

COAG Energy Council Secretariat

By email: energycouncil@environment.gov.au

29 October 2018

Dear Secretariat,

Re: National Electricity Rules and National Gas Rules consultation – proposed changes to the estimation of tax

Spark Infrastructure has been listed on the Australian Stock Exchange (**ASX**) since 2005 and has a current market capitalisation of around \$4 billion. Our businesses transport electricity to 5.5 million consumers in South Australia, Victoria and NSW, and provide high voltage interconnection between regions in the National Electricity Market (**NEM**). Spark Infrastructure's investment portfolio comprises 49% interests in SA Power Networks (**SAPN**) (South Australia), and CitiPower and Powercor (together known as Victoria Power Networks (**VPN**), in Victoria), and a 15% interest in TransGrid (NSW), the transmission company in NSW. Spark Infrastructure is approximately 75% owned by Australian professional, superannuation and retail investors, with the remaining 25% being held by foreign investors.

Spark Infrastructure and its investors are the providers of long-term equity capital into these Network Service Providers (**NSPs**) which is necessary to build and maintain the networks required to deliver critical electricity to consumers whilst maintaining the high standards of safety, reliability, security of supply and efficiency demanded by consumers and regulators. These networks will be critical to supporting a changing mix of generation and distributed energy resources as the market evolves from thermal to renewable generation.

Spark Infrastructure is concerned with the number of changes being proposed and implemented in the energy industry with little regard to proper governance processes or the individual and cumulative effect on the investment environment.

Investment in energy networks is critical to the transformation required in the energy sector to deliver lower costs to consumers. The Australian Energy Market Operator (**AEMO**) has identified that further investment in transmission networks can deliver more than \$1 billion in savings to consumers and that \$4 billion more in savings can be delivered with greater use of distributed energy resources (**DER**) to lower wholesale resource costs.

Increased sovereign and regulatory risk, together with lower regulated returns and diminishing opportunities to achieve returns higher than the regulated return by outperforming efficient benchmarks will put this investment at risk and contribute to prolonged higher prices to customers.

The most recent changes proposed by the COAG Energy Council to the National Electricity Rules (**NER**) and National Gas Rules (**NGR**) are a further example of the government intervening in the regulatory process without proper process and have the potential to add to the growing risk, and consequential increases in the cost of debt and equity in the energy sector.

We understand that the proposed changes aim to remove or amend the NER and NGR that will be outdated after the draft Statutes Amendment (National Energy Laws) (Binding Rate of Return Instrument) Bill 2018 (**the Bill**) is passed. The Bill amends the national energy laws to introduce a binding rate of return instrument in setting the revenue of regulated electricity and gas businesses.

Our comments in this letter are contained to the proposed changes to the NER 6.5.3 regarding the estimation of corporate income tax for regulatory purposes.

These changes are not a natural consequence of the Bill becoming law, have not been the subject of proper consultation, and make fundamental changes to the nature of the regulatory framework. Therefore, we consider that the proposed changes to the rules in relation to the estimation of corporate income tax are outside the powers of the SA Minister.

In addition, these changes directly relate to matters currently the subject of review by the AER in response to a request from the former energy minister to review, and advise on rule changes, on this matter. This review is yet to be completed.

Our key concerns regarding the proposed changes to the rules relating to the estimation of income tax for regulatory purposes are as follows.

1. The proposed changes pre-empt the AER's current process to review the regulatory approach to tax and are contrary to the views of the AER stated in its Initial Report.
2. The proposed changes fundamentally alter the regulatory framework with no stated change in policy to justify the change.
3. The proposed changes could result in customers paying more, including for inefficient costs, and are not in the long-term interest of consumers.
4. The proposed changes will increase the cost of administering the regulatory arrangements.
5. The proposed changes are outside the scope of the power of the South Australian Minister to make rules.

We address each of these issues below.

1. The changes pre-empt the AER's review of the regulatory approach to tax

The proposed changes relate to issues currently being reviewed by the AER in response to a request from the then Minister for Energy. The AER is considering the current regulatory approach to tax and, if required, is expected to propose rule changes.

Spark Infrastructure, together with many other stakeholders, has contributed to the review in good faith with the expectation that the AER's process is transparent, independent, meaningful and that recommendations and submissions will be taken in to account. These contributions have been extensive and include submissions as well as contributions to public forums and meetings with consumer groups and the AER's review team. Making the proposed changes prior to the conclusion of the review diminishes the value of the process and the confidence of stakeholders in contributing to the process and to future processes.

Further, the AER's view presented in its initial Report is contrary to the proposed changes.

The AER recognises the value of the incentive based economic regulatory framework that applies to regulated NSPs in Australia and the important role of the benchmark efficient entity (BEE) concept to ensure that only the efficient costs of financing and tax are included in the revenue allowance. The AER has foreshadowed that the impact on customers of a change in approach could be an increase in prices. In its initial report the AER states:

“Our current assessment is that we should exercise caution before moving to a tax pass-through approach. Such a move could lead to increased consumer charges across time. It could also create windfall gains or losses at the point of transition, and an incentive to shift tax between unregulated and regulated components of each corporate entity.”¹

The AER is currently considering whether there are more efficient approaches to taxation that should be reflected in the benchmark from time to time, to ensure customers continue to pay only the efficient costs of a contemporary assessment.² However, the AER has not proposed to move to a cost pass-through approach or abandon the estimation of tax costs based on an efficient benchmark entity.

The COAG Energy Council has not provided information that indicates that it has considered the implications of the changes, whether the changes will provide net benefits to customers, or that the caution suggested by the AER has been exercised. It is not good public policy to make changes in advance of a review undertaken with the specific objective of advising on the changes required.

2. The changes fundamentally change the regulatory framework with no stated change in policy

The proposed changes fundamentally alter the regulatory framework and remove the reference to the use of the current benchmark approach to setting the regulatory tax allowance to an approach based on actual tax paid by each NSP. For example, where an NSP is not a tax paying entity, the amount of tax paid might appear to be zero. This would be despite another entity within the ownership structure of the NSP that is actually a tax payer, being liable to pay tax on the revenue received by the NSP. This would result in the NSP not being able to recover the efficient cost of complying with tax obligations, albeit via another entity within the ownership structure. This outcome is inconsistent with the national energy laws which provide for an NSP to have an opportunity to recover its efficient costs.³

There are very few NSPs that are tax paying entities themselves. Rather they are part of a larger group within which there is a different relevant tax paying entity. The ownership structure of a firm does not change the obligation to pay tax, it just changes where tax is paid and by whom. To maintain a tax pass-through approach and ensure an NSP has an opportunity to recover the efficient cost of complying with tax obligations, the rules would need to allow for the assessment of the actual circumstances of the NSP, including the different structure of the firm, and the many different statutory tax rates that might apply to owners with different characteristics.

The statutory rate applying to different investors can vary between zero and 47% depending on Commonwealth policy and many investors do not receive any value from imputation credits. As a result outcomes for customers would differ for various structures and ownership, and changes in structure and ownership including acquisitions, rather than efficiency.

¹ AER, Initial Report, Review of regulatory tax approach, June 2018, p. 2-3.

² AER, Initial Report, Review of regulatory tax approach, June 2018, p. 1.

³ See attached legal advice from Herbert Smith Freehills.

In advance of the legislative changes being enacted, the COAG Energy Council should outline the policy and reasons for moving away from the incentive-based approach adopting efficient benchmarks to an approach that seeks to pass-through the actual tax paid by the NSP, address the inconsistency with the national energy law, and report the net impact of the change in approach consumers.

3. The changes could increase prices to customers and are not in the long-term interests of consumers

A change from the benchmark approach to estimating tax costs to one that considers the tax circumstances of an individual NSP is likely to impose additional costs, result in customers paying more than the efficient costs and reduces the incentives on NSPs to achieve efficiencies over time. This is not in the long-term interests of consumers.

The AER's current approach to the regulatory treatment of tax ensures that an NSP has an opportunity to recover the efficient cost of the benchmark efficient firm complying with its tax obligation and that customers pay no more than these efficient costs as a result of the NSP's particular tax circumstances, acquisition activity or as a result of an NSP earning higher profits due to outperformance.

This approach ensures the lowest cost, reliable and sustainable services to customers, that the NSP can comply with its obligations, and does not introduce unnecessary uncertainty and risk that could reduce the incentives for future investment, or increase the cost of debt and equity that increase future costs to customers.

In contrast, the long-term impact on customers of an NSP specific approach to estimating tax is likely to be:

- Higher costs to administer and implement the approach due to the significant amount of additional information needed to be produced, collected and analysed;
- Higher cost of capital and lower incentives to invest due to the complexity and uncertainty of the revenue to be recovered;
- Price volatility as variations between the allowance and actual tax paid due to differences in activities, behaviours and tax cycles are passed through;
- Weaker incentives for efficiency on operating and capital expenditures because the financial incentive is reduced by the off-setting tax payment; and
- Additional (and potentially inefficient) costs being recovered by NSPs that are not related to the provision of regulated services such as corporate and capital structure, acquisition and purchase price, related party activities, unregulated services and tax litigation.

4. Implementation and cost

There are very few NSPs that are stand-alone tax paying entities and the individual circumstances of an NSP will vary and change over time. Therefore, the approach has higher implementation and administration costs that would need to be recovered from customers. These costs include:

- Producing, collecting, reviewing and analysing the significant amount of information provided by NSPs and multiple related parties;
- Developing guidelines to allocate and attribute tax payments so that they reflect the efficient costs incurred only by the NSP and only in the provision of regulated services and so that the information can provide an 'apples with apples' comparison across time, NSPs, structures and owners; and
- Continual review of relevant tax obligations, tax disputes and changes in tax policy.

5. Power to make the changes

Under the Bill, the SA Minister has the power to make changes to the NER and NGR where those changes are consequential to the Bill. That is, the rule changes result from or are required as an effect of the Bill. We have sought legal advice and do not consider that these changes meet the requirement that they be consequential on the enactment of the Bill. As such we contend that it is not within the power of the SA Minister to make the rules amending the estimation of income tax. We have attached our draft legal advice regarding this issue for your consideration.

Please contact Sally McMahon on 0421 057 821 with any follow up questions or discussion regarding this submission.

Yours sincerely,



Rick Francis
Managing Director & CEO
Spark Infrastructure