The corporate tax allowance for Seqwater

Report for Seqwater | 31 January 2022

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1 Overview and executive summary

1. On 7 December 2021, the QCA released a Draft Report in relation to its investigation into Seqwater's bulk water prices for 2022-2026.[1]

2. Frontier Economics has been engaged to provide a response in relation to the QCA's assessment of the regulatory allowance for corporate tax.

3. We first establish that, as a general principle, a corporate tax allowance should be made in relation to all revenues that are subject to corporate tax (rather than a subset of the allowed revenues). This includes allowed revenues for the purpose of recovering the principal balance of the price path debt.

4. Another general principle is that Seqwater's actual reported statutory tax losses are irrelevant. This core principle—that regulatory allowances should, in general, be set with respect the costs that are expected to be incurred by a benchmark efficient business—is accepted by all economic regulators in Australia, and has been the bedrock of the QCA's own regulatory framework. What is relevant are Seqwater's *regulatory* tax losses – the tax losses that arise in the regulatory model for each year.

5. As we understand the Draft Decision, the QCA does not dispute the point that all allowed revenues, including revenues provided for the purpose of repaying price path debt, are taxable. Rather, our understanding of the QCA's position is that:

   a During the early years of the price path debt period, the allowed revenues were less than the MAR giving rise to tax losses as the price path debt balance increased; and

   b During the later years of the price path debt period, the allowed revenues will be higher than the MAR giving rise to higher taxes payable as the price path debt is paid down; and

   c There would be a windfall gain to Seqwater if an allowance for additional taxes was made in relation to (b) above while not having regard to all of the tax losses created in relation to (a) above.

6. We agree that there must be consistent and symmetric treatment applied to:

   a The accumulation of the price path debt and the tax losses associated with that phase; and

   b The repayment of the price path debt and the tax payments associated with that phase.

7. There would seem to be two possible internally-consistent approaches to regulatory tax available to the QCA:

   a Include the tax effects from both phases of the price path debt mechanism so that:

      i Tax losses are recorded for the first phase of under-recovery where the price path debt is being accumulated; and

      ii Tax payable is computed for the second phase of over-recovery where the price path debt is being paid down; and

[1] QCA, November 2021, *Draft Report: Seqwater bulk water price review*.

   iii The tax losses from the first phase are used to offset the tax payable in the second phase; or

 b Omit tax effects from both phases so that there is no tax allowance for revenue provided for the purpose of paying down price path debt in the second phase, on the basis of an assumption that an equivalent quantum of tax losses would have been created during the first phase.

8. We note the rationale for the first approach in the body of this report. However, we note that the Draft Decision purports to adopt the second approach.

9. We also note that the second approach appears to be inconsistent with the QCA's regulatory model, which seems to embed the double-counting of regulatory tax losses from the 2014 to 2022 period. Specifically, the approach that is adopted in the QCA's regulatory model for the Draft Decision:

   a Provides no tax allowance in relation to revenue provided for the purpose of paying down price path debt in the second phase; but then

   b Makes a deduction for regulatory tax losses incurred from the first phase of the price path debt mechanism over the 2014-2022 period.

10. The total accumulated tax loss that is carried forward into the 2022-26 regulatory period is $363.4 million. This amount appears to have been double counted in that:

   a It is part of the total tax loss that is the basis for excluding price path debt revenues from the corporate tax calculation; and

   b It is used a second time as a deduction to the MAR allowance.

11. It cannot be the case that the same $363.4 million is used to offset the tax allowance on revenue provided in relation to price path debt *and also* to offset the tax allowance for the MAR.

12. If the second approach is to be adopted, the $363.4 million of accumulated regulatory tax losses that is carried forward into the 2022-26 regulatory period should be used only once. If it is used as part of the rationale for applying no tax gross-up to revenue provided in relation to the price path debt, it should not be used a second time as a deduction to the MAR allowance.

2 Should the corporate tax allowance apply to all taxable revenue?

13. The QCA provides two streams of revenue allowances to Seqwater:

    a The Maximum Allowable Revenue (MAR) that is designed to be sufficient to provide for operating costs and a return on and of capital, in each regulatory period, under the standard regulatory building block framework; and

    b An additional stream of revenues to cover interest and capital repayments in relation to the 'price path debt.'

14. There appears to be general agreement that a standard regulatory corporate tax allowance should be made in relation to the MAR allowance. In this regard, the QCA notes that:

> *Tax liabilities, including tax equivalent payment liabilities, are legitimate costs that should be recovered through bulk water charges.*
>
> *Our aim is to provide a tax allowance that reflects the efficient costs of a firm meeting its tax obligations, based on the cost and revenue allowances we provide.*[2]

15. There also appears to be general agreement that a corporate tax allowance is not relevant to allowances provided for the purpose of interest payments on price path debt. Such payments are taxable as revenue and then are used to make a tax-deductible payment, so there is no net tax implication. That is, because taxable income is zero for these payments, the tax allowance would be zero in any event.

16. Thus, the point of disagreement is whether a corporate tax allowance should be made in relation to revenue provided to allow Seqwater to pay down the principal balance in relation to price path debt. The revenues provided for this purpose will be taxable – in the same way that all allowed revenues are taxable. But a repayment of principal is not tax deductible.

17. In our earlier report for Seqwater,[3] we noted that:

> *The revenue allowance in relation to the repayment of principal would presumably be taxable and a tax allowance should therefore be made in relation to it. For example, if the QCA determined that Price Path Debt should be reduced by $100, its regulatory allowance should be set to $143, such that the required $100 would be available after the payment of corporate tax.* [4]

18. Thus, if the intention is for Seqwater to repay $100 of principal in relation to the price path debt, the regulatory allowance must be $143. That allowance would be taxed in its entirety as revenue because the repayment of principal does not give rise to a tax deduction. Hence, the $143 of allowed revenue would give rise to a tax liability of $43, leaving the required $100 to reduce the principal balance.

[2] QCA, November 2021, *Draft Report: Seqwater bulk water price review*, p.77.

[3] Frontier Economics, 17 June 2021, *Regulatory corporate tax allowance*.

[4] Frontier Economics, 17 June 2021, *Regulatory corporate tax allowance*, p. 13.

19. If the revenue allowance was only $100, tax of $30 would be payable leaving only $70 to reduce the principal of the price path debt.

20. Consequently, as a general principle, a corporate tax allowance should be made in relation to revenues allowed for the purpose of making price path debt principal repayments.

21. As we understand the Draft Decision, the QCA does not dispute the point that all allowed revenues, including revenues provided for the purpose of repaying price path debt, are taxable. Rather, our understanding of the QCA's position is that:

    a During the early years of the price path debt period, the allowed revenues were less than the MAR giving rise to tax losses as the price path debt balance increased; and

    b During the later years of the price path debt period, the allowed revenues will be higher than the MAR giving rise to higher taxes payable as the price path debt is paid down; and

    c There would be a windfall gain to Seqwater if an allowance for additional taxes was made in relation to (b) above while having no regard to the tax losses created in relation to (a) above.

22. In this regard, the Draft Decision states:

> *If we adopted an approach based on forecast revenue, we would need to offset taxable income in the later years of the price path by tax losses generated in the early years. Otherwise, the tax allowance would be inefficiently high because it would not reflect Seqwater's ability to offset higher taxable income in the debt repayment phase by tax losses accrued in the debt accumulation phase.* [5]

23. We agree that there must be consistent and symmetric treatment applied to:

    a The accumulation of the price path debt and the tax losses associated with that phase; and

    b The repayment of the price path debt and the tax payments associated with that phase.

24. However, we explain in the subsequent section that the Draft Decision does *not* apply consistent and symmetric treatment to each phase. Rather, it reduces allowed revenues in relation to tax losses generated during the first phase without having regard to the tax payments associated with the second phase.

[5] QCA, November 2021, Draft Report: Seqwater bulk water price review, p.78.

3 The proposed treatment of historical tax losses

3.1 Tax losses within the regulatory framework

25. Within the Australian regulatory framework, the standard approach is for the regulator to keep track of any regulatory tax losses within the regulatory model. Those regulatory tax losses are then used to offset any future regulatory tax allowances. This process is usually straightforward as it flows directly from the regulatory building block model for each year.

26. Within this context, it is important to note that actual or statutory tax losses reported by the regulated business are irrelevant. We agree with the QCA's assessment of this point, as set out in the Seqwater Draft Report:

> *It would not be appropriate to use Seqwater's actual or reported tax losses, because our aim is to determine an efficient tax allowance, not to reflect a firm's actual tax costs.* [6]

27. The Draft Report goes on to note that:

> *Practically, it would also be difficult to isolate losses generated from selling bulk water from losses generated from Seqwater's other activities, as well as to identify any tax impacts resulting from restructuring the bulk water sector, including changes in asset ownership.* [7]

28. We agree that no use can be, or should be, made of information about Seqwater's actual or reported tax losses. Rather, what is required is information about the corporate tax position within the regulatory framework. The standard regulatory practice is to use tax losses that arise *within the regulatory model* to offset future tax payments *within the regulatory model*. That is, *regulatory* tax losses are used to offset *regulatory* tax allowances.

29. Thus, the standard regulatory approach to tax is to record all regulatory tax losses as they occur and to use them to offset tax allowances on allowed revenues – all within the regulatory model.

3.2 The 'missing' historical regulatory tax losses

30. The Draft Decision states that the QCA has an incomplete record of historical regulatory tax losses. The QCA's regulatory model records tax losses only back to 2014/15, whereas the price path debt accumulation (and potential tax losses associated with that) began in 2008. Thus, the QCA's regulatory model is said to be 'missing' tax losses pertaining to the 2008 to 2013 period. In this regard, the Draft Decision states that:

> *A standard regulatory tax calculation would reflect forecast revenue. It is not possible to adopt the standard approach in this specific instance, because we do not have access to the extensive data required to estimate tax losses accrued in the early years of the price path (2008 to 2013).* [8]

[6] QCA, November 2021, Draft Report: Seqwater bulk water price review, p.79.

[7] QCA, November 2021, Draft Report: Seqwater bulk water price review, p.79.

[8] QCA, November 2021, Draft Report: Seqwater bulk water price review, p.78.

31. The Draft Decision also notes that the approach of having no regard to tax losses that might have been accumulated over the 2008 to 2013 period:

> *would deliver a windfall gain, because Seqwater would keep the benefit of tax losses accrued from 2008 to 2013, instead of using those losses to reduce high taxable income in the price path debt repayment phase.* [9]

32. That is, the QCA's regulatory model for Seqwater contains a record of regulatory tax losses only for the post-2013 period, as shown in **Figure 1** below.

Figure 1: Regulatory tax losses for Seqwater

	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22
Tax calculation											
Income				$822.8m	$830.8m	$808.5m	$801.2m	$852.2m	$1,058.4m	$595.7m	$852.5m
less Opex				$224.7m	$222.3m	$229.9m	$230.6m	$228.2m	$234.1m	$242.6m	$248.3m
less Tax depreciation				$211.0m	$213.5m	$216.8m	$220.2m	$222.9m	$226.4m	$227.8m	$227.4m
less Interest shield				$522.2m	$527.0m	$513.9m	$485.0m	$290.3m	$252.2m	$245.8m	$247.3m
less Accumulated tax losses				$275.0m	$410.2m	$542.1m	$694.2m	$828.9m	$718.1m	$372.4m	$492.9m
Taxable income				**($410.2m)**	**($542.1m)**	**($694.2m)**	**($828.9m)**	**($718.1m)**	**($372.4m)**	**($492.9m)**	**($363.4m)**

Source: QCA regulatory model for Seqwater, ***Price path*** *tab.*

33. The tax losses in **Figure 1** above result from the design of the price path debt mechanism. In particular, in the first phase of the mechanism (through to 2020/21) the price path debt balance is increasing as allowed revenues are insufficient to cover MAR and debt interest costs, as shown in **Figure 2** below.

Figure 2: Source of regulatory tax losses for Seqwater

	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22
Price path debt (historic)											
Balance 01/07				$1,927.7m	$2,126.7m	$2,311.8m	$2,415.9m	$2,482.6m	$2,530.3m	$2,732.3m	$2,438.9m
MAR (post-tax)				$822.8m	$830.8m	$808.5m	$801.2m	$852.2m	$1,058.4m	$595.7m	$852.5m
Revenue				$736.3m	$766.8m	$829.6m	$856.5m	$931.3m	$990.0m	$1,018.0m	$1,085.0m
Debt increments				$88.9m	$65.8m	($21.7m)	($56.7m)	($79.2m)	$73.7m	($430.5m)	($236.4m)
Debt interest cost				$110.1m	$119.3m	$125.8m	$123.5m	$126.9m	$128.3m	$137.2m	$125.6m
Balance 30/06				$2,126.7m	$2,311.8m	$2,415.9m	$2,482.6m	$2,530.3m	$2,732.3m	$2,438.9m	$2,328.1m

Source: QCA regulatory model for Seqwater, ***Price path*** *tab.*

34. In its Draft Decision, the QCA notes that implementation of the standard regulatory approach:

> *would require extensive data to estimate tax losses accrued before 2013. This would include establishing a RAB and tax asset base at the start of the price path in 2008, even though we were asked to accept the RAB as at 1 July 2013 (as advised by government) for the 2015 review.* [10]

35. That is, the QCA's regulatory models do not record regulatory tax losses for the 2008-2013 period, but they do record all subsequent regulatory tax losses.

3.3 What to do about the 'missing' regulatory tax losses

36. The Draft Decision indicates that it is not feasible to go back and re-create regulatory models from 2008 to 2013 to compute what the regulatory tax allowances would have been if they had been

[9] QCA, November 2021, Draft Report: Seqwater bulk water price review, p.78.

[10] QCA, November 2021, Draft Report: Seqwater bulk water price review, p.78.

recorded for that period – because this would be a complex task and the required information may not be available. [11]

37. Consequently, there would seem to be two possible approaches to regulatory tax available to the QCA:

    a Include the tax effects from both phases of the price path debt mechanism so that:

        i Tax losses are recorded for the first phase of under-recovery where the price path debt is being accumulated; and

        ii Tax payable is computed for the second phase of over-recovery where the price path debt is being paid down; and

        iii The tax losses from the first phase are used to offset the tax payable in the second phase; or

    b Omit tax effects from both phases so that there is no tax allowance for revenue provided for the purpose of paying down price path debt in the second phase, on the basis of an assumption that an equivalent quantum of tax losses would have been created during the first phase.

38. The rationale for the first approach, which has been rejected in the Draft Decision, is that:

    a The revenues allowed for the purpose of paying down the price path debt are, as a matter of fact, subject to tax; and

    b Those tax payments can be offset using the regulatory tax losses that are available.

39. The Draft Decision implies that this approach would result in a windfall gain to Seqwater because it omits any regulatory tax losses that might have been accumulated in the 2008-2013 period. However:

    a The QCA's regulatory model includes $275 million of carried forward regulatory tax losses into the 2014/15 period. It is unclear what this figure represents, if not the balance of regulatory tax losses at the end of the 2008-2013 period; and

    b The Draft Decision notes that "we were asked to accept the RAB as at 1 July 2013 (as advised by government) for the 2015 review,"[12] in which case it is unclear whether there is a role for the QCA in going back to re-create a different set of figures for an earlier period.

40. This approach would be implemented by simply changing the QCA's current regulatory model to recognise that total revenue is subject to tax (the current version of the regulatory model applies a tax gross-up to MAR only).

41. The rationale for the second approach, which has apparently been adopted in the Draft Decision, is the assumption that the regulatory tax losses pertaining to the creation of the price path debt would be just sufficient to offset the taxes payable on the revenue provided to pay down the price path debt.

42. However, that approach appears to be inconsistent with the QCA's regulatory model. Specifically, the QCA's regulatory model provides no corporate tax 'gross-up' to revenues provided in relation to price path debt. The implicit assumption seems to be that the tax that would be due on these

[11] QCA, November 2021, Draft Report: Seqwater bulk water price review, p.78.

[12] QCA, November 2021, Draft Report: Seqwater bulk water price review, p.78.

allowed revenues could be offset against regulatory tax losses that would have been accumulated in the earlier phase of the price path debt period, beginning in 2008.

43. This is apparent from the fact that the tax calculation in the regulatory model includes only the MAR as taxable revenue. It does not include total revenue, which is the sum of the MAR and revenues allowed in relation to price path debt.

44. But this approach would appear to embed the double-counting of regulatory tax losses from the 2014 to 2022 period. Specifically, the approach that is adopted in the QCA's regulatory model for the Draft Decision:

    a Provides no tax allowance in relation to revenue provided for the purpose of paying down price path debt in the second phase; but then

    b Makes a deduction for regulatory tax losses incurred from the first phase of the price path debt mechanism over the 2014-2022 period.

45. The total accumulated tax loss that is carried forward into the 2022-26 regulatory period is $363.4 million. This amount appears to have been double counted in that:

    a It is part of the total tax loss that is the basis for excluding price path debt revenues from the corporate tax calculation; and

    b It is used a second time as a deduction to the MAR allowance.

46. It cannot be the case that the same $363.4 million is used to offset the tax allowance on revenue provided in relation to price path debt *and also* to offset the tax allowance for the MAR.

3.4 Recommended approach

47. In our view, there are two internally-consistent approaches to corporate tax allowances for Seqwater:

    a Include the tax effects from both phases of the price path debt mechanism so that:

        i Tax losses are recorded for the first phase of under-recovery where the price path debt is being accumulated; and

        ii Tax payable is computed for the second phase of over-recovery where the price path debt is being paid down; and

        iii The tax losses from the first phase are used to offset the tax payable in the second phase; or

    b Omit tax effects from both phases so that there is no tax allowance for revenue provided for the purpose of paying down price path debt in the second phase, on the basis of an assumption that an equivalent quantum of tax losses would have been created during the first phase.

48. If the second approach is to be adopted, the $363.4 million of accumulated regulatory tax losses that is carried forward into the 2022-26 regulatory period should be used only once. If it is used as part of the rationale for applying no tax gross-up to revenue provided in relation to the price path debt, it should not be used a second time as a deduction to the MAR allowance.

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