Post-tax revenue model: Proposed amendments

Electricity transmission and distribution network service providers

12 March 2019

Energy Networks Australia

Overview

Key messages

- The amendments to the Post-tax revenue models (PTRMs) are generally reflective of the outcomes of the AER's recent decision on its approach to regulatory taxation allowances and proposed changes outlined in the PTRM Explanatory Statement
- Some minor amendments are recommended to clarify how some concepts are addressed in practice, namely how:
  - changes to the diminishing value multiplier impact depreciation
  - the proportion of immediately expensed capital expenditure is to be determined.
- Financeability ratios will play an important role in the AER's revenue determinations, as businesses are transitioned to the new tax estimation approach.
- The residual tax asset value should be written-off using a third preferred option that better reflects actual business practice.
- Further changes are required to the PTRM to cater for the differing tax pools in the next period.

Energy Networks Australia (ENA) welcomes the opportunity to provide a submission in response to the proposed amendments to the PTRMs for electricity distribution and transmission network service providers, arising as a result of the review of the regulatory tax allowance setting approach.

We look forward to working with the AER to complete the revisions of the PTRMs and associated roll-forward models (RFMs).

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Proposed changes

Changes to the diminishing value multiplier

The PTRM Explanatory Statement mentions the potential for the Diminishing Value (DV) multiplier to be altered in line with changes made by the Australian Taxation Office (ATO).

It does not, however, make it clear that any change in the DV multiplier is only to be applied prospectively (beginning in the year the DV multiplier changes), not retrospectively. Prospective application is consistent with Australian tax law and has been correctly modelled in the PTRM.

For clarification, ENA suggests this additional explanation be added to both the PTRM, via a cell comment, and the PTRM Explanatory Statement.

Proportion of forecast immediately expensed capital expenditure

The PTRM Explanatory Statement indicates that the AER's forecast of the proportion of capital expenditure to be immediately expensed will be "informed by the amount of actual capital expenditure that was treated as immediately deductible over a previous period, and the actual use of immediate expensing across the sector[1]." This statement does not, however, specify the AER's intentions regarding the likely weighting it will place on the historical sector data proportion versus the entity's forecast proportion.

Given the materiality that the choice of this parameter may have on businesses' cash flows and financeability, we suggest the AER consult with stakeholders in determining how the proportion of capital expenditure that is assumed to be immediately expensed will be derived.

Financeability testing

The level and timing of tax allowances as businesses are transitioned to the revised tax approach in the new PTRM may create significant implications for cash flows. This has the potential to create or exacerbate a short to medium term financeability issue for a range of network businesses. In particular, financeability issues may arise where:

» ongoing capital expenditure is high, thus generating higher deductible expenses; and/or

» asset lives are relatively short, thus generating higher depreciation deductions; and/or

» the PTRM assumes a higher proportion of immediately expensed capital expenditure than what the business actually occurs, potentially eliminating taxable income for a substantial period of time and precluding the receipt of cash flows from tax allowances.

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[1] AER Post-tax Revenue Model, Explanatory Statement (January 2019) p.11

As such, we recommend that the AER seek to develop a suitable financeability framework, in conjunction with stakeholders, to allow for financeability testing to be undertaken as part of the revenue setting process. This need is reinforced due to the significant number of single issue reviews that have been recently undertaken that, when combined, have the potential to create material regulatory revenue and cash-flow impacts.

Such a framework would assist in ensuring that determinations that incorporate the cumulative impacts of recent individual AER guideline, model and methodology reviews remain capable of clearly meeting the National Energy Law revenue and pricing principle of providing the operator with a reasonable opportunity to recover efficient costs in delivery of the regulated network service (see *National Electricity Law* s.7A(2)).

Treatment of residual tax asset value

The Explanatory Statement has provided two options to write-off the residual tax asset value, with a preference for the use of the RAB standard asset life as the constraint.

Networks' initial advice is that the two approaches put forward by the AER could result in substantial write-offs that may be contrary to existing tax law. ENA instead suggests a third option that more closely reflects actual business practice.

In practice most businesses do not write off the remaining asset value at the conclusion of the tax or regulatory asset life. Rather, the common practice is to transfer assets into a low-value pool once their tax value is less than $1,000. This low-value pool is then depreciated at an annual diminishing rate of 37.5%, in line with tax law.

As such, network businesses suggest a simpler approach whereby assets be allowed to depreciate in perpetuity under the DV approach. The Essential Services Commission (ESC) in Victoria formerly applied this DV approach to electricity networks.

Under the ESC's approach, the value of the TAB in a given year, for a particular asset class was calculated as:

Closing TAB = Closing TAB in previous year + Capital expenditure - Depreciation

And:

Depreciation = Closing TAB in previous year × 200% ÷ Tax standard asset life

This perpetual DV approach:

- is simpler than the AER's suggested approach as it does not require depreciation to be tracked by asset class by year; and
- more closely reflects real-world practice than either of the two options considered by the AER, as it minimises the potential for substantial write-offs that may arise, contrary to tax law.

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This DV approach does apply the same DV multiplier to all assets regardless of when the business acquired the assets. This means that if the ATO were to change the DV multiplier, either the old multiplier would need to remain locked in (thus disregarding any change by the ATO) or the new multiplier would need to be applied retrospectively to all assets. Neither of these options is consistent with business practice, but do provide simplicity to the process.

An alternative solution would be to create a new asset class for each impacted asset class within the model, to which the new DV multiplier could be applied. This would allow the old DV multiplier to continue to apply to all previous asset classes.

In the absence of this proposed approach, ENA supports the use of the RAB standard asset life as the constraint.

Further changes required to the PTRM

Ahead of the following regulatory period, an additional Opening TAB section will be required at the top of the “PTRM input” tab to cater for both the:

- existing asset pool that will continue to be depreciated under the current tax method; and
- new asset pool arising in the next regulatory period that will depreciate under the new tax method.

These changes will also impact the rebuild of the Roll Forward Model and ENA assumes the AER will consult on these additional changes in the future.

Minor corrections to some PTRM formulas

ENA is aware of some minor errors regarding inconsistent formulae within the PTRM.

The details of these errors are outlined in Jemena’s submission and ENA supports the resolution of these identified errors.