SUBMISSION TO THE ORG:

THE APPROPRIATE TREATMENT OF COMPANY TAXATION IN DETERMINING A REVENUE CAP FOR A REGULATED BUSINESS

ENERGY
ISSUES PAPER NO. 14
APRIL 2000

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Introduction

> *".... you only get capital forming if the benefits are passed on to customers. That is ... how the thing transmits. If you imagine a pipeline project or an electricity transmission project, and you have got a set of customers - potential customers who aren't there yet, and at the price you have to supply them you are - you don't have a market, the project is not going to go ahead.*
>
> *"If you come and introduce something like an investment allowance or accelerated depreciation you can now reduce your prices ... the project only goes ahead if the benefits are passed on to customers through lower prices. Without (that, the) market that previously wasn't there doesn't emerge. The government's policy of encouraging capital formation doesn't work unless the benefits of accelerated depreciation are passed on to customers."*

Mr Balchin, the ORG's adviser, offered the above remarks at the ORG meeting of 27 March 2000. Following a comment on these remarks by Mr Gleeson (United Energy), Mr Tamblyn appeared to endorse them, suggesting the ORG's thinking was that in a competitive market a rival, "could take away some of your market share if you didn't pass on benefits of investment (incentives)" and he invited short submissions on the issue.

In contrast to these remarks, at the ACCC/ORG Public Forum on WACC of 3 July 1998, Mr Anthony Cohen of KPMG said,

> *"Dealing with the public policy matter, ... every Treasurer I can remember who has said that he was introducing accelerated depreciation in a budget said he was doing it to encourage investment in productive goods.*
>
> *"If we simply pass the benefit of that on to consumers in lower prices we will deny the consumers the majority of the incentive. The clear cost of that public policy initiative is the NPV benefit to the company of being allowed to retain that amount of money."*

The effective tax rate differs from the nominal rate largely because of the treatment of depreciation. Although widely described as "concessions", the measures that have allowed accelerated depreciation can also be viewed as providing corrections for inadequate levels of depreciation. These inadequate provisions may occur because of:

- <u>an inflationary environment</u>; even if the inflation rate is only 3%, the depreciation under-provides the real funds available for replacing an asset with a 10 year life (in that case by 34%); post 21 September 1999, nominal and effective rates are to be aligned with the termination of accelerated depreciation, though the many changes over the past 25 years do not provide confidence that this brings a new era of stability in company taxation arrangements.

- the physical rather than the useful life of an asset; innovation is likely to mean that some assets will become obsolete before they are worn out and will be prematurely scrapped; Option 2 of the post Ralph tax code seeks to redress this but the Australian Taxation Office is unlikely to allow firms *carte blanche* in opting for unique depreciation rules – applicants will need to provide persuasive evidence that the chosen rate should apply.

The Issues

The issues are twofold:

First,

- whether the benefits of taxation concessions to a regulated natural monopoly industry should be passed through directly as lower prices/increased service to consumers; or
- whether, as with other industries, these benefits should – or even could – result from the incentives increasing the level of investment and hence productivity with a subsequent pass-on of the lower prices/increased service to customers.

Secondly, does the application of an effective rate of tax through recalibrating the previously set nominal depreciation rates mean retrospective taxation?

Addressing the Issues

The Pathway to Achieve Benefits of More Rapid Depreciation

A policy of allowing more rapid depreciation is intended to bear fruit as follows:

- faster depreciation means reduced nominal profits and lower levels of company taxation
- the lower levels of company taxation mean higher real profit levels
- higher real profit levels create a greater incentive to undertake investment (leaving more funds available to the companies the procedure may also increase the supply of funds, though this is a less important aspect)
- increased investment means 'capital deepening' in existing activities and bringing other activities under the investment hurdle rate
- consumers obtain the benefits of these developments' future lower costs.

The Pass-Through with Regulated Industries

Reducing the level of company tax (the *de facto* effect of faster depreciation) will increase investment by making previously marginal projects profitable. At the same time it delivers improved profits for those projects that would have proceeded in any event. This may be a windfall gain to investors or a rectification of a distortion depending on whether it shifts the previous arrangements towards or away from neutrality. In either event, the measure applies to all investments. Trying to confine it to marginal investments would create distortions akin to the “poverty traps” that discriminatory payments create in the welfare system.

How a change in depreciation pans out in investment behaviour is an empirical matter. It is most unlikely that any industry would experience no capital investment increase from reduced taxation of capital expenditure. Any industry not so affected would be characterised by having already reached its technology limits and exhausted its possibilities of capital labour substitution.

In competitive markets, it is the nature of demand and supply that will determine what part, if any, of a reduced taxation bill is passed through to customers at the outset and what part must await the productivity gains pass through. The latter are compensation from lower levels of economy-wide consumption implicit in the government tax concession.

Regulated natural monopolies are unlikely to be different from other industries in the profile of profitable opportunities confronting them. The incentive remains for such firms to increase investment spending, thereby improving profits by reducing taxation payments (and, in the process, raise productivity). In competitive markets, this increased productivity is competed away but with regulated natural monopolies the regulator has to synthesise the outcomes of that rivalry.

However, if the regulator were to deny the incentive to the regulated business, this would forestall the productivity gains and create a distortion between industries. Denying the industry-wide system to one industry would shift resources from it to other industries or to consumption. Interventions of this nature that favour/prejudice one industry over another are generally presumed to lead to misallocations. Import protection has been the classic case in Australia. Differential treatment shifts investment resources away from promising venues in the regulated industry and denies that industry and its consumers the higher levels of productivity that other industries would experience. This would mean a reduction of the productivity gain which higher levels of investment furnish and which regulators seek to extract through the X-factor under CPI-X price setting.

Moreover, if policies at a lower level of government seek to divert the cost savings introduced by the central government from businesses directly to the consumer, they undermine the intent of the (Commonwealth) taxation policy. Those policies of the lower level of government frustrate the increase in investment and living standards that might be expected to arise from the industry they control.

Resetting Depreciation on Previous Investment Expenditures

It is possible for the regulator to force a pass-through of lower taxation from more rapid depreciation rates by resetting depreciation streams from previous investments.

Clearly, since the investments have already been incurred, this would not disturb the productivity gains they might bring.

At first glance, this would offer an opportunity for consumer gains both through a pass through of the tax savings and the increased productivity the investment brought. The latter would be captured in the X-factor under CPI-X price setting. However, the approach would be retrospective action on the part of the authorities. Such actions destroy incentives for future capital expenditure and bring about a reactive low-productivity industry. It would be particularly harmful where, as in the Victorian industry, firms have been sold on the basis of expectations that previous decisions would not be disturbed and that any changes would not be discriminatory.

Concluding Comments

It would, in principle, be possible for the regulator to ensure an optimal level of spending and service by the firms in the regulated industry. This would entail control of the nature and timing of all investment, and O&M expenditures. It would, in short, require the regulator to control the industry. Such an outcome is precisely what the present regulatory arrangements – whether or not we call them ‘light handed’ – seek to avoid.

The regulators’ approach should avoid overriding private sector incentives to invest and operate efficiently but instead make use of those incentives. Is means the regulators should accept the general laws on taxation and other matters, seek to ensure firms do not have incentives to “gold plate” by being rewarded by an excessive and seek to extract the consumer benefits in the same way that commercial rivalry forces their extraction and transfer to consumers in competitive markets.

Revenue and profit controls presently being used by regulators are a far cry from the CPI-X approach that governments’ intended to apply. Nonetheless, the regulators’ remain wedded to the notion that incentives to the providers need to be in place if efficient outcomes are to emerge. Deciding that generally available taxation provisions should not apply to the regulated industry means a substitution of the private sector’s decision making by the regulator.