Submission to AER Issues Paper: Review of regulatory tax approach

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Thank you for the opportunity to provide submissions to your Review of Regulatory Approach Initial Report.

I am a PhD student through Curtin University and parts of my PhD have involved examining the difference between the tax allowance and tax paid for a number of organisations and industries, including the electricity industry. I have studied several price regulators and how the regulatory process works in conjunction with our tax system.

This submission draws on some of the research undertaken in the course of my candidacy to date and my work experience.

As this draws on research undertaken to date, no part can be quoted from or used without the prior written consent of the author.

Thank you for taking the time to read and consider the points raised in this submission.

Josephine Doueihi

Overview

There are two very different frameworks that underpin the calculation of the tax paid and the tax allowance.

The first is the tax law framework which is administered by the ATO and requires companies to lodge tax returns based on actual figures and results and within the requirements of the tax law.

The second is the regulatory framework, which is based forecast income and expenses, uses the concept of a benchmark efficient business, and calculates prices based on the building block incentive approach. One of the building blocks in this regulatory framework is tax.

Therefore, it can be expected that the tax paid, which comes out of actual results will differ from the tax allowance which comes out of forecast results for a benchmark efficient business.

Response to Dr Martin Lally's paper: Tax payments versus the AER's allowances for regulated businesses

Dr Lally appears to make the underlying assumption that a business is able to choose how much or how little tax it pays. He states:

> If applied at the sector-wide level, the level of tax minimization activities is likely to increase as firms seek to ensure that their tax payments do not exceed their tax allowances.[1]

He further goes on to give the example of two firms (A and B) and their actions around the relationship between tax paid and the tax allowance:

> Firm A continues as before but firm B might reduce its tax payments to $20m… Eventually, this 'race to the bottom' would lead firm B to reduce its tax payments to zero, and the regulatory tax allowance would then also be zero….[2]

A business is unable to randomly choose how much tax it will pay in any given year. Using the drivers of the difference between the tax allowance and tax paid as an example, if a business were to try to manipulate these to achieve a desired level of tax, the outcome would be as follows:

- Ownership structure: Any change to ownership structure take time and come at great expense to a business (through consultants' fees and so on). Changes to ownership, for example, selling part of a business, are lengthy and time-consuming and often involve great cost in lawyers and due diligence process. The setting up of legal structures, for example trusts, is also lengthy, time-consuming and expense, as a business would need to ensure that the structure is appropriate for its purposes.
- Depreciation: Once a depreciation method is selected (prime cost or diminishing value), it is unable to be changed. In addition, an entity cannot randomly change the

[1] Dr Martin Lally, "Tax payments versus the AER's allowances for regulated businesses", Capital Financial Consultants Ltd, 16 June 2018, pg. 4.
[2] Dr Martin Lally, "Tax payments versus the AER's allowances for regulated businesses", Capital Financial Consultants Ltd, 16 June 2018, pg. 22.

effective life of an asset without having an acceptable underlying reason for doing so. Therefore, any changes which will affect the tax depreciation will need to be made to newly acquired or constructed assets, and any affects of such will be observed over the medium to long-term.

- Carry-forward tax losses: if an entity doesn't already have carry-forward losses then it can't minimise its tax using losses. Even with existing losses, a business needs to meet the necessary criteria before it is able to utilise these losses.
- Interest/gearing: large debt and borrowings are often locked in for the long term and are unable to be exited or unwound with ease or without cost to the business.

One could also assume that an efficient business is already minimising its tax as much as possible, leaving it with not much opportunity to further minimise its tax as a result of the price regulator reducing the tax allowance.

Dr Lally then states the opposite for government-owned businesses:

> "…if the tax allowances for these businesses were raised to reflect the actual payments of these businesses, the businesses would face the perverse incentive to take actions that raised their tax payments, because they receive both the revenue and the taxes."[3]

Again, as above, an entity cannot choose to randomly increase the amount of tax it pays. One of the main reasons that government-owned businesses pay more tax than their privately-owned counterparts is because they operate in a different tax framework. The National Tax Equivalent Regime (NTER) does not allow for complex structures involving trusts to minimise tax. Many changes to the regime need to be approved by the State and Territory Treasuries, who also receive the tax paid by these NTER entities and so have a vested interest in maximising tax. This was illustrated in the ATO Note, where the ATO found that the government-owned businesses paid more tax. It is unlikely that these tax payments will further increase as a result of an increase in the tax allowance. In addition, government-owned businesses are not free to structure their borrowings, and are required to borrow from their State-Owned Treasury Corporation.

AER Information Requests

Tax assessments

Similar to tax returns and consolidated financial statements, tax notices of assessment are issued on a consolidated basis. Therefore, the AER would run into the same issues the ATO had in its Note, in that assumptions would need to be made on how to allocate the tax assessed to the regulated portion of the business. The AER would need further information from the businesses in order to arrive at an accurate basis of allocation.

Further, the tax assessments might not tie back to the financial statements. The Current Tax Expense line of the financial statements should represent the tax assessed for that year, however, current year tax figures presented in the financial statements are in draft and are subject to a more detailed review when the tax return is prepared. There will almost always be a variation between the tax return and the tax presented in the financial statements. Any differences are then trued-up and reported on the "adjustments related to prior year" line of the financial statements in the following year.

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[3] Dr Martin Lally, "Tax payments versus the AER's allowances for regulated businesses", Capital Financial Consultants Ltd, 16 June 2018, pg. 6.

Capitalised labour, unbilled income, and customer contributions/gifted assets

These items are already covered by ATO Interpretative Decisions and legislation:

- ATO ID 2011/42: Income tax: Deductibility of salary or wages to the extent that employees are engaged in the self-construction of depreciating assets
- ATO ID 2011/43: Income tax: Deductibility of labour on-costs to the extent that employees are engaged on the self-construction of depreciating assets
- ATO ID 2012/15: Income tax: Derivation of income: unbilled supply of energy
- Section 21A: Non-cash business benefits (ITAA1936)

Given the ATOIDs and legislation above, it can be assumed that the regulated businesses are complying with the tax law, and it should be left to the auditors and ATO to determine if they are not.

Timeframe

The AER has a very narrow timeframe for completing this project. No two businesses are the same and the time taken to understand each and possibly determine parameters for the separation of the regulated part of the business from the unregulated should not be underestimated.

For example, if a business needs to recut its asset book in order to identify the regulated portion separately, this process could take several months.

The AER would be best to consider extending the timeframe in order to get any potential changes right rather than risk missing some key information and crucial factors in its haste to meet the timeline presented.

Changes that might be made

Tax depreciation changes

The AER might consider making any depreciation changes to new assets only, and carrying on the existing depreciation. Doing so would mean that there would not be any large adjustments from changing methods relating to any existing assets.

In addition, the AER might want to consider using the regulated entity's forecasts and actuals for all new assets from the time of implementation of any model or rule changes. Doing so will eliminate the AER's need for any further consideration of self-assessed effective lives and low-value pools.

Ownership structures

Unless the statutory tax rate is less than 30% (for example, MITs), changing the statutory tax rate for the tax allowance is inconsistent with the statutory tax rate in tax law.

Gearing

To use different gearing levels for tax allowance and WACC purposes is inconsistent. For example, a regulated business' actual gearing does not match the gearing level set by the AER. This would result in a greater interest deduction for that business, and therefore less tax payable. As a result, tax payable is less than tax allowed. Whilst, using this example, it appears that the tax allowance was set too high, the true result is that the business was not adequately compensated for its interest expense through prices set by the AER. To then decrease the tax allowance to match actual gearing (or another gearing) is to penalise the business twice.

Other expenses

Other expenses should only be considered in the tax building block if they are also being considered in other parts of the building block. To use an expense to reduce the tax allowance without allowing the business to recover that expense in other parts of the framework is inconsistent.

TAB revaluation

I agree with what the AER is proposing in relation to the TAB revaluation.

Prior tax losses

The AER should consider the reasons for those tax losses. For example, the tax losses might have arisen from the application of diminishing value depreciation to a very large asset base, the benefits of which would unwind in the coming years. If this is the case, and the AER has based its tax depreciation on the straight-line method, it should not use this loss to offset tax payable when calculating the tax allowance. This is because, in future years, that business would be claiming less tax depreciation (and therefore paying more tax) than what the AER would allow in its tax allowance.

Framework changes

Pass-through of actual tax costs

As discussed in the opening, the tax paid and the tax allowance exist in two very different frameworks. Using tax as a pass-through cost suggests that the AER accepts the notion of an efficient benchmark business except for the amount of tax that the efficient benchmark business would pay, and so intends to replace this with the tax arising from a different framework. For the AER to abandon the tax allowance for the actual tax paid is inconsistent with other parts of the regulatory framework.

Other

If all other things (i.e., depreciation, ownership structure, and so on) are not the cause of the difference between tax allowed and tax paid, it suggests that the difference is due to shortfalls calculated in other parts of the building block, or other items which are not reflected in the regulatory framework. This would indicate that even though the tax allowance is greater than tax paid, the business is worse-off because it is claiming deductions which are not being compensated in prices.