pools	1	1	These are a minor issue given the types of assets involved; most of our asset base is tied up in large items like pipeline
prior tax losses	2	1	This may be an issue for certain businesses, but will lead only to a temporary issue, which is automatically fixed as the losses dissipate.
R&D deductions	1	1	This is likely to be minor and R&D expenditures are not part of the regulatory tax allowance
Cost of debt	3	1	The work on cost of debt indicates that differences between the allowed cost of debt and actual cost of debt in percentage terms is small, but the dollar cost may be larger because the actual asset value is larger where businesses have been sold at a premium (see below).
TAB revaluation	4	1	This is likely to have a significant dollar impact for some businesses, particularly as businesses are bought and sold, but it has no policy impact, because regulated prices are not based upon this revaluation.
Immediate expensing of refurbishment	2	1	This is unlikely to be significant given the nature of our capital base, and in any case, its effects are similar to accelerated depreciation.

[1] *We accept that the Stapled Securities Exposure Draft anticipates changes to the use of stapled securities. This will have the further effect of potentially rendering information from the past less relevant when anticipating future tax payments.*

The only one of these issues which rates highly in terms of policy importance is the ownership structure. Ownership structure is one instance of a situation whereby is it not the case that the allowance is too high, but rather the cash tax required to be paid is low. This might occur for several reasons:

- Cash tax paid throughout the economy is relatively low due to the GFC and the tax losses associated with it, which are presently washing through the tax system.
- The incentives given by the Australian Government using the taxation system for different industries/regions in Australia.
- The legal use of allowed tax structures which has an effect of decreasing requirements for tax to be paid.

The first of these is a temporary phenomenon, and to the extent to which it has been important in the past, it is likely to be less important going forwards. The latter two are issues of government tax policy and, if problems do exist, it is appropriate for these to be treated as a component of tax policy, not through regulatory policy; at best the AER might point to the issue in energy (if it exists) and refer the matter to the ATO and policymakers for further consideration.

Note also that there are instances where the cash tax required to be paid is "too high" compared to the regulatory model. In particular, in the case of a price cap (as all APGA member pipelines face), demand growth results in greater revenues and more tax actually being paid as compared to regulatory assumptions.

We are not aware of any other major drivers other than those which the AER has provided, beyond consideration of the actual prices paid for assets (see below) and smaller issues such as deduction for stamp duty which affect actual tax paid but are not considered in regulatory tax allowances.

The remaining question asks how the AER ought to assess materiality. We believe that this should not be based upon dollars. This is apt to mislead. Rather, we believe that the assessment of materiality should be based upon an assessment of the relative impact of a change versus the status quo on the overall integrity of the regulatory system.

This is something which we return to in more detail below, but to give an example, suppose we have a pipeline that is sold for 1.5 times RAB. This is likely to have a large dollar impact on the difference between actual tax paid and the tax allowance. However, any solution to this difference would require the AER to take into account the cause of the difference; the price paid for the asset (see below). If the AER does this, then the actual price paid for assets has an impact on regulatory revenue allowances, and the incentive characteristic of the regulatory regime is fatally weakened. The negative impact on the integrity of the regulatory regime from making such a change should, we believe, militate against making it.

We consider the integrity of the regulatory regime to be a primary consideration of the AER, and lead with this issue in our discussion of four key points of extension from the AER's issues paper questions below.

Additional issues

There are four additional issues we believe the AER should consider through the tax review, and which we consider it worthwhile pointing out at this early stage to assist in the future debate. These are:

- The AER's key concern is, the integrity of the incentive-compatible regulatory regime, which is specifically designed to operate for the long-term interests of consumers, and this should drive the current review on tax, particularly when considering changes.
- If the tax allowance is to be based upon something else, then the issue turns to what might form an adequate basis; it cannot simply be lowered or raised arbitrarily. One base (certainly one which the Minister seems to think deserves consideration) is actual tax payments. However, for infrastructure, these change through time, and any change in this direction might lead to higher prices for consumers in the future.
- Tax paid is an output; a consequence of a large number of other factors, historical and current, associated with the operation of regulated firms. A change made to the allowance for tax paid necessarily involves unpicking the allowances for all the things which lead to the payment of tax, and it is not clear that doing this will benefit consumers or positively impact the integrity of the regulatory regime.

- APGA members all comply with both the tax and regulatory regime. The tax regime in particular is an outworking of a large number of related government policy decisions, including foreign policy decisions. Changes must therefore take this wider context in mind.

We turn to the detail on each of these four points below.

The integrity of the regulatory regime

We consider that the key driver underpinning this review is the overall integrity of the regulatory regime. In Australia, the regulatory regime is an incentive-based regime. This is because it is well-recognised, by all stakeholders, that providing incentives to reduce costs is the best way to achieve efficiency gains, which are subsequently passed on to consumers through the regulatory process.

This is quite distinct from the "rate of return" regulation which prevailed in the US for decades, whereby regulated businesses obtain a particular return on whatever spending they actually incur, provided that can be shown to be prudent. Under such a regime, there are few incentives to cut costs.

The current review needs to be considered from within that context. We discussed this point above when discussing the basis for determining materiality. We consider the AER ought to, at the outset of its review, make it clear that the integrity of the incentive regulation framework is a key driver of what it does during the review.

The integrity of the regulatory system should be of key importance to all stakeholders, and we believe that it is. However, a benefit of stating it explicitly as a principle by which the review will proceed, and, importantly, as a criteria by which changes seeking to ameliorate perceived tax problems will be assessed, is that it allows all stakeholders to remain focussed on the wider picture, rather than upon points of detail. It also keeps a focus on the consequences of change, which is important when dealing with tax, which can have long range consequences for long-lived assets.

The price consequences for consumers from a change

A key concern, particularly for consumers, is what will happen to prices if any change is made to the treatment of tax; to the extent that they increase, it seems unlikely that consumers will support change.

Obviously, the AER could simply look at disparate evidence and simply conclude using judgement that tax paid seems to be low, and thus some arbitrary number should be lopped off the current 30 percent allowance. This, however, is not good regulatory practice, and we would not expect the AER to act in such an arbitrary fashion. This gives rise to the question of what might be used.

Whatever the AER does do, it needs to be consistent through the life of a given asset; it could not act in such a way that crystallised gains or losses at a particular point in time, or depreciated an asset more (or less) than once for taxation purposes. This is something the AER put particular focus on when it made changes to the cost of debt allowance recently and we would expect the AER would operate under a similar consistent framework when examining tax.

As the review progresses, other options may become apparent, but at present we can only perceive two ways of treating tax that are consistent through the life of the asset, result in no crystallisation of gains or losses and result in depreciation happening only once:

- The AER could use a single rate such as it does now, with the statutory rate being the obvious candidate.
- The AER could base its allowance on an actual effective tax rates which change through time, effectively causing tax to be a pass-through.

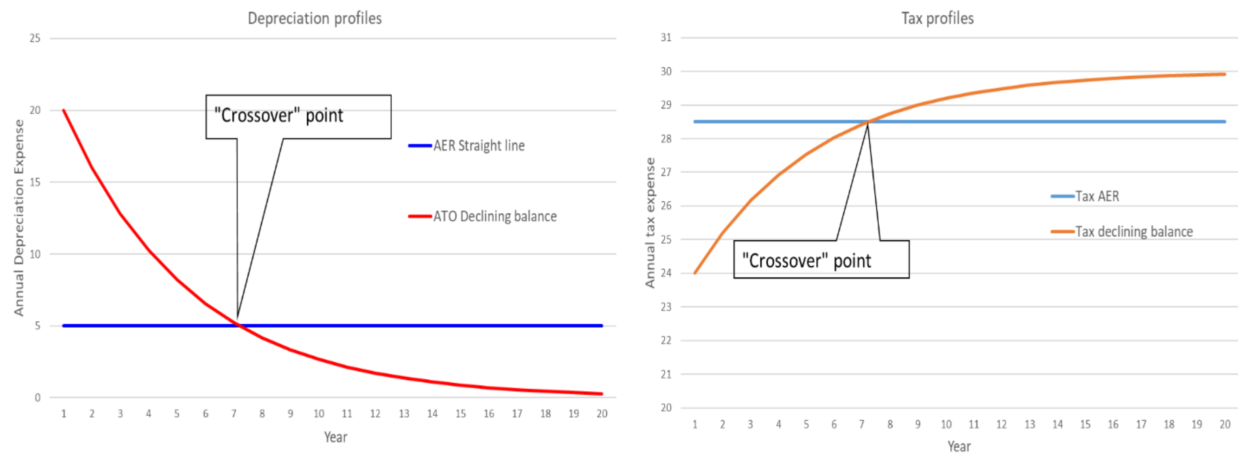
The latter has concerns from the perspective of the integrity of the regulatory regime, as it moves towards a cost-plus, rather than an incentive outcome. However, it is also likely to have poor price consequences for consumers in the future, due to because actual tax payments are dynamic through time and, in fact, the historical record of taxes paid, far from being predictive of the future (noting that the AER set building block allowances for the next five years), is often precisely the opposite.

The AER has examined this issue previously, in 2007, when it was considering a move from the then current pre-tax real to the current post tax nominal framework. As the AER points out:[2]

> *The major challenge in this approach is the calculation of the tax wedge that meets this objective. The issue is complicated by the operation of tax law whereby the tax payable by a firm is based on income which differs from regulatory income. This is primarily (but not solely) due to tax depreciation allowances which differ from regulatory depreciation allowed for in the revenue stream. The impact of these tax rules is that revenues available from new investments attract little or no tax because the allowance for tax depreciation exceeds regulatory depreciation and taxable income is reduced substantially.* ***Tax is not avoided but merely deferred to a later time when the relative magnitude of tax depreciation and regulatory depreciation reverses****. This deferral of tax may be for a period of up to 20 years (emphasis added).*

Following this conclusion, the AER goes on to report on some modelling based on an asset which has a regulatory life of 50 years, and an effective tax life of 25 years. It then traces out the effective tax rate for that asset over the course of 50 years, and shows a "crossover point" in the middle, where tax payments go from being lower to higher than those paid under a 30 percent rate. This was done in the context of a change from a pre-tax real to a post-tax nominal framework, and that the inclusion of a tax asset base in the PTRM alleviates some of the concerns the AER raised back in 2007. However, to the extent that the actual depreciation schedule for tax used by regulated energy firms differs from that used in the PTRM (as it will between different companies, just like any other aspect of the PTRM), there will still be the same crossover from a situation where the cash value of tax paid is less than assumed in the PTRM to one where it is more. To appreciate this, consider the simple model outlined in Figure 1, which is based upon the intuition behind the AER's 2007 work.

Figure 1: Graphical representation of tax liabilities forecast to arise in respect of a one-off investment with no subsequent investments



Note - $100 asset depreciating over 20 years, with $500 of revenue and $400 of opex per annum and no other costs, together with a 30 percent tax rate.

The graphic above is based upon a single asset, and energy companies have a mix of assets, meaning that the crossover point occurs at different times for different assets. It also assumes a 20-year asset life, where most regulatory asset lives are much longer than this; upwards of 50 years for pipe.

We have not examined this issue in any detail at this early stage of the review process. However, it is possible that any switch to tax as a cost pass-through could result, within the next decade, in customers

[2] *AER, 2007, Matters Relevant to Distribution Determinations for ACT and NSW DNSPs for 2009-2014: Preliminary Positions, December 2007, p60, available from https://www.aer.gov.au/system/files/Preliminary%20positions%20paper%20-%20guideline%20on%20the%20AER%27s%20approach%20to%20determining%20materiality%20thresholds%20for%20possible%20pass%20through%20events%20-%20December%202007.pdf*

facing prices which include a tax allowance which is greater than the current 30 percent; depending upon where the "crossover point" is for the bulk of the asset base.[3] Had actual tax payments been used from the outset, this might not matter much; prices for consumers at the start of regulation might be lower and prices later on higher, but overall, consumers would pay for the "right" amount of tax over the life of the relevant asset. However, switching regimes partway through might result in businesses being able to crystallise gains and consumers losses. We would urge further study of this if actual taxes paid are ever seriously considered, and more sophisticated modelling than shown in Figure One. However, our view at the present time is that the shift is unlikely to be in the long run interests of consumers.

Unpicking the drivers of actual tax paid

As outlined in the previous section, the amount of tax paid is dynamic; depending upon decisions about tax depreciation, actual tax paid may be low at the start of the life of an asset and higher towards the end of the life of that asset.

The actual tax paid is also a function of a myriad of other actual costs incurred by the business but not taken into consideration by the regulator when forming the allowed revenue. For example:

- Where a business is more highly geared than the regulatory assumptions, this additional gearing is not reflected in the regulatory allowance, but the higher interest payments which result will act to lower actual tax payments.
- Where a business has been sold for more than its RAB value, none of these additional costs are borne by consumers via the prices paid for regulatory services (which are based solely on the RAB), but some of them, such as higher interest payments, will affect actual tax payments.
- Where price capped businesses outperform on demand growth and earn more revenue than projected, this translates to higher tax payments, which are never taken into consideration by regulators in the current or future regulatory periods.
- When any business reduces other costs as the incentive regulation framework is intended to provide incentives for them to do, this results in higher profits and more tax paid than the regulatory model assumes. This is likewise not taken into consideration by regulators in the current or any future regulatory period.

The list is not exhaustive, but rather makes the basic point that tax is based on actual costs and these deliberately differ from the allowed costs in an incentive-based regulatory regime. Tax is in fact the end point of a number of other business decisions. Focussing just on the end-point and not on how it has been arrived at, means that consumers are receiving benefits that are unrelated to the costs associated with delivering the service they are consuming, which is inefficient and a form of cherry-picking.

We do not believe the AER would cherry pick; it is careful to avoid cherry-picking in its other activities, and we can see no reason why it would treat tax differently. However, if it did not, it would need to unpick all of the causes of actual tax paid and reflect these in regulatory allowances. The result would not be incentive based, but rather cost-plus regulation, and the integrity of the regulatory regime would be impaired.

The interaction between tax and the regulatory regime

There appears to be some concern in the position paper, and in the ATO note, that businesses may be adopting particular tax structures and that, potentially, not all of these tax structures are equally desirable. This may or may not be the case. To the extent that it is, then this is an issue which should appropriately be dealt within the tax regime, not in the regulatory regime.

At present, the AER takes no view on what is the "optimal" tax structure, but simply uses a vanilla 30 percent corporate tax structure. Additionally, the AER takes no view on any other aspect of a business which is driven by incentives in Australian tax law. If the approach changes, and the AER does begin to take consideration of "optimal" responses to tax law, it is not clear how the AER could do this effectively.

[3] *For assets that have already passed the crossover point, the price rise would be immediate.*

In particular, tax law changes with government policy, providing incentives for businesses to behave in a certain way, including, but not limited to, the way they structure themselves.

Such changes in government policy can change frequently, which would result in frequent changes to regulatory tax allowances, which would flow through to prices to consumers. Additionally, not all aspects of tax policy are economic in nature, some support the social policy aims of the government of the day.[4] It is not clear how the AER could adequately calculate how a firm might respond to such initiatives in a way that is economically efficient. We consider that a regulatory regime which is continuously in flux attempting to react to the incentives provided by Australian tax law is not aligned to the long run interests of consumers.

There is an additional consideration. For some businesses with foreign ownership, tax might not be paid in Australia, but in overseas jurisdictions. Under a cost pass-through framework (we struggle to understand how the AER might opine on an "optimal" or "benchmark" level of foreign ownership), if the AER's investigations stopped at Australia's shores, then it might not capture tax which is paid overseas by owners of Australian assets, in line with the various Australian reciprocal tax agreements with various countries. Conceptually, the AER could look globally, but it is not clear to us how it could effectively do this given that its information gathering powers stop at Australia's borders; how would the AER actually verify whether a tax payment claim made by a foreign owner was genuine? We would suggest that perhaps the AER would find little value in any attempt to expand its remit into foreign policy, and we would be very surprised if the AER holds a different view.

[4] *For example, a government may seek to promote regional communities by providing favourable tax treatments for rural infrastructure. This might have a permanent impact if the favourable tax treatment is, for example, accelerated depreciation. The AER would thus, somehow, need to consider the accumulated history of such social policy decisions, where they occur.*