

The Allen Consulting Group

Review of the Information Disclosure  
Regime:  
Treatment of Taxation and Other  
Issues

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# Outline of Presentation

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- Context of the Information Disclosure Requirements
- Deriving tax depreciation allowances for a regulatory purpose
- Other tax related issues – treatment of losses and definition of returns / WACC
- Incentives to make efficiency gains – disclosure and ACAM

# Information Disclosure Requirements

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- At least three possible purposes
  - legislative disclosure requirements – ‘moral suasion’
  - information to reset thresholds
  - information for investigating breaches
- Return on assets is central to each of the purposes – a higher return likely to:
  - increase pressure for price reductions
  - imply a lower threshold at reset
  - Imply a lower price cap (all else constant) if control imposed
- Taxation – and all elements in its calculation – will impact on the return on assets
  - Tax depreciation allowance a central part of the tax calculation

# Tax Depreciation Allowance – Principles

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- Two important principles:
  - ignore actual financing decisions (including purchase prices)
  - adopt consistent benchmarks
- Why ignore financing decisions?
  - incentives for efficient decisions
  - complexity of financing arrangements
  - risk
- Why adopt consistent benchmarks?
  - Benchmarks must be *achievable* by an efficient firm to ensure investment incentives
- Broader objectives – comparison to a hypothetical new entrant
  - Prices charged by the hypothetical new entrant would be independent of the actual financing decisions of the incumbent operator

# Tax Depreciation Allowances – Gas Control Inquiry

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- Commission adopted ODV for the regulatory value but actual tax book values for tax depreciation
  - For some firms, actual tax book values reflect recent purchase prices for assets – in excess of ODV
- Not consistent with my two principles:
  - Directly reflects purchase prices for the assets
  - Used the **lower** ODV to determine the allowed return (adverse to owner), but used the **higher** purchase price to imply lower tax payments and so higher returns (also adverse to the owner)
- Regarding consistency:
  - To only require a return on ODV ⇒ must have bought / built the business for ODV
  - But a firm that paid / built the business for ODV would have a tax book value of ODV (not in excess of ODV, as assumed by the Commission)
- Higher purchase price ⇒ more likely to be judged to be making excessive returns, for given prices
  - Not consistent with the hypothetical new entrant test for ‘monopoly rent’

# Tax depreciation allowances – the Victorian case study

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- Distributors privatised in 1995 for up to **twice** regulatory value – all have since been sold (in whole or in part)
- During the 2001 review, substantial pressure to set prices to underwrite original purchase prices
  - Ability to justify ignoring actual financing decisions an imperative
- Ignored actual financing decisions – and applied principle equally to taxation:
  - Adopted the regulatory value as the opening tax book value
  - Has not reset the tax value even though there have been subsequent sales
- The Victorian approach not unduly favourable compared to other Australian regulators – converse the case
  - A number of regulators have adopted a pre tax (higher) WACC
  - Pre tax is more favourable to the businesses than the Victorian approach

# Tax depreciation allowances – relationship to asset valuation

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- Broader objective – comparison to a hypothetical new entrant
- ‘Theoretical’ ODV is the price you would pay for old assets relative to the new asset
  - I.e. cost of buying new asset, less the net increase in cost of operating the old asset (in PV terms)
- If the Commission assumes a unique tax advantage to the incumbent, then ‘theory’ would imply a higher ODV – capitalise the tax benefit
  - Theoretical ODV is not normally undertaken – but a guide for particular issues, like tax

# Other Tax Related Issues

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- ✦ Tax benefits from other activities (e.g. losses) – ignoring actual financing arrangements ⇒ adopt a benchmark
  - ✦ Standard in Australia to treat as ‘stand alone’ entities
- ✦ Related issue – should the tax benefit of interest be included in the WACC or cash flows?
  - ✦ Including tax-benefit of debt in the WACC is problematic when firms are making losses – requires ad hoc adjustments
  - ✦ Simpler and less prone to error to factor into the tax calculation in cash flows – where interest deduction reflects the benchmark financing assumptions
  - ✦ Standard approach in Australia (where a post tax WACC is used)

# Efficiency gains, public reporting and ACAM

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- The Commission's *philosophy* is to reward efficiency gains:
  - 'lag' between threshold reviews
  - interplay between C1 and C2 ( $\Rightarrow$  higher return for greater relative efficiency when thresholds set)
- 'Moral suasion' against excessive returns is problematic – may weaken incentives
  - A need for the Commission to explain the role of returns in its framework
- Is there sufficient certainty about rewards for pursuing efficiency gains?
  - Dependent on expectation of how thresholds will be reset
  - Even if previous approach re-implemented, rewards not obvious
- Relevant to the debate over ACAM – will incentives for beneficial M&A remain?
  - Need to ensure that all forms of efficiency gains are appropriately rewarded
  - Need to ensure that incentives not counteracted by 'moral suasion'