HERBERT SMITH FREEHILLS

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By Email

Dear Rick

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Spark – Draft consequential rules

You have asked us to consider and advise you on the proposed draft rules to be made pursuant to proposed section 90BA of the *National Electricity Law* (**NEL**) once amended by the *Statutes Amendment (National Energy Laws) (Binding Rate of Return Instrument) Bill 2018* (SA) (**Amendment Bill**). In particular, you have asked us to consider the amendments proposed to clauses 6.5.3 and 6A.6.4 of the National Electricity Rules (**NER**).

Clauses 6.5.3 and 6A.6.4 relate to the estimation of the cost of corporate income tax in the post tax revenue model (**PTRM**). The proposed amendments amend the language used to describe how a network service provider's taxable income is estimated amongst other things. The NER currently describe the estimation of a network service provider's taxable income as follows (in the case of clause 6.5.3 of the NER):

> *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*

The proposed amended wording is 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*

The current wording and proposed amendment is materially identical for clause 6A.6.4 of the NER, which relates to transmission network service providers.

Proposed rule is not consequential on the Amendment Bill

The Amendment Bill will insert new section 90BA(1) in the NEL, which provides a power for the Minister to revoke or amend the NER if that revocation or amendment is consequential on the enactment of the Amendment Bill (emphasis added):

> *The South Australian Minister may make Rules that revoke or amend a Rule <u>if the revocation or amendment is consequential on the enactment</u> of the Statutes Amendment (National Energy Laws) (Binding Rate of Return Instrument) Act 2018.*

Such rules may only be made on the recommendation of the Ministerial Council of Energy under section 90BA(6).

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The NER sets out a number of 'building blocks' that are estimated in order to determine the amount of revenue allowed to be earned by network service providers. These 'building blocks' include the rate of return on capital and the cost of corporate income tax, as well as the estimation of capital expenditure and operating expenditure (amongst others). Similar to other regulatory regimes in Australia and internationally, these building blocks are estimated by the Australian Energy Regulator (**AER**) separately and the method for their estimation is set out in a separate clause of the NER.

The Amendment Bill introduces a binding rate of return instrument to be made by the AER, which will state:

- for a rate of return on capital – the way to calculate the rate; and
- for the value of imputation credits – the value or the way to calculate the value.

The Amendment Bill makes a number of other amendments to the NEL to support the adoption of a binding rate of return instrument. For example, it sets out the process that the AER must follow when making the instrument and the criteria which it must consider when doing so.

The relevant question is whether the Amendment Bill, once made, will authorise the making of the proposed amended Rule: '*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*'. If the Bill will not authorise the amending rule there will be jurisdictional error. As Hayne J has said:[1]

> *There is a jurisdictional error if the decision maker makes a decision outside the limits of the functions and powers conferred on him or her, or does something which he or she lacks power to do.*

Under the NER the value of imputation credits is used in the estimation of the cost of corporate income tax, which is separate from the determination of the rate of return. Clauses 6.5.3 and 6A.6 4 of the NER sets out the method for estimating the cost of corporate income tax and does not address the rate of return. It requires the estimate of taxable income to be multiplied by the statutory tax rate and then adjusted for the value of imputation credits (which provide a tax benefit for shareholders).

The Amendment Bill does not deal in any way with the method to be used by the AER to estimate the taxable income of a network service provider. In relation to the estimation of the cost of corporate income tax the Amendment Bill only addresses the value of imputation credits. The estimate of taxable income is a separate parameter on both a literal reading of clauses 6.5.3 and 6A.6.4 of the NER and within the field of regulatory economics. While the estimate of taxable income and the value of imputation credits are both used to determine the estimated cost of corporate income tax, they are amounts estimated separately and without reference to each other under the NER.

This separation is further demonstrated by the fact that the estimation of taxable income is not dealt with by the current rate of return guideline published by the AER in December 2013,[2] has not been addressed in the AER's current consultation into the revised rate of return guideline[3] and has been addressed separately by the AER through its current review into the approach to regulatory tax.[4] Furthermore, the estimate of taxable income

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[2] AER *Rate of Return Guideline* (December 2013) available at https://www.aer.gov.au/system/files/AER%20Rate%20of%20return%20guideline%20-%20December%202013.pdf.

[3] See generally https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/review-of-rate-of-return-guideline.

[4] See generally https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/review-of-regulatory-tax-approach-2018.

is not required to be addressed in the binding rate of return instrument to be made under the Amendment Bill.

We consider that the better view is that the estimation of taxable income and the valuation of imputation credits are separate and distinct matters. The fact that the Amendment Bill does not in any way address the estimation of taxable income means that an amendment to the estimation of taxable income set out in clauses 6.5.3 and 6A.6.4 of the NER is not '*consequential*' on the enactment of the Amendment Bill as required by section 90BA(1) of the NEL (as amended). The Macquarie Dictionary defines consequential as being something that follows as an *effect* or *result*, or as a *logical conclusion* or *inference*. It has also been held to be something that is *solely the result of something else*,[5] or *because of'*.[6] It follows that there must be some logical or causal relationship in order for matters to be consequential. The amendment to the estimation of taxable income does not follow from, is not 'because of' and has no logical or causal connection to the amendments made to the rate of return framework and the value of imputation credits made by the Amendment Bill. Furthermore, the amendment to the estimation of corporate income tax is not required for the Amendment Bill or the binding rate of return instrument made under it to operate.

We note that there may be arguments that the changes made by the Amendment Bill to the rate of return framework means that changes to any parameter used to estimate the cost of corporate income tax could be amended. For example, the rate of return framework is post tax so a change in the rate of return framework makes the amendment of any parameter used to estimate the cost of corporate income tax consequential on those changes. We do not consider such a broad brush interpretation that disregards the nature of the Amendment Bill and the drafting of the NER to be convincing.

Accordingly, our preliminary view is that the rules amending the estimation of income tax cannot be made lawfully under the Amendment Bill as drafted.

Proposed rule may not allow recovery of corporate income tax

The national electricity objective set out in section 7 of the NEL provides that the object of the NEL '*is to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity…*'. Furthermore, the revenue and pricing principles state that '*a regulated network service provider should be provided with a reasonable opportunity to recover at least the efficient costs the operator incurs in providing direct control services*'. We do not consider that the proposed amendment to the estimation of taxable income will be consistent with or promote either the national electricity objective or the revenue and pricing principles.

As drafted the proposed amendment to the estimation of corporate income tax contemplates that the network service provider is the relevant entity within the corporate group that pays income tax. That is, it is the taxable income of (and cost of corporate income tax to) the network service provider that is to be estimated under the amended rule. The reference to distribution network service provider in proposed clause 6.5.3 and transmission network service provider in proposed clause 6A.6.4 of the NER could be read to be the registered network service provider through Chapters 2 and 10 of the NER. The removal of the reference to standard control services in the draft rule reinforces this interpretation.

In practice, investors invest in a manner that is the most efficient and effective and permitted by tax laws. Investors can choose where tax is paid in its corporate structure. The registered network service provider may not be the most efficient or effective entity to pay tax. This is not about investors not paying tax, or sufficient tax (these issues are

[5] *Mullett v Gabriel* (1989) 52 SASR 330 (in the context of a consequential amendment in court proceedings).

[6] *Delohery v Williams* (1911) 11 NSWSR 596.

being addressed by the Commonwealth Government elsewhere), but about where the investor chooses to pay it.

The taxable income of a registered network service provider that does not pay tax will be zero and the allowance for the cost of corporate income tax as estimated under the proposed rule will also be zero. This is despite the costs of corporate income tax in relation to the activities of the network service provider being incurred by other entities related to the registered network service provider. The proposed rule would not give the network service provider a reasonable opportunity to recover its efficient costs and would not promote efficient investment in electricity services. The draft rule may therefore create inequitable outcomes that are inconsistent with, and do not promote, the national electricity objective, and revenue and pricing principles.

The current NER addresses this issue by requiring the estimation of corporate income tax to be undertaken by reference to a benchmark efficient entity providing standard control services, which ensures that all investors in network service providers are given a reasonable opportunity to recover their taxable income. We consider that the current drafting of the rule appropriately reflects the national electricity objective, and revenue and pricing principles, and avoids the risk identified above in relation to the proposed rule.

AER's tax review the appropriate place to address this potential change

Finally, we note that the AER is currently consulting on possible changes to its regulatory models in relation to tax and may make a rule change request to the Australian Energy Markets Commission (**AEMC**) to amend the NER to address any issues that it identifies in relation to the estimation of the cost of corporate income tax. We consider that any change to the method used to estimate taxable income should be undertaken through that process rather than included in rules to be made under section 90BA of the NEL particularly given that no consultation on the estimation of taxable income has been undertaken in the development of the Amendment Bill.

Yours sincerely

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