Proposed Energy Rule Amendments: Binding rate of return instrument

Response to COAG Energy Council Consultation

Energy Networks Australia

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1 Overview

Key messages

- The proposed amendments to the definition of estimated taxable income reach significantly beyond changes required to implement a binding guideline and would undermine the policy goal of stable, predictable, and incentive-based regulation.
- The proposed change appears to risk the unintended outcome of requiring change to current regulatory taxation approaches, by requiring an estimate of the actual taxable income of the network service provider, rather than an estimate of a 'benchmark efficient' taxable income.
- This risks pre-empting the outcome from a Ministerially requested review by the AER on the regulatory approach to taxation which has not yet been completed.
- Approaches that use concepts of 'actual tax paid' are not in the long-term interests of consumers as they would result in higher costs.
- The COAG Energy Council should reject the unnecessary removal of references to the benchmark efficient entity from rule provisions relating to estimation of corporate income tax.
- Alternatively, the COAG Energy Council should adopt alternative drafting changes to the provisions to ensure flexibility to continue to apply benchmark rather than 'actuals based' approaches.

On 28 September 2018 the COAG Energy Council published a set of draft amendments to the National Electricity Rules (NER) and National Gas Rules (NGR) to support the introduction of legislation to create a binding rate of return instrument. The COAG Energy Council has invited stakeholder feedback on the proposed amendments.

Energy Networks Australia (ENA) recognises that the majority of the proposed amendments are consequential upon the prior policy decision by the Energy Council to adopt a binding rate of return guideline. These technical and mechanistic implementation changes were foreshadowed in consultation and are not the focus of this submission.

This submission is instead focused on ENA members' strong concerns around the proposed newly introduced definition of estimated taxable income in the NER and NGR. These were not anticipated or foreshadowed in prior consultations, and could result in a significant unanticipated policy change if implemented through this legislative rule amendment process.

The legal effect of the draft amendments would appear to be to redefine estimated taxable income as an estimate of the actual taxable income of the network service provider (NSP) in question, rather than an estimate of the taxable income of a

benchmark efficient entity (BEE). It is our understanding from early discussions with officers of the Commonwealth Department of Energy and the Environment and the AER that this was not the intended outcome of the proposed rule drafting. While there is no explanatory material accompanying the draft amendment which explains its purpose or intent, the Council's description of the package of changes notes that it is intended to remove or amend provisions 'outdated' by movement to a binding rate of return guideline.

Taking into account the above, ENA assumes it is not an agreed COAG Energy Council decision or intention to move away from an approach which estimates the cost of corporate income tax building block by reference to an efficient benchmark. Such a decision would be an issue of fundamental policy consequence for the overall incentive framework.

However, as there is uncertainty in this area in the absence of an agreed COAG Energy Council policy statement, this submission discusses the potential adverse consequences of adoption of the COAG Energy Council's proposed amendments to the energy rules in relation to the estimated cost of corporate income tax.

In summary, our concerns about the new definition of taxable income in National Electricity Rule 6.5.3 and its gas and electricity transmission equivalents are:

» **The proposed change is not necessary or consequential to implementing a binding guideline approach -** The amendments proposed by the COAG Energy Council to amend the rate of return rules do not require the proposed change to the definition of taxable income. There is no reason why the current definition of taxable income cannot still be applied within the amended rate of return framework.

» **The proposed change would represent a pre-emption of independent regulatory review outcomes -** The AER is presently conducting a separate review of the current regulatory tax approach. One aspect of that review is whether the regulatory tax allowance should continue to be set on a benchmark basis, or whether the approach should be modified to reflect an estimate of actual tax payable. This AER review is ongoing and many stakeholders have provided submissions to that review through a process of open consultation. It would be premature and inappropriate for the NER and NGR to be amended to alter the definition of taxable income before the AER has had an opportunity to consider fully, and make any determination on, the matters on which it has been consulting.

» **The proposed change would be a regressive shift away from incentive-based regulation -** If the concept of the BEE was abolished for the purposes of setting the corporate tax allowance this would reflect a regressive shift away from the incentive-based system of regulation that has prevailed in Australia for decades, towards a system of cost-plus regulation that has poor incentive properties, and which regulators overseas have been actively moving away from for a number of years. Incentive-based regulation evolved from widespread policymaker recognition of the failure of cost-plus regulation to serve consumers interests.

- **The proposed change would lead to the introduction of a disjointed hybrid revenue-setting framework -** The proposed amendment would result in a disjointed regulatory framework for setting the revenue allowance, under which the allowance for corporate tax would be determined on the basis of an estimate of the actual tax payable, while other components of allowed revenue would be determined on an efficient benchmark basis. Any perception of arbitrary 'cherry-picking' in relation to the components of the revenue allowance that are to be set on either an actuals-based approach or a benchmark basis is likely to undermine investor confidence in the regulatory framework and dull incentives to seek out and realise efficiency savings.
- **The proposed change would be inconsistent with forthcoming binding AER rate of return guideline -** A key input to the calculation of the estimated cost of corporate income tax within the NER and NGR is gamma, defined in the energy rules as the value of imputation tax credits. If one component of the estimated cost of corporate income tax (estimated taxable income) is to be defined on an 'actuals' basis, then, for consistency, *all* components of the estimated cost of corporate income tax should also be determined on an actuals basis. This would mean that the AER's pending determination of gamma would need to reflect the actual redemption of imputation tax credits by individual shareholders of individual NSPs—which would be very low for many NSPs, given the extent of foreign ownership within the sector. This is not an approach which has been considered or even assessed as feasible by the AER in its draft guideline.

Given these concerns, ENA submits that the present definition of taxable income within the NER and NGR should be retained rather than amended.

Alternatively, COAG Energy Council should adopt different drafting changes (detailed in Section 4) to the provisions to retain the overarching role of incentive-based regulation and to clarify that proposed changes are not policy decisions designed to pre-empt the AER review outcomes or restrict benchmark-based approaches.

2 Proposed amendment to definition of taxable income

The current NER and NGR state that the estimated cost of corporate income tax of a NSP for a regulatory year (ETC_t) should be calculated using the following formula:[1]

$$ETC_t = (ETI_t \times r_t)(1 - \gamma).$$

The first term within this formula, ETI_t, is presently defined for a Distribution Network Service Provider (DNSP) within the NER as follows:

> *ETI_t is an **estimate of the taxable income for that regulatory year that would be earned by a benchmark efficient entity** as a result of the provision of standard control services if such an entity, rather than the Distribution Network Service Provider, operated the business of the Distribution Network Service Provider, such estimate being determined in accordance with the post-tax revenue model[2] (emphasis added)*

Analogous definitions of taxable income appear in the current versions of the NER and NGR applying to gas and electricity transmission networks.[3] This definition makes clear that it is an estimate of taxable income that would be earned by a benchmark efficient entity (BEE), rather than the particular network in question, that should be used to calculate the estimated cost of corporate income tax. The current rule is clear and requires an estimate of the taxable income of the BEE. It is one of the clearest articulations of the benchmark approach in the Rules.

The COAG Energy Council has not proposed to amend the formula for calculating the estimated cost of corporate income tax. However, the amendments do propose to redefine taxable income for a regulated network, as follows:

> *ETI_t is an estimate **of the taxable income of the Distribution Network Service Provider** for the regulatory year determined in accordance with the post-tax revenue model[4] (emphasis added)*

Equivalent amendments have been proposed for electricity transmission and gas network service providers.[5]

The legal effect of these proposed amendments is to require the regulator to estimate the actual taxable income of the network in question, rather than by reference to the

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[1] NER 6.5.3 and 6A.6.4, and NGR 87A.
[2] NER 6.5.3.
[3] NER 6A.6.4 and NGR 87A, respectively.
[4] National Electricity (Binding Rate of Return Instrument) Amendment Rule 2018 6.5.3.
[5] National Electricity (Binding Rate of Return Instrument) Amendment Rule 2018 6A.6.4 and National Gas (Binding Rate of Return Instrument) Amendment Rule 2018 87A, but the reference to the taxable income being determined in accordance with the post-tax revenue model does not appear in the proposed amendments to the NGR (Rule 87A).

BEE. The very clear and deliberate change in the drafting of the current Rules, from an estimate of taxable income:

> *"that would be earned by a* ***benchmark efficient entity*** ***as a result of the provision of standard control services if such an entity, rather than the Distribution Network Service Provider****, operated the business of the Distribution Network Service Provider",* (and equivalent provisions for TNSPs and gas network service providers)

to:

> *"an estimate of the* ***taxable income of the Distribution Network Service Provider****"* (and equivalent provisions)

is likely to be interpreted as an intentional move away from a BEE approach to an 'actuals-based' tax approach, even if that is not the intent of the drafting.

The stark difference between the concepts captured in the current definition and the proposed amended definition leaves little doubt about its legal interpretation. In the view of our legal advisors based on commonly accepted principles of legislative interpretation, the effect of the proposed amendment to the definition of taxable income is to direct the regulator to change its approach from an estimate of the taxable income of the BEE to an estimate of the actual tax of the service provider.

The proposed amended definition of "taxable income" in the NER requires the estimate to be determined in accordance with the post-tax revenue model (the PTRM). The PTRM currently contemplates a benchmark approach to the tax allowance, but this may not always be the case. Further, no such requirement is included in the proposed amendments to the NGR.

As noted, such an outcome appears unintended. Given the critical nature of the issues and potential consequences of leaving the provision as drafted, however, the undesirability of these potential outcomes is detailed in the next section.

3 Policy issues created by new definition of taxable income

This section sets out network sector concerns with policy issues created by the proposed changes to the definition of taxable income in the NER and NGR.

3.1 Proposed amendment is not necessary or consequential

The draft amendments to the NER and NGR published by the COAG Energy Council also propose other changes to the Rules, in particular removing the previous rate of return rules and the concept of the allowed rate of return objective (ARORO). The amendments are said to support the introduction of legislation to create a binding rate of return instrument, and be consequential to that legislation.

As noted above, no explanatory material has been published with the proposed rule changes making it difficult to establish that the change to taxable income has any necessary or consequential link to the legislation. The extent of the discussion of this issue is that the proposed rules are said to remove or amend the NER and NGR "that will be outdated after the passage of the legislation". The COAG Energy Council says that it is seeking feedback on the rule changes that:

- *"remove the rate of return guideline and calculation of the rate of return from the rules;*
- *amend the rate of return definition; and*
- *amend relevant clauses where the rate of return is referenced, such as the revenue determination, access arrangement and network tax allowance."*[6]

The present definition of taxable income in the NER and NGR does not include any reference to the rate of return or any other term that would require a consequential amendment. The only relevant term in the formula used to estimate the cost of corporate income tax that is impacted by the binding rate of return guideline framework is the definition of gamma. No other part of the Rule requires amendment.

The BEE is referenced in the ARORO (which will be deleted under the proposed amendments) but it has no necessary connection to the BEE referenced in the present definition of taxable income. The definition of taxable income does not require an amendment to support, or as a consequence of, the introduction of the binding rate of return guideline legislation.

[6] http://www.coagenergycouncil.gov.au/publications/national-electricity-rules-ner-and-national-gas-rules-ngr-consultation

3.1 Overriding an ongoing AER review into the regulatory tax approach

The AER is presently undertaking a review into its approach to calculating the regulatory tax allowance. This review was sought in writing by the previous Federal Energy Minister.[7] In his letter to the Chair of the AER, the Minister asked the AER to review "how the AER models tax costs" and to "consider whether the method for estimating the cost of corporate income tax as set out in the rules remains appropriate".

To date, the AER has, as part of its regulatory tax review, published an Issues Paper (May 2018) and an Initial Report (June 2018). The AER has also received several submissions on the matter through an open consultation process and is due to release a draft position shortly.

One of the issues that the AER is currently considering explicitly as part of its review is whether regulatory tax allowances should be set to reflect the actual tax payments of network service providers.[8] The AER has commissioned expert independent advice on this question, and has also received a number of submissions from stakeholders on this issue.

ENA is concerned that the COAG Energy Council's proposed amendments to the NER and NGR that relate to the estimation of the cost of corporate income tax would effectively pre-empt and pre-determine the outcomes of the AER's review process, before the AER has had an opportunity to consider fully the evidence and make a determination on the matter.

ENA is particularly concerned because the proposed amendments to the NER and NGR do not appear to have effectively given consideration to potential unintended impacts that the changes might have on the functioning of the broader incentive-based system of regulation across Australian infrastructure sectors.

Implementing a definition of taxable income which had the effect of requiring a change in current regulatory approach outside of a robust and transparent policy and rule-making process would undermine confidence in regulatory processes. It would also increase the perception of investors and other stakeholders that the regulatory system is not free from arbitrary, unintended and non-transparent changes.

3.2 Shift away from incentive regulation to cost-plus regulation

The regulatory framework codified within the National Energy Law, including the NER and NGR is a standard incentive-based system of economic regulation.

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[7] Letter from Hon. Josh Frydenberg to Chair of the AER: https://www.aer.gov.au/system/files/180503%20-%20LTR%20-%20Chair%20of%20AER%20-%20Network%20tax%20allowance.pdf

[8] AER, Review of regulatory tax approach, June 2018, Section 6.3.

The proposed amendments, which would redefine taxable income in terms of an estimate of the actual taxable income of the network in question, would if implemented represent a fundamental and regressive step away from incentive regulation, towards cost-plus regulation.

Under a system of incentive regulation, the regulator determines the revenues that businesses are allowed to earn over the next regulatory period in line with its best, forward-looking assessment of the businesses' efficient, benchmark costs over that period. Once the regulator has set the revenue allowances, the businesses have an incentive to strive to generate efficiencies. If they succeed in spending less than the efficient benchmark set by the regulator, the businesses (and their shareholders) may keep a share of those savings for a time.

In the quote below, the AER explains, in its own words, the operation of the incentive-based system of regulation that it administers. Critically, the AER notes that its benchmark incentive framework promotes the delivery of the National Electricity Objective (NEO) and the National Gas Objective (NGO):

> *We use an incentive approach where, once regulated revenues are set for a five year period, networks who keep actual costs below the regulatory forecast of costs retain part of the benefit. This benchmark incentive framework is a foundation of the AER's regulatory approach and promotes the delivery of the national electricity objective (NEO) and national gas objective (NGO). Service providers have an incentive to become more efficient over time, as they retain part of the financial benefit from improved efficiency. Consumers also benefit when efficient costs are revealed and a lower cost benchmark is set in subsequent regulatory periods.*[9]

Incentive regulation provides regulated firms with monopoly power with financial rewards for finding and realising efficiencies that they would otherwise have no reason to pursue. The short-term rewards that the firm gains from making such savings are ultimately translated into long-term benefits to consumers. This is because by making savings, the firms reveal to the regulator the true scope for efficiencies. In subsequent periods, the regulator can use this revealed information to set a more challenging benchmark, thereby passing on savings permanently to customers.

The system of incentive regulation described by the AER in the quote above is not new. This was the basis of the system of regulation that the ACCC administered prior to the establishment of the AER from the commencement of the previous National Electricity and Gas Codes, and the ACCC's 2004 *Statement of Regulatory Principles*. In fact, it is essentially the system of regulation that has operated for decades in nearly every industry that is formally regulated, in every jurisdiction throughout Australia. In short, it is the well-established system of regulation that all investors in regulated infrastructure in Australia recognise instantly and understand well, and that underpins investment and management decisions related to such assets.

[9] AER, Review of regulatory tax approach, June 2018, p. 1.

The alternative system of regulation is known as 'cost-plus' regulation, whereby the regulated firm recovers all of its actual costs, plus a fixed profit margin. Under such a system, there is no real incentive for the firm to minimise costs or to operate efficiently since actual costs are simply 'passed through' to consumers. Consumers pay for all of the actual costs incurred by the firm, regardless of the efficiency of those costs.

The proposed amendments – redefining taxable income in terms of an estimate of the actual taxable income of the network in question - risk an unintended but fundamental and regressive step away from incentive regulation towards cost-plus style regulation.

Internationally, the consistent trend has been for regulatory regimes that began as cost-plus systems to adapt towards incentive-based systems. The most notable examples of this are in the United States, where cost-plus regulation in many jurisdictions has evolved into various forms of incentive-based systems of regulation, whereby regulatory allowances are set using benchmarks rather than actual costs.[10, 11]

This change has occurred because economic regulators around the world have increasingly recognised the cost-plus regulation creates very poor efficiency incentives for regulated businesses, which can be improved significantly by systems of regulation that set allowances using benchmarks.

In view of this clear trend away from cost-plus regulation towards incentive regulation, it would be a mistake Australia to – through unintended drafting consequences - set in train a movement away *from* standard incentive regulation *towards* cost-plus regulation.

3.3 Incompatibility with the approach for determining other cost allowances within the AER's framework

The incentive-based system of regulation adopted ubiquitously throughout Australia applies to all elements of the building block framework.

For example:

» Return on capital: The rate of return is currently estimated by reference to the efficient financing costs of the benchmark efficient entity with a similar degree of risk to the service provider. The rate of return is not estimated by reference to any particular service provider's actual financing costs.

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[10] In North America, incentive regulation is often referred to as 'performance-based regulation' or 'performance-based rate-making' (PBR).

[11] Examples of regulators in the United States that have gradually shifted from cost-plus regulation to incentive-based regulation are provided in: Aas, D. (2016), Performance based regulation: Theory and applications to California, Report to the California Public Utilities Commission; London Economics (2014), Literature review: regulatory economics and performance-based ratemaking, Report to the Nova Scotia Department of Energy.

- **Operating costs:** Operating expenditure allowances are assessed by reference to the efficient costs that a benchmark efficient operator would require, not any particular firm's actual costs.
- **Network capital investment:** Capital expenditure forecasts are similarly assessed by reference to efficient costs of a benchmark efficient operator, not any particular firm's actual costs.

The cost of corporate tax is no different to any of these building block cost components. Under an internally-consistent incentive-based regulatory framework, they should be estimated by reference to benchmark efficient costs. The benchmark efficient cost of tax is, by definition, the tax that would be paid by a firm efficiently following all regulatory benchmark assumptions (for example, gearing assumptions set in the rate of return guideline).

The proposed amendments to the definition of taxable income could unintentionally result in a disjointed, rather than an internally-consistent, framework, where the corporate income tax allowance would be set on the basis of an estimate of actuals liabilities, whereas all other building block elements would be set using the standard efficient benchmark approach.

The use of actual cost data is, by deliberate policy design, highly circumscribed and limited in the national energy rules, representing an exception to the incentive framework (as for example cost-pass through arrangements, which only apply to pre-designated pass through events that represent significant material one-off changes where actual costs can be verified).

As explained above, investors in regulated infrastructure in Australia understand well the incentive-based system of regulation, which has operated for decades in multiple sectors and jurisdictions throughout Australia.

The common understanding of this system is that *all* (not just some) cost components of the overall revenue allowance are set on a forward-looking, benchmark basis. It is this common understanding of the 'regulatory compact,' developed and operated over a long period of time, that gives current and future investors the confidence to consider making long-term capital commitments to regulated assets, and provides the motivation for network owners to actively seek out and invest upfront in efficiency improvements (which ultimately benefit consumers) in exchange for the financial rewards provided by the incentive-based regulatory framework.

If the draft definition is not amended, and the incentive framework is effectively undermined by legislative action directed at implementing a *different* policy reform (implementation of the binding rate of return guideline), this has the potential to send a powerful signal to network owners, current and future investors that critical pillars of a forward-looking incentive based approach are in fact highly uncertain.

This concern is reinforced if there is a possible perception that one component of the regulatory allowance can be cherry-picked and determined on some form of actuals basis on an opportunistic or short-term basis. In these circumstances, potential capital providers might reasonably form an apprehension that policymakers could decree in

future that other elements of the revenue allowance should similarly be determined on actuals-based approach.

To provide an example, suppose it emerges at some point in the future that the operating and capital expenditures incurred by networks are significantly lower than had been allowed by the AER—because networks had responded properly to the efficiency incentives created by the regulatory framework. Network owners and investors could in these circumstances lack confidence that policymakers would not respond by compelling the AER to set expenditure allowances on the basis of actual expenditure, rather than a benchmark. Having demonstrated a willingness to do precisely this in relation to one component of the revenue allowance, any assurances by policymakers to not make similar changes in other areas would simply not be credible.

The logical outcome of such ad hoc interventions, even in the narrow aspects of the regulatory framework, would be a significant erosion and eventual loss of confidence from investors in the incentive properties of the regulatory framework as a whole. This would have poor long-term outcomes for consumers and be inconsistent with the NEO and NGO. If networks consider that they may not be rewarded financially for seeking out and realising efficiencies, there would be little incentive for those businesses to become more efficient over time—which would be to the long-term detriment of consumers.

3.4 Inconsistency within cost of corporate income tax formula and rate of return guideline process

The proposed change to the definition additionally risks requiring a re-opening of the final rate of return AER guideline outcomes, or the guideline being based on assumptions that are no longer sound. In this way, a rule change package actually designed to support implementation of a rate of return guideline could have the perverse impact of frustrating and hindering its entry into force by creating unanticipated issues of transition.

To see why this is the case, it is critical to understand that a key input to the calculation of the estimated cost of corporate income tax within the NER and NGR is the value of imputation tax credits, referred to in the cost of corporate income tax formula as 'gamma', which is proposed to be set in the new binding guideline due in December 2018.

If one component of the estimated cost of corporate income tax formula (estimated taxable income) is now proposed to be defined on an estimated 'actuals' basis, then internal consistency will require that <u>all</u> components of the estimated cost of corporate income tax formula should also be determined on some form of an actuals basis.

There is no principled reason why one component should be determined on an actuals basis, and all others should be determined on a benchmark basis. Mixing and matching approaches in this way would result in a 'hybrid' estimate of the cost of corporate income tax that would be potentially economically meaningless. It is these types of

considerations that form the basis of current rule requirements on the AER to consider interrelationships in cost of capital matters.

If all components of the cost of corporate income tax formula were required to be determined on an actuals basis, then the AER's determination of gamma will logically need to reflect the actual redemption of imputation tax credits by the shareholders of individual networks. This is not an approach which has been entertained, considered or consulted upon in the rate of return guideline consultation process, which has now concluded. The actual redemption of imputation tax credits is low for many networks, given the extent of foreign ownership within the sector, since foreign investors are ineligible under Australian tax law to redeem imputation tax credits. Any reduction in the estimate of gamma would increase the cost of corporate income tax and, consequently, the revenue allowance (all else remaining equal).

4 Recommendations

Recommendations
» The present definition of taxable income within the NER and NGR should be retained rather than amended. » Any definition should reflect the incentive-based regulatory framework and be a benchmark-based approach » If any substantive policy change is to be made to the definition, it should follow from the AER's review of the regulatory tax approach and not pre-empt or override it.

As noted, ENA's understanding based on discussions to date is that the COAG Energy Council does not intend to direct the regulator to move away from the incentive-based benchmark approach to an actual tax approach in these changes contemplated.

ENA considers this to be the effective likely impact of the proposed amendment and it has substantial concerns with that outcome which are explained above. Therefore, networks consider the present definition should be retained.

Alternatively, if COAG Energy Council considers some changes remain warranted, it should adopt different drafting changes to the provisions that retains the overarching role of incentive-based regulation and to clarify that proposed changes are not policy decisions designed to pre-empt the AER review outcomes or restrict benchmark-based approaches.

ENA would propose that the following amended definition would achieve these objectives, and be a clearer and more certain alternative to allow for the continuation of current regulatory approaches until the finalisation of the AER review:

> ETI_t *is an estimate of the taxable income for that regulatory year that would be earned by an ~~benchmark efficient entity~~ efficient and prudent operator as a result of the provision of standard control services if such an ~~entity~~ operator, rather than the Distribution Network Service Provider, operated the business of the Distribution Network Service*

Provider, such estimate being determined in accordance with the post-tax revenue model.

For gas, equivalently, Rule 87A would include the following definition:

> ETI_t *is an estimate of the taxable income for that regulatory year that would be earned by a prudent service provider ~~benchmark efficient entity~~ acting efficiently in ~~as a result of~~ the provision of reference services if such a service provider~~entity~~, rather than the service provider, operated the business of the service provider*

Such an approach:

- represents a simple consequential amendment;
- utilises consistent terminology routinely applied in other building block areas of the Rules (such as forecast operating and capital expenditure clauses); and
- would remove the term ‘benchmark efficient entity’, in a manner consistent with our understanding of an intent of making only consequential changes to those made in relation to rate of return.