

13 November 2014

Mr Warwick Anderson
General Manager – Networks Finance and Reporting Branch
Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601

Dear Warwick

**AER PROPOSED AMENDMENTS TO POST-TAX REVENUE MODELS
ELECTRICITY TRANSMISSION AND DISTRIBUTION**

SA Power Networks welcomes the opportunity to provide comments in relation to the Australian Energy Regulator's (AER) proposed amendments to the post-tax revenue models (PTRM) for electricity transmission and distribution businesses.

Our review has focussed on the distribution PTRM. The main purpose of the AER's proposed amendments is to give effect to the AER's Rate of Return Guidelines. In addition, the proposed amended PTRM enables revenue adjustments for the sharing of unregulated revenues earned with shared assets, as well as include some presentational changes directed at improving clarity in the models.

SA Power Networks primary concern relates to how the sharing of unregulated revenues earned with shared assets is implemented in the PTRM. In particular, the AER incorporates the amount of the revenue sharing adjustment into the calculation of the tax allowance in the PTRM. This results in a reduction in the taxation building block. As a result of the calculation in the AER's proposed PTRMs, more than 10 per cent of unregulated revenue earned with shared assets is returned to consumers.

SA Power Networks considers that this approach is inconsistent with the AER's Shared Asset Guideline, which provides that the shared asset cost reduction should reduce a service provider's standard control (or prescribed transmission) revenues by 10 per cent of the value of the service provider's expected total unregulated revenues from

shared assets.¹ The AER's Shared Asset Guideline Explanatory Statement specifically states that:

*"Under our method, we will reduce a service provider's regulated revenues from assets providing standard control (or prescribed transmission) services by a fixed 10 per cent of the value of unregulated revenues earned with shared assets. We consider that setting a fixed proportion further enhances transparency and certainty for both service providers and consumers."*²

No tax adjustment is discussed in the Shared Asset Guideline or Explanatory Statement. SA Power Networks considers that the Guideline is correct in that no tax adjustment is required to give effect to the intention of the AER's Shared Asset Guidelines. The correct implementation of the guideline is to simply deduct 10 per cent of unregulated revenues derived with shared assets from a service provider's standard control (or prescribed transmission) revenues. This interpretation is consistent with the worked example provided in Appendix A to the Shared Asset Guideline. The worked example does not include any adjustment to tax allowance.³

The attachment to this response describes this issue in more detail. SA Power Networks considers that the AER should remove the adjustment for the sharing of unregulated revenue earned with shared assets from the calculation of tax allowance in the proposed amended PTRMs.

If you have any questions in relation to this matter, please contact myself or David Craig, Manager Regulatory Finance and Modelling (08 8404 5738).

Yours Sincerely,



Sean Kelly
General Manager Corporate Strategy

¹ AER, Shared Asset Guideline, 2013, p.15.

² AER, Shared Asset Guideline Explanatory statement, p.32.

³ AER, Shared Asset Guideline, 2013, p.20.



Attachment

Shared Assets Adjustment

PTRM Treatment inconsistent with the Shared Assets Guideline

The treatment of the shared assets adjustment in the proposed amended PTRM is inconsistent with the Shared Asset Guideline. The shared assets adjustment as described in Section 3.1(c) of the Shared Asset Guideline states:

A cost reduction will reduce a service provider's standard control (or prescribed transmission) revenues by 10 per cent of the value of the service provider's expected total unregulated revenues from shared assets in that year.

In addition, Attachment A to the Shared Asset Guideline (in Table A1) demonstrates that the shared assets adjustment is intended to simply be a deduction from the Annual Revenue Requirement (ARR) and as such had no implications for the building block calculation itself, including the tax allowance.

The proposed amended PTRM has input fields for the shared asset adjustment. In order to reflect the treatment in the Shared Asset Guideline, all that is required is for the PTRM to deduct the input values for the shared asset adjustment from the ARR.

However the proposed PTRM adopts a differing methodology, whereby the input values for the shared asset adjustment are incorporated into the tax allowance calculation. This results in a reduction in the tax allowance, in addition to the reduction in revenue from the input values for the shared asset adjustment. The resulting adjustment to revenues is consequently greater than 10 per cent of revenues from shared assets.

This methodology is a departure from the Shared Asset Guideline and results in a larger reduction in revenue than is intended by the Guideline.

No explanation is provided as to why the PTRM adopts this treatment, however one interpretation is that the AER considers that the shared assets adjustment has an associated tax 'benefit' from the lower revenue that should be shared with customers. For this to be valid, the shared assets revenue would need to be part of the build-up of the original building blocks. If this were the case, the shared assets adjustment to share 10% of the shared assets revenue would have an associated tax allowance in the building block calculation.

However, the shared assets revenue is not part of the building blocks, so it is incorrect to assume that there is an element of the tax allowance associated with the shared assets adjustment.

In the calculation of taxable income for the NSP, the calculation of taxable income and tax payable will be lower by virtue of the shared assets adjustment. This lower tax payable is not a 'benefit' to be shared with customers as it only occurs due to the reduction in income arising from the shared assets adjustment.

The end result of the calculation in the proposed amended PTRM is that approximately 13% of shared assets revenue is returned to customers, not the intended 10% of the Guideline.

Example 1 below illustrates this.

Example 1 Effect of the AER PTRM treatment, with 10% shared assets adjustment.

Notional profit and loss statement for the shared assets revenue [3].

	Before Adjustment	PTRM Adjustment 10% Note [2]	After Adjustment	Impact of Adjustment (\$)	Impact of Adjustment (%)
Shared Assets income	100.0	(13.0)	87.0	(13.0)	
NSP Profit before tax	<u>100.0</u>		<u>87.0</u>	<u>(13.0)</u>	(13.0%)
Tax @ 30%	(30.0)		(26.1)	3.9	
Shared assets profit after tax	<u>70.0</u>		<u>60.9</u>	<u>(9.1)</u>	(13.0%)

The error in this logic can be illustrated further, by considering the outcome in an extreme case where the shared assets adjustment was 100% of shared assets revenue. This would result in the NSP being out of pocket by 130% of the shared assets revenue.

Example 2 below demonstrates the before and after tax impacts of a 10% shared assets adjustment and illustrates that the before and after tax adjustments remain at 10%. This example illustrates that no adjustment beyond the 10% revenue adjustment is required in the PTRM, to give effect to the AER's intention to adjust for 10% of shared assets revenue on both a before and after tax basis. The resulting change in the NSP's tax payable will ensure that the after tax impact remains at 10%.

Example 2 - Shared Assets adjustment at 10% of revenue

Notional profit and loss statement for the shared assets revenue [3].

	Before Adjustment	Guideline Adjustment 10%	After Adjustment	Impact of Adjustment (\$)	Impact of Adjustment (%)
Shared Assets income	100.0	(10.0)	90.0	(10.0)	
Shared assets profit before tax	<u>100.0</u>		<u>90.0</u>	<u>(10.0)</u>	(10.0%)
Tax @ 30%	(30.0)		(27.0)	3.0	
Shared assets profit after tax	<u>70.0</u>		<u>63.0</u>	<u>(7.0)</u>	(10.0%)

Summary

In summary, no adjustment to the PTRM tax allowance is required to give effect to the AER's Guideline intention of a 10% shared assets adjustment. As example 2 shows, an deduction to the ARR of 10% of shared assets revenue, with no adjustment to the tax allowance calculated in the PTRM, will result in the shared assets adjustment being at the 10% of revenue on a before and after tax basis.

The proposed PTRM's methodology is in error as it results in a shared assets adjustment of 13%, rather than 10%.

Notes:

[1] For simplicity in this example, the impacts of gamma and iterative impacts of the tax allowance on ARR is ignored.

[2] Calculated as:

Shared Asset Adjustment	(10.0)
Reduction in Tax Allowance ^[1]	<u>(3.0)</u>
Total reduction to ARR	<u>(13.0)</u>

[3] For simplicity, assumed that there are no associated costs.