Major Energy Users Inc.

28 May 2018

Mr Warwick Anderson
General Manager
Australian Energy Regulator
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By email to: TaxReview2018@aer.gov.au

Dear Warwick

Review of regulatory tax approach
Issues paper

The Major Energy Users Inc (MEU) thanks the AER for providing the opportunity to provide input into the AER review of regulatory tax approach that will assist in the development of its revised guideline on setting the allowed rate of return (RoR) for regulated energy transport networks through the release of its Issues paper May 2018.

The MEU notes that its Public Officer (Mr David Headberry) was a contributor to the AER Consumer Reference Group (CRG) report which provided consumers views on the various elements contributing to the overall rate of return guideline. The CRG noted in its report that some aspects of the regulatory tax approach did not reflect the basis that the allowed rate of return should be based on the benchmark efficient entity (BEE).

Further, the MEU observes that the report from the CRG was quite concerned about the sources of information that the AER uses for various inputs to its rate of return guideline, the extent that the rules transfer risks away from networks and that the rules provide an outturn revenue greater than is implied by the building block approach. This MEU response to questions raised by the AER in its Issues paper is influenced by these concerns expressed by the CRG.

The AER observes that tax paid by the networks shows that government owned networks paid more tax than that allowed by the AER and that the private networks paid less. What is not examined in detail is why this might be the case.

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Tax payable is essentially based on the profits that a firm makes. The profit made by a firm is the excess from the revenue it receives after allowing for the costs in getting that revenue. The AER tax allowance is based on the assumption that its allowed revenue provides the total profit to the network being in the return on equity element of the WACC*RAB calculation. In fact, the networks also get an increase in profit from other allowances and sources of revenue excluded from the building block approach.

These increased profits come from:

- The difference between the allowed cost of debt and the actual cost of debt[1]
- Under-running the allowances for opex and capex
- Inflation of the regulatory asset base
- Payments from the EBSS, CESS and STPIS incentive schemes designed to increase efficiency
- Revenue allowed from the sale of shared access to the regulated assets to third parties

Most of these other sources of additional revenue have little cost so they provide a significant increase in profitability[2], thereby leading to a greater exposure to tax payments.

Consumers have consistently pointed out to the AER that networks have achieved higher profits than those included in the revenue allowance but, in contrast to privately owned networks, government owned networks have little ability to implement tax savings measures like privately owned networks can. The MEU considers that there is also little desire for the government owners for tax minimisation, as it means little to the government owner if the return it gets from the network comes as a network dividend or as tax payable under the National Tax Equivalent Regime (NTER)[3]. When considering the increased profitability enjoyed by the networks, this explains why the AER tax allowance for government owned networks might be lower than the actual tax payments observed. The MEU considers the AER needs to carry out a more in-depth analysis of the tax paid by government owned networks as, implicitly, paying a higher amount of tax only occurs if the profit generated exceeds the profit assumed by the AER in the building block.

This analysis also highlights that, although the privately owned networks benefit from the rules much the same as government owned networks, the privately

[1] The MEU notes that the AER has identified that, as well as government networks having a lower cost of debt based on the low cost governments access debt, the privately owned networks achieved a considerable profit margin on the cost of their debt (see for example Chairmont report "Aggregation of Return on Debt Data" provided with the AER review of allowed return on debt Discussion paper)

[2] This point is exemplified in the recent report by Hugh Grant for CaneGrowers and others available at https://bit.ly/2HsZKrS and in the response by WAMEU to the draft decision of ERA on Western Power

[3] It is even probable that the government owner would prefer the tax paid as the network could seek to limit its dividend and retain some of its profits for reinvestment.

owned networks have tools available to them to reduce their tax liabilities. Even with the higher profitability that the rules deliver to networks, the AER points out that the privately owned networks have been able to still maintain a lower tax cost than the AER allowance despite enjoying the higher profitability they get. This means that the real differential between allowed and actual tax payment when measured on the same basis, is probably even greater than has been observed.

The first part of the Issues paper addresses sources of data to inform the AER about the amounts of tax paid by networks.

While the MEU considers the AER has identified in its Issues paper the best sources of information about tax matters applying to the networks, the MEU points out that there are concerns about even these sources of data in that market data does not provide information about the tax which would be payable by the BEE. The BEE is a theoretical concept which has no real equivalent in the market whereas the market data reflects the structure and approaches of actual entities which do not match the BEE in several key aspects[4].

Under the post tax revenue model (PTRM) used by the AER, the AER is required to include for tax payable by a network firm but to adjust this where shareholders would otherwise benefit from the tax paid. This has led to in-depth discussions as to the extent that the firm distributes the benefit from the tax it pays and the number of shareholders that can utilise the benefit. In the PTRM, the extent to which shareholders can benefit from tax paid is set by the value of "gamma" (the multiple of the distribution rate and the utilisation rate).

In its current rate of return guideline, the AER calculated gamma as 0.5 but later revised this downward to 0.4; network firms have consistently sought a gamma value of 0.25. The calculation of gamma has been based on various studies and assessments which are supposed to reflect what is seen across all firms listed on the ASX. Listed firms have a range of different ownership structures and different drivers about what to do about tax imputation. The basis of the AER approach assumes that the BEE is like the average of all listed firms, but the BEE is not like the average.

It is the use of market data that has led to observation that AER allowances for tax liabilities are more that what has been observed, implying that the market data and/or the approach used is flawed.

As the CRG noted in its response to the AER deliberations on the rate of return guideline, a listed firm which is an growth phase might seek to maximise its holding of cash by not paying some tax liability (ie by not fully franking its dividends) so that the unpaid tax has to be paid by the shareholder. While the studies of tax payable by all firms listed on the ASX might imply that the "average listed firm" does not fully frank its dividends, the MEU (and the CRG) considers

[4] These differences are detailed in the CRG response to the AER of the rate of return guideline

that a firm with mature technologies, a static market and little need to retain earnings for growth (such as the BEE) and a secure cash flow (as enjoyed by network firms) would have little reason not to fully frank its dividends.

The CRG observed that the three remaining ASX listed network firms (Ausnet, APA and Spark) all had provided their shareholders with franking in excess of unity as this gave more value to their shareholders by effectively returning some capital; this supports a view that network firms would fully frank their dividends, reflecting the unique features they enjoy. The AER adviser Dr Martin Lally also came to a similar view that network firms would highly (if not fully) frank their dividends and his assessment of the top 20 firms listed on the ASX confirmed this conclusion.

To show that the BEE is different to all other listed firms requires examination of how the AER develops its building block approach to develop the allowed revenue for the BEE.

The AER assesses that the funding of the BEE is from Australian sources in that it sources input data for:

- The market risk premium used in the CAPM to be a value calculated from the accumulation index of all firms listed on the ASX weighted in accordance with the Australian ASX market capitalisation of firms. By using this measure and not other overseas measures, and using a risk free rate based on Australian government 10 year bonds, it implies very clearly that the BEE must be assumed to be an Australian firm with its equity sourced exclusively from Australian shareholders[5].
- The cost of debt allowance used by the AER in its trailing average approach to debt is assumed to be sourced exclusively from Australian corporate bonds.

These two observations imply very clearly that the BEE is an Australian firm funded by Australian shareholders with no influence from non-Australian debt, reinforcing the view that the firm has only Australian roots.

When the BEE is considered in these terms, then there is no doubt that dividends from the BEE would only be expected to be distributed to Australian tax payers who are also beneficiaries of tax imputation. This supports a view that the utilisation rate should be assessed as unity.

The MEU does recognise that a firm has the ability to reduce the tax it pays depending on what it might require cash for that otherwise would be paid as tax. However, networks have little need for additional cash as the rules provide a revenue allowance that delivers the necessary free cash flow to maintain the firm's

[5] If the network is assumed to have some overseas equity or debt then the AER would have to set the WACC based on a mix of equity and debt from local and overseas sources. But this does not occur, leading to the conclusion that the BEE is exclusively funded locally

operations. With this in mind, the BEE would most probably have a distribution rate of unity, and this view is supported by the data observed from the listed network firms.

This, admittedly a theoretical approach, implies that the need to source data from the market to inform on what tax allowances should be provided is not necessary to the extent implied by the AER Issues paper.

The MEU is very concerned that in attempting to secure accurate data from the market is not only exceedingly difficult (recognising that actual tax data is confidential) but confusing as well. The MEU has noted that over the years through their appeals to the Competition Tribunal, the networks have been able to use the paucity of "clean" data as a tool to get consumers to pay a higher allowance for tax than the network firms incur and therefore more for their network services than necessary. The very fact that the Federal government has initiated a review[6] indicates that the current approach is demonstrably not complying with the national energy objectives.

Based on earlier comments, the MEU considers that an approach based on accessing market data is basically flawed as the BEE would have to manage its tax affairs differently to what listed firms might be able to do. This means the data which can be sourced from the various network firms really have little to do with what the tax payable by the BEE is as all of the network firms have different features and so the tax approach by each is unique to them.

The MEU considers that the AER is getting lost in the masses of data that is available from the various network firms but by doing so, loses sight of the fact that they should assess the tax payable on the basis of the BEE.

The second part of the AER Issues paper addresses the relative importance of the various drivers available to a privately owned network to reduce its tax payable.

The MEU agrees with the listing of the drivers included in the tables 5.1 and 5.2 but considers that the ownership structure is a core element of how a network might seek to reduce its tax payable. Specifically, the MEU is aware that dividends can be delivered to shareholders in more ways than one. A common way is for the equity to be provided in a form of debt where the interest payable on the debt is equivalent to the dividend payable. By converting the equity to "debt" allows the cost of the "interest" to be deducted as a cost, reducing the notional profit.

The MEU also considers that a cause of the differential results in how the AER has used market data to inform on the imputation allowance to be included in the building block allowance.

[6] For example "Frydenberg asks energy regulator to probe electricity price-gouging claims" AFR May 15 2018

If the AER accepted that the BEE is different to what is revealed as market data then the allowance for tax would be significantly reduced by increasing the value of "gamma".

Conclusions

The MEU is pleased that the AER has identified there is a need to investigate further why tax allowances have resulted in benefits transferring to the networks at the cost of consumers.

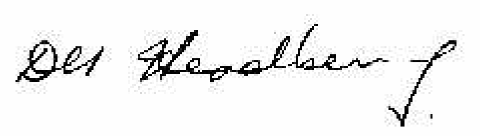
The MEU considers that the approach used by the AER to set the returns on equity and the cost of debt imply that the BEE is Australian owned and to maximise its financial efficiency, the BEE would have all its shareholders able to use imputation. The primary cause of the tax discrepancy identified for private firms is from the approach used by the AER to assess gamma. There would be a major reduction in the tax differential if the value for gamma was increased to (or near) unity as proposed by the CRG and Dr Lally.

The MEU notes a concern that the AER is using market data to develop its calculation of the tax allowance but has not recognised that the market data is not applicable to a firm which reflects the required character of the BEE.

The MEU considers there the simple explanation as to why government owned networks have incurred higher tax payments than allowed by the AER is that the networks make a higher profit than the AER forecasts, therefore making a higher NTER payment. The MEU notes that the privately owned networks would also pay a higher tax than the AER allowed for the same reason that the government owned networks do, yet the privately owned networks have an ability to implement tax minimisation strategies that government owned firms do not.

Should the AER require additional explanation as to the concerns expressed herein, please contact the undersigned.

Yours sincerely



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Public Officer