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ATCO 2020-24 REVISED PLAN

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Review of regulated tax asset base for regulated revenue purposes - addendum to the report of Vaughan Lindfield, Vaughan Linfield, Ernst & Young, 21 November 2014

Appendix 12.4

27 November 2014

Response to the ERA's Draft Decision on required amendments to the Access Arrangement for the Mid-West and South-West Gas Distribution System

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21 November 2014

Reliance restricted

Review of regulated tax asset base for regulated revenue purposes – addendum to the report of Vaughan Lindfield

Dear Ms McMahon

Enclosed is the addendum to the report of Vaughan Lindfield dated 18 December 2013 in relation to the review of regulatory tax asset base for regulated revenue purposes.

Our engagement was performed in accordance with our Statement of Work dated 30 September 2014. You have requested my expert opinion on a certain taxation related aspect raised by the Economic Regulation Authority (ERA) in its draft report, entitled "Draft Decision on Proposed Revisions to the Access Arrangement for the Mid-West and South-West Gas Distribution System dated 14 October 2014 (the Draft Decision)."

The enclosed addendum is based on information and instructions provided by you. We have not conducted an audit or other verification of any information supplied to us. We have assumed that the information supplied to us is accurately stated, except where indicated.

Neither this enclosed addendum nor any part of it may be published or distributed other than for the purpose specified in the engagement letter without obtaining the written consent of EY, unless disclosed in accordance with any law or by order of a Court of competent jurisdiction or as reasonably required for the purpose of the proceedings.

We appreciate the co-operation and assistance provided to us during the course of this work. If you have any questions, please call me on 9429 2261.

Yours sincerely

Vaughan Lindfield
Partner - Tax

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Addendum to Vaughan Linfield's report of 18 December 2013

Background

1. On 17 March 2014, ATCO Gas Australia Pty Ltd (ATCO), as the owner and operator of the Mid-West and South-West Gas Distribution Systems, submitted proposed revisions to the current access arrangement. The ERA released an issues paper to assist in the submissions process.

2. The ERA received two submissions in response to the issues paper on the proposed access arrangement for the Mid-West South-West Gas Distribution Systems (none of which related to the tax matters discussed in this addendum).

3. On 14 October 2014, the ERA published its Draft Decision on ATCO's proposed revised access arrangement for the Mid-West and South-West Gas Distribution Systems.

4. The ERA has not approved ATCO's proposed changes to the access arrangement for the Mid-West and South-West Gas Distribution Systems and has required 45 amendments.

5. In the Draft Decision, the following view has been expressed in relation to the tax depreciation method adopted by ATCO:

   1103. ATCO has applied the straight line method to calculate tax depreciation. The Authority notes that diminishing value depreciation is an option under tax law.

   1104. In implementing the NGR requirement to move to a post-tax model consistent with the requirements of rule 87A, the Authority considers that ATCO's tax liabilities going forward should align with the tax liabilities of a benchmark efficient entity. The Authority considers that a benchmark efficient entity would seek to minimize its tax liabilities.
   Accordingly, the Authority has decided to require ATCO to apply the diminishing value method to calculate tax depreciation for capital expenditure over the fourth access arrangement period.

   1105. The Authority has therefore applied the diminishing value method to calculate tax depreciation for capital expenditure incurred over the fourth access arrangement period. The Authority has noted that if ATCO adopts diminishing value depreciation for capital expenditure incurred over the fourth access arrangement period, then ATCO would incur higher tax depreciation. This would lead to lower income tax payments.[540]
   This outcome is in line with the Authority's expected outcome for a benchmark efficient entity.

6. ATCO may submit revisions to its proposed revised access arrangement for the Mid-West and South-West Gas Distribution Systems. The submission is due by 4:00 pm (WST) on Tuesday, 25 November 2014.

Scope of work

7. I am instructed to provide my expert opinions on the view expressed above in the Draft Decision regarding the requirement by the ERA that ATCO adopts the diminishing value method to calculate tax depreciation for capital expenditure incurred over the fourth access arrangement period.

Basis of my expert opinion

8. This is an addendum to the report of Vaughan Lindfield dated 18 December 2013. Unless otherwise stated, I have relied upon and referred to the matters stated in my original report in forming my expert opinion (where relevant). Such relevant matters include the matters as stated in Assumptions, Information and Qualifications sections of my original report (i.e. Paragraphs 5 to 14 of my original report).

Reliance on this addendum

9. Paragraphs 15 and 16 of my original report apply to this addendum.

Assistance by colleagues

10. Paragraph 17 of my original report applies to this addendum.

Conduct of this assignment

11. Paragraphs 18 and 21 of my original report apply to this addendum.

Background on relevant tax law

12. Under Division 40 of the ITAA 97, a taxpayer can deduct an amount equal to the decline in value of a depreciating asset, provided that the taxpayer meets various requirements prescribed under this division.

13. Under Section 40-65 of the ITAA 97, a taxpayer has a choice of 2 methods to work out the decline in value of a depreciating asset which is the diminishing value method or prime cost method (Note: I use the term "the straight-line method" in this addendum in substitution to "prime cost method" as it is the term used in the Draft Decision).

14. Section 40-130 of the ITAA 97 states that a choice of the tax depreciation methods must be made by the day the taxpayer lodges the income tax return for the income year to which the choice relates or within a further time allowed by the Commissioner of Taxation. Once the choice over the tax depreciation method is made, the taxpayer cannot change it.

15. Improvements or alterations to an existing depreciable asset are treated as being part of that depreciable asset. Costs of such improvements or alterations are added to the cost base of that depreciable asset and depreciated over the remaining effective life of that asset under the depreciation method that has been adopted for that asset.

Opinion

16. Based on the above, it is my view that ERA's recommendation in relation to the forced adoption of the diminishing value method for all capital expenditure incurred post 1 July 2014 for the post-tax revenue model purposes is inappropriate as it can't be assumed that the adoption of the diminishing value method is consistent with an expected outcome for a benchmark efficient entity. In my opinion, there are circumstances where a benchmark efficient entity would not choose to adopt the diminishing value method as it would not result in an overall minimisation of the income tax liabilities over the effective lives of depreciable assets. The reasons for my view are stated below:

a. At Paragraph 1104 of the Draft Decision, the ERA noted that it "considers that ATCO's tax liabilities going forward should align with the tax liabilities of a benchmark efficient entity." It further stated that the ERA "considers that a benchmark efficient entity would seek to minimize its tax liabilities". It is reasonable to conclude that Federal taxpayers as collective group are motivated to minimize tax by means available under the tax legislation (including a choice of depreciation methods). Whilst there would be exceptions to this general rule such exceptions would be in the minority. ATCO, as a federal taxpayer, would seek to minimise its income tax liabilities to the extent permissible under tax law and has adopted the straight-line method as a result of that. As such, the adoption of the straight-line method for the post-tax revenue model purpose is also driven by the same desire as described in the Draft Decision.

b. ATCO has already adopted the straight-line method for its existing depreciable assets in determining its income tax liabilities prior the ERA decision to apply the post-tax revenue model. ATCO's adoption of the straight-line method is not solely motivated by the gas price determination purposes.

c. As the ERA correctly pointed out at Paragraph 1103 of the Draft Decision, the diminishing value method is an option under tax law. If the ERA is correct by arguing that a benchmark efficient entity always adopts the diminishing value method, this leads to an absurd outcome that the choice of the depreciation methods becomes effectively redundant for federal taxpayers as a broad collective. The ERA approach appears to presuppose that the diminishing value method will always be the best choice for federal taxpayers in minimising their income tax liabilities. However, such a presumption is unlikely to be correct in all circumstances. Whilst the diminishing value method provides larger tax depreciation at an early stage of the effective life of a depreciable asset in comparison with the straight-line method, this is not the only factor for federal taxpayers to determine a choice of the tax depreciation methods. There are other relevant factors such as one described at Subparagraph d below.

d. The diminishing value method results in an undeducted amount remaining at the end of the effective life of a depreciable asset whereas there is no such undeducted amount under the straight-line method. Given these characteristics of the depreciation methods and the size of the capital investments, infrastructure taxpayers will generally choose the method that provides the better after tax return based on discontinued cash flows. The assumption that the diminishing value method provides the best outcome in all circumstances is false. This choice can be influenced by many factors including any disparity between the economic life of the asset as compared to the effective life of the asset for tax purposes.

e. Under tax law, improvements or alterations to an existing depreciable asset are treated as being part of that depreciable asset. Consequently, such costs are added to the cost base of that depreciable asset and depreciated over the remaining effective life of that asset under the depreciation method that has been adopted for that asset.

   There is no option under tax law which allows taxpayers to treat such improvements or alterations as a separate depreciable asset. Furthermore, Section 40-130 does not allow taxpayers to change the tax depreciation method for those assets (including any subsequent improvements or alterations made to those assets) to which it has already applied the straight-line method.

ATCO has already adopted the straight-line method for its existing depreciable assets in determining its income tax liabilities and its starting base for regulatory purposes. Consequently, the ERA's blanket recommendation in relation to post-1 July 2014 expenditure incurred for improvements or alterations to ATCO's existing depreciable assets cannot be implemented unless ATCO applies the depreciation rules in contravention to the tax law principles described above. Specifically, if any of the expenditure incurred by ATCO post 1 July 2014 relates to an improvement or alteration to a functional depreciable asset that ATCO has already depreciated using the straight line method prior to 30 June 2014, then ATCO does not have an ability to adopt the diminishing value method in respect of such expenditure.

f. The ERA's approach in the Draft Decision is not consistent with the view adopted by other independent regulators in respect to gas distribution networks. For example, the Australian Energy Regulator (AER) has allowed SPI Networks (Gas) Pty Ltd (SP AusNet) to adopt the straight-line method as part of its review of the revised access arrangements of the three Victorian gas distribution networks (refer to Paragraph 9.4.2 of Part 2 Attachments of Access Arrangement Final Decision 2013-17, published in March 2013). Relevantly, the AER made the following statement:

> *The AER accepts the tax depreciation approaches to groups 1–7 tax assets in SP AusNet's revised proposal. These tax depreciation approaches reflect the revisions proposed by the AER in its draft decision.*[619]
>
> *In the draft decision, the AER accepted SP AusNet's proposed tax depreciation approaches to groups 1–6 tax assets.*[620] *These approaches are consistent with the ESC's decision for the 2008–12 access arrangement period.*[621] *For group 7 tax assets for the 2013–17 access arrangement period, SP AusNet proposed to change the tax depreciation approaches from declining balance to straight-line. The AER accepted the proposed tax depreciation approaches (except for the proposed 'Land & buildings' asset class). This is because Australian taxation law allows both the declining balance method and straight-line method to be used to depreciate new tax additions (capex) for tax purposes.*[622] *Due to land being a non-depreciating asset, the AER split the 'Land & buildings' asset class into separate asset classes.*

This revision must be based on similar (if not the same) benchmark efficient entity principles. The AER acknowledged that Australian tax law allows both methods to be used to depreciate new tax additions (capex) for tax purposes. In this instance, the AER has also accepted SP AusNet's proposal to change the tax depreciation approaches to the straight-line method.

g. As noted at Subparagraph e above, under tax law, an improvement or alteration to an existing depreciable asset is treated as being part of that depreciable asset and such costs (together with the remaining cost base of the depreciable asset) are depreciated over the remaining effective life of that asset under the depreciation method that has been adopted for that asset. As such, the adoption of the diminishing value method would potentially be one of the factors which discourage improvements or alterations to the existing assets especially during a later stage of the effective lives of those assets as there is a risk of large portion of capital costs remaining undeducted at the end of the effective lives (until the relevant assets are disposed of, which would not be expected to occur until well after the end of the effective lives). It is my understanding that the decision made by the ERA must meet the National Gas Objective. In this regard, Paragraph 33 of the Draft Decision states the following:

33. The National Gas Objective is defined in section 23 of the NGL(WA) as:

> *The objective of this Law is to promote efficient investment in, and efficient operation and use of, natural gas services for the long term interests of consumers of natural gas with respect to price, quality, safety, reliability and security of supply of natural gas.*

It is not clear as to whether the ERA's recommendation for the adoption of the diminishing value method is in line with the National Gas Objective and would promote efficient investment in natural gas services especially when viewed over multiple access periods.

h. The straight-line method produces a relatively constant depreciation amount over the effective life of a depreciable asset. As such, the adopt of the straight-line method should contribute to a "smoothing effect" over the gas pricing (i.e. less volatility in gas pricing) not only within the access arrangement period but also over the different access arrangement periods. The adoption of the diminishing value method for this access period is likely to increase tax costs in future access periods to the extent that the quantum of capital costs included do not remain at the same level (i.e. the starting base for future access periods may be lower as a consequence of adopting the diminishing value in respect of capital expenditure incurred after 1 July 2014).

i. If ATCO is to adopt the diminishing value method despite the contrary tax law principle described at Subparagraph e, it would create the following potential issues for ATCO:

    i. For the purposes of determining its federal income tax liabilities for this access period, ATCO is required to adopt the straight-line method for post-1 July 2014 expenditure in relation to improvements and alterations to the existing functional assets. If ATCO incurs the actual federal income tax liabilities for the period, the ERA's recommendation of adopting the diminishing value method will not give ATCO an opportunity to recover such tax costs as it will effectively allow ATCO to recover lower or no tax costs for this access period (refer to Table 61 of the Draft Decision).

    ii. ATCO will suffer additional compliance burdens as it is required to maintain 2 separate sets of the tax depreciation schedules (one for federal income tax compliance purposes and another for the regulatory purposes).

j. According to the Rate of Return Guideline (December 2013) published by the AER, the benchmark efficient entity is defined so that the allowed rate of return estimated for that benchmark efficient entity provides service providers with a reasonable opportunity to recover at least their efficient financial costs, consistent with the national electricity objective, national gas objective and revenue pricing principles. According to Table 61 of the Draft Decision, the ERA currently estimates that ATCO would be in a tax loss position for 2015 to 2019 years if it adopts the diminishing value method. The tax losses generated will not be able to be taken into account when determining the gas price for the relevant access arrangement period. There are doubts, in my opinion, as to whether a benchmark efficient entity would adopt the diminishing value method under such circumstances.