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Jemena Gas Networks (NSW) Ltd
ABN 87 003 004 322

Level 20
111 Pacific Highway
North Sydney NSW 2060
PO Box 1220
North Sydney NSW 2059
T +61 2 9455 1500
F +61 2 9455 1589
www.jemena.com.au

By email: wacc@ipart.nsw.gov.au

The incorporation of company tax in price determinations
Independent Pricing and Regulatory Tribunal
PO Box Q290
QVB Post Office NSW 1230

The incorporation of company tax in price determinations

Dear Sir/Madam

Jemena Gas Networks (NSW) Limited (**JGN**) appreciates the opportunity to make this submission to the Independent Pricing and Regulatory Tribunal's (**IPART**) discussion paper on the incorporation of company tax in price determinations.

JGN and transitioning from pre-tax to post-tax WACC

In its most recent Gas Access Arrangement Review (**GAAR**), JGN adopted a pre-tax weighted average cost of capital (**WACC**) for its initial proposal. The Australian Energy Regulator (**AER**) in its draft decision, did not accept this and required that JGN adopt a post-tax WACC and to calculate tax as a discrete building block. JGN did not contest this requirement.

This change puts JGN in an ideal position to respond to IPART's consultation.

Stability of regulatory framework

Given the long term nature of investment in network infrastructure it is important for regulated businesses that the regulatory framework remain stable over time. In the case of the incorporation of company tax in price determinations, stability can be facilitated by only changing to an alternative where the advantages of doing so can be clearly demonstrated.

Criteria for assessing options

Rules 74 and 76 of the National Gas Rules (**NGR**) require that where a post-tax WACC is adopted then the estimate of tax must be the best possible in the circumstances, and consistent with the efficient cost of providing reference services.

While JGN is aware that IPART is consulting on an approach for the treatment of taxation for businesses not covered by the NGR, it is still a desirable attribute for any regulatory regime that all forecasts should be the best estimate in the circumstances.

JGN notes that among the criteria that IPART is proposing for assessing the approach there is no criterion similar to that contained in the NGR that the estimate be the best available in the circumstances.

At a theoretical level such a criterion would not be required as both pre-tax and post-tax approaches should produce essentially identical outcomes. However, as IPART observes, there is a gap between theory and practice. In these circumstances the best approach would be the one that, in practice, either closest approximates the theoretical outcome or that is the least costly to implement.

Importance of detail to implementation

The paper contains a high level analysis as is appropriate in an initial discussion paper. However, if IPART chooses to move from a pre-tax to post-tax WACC the success of the transition will be determined by the detail of the tax building block calculation and how it is implemented.

An important aspect of the tax building block is the tax asset base (**TAB**). The accuracy of the TAB will be determined by the level of detail that businesses have on their assets in the regulatory asset base (**RAB**).

It is practical considerations such as this that should inform IPART's final decision on whether to move from a pre-tax to post-tax WACC rather than only on high level conceptual consideration currently being consulted on.

IPART Specific issues

IPART has asked a number of specific questions in the discussion papers and JGN responds to some of these questions below.

Use benchmark or business specific gearing?

One of IPART's criteria for assessing options is that the approach should reflect the rate of taxation for an industry rather than being specific to a business.

JGN strongly supports the use of industry rather than business specific benchmarks as there is significant variation in business structures, ownership and tax structures that are relevant to the matter under consideration across the regulated industries.

It is unlikely that the use of business specific gearing is consistent with IPART's criterion.

Allow for accumulated tax losses?

JGN supports IPART's analysis on not requiring the inclusion of accumulated tax losses. It is not clear why an efficient business should be penalised with lower future revenues in the event of incurring tax losses.

Use tax depreciation or regulatory depreciation

One of the questions IPART poses is "Should we use tax depreciation or regulatory depreciation for estimating tax liabilities?"

If IPART does elect to move to a post-tax WACC then the best estimate would require that the TAB and tax liability be consistent with the tax law rather than RAB just as a company's tax and statutory accounts are different.

It is JGN's view that when establishing a TAB, IPART should use a realistic estimate of the tax position of an efficient business. JGN considers that these circumstances include:

- the business's historic nominal capital expenditure
- the tax law existing at the time of the expenditure

- the tax depreciation method that would be adopted by an efficient business.

These matters are outlined in more detail below.

The business's historic nominal capital expenditure

JGN understands this is a relatively uncontroversial aspect of taxation treatment. The nominal capital expenditure added to the TAB should be the same as that added to the RAB.

The tax law existing at the time of the expenditure

In order to generate a realistic estimate of the tax position of an efficient business the TAB should reflect the tax law existing at the time of the capital expenditure as this affected the decision. That is, tax assets should be subject to the taxation depreciation or taxation lives at the time it was incurred rather than the taxation treatment that was in place at the time of the creation of the TAB.

The tax depreciation method that would be adopted by an efficient business

In the context of the TAB the assumed depreciation method is a choice between straight line and diminishing value. In determining which approach to adopt IPART should apply the depreciation approach that would have been used by an efficient business at that time.

In the GAAR JGN proposed, and the AER accepted, a diminishing value depreciation method as being consistent with that which would be adopted by an efficient business. This is in contrast to the straight line depreciation method that JGN used in our RAB.

JGN is not proposing this as conclusive evidence that in all circumstances diminishing value depreciation is the correct approach but rather that it can be appropriate that one method of depreciation can be used in the TAB and a different depreciation methodology used in the RAB provided it is consistent with the approach an efficient business would adopt.

If you have any questions or there is additional assistance that JGN can provide please contact me on (02) 9455 1557.

Yours sincerely

Mark Allen
Manager, Regulatory Economics
Jemena