



Gas Control Inquiry

**Powerco Ltd's submission on Tax
Treatment in the Commerce
Commission's Cost Benefit Analysis**

23 September 2004



1. The Commission released its draft report on 21 May 2004 (Draft Report), setting out its preliminary view on whether gas services should be controlled. Following submissions in response to the Draft Report, the Commission acknowledged a potential error in its treatment of tax, and sought additional information from affected businesses.
2. The Commission released a note on 8 September 2004, setting out its proposed approach to the treatment of tax in the cost benefit modelling, and indicating the impact of the approach, using updated figures provided by the gas businesses. This note was accompanied by two reports by Associate Professor Lally: The Treatment of Gains on the Sale of Assets, 2 September 2004; and The Interest Tax Deduction and the Calculation of Excess Earnings, 6 September 2004.
3. This submission is Powerco's response to the Commission's tax note and the accompanying reports from Associate Professor Lally.
4. At the outset, Powerco notes that these papers have been provided very late in the Commission's deliberative processes and that limited time has been made available to parties to respond in any meaningful way to the matters raised. This concern is especially acute given the technical nature of the issues and their importance in the context of the Commission's assessment of the benefits of price control.
5. Powerco is also concerned that it has not seen the Commission's NAB model with the proposed approach to tax included.
6. Within the time available to analyse the Commission's papers, Powerco's immediate concerns relate to paragraphs 22 and 23 of the Commission's note, which are reproduced below:

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| <p>22 The Commission proposes that businesses that have paid more than ODV for network assets be required to pass on to consumers the tax benefits that arise from basing tax depreciation on the acquisition value. This is achieved by using the acquisition value of the assets to calculate tax depreciation and resulting tax payable. In the Commission's analysis the tax benefits that result from high acquisition values are taken into account in assessing excess returns as they arise in the years following the acquisition.</p> <p>23 The tax payable calculated on the basis of the acquisition value is lower than the value that would be estimated using the ODV value. Using the ODV value to assess tax payable would allow the businesses that had paid more than ODV for their assets, to keep some of the tax benefits, effectively recovering through their tax returns, over the life of the assets, some of the excess paid. This would be inconsistent with the Commission's adoption of ODV as the regulatory asset base.</p> |
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7. The Commission's proposed approach is contrary to the arguments Powerco presented in its cross submission under the heading *Benchmark vs actual tax* (paragraphs 46 to 54). Moreover, neither the Commission's note, nor the supporting papers from Associate Professor Lally, appear to take any account of the arguments presented by Powerco in that cross submission. Powerco stands by the points made in its cross-submission and, to the extent that the Commission has not given full consideration to them, requests that the Commission now does so in conjunction with these additional submissions.
8. While the Commission's task under Part IV involves matters of judgment and degree, the Commission's discretion is not unfettered. The Commission must act in a way so as to best reflect the relevant statutory objectives, and in a manner consistent with the corpus of accepted accounting and economic theory which underpins the Act. There must be a logical and rational connection between the methodology adopted by the Commission and what it hopes to achieve by application of that methodology. Powerco notes, for example, advice received from KPMG (attached) that the Commission's approach in relation to tax is not consistent with generally accepted accounting principles.
9. Equally, the Commission must recognise the legitimate business interests of regulated parties, especially in relation to transactions effected before the regulatory regime came into force or was even contemplated.
10. See generally *Application by East Australian Pipeline Ltd [2004] ACompT 8*; *Application by Epic Energy South Australia Pty Ltd [2003] ACompT 5*; *Ex Parte Epic Energy (WA) Nominees Pty Ltd [2002] WASCA 231*.
11. Powerco does not accept the Commission's position that adopting a "benchmark" approach to estimating the cost of tax (using the ODV as the tax book value of assets) would be "inconsistent with the Commission's adoption of the ODV as the regulatory asset base" as the Commission asserts. Not only is this incorrect as a matter of principle, but for reasons in outlined in the cross-submission, it is also internally inconsistent.
12. On the one hand, the Commission proposes to **ignore** the owner's valuation of Powerco for the purpose of determining a building block revenue requirement, and to adopt ODV for the purpose of revenue setting. In effect, this exposes Powerco's owners to the risk of a substantial capital loss, as wealth is transferred to consumers.
13. On the other hand, the Commission's proposes to **recognise** the owner's valuation of Powerco for the purpose of imputing a (lower)



allowance for tax expenses in the building block revenue. The effect of this inconsistent approach is to penalise Powerco's owners, firstly for paying "too much" for the assets; and secondly, for paying less tax as a result. In effect, this is a double-penalty that is likely to have long-term detrimental impacts on investors and, therefore, customers.

14. It is inconsistent for the ODV and market value of assets to be combined in the way that the Commission proposes. This inconsistency was recognised by the Victorian Office of the Regulator-General when it considered this issue some years ago, as we noted in the cross submission. To illustrate this point further, Powerco has commissioned a paper by Jeff Balchin, a consultant who has acted for the Victorian regulator on these matters. Jeff Balchin's paper will be submitted to the Commission shortly.
15. Furthermore, the Commission's approach on this issue is likely to seriously distort its analysis of the benefits of control. It can be demonstrated that two businesses equivalent in every respect, apart from their acquisition costs, would be found to have different outcomes under the proposed tax methodology. For example, assume *Business A* pays 1.5x ODV for the assets while *Business B* pays 2x ODV. The taxation methodology proposed by the Commission would find *Business B* to be making higher profits relative to *Business A* due to the higher tax depreciation available to *Business B*, yet both businesses have the same network charges and identical costs in all other respects.
16. This result contradicts conventional accounting concepts that would suggest that *Business A*, having paid less for its assets, would have higher accounting profits relative to *Business B*, which has paid more for the assets. Yet the Commission's approach is suggesting that the opposite is true i.e. the more you pay the higher the profit. This is an outcome that is difficult to reconcile with any common-sense analysis.
17. Powerco notes that the Commission mistakenly believes (see paragraph 7 of the Commission's note) that its approach is consistent with its "NPV=0 principle". In our example, however, NPV=0 is only properly achieved by allowing *Business B* to charge higher prices, thereby ensuring the same rate of profit for both businesses. The Commission has rejected this view and instead would impose the same out-dated ODV asset value on both *Businesses A and B*. Under this approach, it would be common sense to expect the Commission to conclude that both businesses *should* be charging the same prices. Perversely, however, the application of the Commission's NPV=0 principle leads to the conclusion that *Business B*, with higher asset costs, should charge *lower* prices.



18. Powerco notes that if the Commission had considered its cross-submission, the Commission would have realised that its approach is out-of-step with regulatory practice elsewhere. By focussing as it has on the provision of accounting advice, the Commission risks failing to inform itself properly as to the economic and regulatory policy issues that arise.
19. As the Tribunal in *East Australian Pipeline Ltd* noted, it is a fundamental error of principle for a regulator to put aside known methodologies and devise a novel methodology of its own. Such an approach can properly be described as “idiosyncratic” and should be resisted (paras 25 et seq).
20. There is well-established regulatory precedent for adopting a benchmark approach to tax and yet the Commission here seeks to depart from that.
21. Powerco is concerned that the Commission is subjecting the sector to significant regulatory risk by attempting to “reinvent the wheel” with regard to regulatory practice. It is likely, therefore, that the Commission has grossly under-estimated the costs of regulation, and its negative impact on dynamic efficiency. Powerco would like to remind the Commission that the Government’s draft policy statement for the gas industry states that the Government is seeking outcomes, including that:

“incentives for investment in gas processing facilities, transmission and distribution, energy efficiency and demand side management are maintained or enhanced.”

The Commission’s unusual approach to taxation issues is a good example of regulatory risk, which will have the effect of weakening incentives for investment.

22. It is self-evident that the Commission’s proposed approach in relation to taxation was not reasonably foreseeable at the time the present owners made their valuation and investment decisions. This fact is demonstrated by the valuation decisions already made by Powerco’s owners. Had investors been aware, at the time of their decision-making, that the Commission was going to adopt an approach that involved immediately transferring tax benefits to consumers, then the asset valuations at the time of the transaction would have reflected this, and there would now be no tax benefits to transfer to consumers.
23. The Commission’s proposals have caught investors by surprise, and thereby provide a stark example of “regulatory risk”. Asset revaluation (and wealth confiscation) as proposed by the Commission is a one shot game. Whilst it may deliver short term benefits to consumers, the negative impacts on investment incentives will lead to long term consumer detriment (points made



repeatedly by the Productivity Commission in Australia, and cited in our cross submission). The Commission's proposed approach does not give adequate (or even any) consideration to the fundamental question of the impact that such large shocks may have on incentives for investment, or to the legitimate business interests of those potentially subject to regulation.

24. The benchmarking the Commission should be undertaking is to derive the appropriate tax amount, assuming investors follow the Commission's reasonable assessment of asset values i.e. establish the benchmark business where tax depreciation is based on a properly assessed ODV, rather than the actual taxation observed. As noted earlier, this is precisely the approach adopted by other regulators.

25. In the limited time available to review Associate Professor Lally's advice, Powerco's preliminary view is that the Commission appears to be applying his analysis inappropriately. As far as we can tell, Associate Professor Lally's advice examines the tax impacts of acquisitions for the sector as a whole, over the entire life of the assets concerned. In his example, the analysis showed a relatively small sector gain, over the life of the asset, as a result of an intra-sector company sale. However, the Commission uses Associate Professor Lally's analysis in a "snap-shot", company-by-company examination of "excess returns". Powerco does not believe that Associate Professor Lally's paper supports the Commission's method for assessing excess profits. In fact, Powerco notes that Associate Professor Lally (page 7) makes the following observation in relation to "snap shot" analysis:

"However, any assessment of Excess Earnings at the end of year 1 would give rise to misleading conclusions. Of course, this is a general problem, of which there are many other examples."

26. Powerco is also concerned that the Commission's analysis of the interest tax shield issue does not explicitly acknowledge that the Commission's assessment of the NAB applied the available data incorrectly. Powerco has previously argued that the risks and consequences of regulatory error are far more serious than the Commission has assumed in its NAB analysis. In our view, the Commission's inappropriate use of data in the NAB is a case in point. Evidence from other jurisdictions is that regulators are not infallible, and therefore are best advised to act conservatively. As a general observation, the Commission's paper on taxation issues strongly suggests that its approach to regulation is novel and risky.