31 May 2018

Mr Warwick Anderson
General Manager, Network Finance and Reporting
Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601

RE: Review of Regulatory tax approach - Response to Issues Paper

Dear Mr Anderson,

We refer to the Australian Energy Regulator's (AER) initial Issues Paper released on 15 May 2018 into the Review of Regulatory Tax Approach and its request for stakeholders to respond with submissions by 31 May 2018.

We welcome the opportunity to provide our comments.

This submission is made jointly by Ausgrid and its equity investors, IFM Investors and AustralianSuper and supported by all Ausgrid investors. Ausgrid distributes electricity to the Sydney, Central Coast and Hunter regions of NSW. On 1 December 2016 the NSW Government entered into a partnership with IFM Investors and AustralianSuper to operate the network under a long-term lease. AustralianSuper and IFM Investors own a 50.4% interest in Ausgrid under the long-term lease.

Summary

Tax is a legitimate cost for regulated energy businesses and it is important that the regulatory arrangements continue to compensate businesses for their tax costs in a manner which:

- allows businesses a reasonable opportunity to recover at least the efficient tax costs it incurs in providing network services;[1]
- provides incentives for businesses to manage costs, including the cost of tax, efficiently;
- is administratively practical to apply and avoids complexity and unnecessary regulatory costs; and
- provides stability and certainty in customer prices.

We consider that the current incentive-based arrangements work very well in meeting these objectives. A departure from the current arrangements is likely to lead to negative impacts on customers by removing business' incentives to pursue tax cost efficiency, increasing complexity and creating regulatory costs.

[1] Revenue and pricing principles, s7A of the National Electricity Law

Approaches where the tax allowance is based on the ownership structure and actual tax paid would lead to increased volatility in prices as well as create concerns about the tax regulations influencing the way in which energy businesses design their capital structure and potentially reducing the pool of equity investors that would otherwise invest in energy network businesses.

Ausgrid is party to Energy Networks Australia's submission, which contains the network sector response to the Tax Issues Paper. This submission provides additional commentary on the key aspects and risks for this review, including those relevant to Ausgrid's ownership structure.

Our submission

Our submission is structured as follows:

- Section 1 provides an overview of the AER's review and our submission
- Section 2 presents the benefits of the current incentive based approach
- Section 3 discusses Ausgrid's ownership structure and the relevant issues for this review, including why asset sales may reduce the actual corporate tax paid in the year of a transaction
- Section 4 raises a number of issues with the analysis presented in the ATO Note
- Section 5 responds to the specific AER questions in the Issues Paper
- Section 6 discusses what we see as the main risks of changing the current arrangements

We look forward to working with you during the course of this review. If you have any queries or wish to discuss this matter in further detail please contact us.

Yours Sincerely,

Michael Hanna
Head of Infrastructure
Australia
IFM

Nik Kemp
Head of Infrastructure
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Rob Amphlett Lewis
Executive General Manager
Strategy and Regulation
Ausgrid

Joint submission on AER Review of Regulatory Tax Approach

1 Overview

We welcome the opportunity to contribute to the AER's review of its regulatory tax approach.

It is important that customers, businesses, investors and the wider community have confidence that the regulatory arrangements for networks are delivering efficient outcomes consistent with the long term interest of customers. Therefore, we are keen to work collaboratively with AER during this review.

The AER's objective is to promote the long term interests of consumers. Any assessment of potential changes needs to be comprehensive and recognise all the impacts on customers, including the incentives on businesses that drive behaviour changes which ultimately impact customers.

The way in which regulated energy businesses approach tax will differ significantly and change over time. The regulated business is typically only a portion of an investor's overall investment in an electricity network asset/utility. In most cases, tax is not paid at the regulated business/asset level, rather, tax is paid at a consolidated business level, and so it includes tax across all assets (regulated and unregulated) owned by that business/investor. Separating the tax paid on the regulated component of the business only would be challenging for many equity investors.

We believe that the current incentive based regulatory frameworks applied by the AER are robust and have worked well in protecting customers through ensuring that prices are set to recover benchmark efficient costs and no more. For the reasons set out in this submission, there are good reasons why the current arrangements should continue to apply for setting tax allowances. Alternatives such as tax pass through would lead to increased complexity, uncertainty and poor incentives which would ultimately create extra costs for customers.

The AER Review of Tax Issues Paper focuses on two issues:

- The potential drivers that cause a difference between actual tax payments and the regulatory tax allowance; and
- The lack of transparency regarding actual tax payments given the limitations of currently available data.

There is an implication within the Issues Paper, informed by the ATO analysis, that any difference between actual tax payments and the AER's benchmark efficient tax allowance is to the detriment of customers. However, differences between actual costs and benchmark efficient allowances are to be expected in an incentive-based regulatory framework where allowed revenues are set to compensate regulated businesses for benchmark efficient costs, and no more.

We are concerned that the analysis put forward in the ATO note is incomplete and is open to mis-interpretation. The analysis conducted by the ATO covers only a very short period of time (3 years) compared to the life of many of the assets employed by network businesses. This is problematic when it comes to assessing how businesses consider their tax position including the treatment of depreciation and tax offsets, which vary considerably over time.

We would also note that historical tax paid is by no means a reliable predictor of future tax payments. Differences between actual tax payments (at the network level) and regulatory tax allowances may occur where the available tax loss carry-forwards in the years following a corporate transaction have been exhausted.

There is a high level of diversity across regulated businesses and so there are many reasons why actual tax paid could differ from the regulatory tax allowance. The majority of these reasons relate to payments being made by network owners that go beyond the benchmark efficient regulatory allowance. Such payments include additional interest expenses (whether due to a higher quantum of debt or a higher interest rate), R&D expenses, and in the case of recent privatisations, stamp duty costs.

It would be highly complicated for any regulator to attempt to disentangle and isolate the range of potential causes of differences between tax allowances and estimated tax paid for any particular year or regulatory period. This issue has been recognised by overseas regulators (e.g. OFWAT).[2]

For reasons outlined in this submission we do not think it would be appropriate, nor in the long term interests of consumers, to reflect the specific circumstances of each investor in regulated energy networks in tax allowances. The ATO is well versed in the diversity across regulated business ownership structures and is well placed to opine on whether any business is acting in a way which is likely to inappropriately avoid tax given their approved tax structure.

We submit that the issue for the AER to consider in this review is not why there may be a difference between regulated tax allowances and actual tax paid but, instead, whether the current approach results in a regulated allowance which does not reflect benchmark efficient costs and, as a result, does not meet the long term interests of electricity consumers.

Benefits of the current incentive based regime

Incentive based regulation is supported by government and policy makers across all regulated infrastructure in Australia and compares well to other alternatives, such as cost plus regulation, which require substantially more information and can lead to the regulator intervening in the commercial decisions of the businesses.

The current arrangements provide strong incentives for businesses to operate as efficiently as possible to minimise costs. Customers are protected as only benchmark efficient costs are allowed to be recovered. Further the arrangements are transparent with reasonable administrative costs for both the AER and the networks.

Incentive-based regulation is widely accepted to be the most effective approach to regulating natural monopolies by encouraging efficient behaviour and so minimising costs for customers. Therefore, this approach should continue to apply to tax which, like other costs faced by network businesses, can vary over time based on a number of factors. Like other costs,

[2] OFWAT, Targeted Review of Corporation Tax, 13 May 2016, Report by Alvarez and Marsal

businesses should have an incentive to pursue tax cost efficiency by only being compensated up to the benchmark efficient level of tax costs

Difficulty in estimating tax payable at the level of regulated services

The AER's building block approach calculates the revenue allowance based on the efficient costs by providing standard control services. However, the regulated business is typically only a portion of an entity's overall business and tax may not be paid at the level of these regulated network services if the asset it is held through flow through holding structures such as partnerships or trusts.

Hence any regulatory approach which seeks to estimate tax at the regulated services level will require an agreed and credible allocation methodology for apportioning and reconciling tax paid at the entity level and tax costs incurred at the regulated standard control services level. This will require detailed verified information and therefore impose additional reporting and auditing requirements. It could also lead to risk of regulatory error and perverse incentives.

Any methodology would also need to account for the diverse range of business structures and tax practices across the sector. Further, the methodology would need to take into account that tax may be paid at different times and also at different equity investor levels, and that past actual tax payments may not be reflective of future tax payments for a wide range of reasons.[3]

Consequently, there are significant difficulties involved in identifying tax paid at the standard control services level that the AER should consider before making any change. The current arrangements have the advantage of avoiding these complexities and costs by setting the regulatory tax allowance to compensate for the efficient benchmark costs.

Alternative arrangements are likely to have negative impacts

Any assessment of potential changes needs to be comprehensive and recognise all the impacts on customers and incentives on businesses, consistent with the National Electricity Objective ("NEO"). However, it is not clear from the Issues Paper how potential alternative approaches to setting regulated tax allowances would be assessed.

We have significant concerns about the potential impacts on incentives and price stability associated with alternative approaches. Alternatives which are based on pass through of actual tax would remove all incentives on businesses to pursue tax cost efficiency.

A pass through approach would expose customers to the actual tax costs of their energy network service provider, regardless of whether this tax cost was efficient or not. It would also expose customers to volatility in network prices due to volatility in actual tax paid, which can vary significantly from year to year.

A pass through approach would also result in customers paying different energy network charges simply based on the tax status of their energy network service provider's owners. This would be inequitable and there does not seem to be any justifiable basis for this. Tax

[3] For example, the approach to tax allowances, the impact of change in ownerships and changes under the recently released Stapled Securities Exposure Draft will mean that future tax payments will differ from past payments.

allowances should not differentiate between different ownership structures. Rather, the tax allowance should be based on what an efficient business would incur.

The Australian regulatory framework must provide confidence to both customers and businesses that network prices reflect efficient costs of providing services. This is best achieved through maintaining the current incentive based arrangements. Further, businesses must continue to have the flexibility to decide how best to structure their tax liabilities at the group level in a manner which complies with the tax laws.

Private sector investments in network businesses have been made on the reasonable expectation that the Australian regulatory framework of incentive-based regulation would be maintained.

Impact of future tax reforms

In conducting this review, it is important for the AER to acknowledge the impact of future changes to Tax Law. To this end, Ausgrid notes that the recently released Stapled Securities Exposure Draft ("ED") legislation proposes various measures to prevent foreign investors from being taxed at a concessional rate of less than 30% on their investments through stapled security structures, and proposes that (after a transition period) income from stapled structures will be taxed at the 30% corporate rate to non-resident investors. This change, which was not in place during the period for which the ATO undertook its review, aligns the tax costs for non-resident investors in stapled structures with the 30% tax rate on which the tax allowance is currently based.

2 Benefits of current incentive based arrangements

In Australia, the framework for regulating natural monopoly infrastructure assets is based on incentive regulation. The regulator determines the approach that a benchmark efficient entity would take to financing, investing in and operating the network services in question and the regulatory allowance is set accordingly.

The incentive based approach applies to all elements of the building block framework applied in Australia. Therefore, the benchmark efficient cost of tax is, by definition, the tax that would be paid by an entity following all regulatory benchmark assumptions. In setting revenue allowances, the AER makes assumptions about business' corporate tax costs to allow businesses to earn a benchmark efficient post-tax return on their investment. Businesses absorb any difference between actual and forecast tax costs over the five-year period, thereby creating incentives to ensure their tax payments are efficient.

The current arrangements also have the flexibility to allow any impacts of significant changes to tax law to be passed through to customers, whether these changes result in an increase or a decrease to the business' tax burden.

This approach is well established and delivers better outcomes for customers than alternatives, such as cost plus regulation. There are good reasons for this. Incentive based regulation provides strong incentives for businesses to operate as efficiently as possible to minimise costs and, importantly, provides them with the autonomy to make decisions to drive efficiency and deliver benefits to customers. Further, the current arrangements ensure that the administrative costs of regulation are proportionate and efficient.

For these reasons, the incentive-based arrangements are supported by governments and industry. Alternative approaches have the disadvantages of being heavily reliant on information gathering and are often seen as interventionist, with the regulator becoming involved in management decisions.

The driver towards promoting efficient investment and operation of regulated networks and recovery of only efficient costs are also reflected in the overarching national electricity objective, and the revenue and pricing principles. These benefits associated with the current approach to incentive regulation have been well recognised by governments, the AER and the Australian Energy Market Commission (AEMC). In its 2012 Rule Determination on economic regulation, the AEMC stated that the network revenue should be determined regardless of ownership and that the most appropriate benchmark to use in the regulatory framework for all service providers is an efficient private sector service provider.[4]

Therefore, it is important to appreciate that:

- Currently revenue allowances, and hence customer prices, are not dependent on an entity's ownership structure; and
- All components of the regulated allowance are determined on the basis of a benchmark efficient entity. There are a range of interactions and interdependencies between the approach for regulatory tax and other components to the regulatory allowance (e.g. gearing and gamma). It is not advisable to consider the approach to regulatory tax in isolation of the other components to the building blocks.

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[4] AEMC, Economic Regulation of Network Service Providers Final Rule Determination, p72

Setting a revenue allowance based on a stand-alone benchmark efficient business is well established as best practice both in Australia and internationally. The approach is well understood and practical to apply, so it avoids complexity and extra costs. Any changes to the current arrangements would be a significant change and undermine the benefits of incentive regulation. Further changes could lead to additional regulatory costs which would ultimately be borne by customers.

3 Ausgrid's structure

Ausgrid's structure was established by the NSW State Government ("the State") for the long term lease of the Ausgrid distribution business in December 2016. For this review, it is important that the AER recognises:

- Ausgrid does not have information on the tax affairs of its equity investors (AustralianSuper, IFM or the State under the National Tax Equivalent Regime ("NTER")), and therefore has no visibility on the tax paid by its owners on the income from Ausgrid's regulated business.
- It is important to note that the tax affairs of Ausgrid's owners are confidential to them and Ausgrid cannot simply request this information for the purposes of obtaining a regulatory allowance for tax.
- Ausgrid's equity investors derive income from various sources, and their tax position is not solely a product of their investment in Ausgrid (for example if income from the Ausgrid business is consolidated with other investments upstream in their holding structure), meaning that determining and isolating the discrete amount of tax paid in respect of Ausgrid's regulated business will involve considerable administrative difficulty.
- Therefore, an ex post adjustment for actual tax paid is neither efficient, nor desirable for Ausgrid.

The transaction structure for the privatisation of a regulated asset can give rise to additional expenses which can reduce taxable income and therefore actual tax payments. In the case of Ausgrid, the sale process was undertaken by way of a long term (ie 99 years) lease which gave rise to:

- Stamp duty being payable on the transaction which was immediately deductible for the entity entering into the long term lease.
- Higher interest expense, as new debt was raised to finance the higher capital investment. Accordingly, higher interest deductions can be claimed.

It is important in understanding the need to maintain a benchmark efficient allowance that a change of ownership as a result of an asset sale does not have any substantive effect on the amount of corporate tax that would be paid by a benchmark efficient entity. Any additional costs in excess of the benchmark efficient allowance, and any related tax effects, are borne entirely by the purchaser of the asset. Accordingly, the additional expenses should not be reflected in consumer prices.

Given that potential purchasers of assets are aware of the fact that additional expenses will go uncompensated under the current incentive-based system, these additional expenses are generally reflected in the purchase price that is bid for such assets upon sale.

For completeness we note that for energy assets privatised on or after 1 July 2001 (like Ausgrid), Division 58 of Schedule 2 of the Income Tax Assessment Act 1936 will apply to limit the tax cost base of the depreciable assets acquired. Specifically, the tax depreciation provisions are modified such that a purchaser of depreciating assets inherits the historical tax cost base of assets reduced for depreciation to-date at rates specified by the Commissioner.

In contrast, for energy businesses sold under the taxation rules prior to 2001, the rules in Division 58 did not apply and the new owner was allowed depreciation deductions based on the market value of the assets (i.e. purchase price of the assets).

The example of the variation between businesses resulting from the application of Division 58 to the tax bases of assets depending on the time at which the asset in question was privatised emphasises the inconsistencies inherent in the determination of actual tax paid on an asset-by-asset basis that will create significant administrative burden for the AER and individual taxpayers.

4 The ATO Note

We are concerned that the analysis put forward in the ATO Note is incomplete and does not properly reflect the long-term tax implications of an investment in an electricity infrastructure asset. Our key concerns with the analysis in the ATO Note are:

- The period of analysis (2013 to 2016) used by the ATO is too short to provide a complete picture of the trends in tax payments across the regulated networks, especially given the long term nature of capital assets. For example, decisions on the treatment of depreciable tax costs could change over the life of the assets, as could the debt payment profiles which in turn impact the quantum of interest deductions in any one year.
- The dataset used is from a period prior to the 99-year lease of 50.4% of Ausgrid and therefore is not reflective of Ausgrid's current situation.
- The period of analysis does not take into consideration the impact of the ED legislation in relation to stapled structures which will (following a transitional period) impact the concessional treatment of foreign owners in stapled entities.
- As stated by the ATO, it had to make some assumptions and exclusions in undertaking its comparative analysis. These assumptions and exclusions have not been explained.

We submit that there is no evidence to suggest that differences between actual tax paid and the regulatory tax allowances are common across all businesses, or that if there are differences, the causes for those differences can be traced back to a common feature.

In the rest of this section, we consider the four drivers identified by the ATO, being:

- entity structure;
- interest expense;
- available tax losses; and
- deductions for depreciation.

Entity Structure

The ATO Note observes that some regulated asset ownership entities are structured as trusts or partnerships such that profits are passed through to investors and may be concessionally taxed at the investors' level.

We note that flow-through structures simply subject investors to tax on the income derived by the business at their marginal tax rate. It is possible that investors in a flow-through structure could be taxed at a rate less than, or in excess of the 30% corporate tax rate (e.g. 0% for a retiree past the retirement age or 45% for an individual in the highest marginal tax bracket).

The ATO considers cases where the ultimate investor pays tax at a rate below the corporate tax rate, citing sovereign wealth funds, foreign superannuation funds, and investors based in low-tax jurisdictions. In those cases, trust and partnership structures result in less net tax being collected by the ATO because profits are passed through to the ultimate investors who face low (or zero) tax rates or who pay their taxes to foreign governments.

These issues are not unique to regulated assets – they are much broader questions relating to how different legal entities should be taxed in Australia. That is, they are not issues to be fixed, for regulated assets, by abandoning the framework of incentive-based regulation.

The appropriate response to this issue, which highlights the complexity - and potential detriments - of attempting to adopt an alternative model which seeks to recover an actual amount of tax paid, is to ensure that the appropriate amount of tax is paid, rather than to assume that it will not be paid and to adjust the entire regulatory framework accordingly, leaving the issue untreated in every other industry outside of the regulated energy networks.

In this regard, we note that the recently released Stapled Securities ED proposes various measures to remove the ability of sovereign wealth funds and foreign pension funds to be taxed at a concessional rate of less than 30% on their investments through stapled security structures. The ED proposes that (after a transition period) income will be taxed at the 30% corporate rate to non-resident investors, bringing it into line with the current standard treatment for Australian resident corporates.

Since the issue of ownership structuring has been addressed in this broader setting, it would be counterproductive to create additional regulatory complexity and it would deliver poorer customer outcomes to seek to address it again in the regulatory setting via an adjustment to the corporate tax allowance.

Importantly, the taxation of non-resident investors should not justify departing from the current incentive based arrangements and changing to an arrangement where tax allowances become dependent on analysis of the ownership structure. There are a number of fundamental problems with such an approach:

- Linking costs and therefore prices to actual ownership structures will result in different treatment of customers based on decisions external to the provision of regulated services.
- Volatility and uncertainty in network prices will increase as ownership structures can change over time, particularly as a result of a change in ownership.
- It is hard to explain to customers why prices need to change due to commercial transactions if customers continue to receive the same quality of services.
- Australian superannuation funds are legitimately taxed differently because the earnings of these funds are being used to provide for Australians in retirement. Changing the regulatory approach may exclude or disadvantage these investors, contrary to the explicit intent of the tax arrangements for superannuation funds.

Interest Expense – leveraging beyond the 60% benchmark gearing level

The ATO Note also considers the case where the asset owner employs more than the benchmark 60% gearing at the consolidated entity level, with the result that actual interest expense exceeds the regulatory allowance. As noted above, under incentive-based regulation, the regulatory allowance is set according to efficient benchmark costs whereby businesses are free to depart from the regulatory benchmark, and any such departure (including its tax effect) is irrelevant to the regulatory allowance.

The current evidence supports a benchmark efficient gearing level for energy network service providers in Australia of 60%. This was the subject of broad agreement through the AER's recent concurrent expert sessions on the 2018 rate of return guideline.

However, this benchmark does not mean that individual businesses cannot choose to pursue higher or lower levels of gearing at a particular point in time. What is important is that the business is exposed to the consequences of such a decision, not customers of electricity network services. For example, if a business leveraged more highly than 60%, the increased risk that equity holders in the business incur would not be compensated for through the regulatory framework.

Available tax losses

The discussion on treatment of tax losses in the ATO Note is an example of the risks of making judgements based on tax data over a very short period.

Networks typically invest in long term assets which are in operation for substantial periods of time, upwards of 40 years. Regarding the treatment of tax losses, businesses will make decisions on a range of factors including profile spend of the projects, historic experience and the overall tax circumstances. These considerations may be revisited during the life of the assets.

It is practice that the tax computations are revisited at the end of a project or otherwise periodically once a full review of actual project expenditure can be carried out. Similarly, capital allowances forecast for the purposes of revenue determinations are also estimates based on projected capital expenditure. As a result, there are likely to be differences between the forecast and the actual tax allowance claims.

Hence tax loss carried-forwards reflect only timing differences and do not affect the total tax paid over the life of an asset. Analysis which only looks at a short period is likely to lead to incorrect conclusions about how tax losses are managed and accounted for over the life of the asset. Therefore, there is a potential concern that the ATO analysis confuses the tax-paying entity with the regulated business. The possibility that tax losses carried forward have been generated in the past outside of the regulated businesses and used to offset their tax obligations in the future should be irrelevant to how the AER approaches setting the benchmark efficient regulatory allowance.

Finally, the current arrangements allow the AER to consider and include carried forward losses into the tax allowance model. It has not been demonstrated that there is an issue with how the AER currently accounts for tax losses in its approach, nor that the AER does not have the ability to adapt its approach in this regard.

If tax loss carried-forwards were somehow relevant to the regulatory allowance, consumer prices may change every time an asset changed hands – according to how many or how few tax losses carried-forwards the new owner had available to it. This would be quite inconsistent with the framework of benchmark efficient costs in relation to the forthcoming regulatory year.

Deductions for depreciation

The use of shorter effective lives may deliver higher deductions for the asset over a shorter period but any value to the business is of temporary value and will be neutral over the economic asset life. That is, under the Australian regulatory framework (and the AER's Post Tax Revenue Model (PTRM)), accelerating or delaying depreciation has the effect of moving the associated tax deduction through time in an NPV-neutral way.

We also note that assets which were privatised prior to the introduction of Division 58 in 2001, were able to step up their asset tax base to market value. Thus, for these assets, their depreciation deductions are greater compared to non-privatised assets.

5. Response to AER questions

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

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

We are not aware of any publicly available sources that would provide data on tax for regulated networks.

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?

In relation to what information the AER would need, we would make the following points:

- The AER building block approach seeks to calculate the efficient revenue allowance required to cover the costs of providing the regulated services. However, tax will not be paid at the level of the business which provides regulated services and therefore any method which seeks to estimate tax at the regulated services level would require an agreed approach to construct the estimate taking into account the unregulated part of the business.
- This would be highly complicated, require significant resources and would need to be able to adapt to particular situations of each regulated business. The current approach of using the benchmark efficient entity avoids this complexity and costs.
- In addition, where the regulated business is carried on in a flow through structure, such as occurs with Ausgrid, it would be necessary to seek tax information from its investors in relation to the tax they have paid on their income from the regulated business. We note that this would pose significant problems for Ausgrid including:
  - The tax information of the investors in Ausgrid is confidential to those funds and their investors;
  - The income derived by the investors from Ausgrid will be pooled with other income derived from both unregulated activities carried on by Ausgrid, as well as income from other investments. In addition, the actual tax burden borne by the investors in a particular year may be further impacted by the availability of tax losses and offsets from other sources, with the result that the accurate determination of actual tax paid in respect of Ausgrid's regulated business being very difficult.

Q4. Are there other potential drivers that could cause the difference (between expected tax costs and actual tax paid) identified in the ATO note?

We submit that it is both difficult and non-productive for the AER to try to identify all potential drivers of differences between regulated tax allowances and actual tax paid. There are a number of reasons for this:

- Each regulated business will have its own unique tax situation. Therefore, there will be a diverse range of reasons why actual tax paid will differ from the allowance.
- Tax situations will change over time and therefore the potential drivers for change will also change.
- Businesses pay other taxes beside corporate tax (e.g. fringe benefits) and this will impact on actual tax paid.
- It is possible that in certain years businesses are subject to higher tax costs than the regulated tax allowance. This would be the case for gas distribution businesses who are subject to price cap regulation and therefore can surpass initial revenue forecasts if energy consumption is higher than initially forecasted.

As noted above, the issue for the AER is not why there may be a difference between the regulated tax allowance and actual tax paid, but whether the current approach results in a regulated allowance which does not reflect the efficient benchmark costs.

Q5. How should we assess materiality of the potential drivers?

We have concerns about any approach which attempts to assess the materiality of potential drivers of differences between the tax allowance and actual tax paid. Doing so creates a risk of regulatory error. Variances between actual and forecast tax allowances are to be expected for a wide variety of reasons such as ownership structure, asset sales and associated deductions for stamp duty paid, the timing of depreciation deductions over time and tax being paid at a consolidated business level that captures non-regulated business operations. Variations could be positive or negative and will differ by business and by year. These issues are discussed in this submission.

Q6. Which of these potential drivers should be the focus for the AER's review?

For the reasons set out above, we consider it is not appropriate to apply a selective lens to the potential reasons for variations between regulated tax allowance and estimated tax paid. There will be a wide range of different drivers (which are subject to change over the life of the network asset) and it will be very complicated for any regulator to attempt to disentangle and isolate a defined selected range of potential drivers. This issue has been recognised by overseas regulators.[5]

Further this question implies that differences between the regulated tax allowance and estimates of actual tax paid is not consistent with the long term interests of customers. This has not been demonstrated. If this is considered to be a concern, then the reasons why this is the case, along with supporting evidence, should be set out and businesses provided the opportunity to respond.

[5] OFWAT, Targeted Review of Corporation Tax, 13 May 2016, Report by Alvarez and Marsal

6 Risks with any reform to current arrangements

Concerns about differences between the regulated tax allowances and actual tax payments do not by themselves validate changing the current arrangements. A further step of considering whether customers benefit in the long term from any changes will be required. In any assessment of potential changes, all the impacts on customers and businesses must be comprehensively evaluated consistent with the national energy objectives.

We believe that there are significant risks with changing the current arrangements. Alternatives to the incentive based regime that use true-up adjustments based on actual tax paid will have the following disadvantages:

- Departing from the current approach where the tax allowance is based on a benchmark efficient entity would remove all incentives on businesses to pursue tax cost efficiency.
- Using an actual cost of tax would be inconsistent with other regulatory cost allowances. Given the interdependencies between the tax allowance and the other components of the regulated revenue, treating the tax allowance differently could have consequences for other aspects of the regime and undermine the incentive based arrangements. It would be inconsistent to adopt one figure for interest costs when setting the allowed return on debt (benchmark efficient interest costs) and to adopt a different figure for the same item when setting the corporate tax allowance (actual interest costs).
- Any approach based on estimating actual tax paid by the regulated business would require detailed, verified information and therefore additional reporting and auditing requirements. If tax is not paid at the regulated services level, a credible allocation methodology for apportioning and reconciling tax paid at the investor level to the regulated standard control services would be required.
- Collecting information on actual tax paid would be extremely complex as many network businesses have multiple upstream owners with varying tax profiles. Collecting information to identify who they are and what tax they paid in relation to their investment in the asset would be near impossible for some of the network assets to collect (e.g., an infrastructure fund that holds a 10% interest in the network may have 50 equity investors). There would then be further complications if there was a change of ownership during the year or if there was an amendment to the tax return in respect of taxes paid by an equity investor.
- At a minimum this would lead to additional complexity and resource requirements. However, it could also lead to risk of regulatory error and potential gaming, and possibly disputes over transfer payments between regulated and non-regulated parts of a business.
- Crucially, true-up mechanisms are likely to lead to increased volatility and uncertainty in future network prices. When engaging with customers in relation to our regulatory proposal, we found that customers place a high value on stable and certain prices.
- Linking prices to actual ownership structures will result in different outcomes for customers in different network areas based on decisions that are external to the provision of regulated services, such as corporate transactions.

There is already an existing mechanism under the National Electricity Rules to allow for tax allowances to be adjusted for significant external unanticipated factors during the course of the regulatory period that have affected the actual tax outcome. The cost pass through arrangements under Rule 6.6.1 allows for tax allowances to be adjusted for changes in tax law thereby ensuring that any savings caused by lower corporate tax rates are given to customers and not retained by businesses.

Table 1 provides an initial assessment comparing the current arrangements to the alternative of an ex-post adjustment for actual tax paid against a range of assessment criteria consistent with the NEO.

Table 1: NEO comparison between current arrangement and alternative approaches

Assessment factor	Current Arrangements	Alternative of an ex-post actual adjustment for actual tax paid
Incentives for efficiency	**Strong** Businesses are incentivised to efficiently manage tax costs.	**None** Businesses would not attempt to efficiently manage tax for regulatory services.
Impacts on customers' prices	**Fair and stable** Prices reflect the efficient tax allowance for a stand-alone benchmark entity consistent with Australian tax laws. Avoids resource intensive reporting requirements which result in extra costs being passed through to customers.	Introduce different outcomes for customers in different network areas as prices will differ based on tax practices which are external to the regulated services. Increased resource intensive reporting requirements which results in extra costs being passed through to customers. Potential for change in ownership to result in changes to network prices paid by customers.
Regulatory costs	**Proportionate and low** Current arrangements provide a practical and predictable approach.	**High** Approaches to estimate tax paid at regulated services level would be highly complicated, require significant resources and would need to recognise the individual situations of each regulated business. Risk of regulatory error and creating perverse incentives for business.
Incentives for investment	**Good** Investors have confidence in the application of incentive regulation for energy business in Australia. Certainty and stability in the treatment of businesses on a consistent basis provides a stable investment environment.	**Damaging** Creates perceptions of the regulator intervening in the behaviour and tax decisions of holding entities. Investors would have concerns about the move towards cost plus regulation away from the current incentive regulation framework

Even if true-up mechanisms were designed to be partial and limited to a list of pre-defined drivers, these issues will remain. Further, for partial true-up mechanisms it will be necessary to identify the nature of the issues that would create a need to adjust certain items and the timing of the quantification and implementation of the resulting adjustments.

Partial true-up mechanisms also create additional risks associated with not compensating businesses for valid tax costs if the regulator selects the wrong list of defined adjustments. The long-term interests of customers would not be served by a framework that made inconsistent and partial adjustments to lower tax allowances without recognising the matching uncompensated costs. As noted earlier, changing the corporate tax allowance on the basis of past observations of actual tax payments will create problems and are likely to be incorrect as past actual tax payments may not reflect future tax payments at the network level.

Changes to the current arrangements will have substantial consequences. Any assessment of potential changes needs to be comprehensive and recognise all the impacts on customers and incentives on businesses plus investors consistent with the NEO. Private sector investments in network businesses have been made on the reasonable expectation that the Australian regulatory framework of incentive-based regulation would be maintained.

Changes to the current arrangements will have different impacts for different types of investors. Overall, increased regulatory uncertainty and risks could dampen investor appetite to invest in this sector which will have negative consequences for customers.

If changes to the arrangements are to be introduced, a range of transitional issues will require adequate consideration. For example, in relation to the start date of implementing changes, we would oppose any reforms to be applied to the forthcoming 2019-2024 regulatory period for Ausgrid given that the regulatory proposal has already been submitted.