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The incorporation of company tax in price determinations
Independent Pricing and Regulatory Tribunal of NSW (IPART)
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Dear IPART

**RE: Company Tax Discussion Paper**

TRUenergy welcomes this opportunity to provide comments on "The incorporation of company tax in price determinations" Discussion Paper of June 2011.

The approach to setting the company tax and other weighted average cost of capital (WACC) parameters is very important to TRUenergy. Adopting a stable and fair methodology will help minimise regulatory risks faced by investors in energy markets covered by IPART. Setting the overall WACC at a level that ensures returns do not fall below reasonable market outcomes is essential to give investors the confidence to provide the investment that the energy industry needs now and into the future.

TRUenergy understands that IPART is seeking to settle an approach to company tax to be used in setting the WACC across a range of industries. IPART currently sets WACCs for both electricity retailing and generation. The Discussion Paper notes that any company tax decision will not apply to the current price control period for regulated electricity prices, meaning any outcomes would only apply to a continuation of regulation after the current period.

TRUenergy provides the following comments, in relation to electricity generation and retail, on the specific question in the Discussion Paper.

*1. Are taxation statistics from the ATO useful for the purposes of considering industry-specific effective tax rates?*

Taxation statistics are of some use as they can be used as a general benchmark which takes into account the differing impact of general tax provisions as a consequence of the industry's characteristics as well as industry-specific taxation. However, beyond providing a general benchmark, tax statistics have limited application due to potentially large variations caused by differences in individual company tax positions. Further, we note that where the effective tax rate arose from timing and not permanent differences, it is inappropriate to apply a lower rate now and a higher rate in the future.

*2. Are Bloomberg business specific effective tax rates a useful source for comparison?*

There is a significant variation in the effective tax rates between utility businesses, resulting from different operations including generation, distribution and retail, as well as differences between regulated and competitive industries. Given this, we are of the opinion that Bloomberg business specific effective tax rates are not likely to provide useful comparative data for establishing a stable and fair regulatory approach.

*3. Are there other options IPART could consider that provide an accurate assessment of tax liabilities with low compliance costs?*
*4. What are the strengths and weaknesses of the options for incorporating tax into our regulatory decisions?*

We are of the opinion that, for electricity generation and retail, the current approach balances the need for an accurate assessment with low regulatory costs. Other assessments are not likely to regularly provide stable and fair outcomes given the different characteristics and tax profiles of specific businesses. Using an effective tax rate approach will encourage inefficient corporate behaviour by encouraging tax positions to maximise regulatory outcomes even when these are not least cost.

*5. What are the information requirements and compliance costs of moving to incorporate tax as a separate building block?*

For electricity generation and retail there is likely to be a material increase in compliance costs if tax is included as a separate building block. Significantly more data will have to be provided including tax depreciation schedules, tax loss profiles and detailed corporate structures.

*6. Should the level of gearing reflect a benchmark or be specific to a business?*

Electricity generation and retail are both competitive. Decisions by individual businesses regarding their level of gearing are made to target appropriate returns given the business and industry profile. Any move towards utilising business specific gearing levels for regulatory purposes is likely to distort funding decisions and lead to inefficient outcomes.

*7. Should we use tax depreciation or regulatory depreciation for estimating tax liabilities?*

Using tax depreciation for electricity generation and retail would be materially more onerous and potentially lead to inefficient outcomes.

*8. Should we allow for nominal interest deductibility?*

If a benchmark gearing is adopted then interest should be assumed to be tax deductible. Accordingly, the deductibility of the interest should be consistent with the benchmark rate of interest at the gearing level adopted.

*9. Should we allow for accumulated tax losses?*

For electricity generation and retail, accumulated tax losses should not be considered as these could have arisen from other parts of the tax entity that are not regulated or be a function of purchase price rather than construction cost. There is also a risk that data bias could be introduced (due to the limited number of affected entities) to the extent that accumulated tax losses were allowed.

*10. Should we use sectoral benchmarks of effective tax rates?*

Developing reasonable sectoral benchmarks of effective tax rates for electricity generation and retail will be difficult given the likely discrepancy in the effective rates of different companies, depending on how much they operate in certain parts of the industry. Given this, we recommend these should not be used.

*Conclusion*

TRUenergy believes that, for the purposes of setting WACCs for electricity generation and retail, there is no persuasive evidence to support the use of more intrusive business-specific company tax estimates. In these areas IPART is effectively setting benchmarks which the competitive industry will attempt to beat. A move to a more business-specific tax approach may encourage inefficient corporate behaviour that will lead to higher price outcomes.

Indeed it would appear to be contrary to IPART's objective of promoting competition (or simulating its effects) to adopt a more business-specific tax approach when setting electricity generation and retail WACCs.

Should you wish to discuss any of the issues raised in this submission please feel free to call me on (03) 8628 1120.

Yours sincerely,

**Andrew Dillon**
**Regulatory Pricing Manager**