23 November 2018

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

Dear Mr Anderson,

RE: AER Review of Regulatory Tax Approach 2018

Endeavour Energy appreciates the opportunity to provide a response to the AER's most recent discussion paper. Endeavour Energy has been encouraged by the manner in which the AER has undertaken the review to date, in particular the demonstrated focus on directly testing the substance of propositions offered by all stakeholders.

To that end we note that the AER has also received the results of Regulatory Information Notices (RINs) from each network. We expect that the AER will continue to critically analyse the data received, and test the results against submissions and other advocacy.

We would also commend attempts by the AER to make the subject material accessible and relevant to a wide range of stakeholders. In particular the one page summaries on each of the key areas of focus in the most recent discussion paper is a welcome advancement in engagement for such a complex issue.

Endeavour Energy supports the submission made by Energy Networks Australia and the comments below are intended to be supportive and supplementary to that submission drawing out facets that are of particular relevance to Endeavour Energy.

The discussion paper released on 1 November 2018 engages with a number of issues, however there are five key position areas on which Endeavour Energy wishes to provide comment, being:

- Primacy of incentive based regulation;
- Resetting the value of the tax asset base;
- Diminishing value tax depreciation;
- Tax treatment of refurbishment expenditure; and
- Interest expense for income tax purposes.

Primacy of incentive based regulation

There are several findings contained in the AER's discussion paper that confirm the AER's commitment to incentive based regulation, and the advice provided to the review of the long terms benefits to consumers of its continued primacy.

The AER has found that changes are not warranted in respect of using a benchmark income tax allowance derived using the prevailing corporate income tax rate.

Alternatives to this approach include a direct pass through of actual tax paid and a half way house of using firm specific income tax rates drawn from the combination of business structures and ownership specific income tax rates.

The findings of the AER and its advisors clearly identify the significant practical difficulties and poor incentive outcomes that would arise in departing from current practices. The discussion paper also highlights questions as to the materiality of changes given current benchmark ownership arrangements as well as expected changes to concessional income tax arrangements.

Resetting the value of the tax asset base

Endeavour Energy supports the findings of the AER in the discussion paper that no change is warranted to amend the tax asset base used for regulatory purposes as a result of a sale of the regulated network.

From a matter of first principles, if a transaction price paid that exceeds the current regulatory asset value the amount above the current regulatory values is 100% paid for by the new acquirer with no cost passed on to customers. It follows logically that as customers are not required to fund any of these additional costs they equally should not receive any of the setting benefits that may arise. This is an important discipline for transactions to ensure that customers are protected from, and that acquirers bear, the net risks and costs.

Diminishing value tax depreciation

Endeavour Energy agrees with the AER that the evidence presented on this issue highlights that there may be a case for change to the current regulatory regime. Endeavour Energy also agrees with the findings of the AER, and recommendations made by its advisors, that any such change should be forward looking.

There does remain however a question as to whether a change to the regulatory models must necessarily be applied to all businesses; and whether the choice of depreciation methods should be consistent in setting both the return of capital and income tax building blocks of the PTRM.

The regulatory models are built on the premise of maintaining the financial capital maintenance (FCM) principle, sometimes referred to as NPV=0. Satisfaction of this principle ex ante in most instances requires simple alignment between forecast profiles and expected profiles. In other words if a firm uses prime cost or straight line tax depreciation, then if the regulatory model also adopts that approach FCM is preserved ex ante, with the same logic also applying to diminishing value.

Therefore the decision to apply one form of tax depreciation over another as a blanket benchmark requires consideration of the inherent NPV value of each form of depreciation, but also consideration of issues such as intergenerational equity and price path.

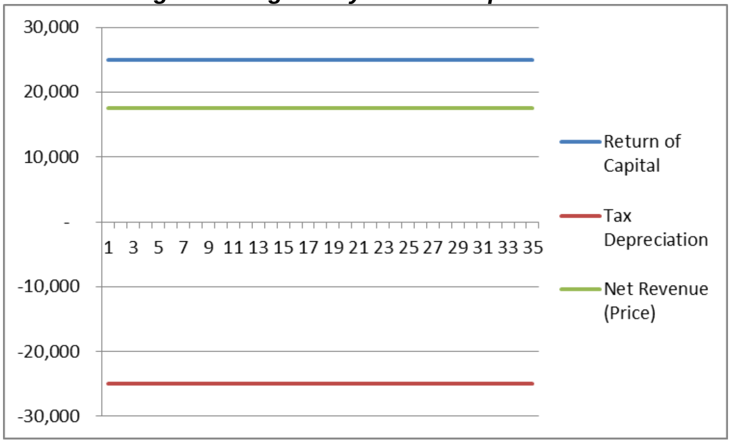
To consider the issue of whether one form of depreciation is inherently superior to the other and whether tax and regulatory deprecation approach should be linked, we undertook some simple stylised modelling to help understand the inherent properties and potential interrelationships.

Straight line regulatory and tax depreciation

The chart below shows the expected profiles built into the current regulatory models where both the regulatory depreciation and tax deprecation are based on straight line. For simplicity, issues such as CPI impacts have been ignored. As can be seen the inherent profile is that of consistent cost recovery over the service life of an asset with customers paying an equal share at all stages of the asset's life.

This approach also infers a bias towards stable prices over time for any given asset.

Chart 1: Straight line regulatory and tax depreciation

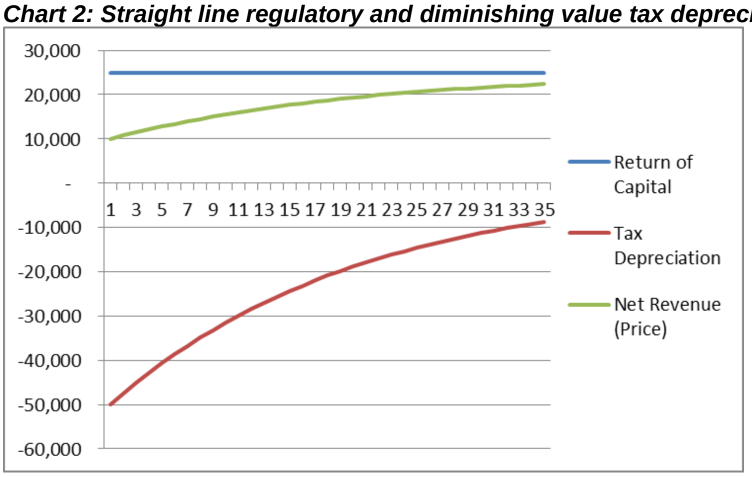


Straight line regulatory and diminishing value tax depreciation

The chart below uses the same data but in this instance diminishing value is used for tax depreciation. What can be seen is that customers serviced by the asset in the early years of an asset's life pay considerably less for the asset than customers using the asset towards the end of the asset's serviceable life. This poses a question of intergenerational equity and whether customers are paying their fair share of the asset's costs for the service that they obtain.

This approach also implies that prices are likely to increase over time for any given asset.

Chart 2: Straight line regulatory and diminishing value tax depreciation

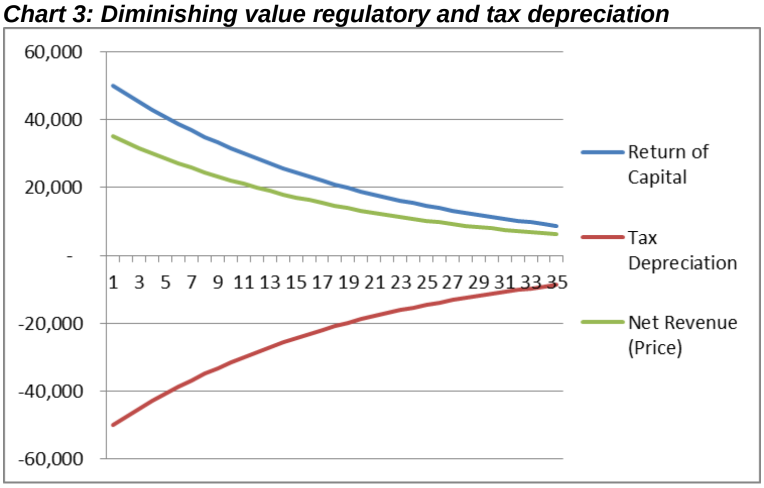


Diminishing value regulatory and tax depreciation

The chart below again uses the same inputs but applies diminishing value to both regulatory and tax depreciation. This aligns the benefits from the tax shield with the costs being recovered from customers for the use of the asset. It again raises intergenerational questions as to whether customers in the earlier year of an asset's life enjoy greater benefits/service than those at the end of an asset's life, and therefore should be required to pay for that benefit.

This approach also implies that prices are likely to decrease over time for any given asset.

Chart 3: Diminishing value regulatory and tax depreciation



What this extremely simplistic analysis seeks to illustrate is that the issues before the AER are complex and long lasting, particularly on the point of whether to apply approaches as sector wide benchmark methods.

Before making a final decision on such matters that AER should satisfy itself and stakeholders on how it will approach the issue of intergenerational equity for both the tax costs and the underlying asset costs recognising the inherent price path that these decisions will create.

Regardless of the approach adopted Endeavour Energy believes that the current models used by the AER can be readily adapted to accommodate both prime cost and diminishing value approaches simultaneously, recognising that even if diminishing value is adopted, ATO rules do not allow it to be applied to all assets. That being said the model size and data requirements will increase substantially.

Tax treatment of refurbishment expenditure

Endeavour Energy agrees with the AER's advisors that if implemented this potential change should not be established on a broad based benchmark. However, Endeavour Energy does not believe that this potential change should be implemented.

The adoption of this approach is fraught for a number of reasons including:

1. As covered in other submissions this subject matter is not straight forward and must be determined on an asset by asset or expenditure by expenditure basis. This leads to risks of clarifications that are unsupportive of approaches adopted.

2. It may distort the current aligned incentives of customers and the network to favour replacement over refurbishment.
3. It would create the potential for even larger intergenerational discrepancies than those illustrated in chart 2 above as all of the tax depreciation would be taken in year 1.

For the past two decades the regulatory regime has been adapted to include focused incentives for networks to drive for efficient outcomes that reduce the costs borne by customers. It appears inconsistent in that light to be considering a change that appears to already strongly align network and customer interests in a manner that intuitively already includes a sharing of the benefits between customers and networks.

As outlined above this issue has the potential to be material to the overall outcomes and incentive properties of the regulatory regime, and Endeavour Energy commends the focus applied to it in the ENA submission.

Interest expense for income tax purposes

Endeavour Energy agrees with views provided by Dr Lally to the AER on this issue. Specifically that there should be alignment of assumptions for gearing and value of debt for the purposes of the rate of return and for income tax calculations.

The advocacy of this issue within the income tax review appears to be better directed to AER's rate of return guideline. Indeed when responding to RINs on this subject matter Endeavour Energy notes that the data requirements were substantively indistinguishable from those provided to the AER for the rate of return process.

Endeavour Energy is of the view that consistent evidence, and the consistent weighting of that evidence, should only lead to the same regulatory outcome irrespective of the review in which the subject material is being considered.

Further as articulated earlier consideration of a capital value of actual debt and equity that differs to that of the total capital value used for regulatory purposes is a risk that should appropriately be entirely borne by the shareholders. Consistent with that principle any mitigating benefits arising from that risk must also be fully attributed to the party taking the risk.

Any departure from this principle would appear to be analogous to the regulator breaking its own ring fencing rules against cross subsidising unregulated activities.
If you have any queries or wish to discuss this matter further please contact our Manager Network Regulation, Mr Jon Hocking, on [redacted] or via email at jon.hocking@endeavourenergy.com.au.

Yours sincerely,

[redacted]

Andrew Schille
General Manager Regulation & Corporate Affairs
Endeavour Energy