



Resource Sector Regulation
Productivity Commission
Locked Bag 2 530 Collins St
East Melbourne VIC 8003
Australia

Resources Sector Regulation

1 November 2019

Dear Ms Gropp,

Aurizon Network welcomes the opportunity to respond to the Productivity Commission's (**the Commission**) Issues Paper on the Resources Sector Regulation. Our submission relates primarily to the tax treatment of capital contributions and gifted assets which may impact on business investment in the resources sector.

The Issues Paper, among other matters, also seeks participants insights into other factors that may represent a material impediment to investment, including the provision of on large-scale, shared infrastructure, such as electricity distribution networks, railway lines and ports.

Aurizon Network considers that the current tax treatment of capital contributions and gifted assets can affect the financing arrangements for these types of infrastructure investments that are necessary to support the development of resource projects.

What is the Problem?

Third Party Funding¹ of Major Lineal Assets² does not currently result in comparable tax treatment for the Third Party Funder compared to the Owner/Operator funding the same assets (**Tax Neutrality**³). This is because when an asset is funded by a third party:

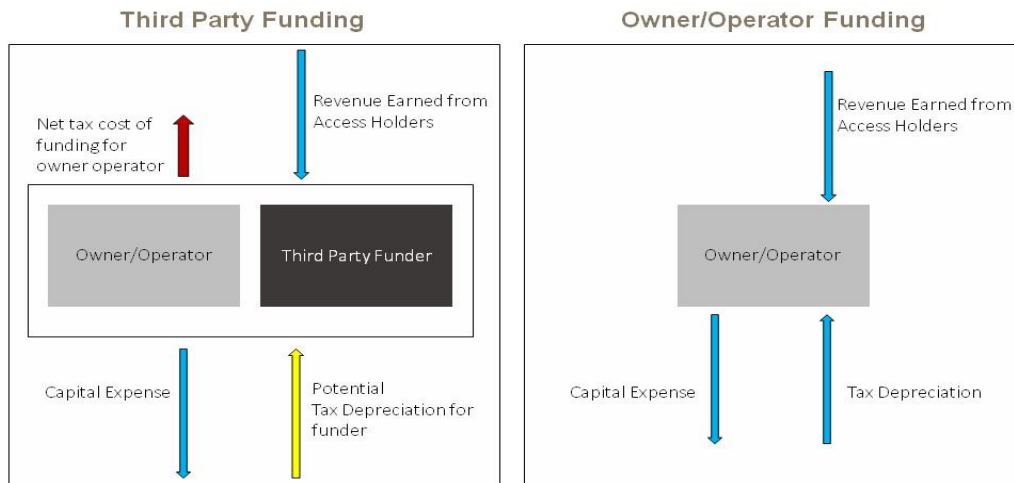
¹ **Third Party Funding** is where one party funds assets which are to be owned and operated by a different party. In Aurizon's case this occurs where a mine or other third party funds an expansion to the CQCN

² **Major Lineal Assets** are assets which are substantial, span long distances and do not have great width – for example roads, railways, pipelines, telecommunications cables and power distribution systems. In Aurizon's case the CQCN is a Major Lineal Asset.

³ **Tax Neutrality** is where two parties have comparatively the same tax outcomes when either funds a given asset.

- the Owner/Operator is assessed upfront on the contribution received and is only able to claim tax depreciation on the constructed asset over the life of the asset resulting in a negative net present value impact for the transaction; and
- the Third Party Funder may not always obtain a tax depreciation benefit for its funding cost – potentially resulting in an additional cost to the transaction.

Third Party Funding Diagram



This lack of Tax Neutrality represents a significant impediment to such Third Party Funding and, thus, can act as a brake on investment in necessary infrastructure, with consequential negative impacts on the timing and cost of resource project investments.

Why is third party funding required?

Major Lineal Assets are key infrastructure assets which are generally natural monopolies and are not able to be duplicated in an economic manner. Broadly, the competition regimes regulate the pricing, terms and conditions under which the existing infrastructure assets are owned and operated and require asset owners to expand the assets (**Expansions**) (except in limited circumstances)⁴ to facilitate growth and competition.

Due to the nature of Major Lineal Assets, Expansions are capital intensive and are generally integrated with existing assets, preventing separation of ownership or operation from the existing assets. For example, an Expansion to a railway network may include duplicating part of the track to enable trains to pass or strengthening existing bridges to carry longer and heavier trains. Further, significant Expansions are generally driven by demand from users of the assets (rather than the owner or operator) and are required to be completed in conjunction with other developments. For example, telecommunications systems and power distribution systems may need to be expanded at a certain time due to an expected increase in demand resulting from the construction or expansion of a mine or port.

⁴ See Appendix B for a summary of Extension provisions within Australian Access Regulation.

The owner and operator of a Major Lineal Asset (whether regulated or not) has the ability to determine whether they expand the asset (including whether or not to fund the Expansion)⁵. The owner and operator of a Major Lineal Asset may choose not to fund an Expansion due to:

- having insufficient funds available⁶;
- having more attractive options for use of available funds (particularly where the return is regulated under a competition regime); or
- not finding the business case for investment attractive (particularly where the return is regulated under a competition regime).

Accordingly, it is necessary to have an effective mechanism for enabling third parties to fund an Expansion to Major Lineal Assets to facilitate resource projects in circumstances where an Owner/Operator does not fund⁷.

What is the tax issue with Third Party Funding?

There are two key elements to achieving Tax Neutrality in the funding of Major Lineal Assets:

1. Treatment of funding contributions by Owner/Operators; and
2. Treatment of funding contributions by Third Party Funders.

Treatment of capital contributions by Owner/Operators

Currently, funding contributions by Third Party Funders are treated as assessable revenue in the income year the contribution is received by the Owner/Operator and subject to tax at the relevant rate. The Owner/Operator is able to claim a tax deduction for the cost of the construction of the Expansion over time.

Instead, these funding contributions should not be treated as income for the Owner/Operator and the Owner/Operator should not be entitled to a tax deduction for the cost of the construction of the Expansion. In this way, the contribution should be tax neutral for the Owner/Operator.

Treatment of funding contributions by Third Party Funders

Currently, funding contributions by Third Party Funders to an Owner/Operator are treated in varying manners under the tax law (depending on the circumstances) and may in some circumstances not give rise to any tax deduction entitlement for the Third Party Funder.

Instead, the Third Party Funder should be entitled to a tax deduction for the cost of the construction of the Expansion, in the same way an Owner/Operator would be entitled to tax

⁵ Despite the requirement by competition regimes to expand Major Lineal Assets, the competition regimes recognise an Owner/Operator cannot be required to fund such an expansion

⁶ This position has been acknowledged by the Infrastructure Finance Working Group of Infrastructure Australia in 2012, which recommended Australia “embrace bold reforms to find new opportunities to fund projects - and efficient finance - to support an enlarged program of infrastructure delivery.”

⁷ For regulated entities, there is generally a requirement that Owner/Operators enable third parties to fund an Expansion to their Major Lineal Asset.

depreciation if it had funded the Expansion itself. In this way, the Third Party Funder would also be Tax Neutral.

Following changes in tax law on this basis, the funding transaction would effectively be ignored for tax purposes and the Third Party Funder would effectively be treated for tax purposes as if it owned the Expansion.

Impacts on Resource Projects

On balance, the tax inefficiency from capital contributions for minor capital works is unlikely to have a material impact on business investment in the resources sector. However, the current tax treatment could add additional upfront costs up to 43% of the project value. This has a significant impact on major capital contribution funding arrangements and would adversely affect a proponent's ability and willingness to develop a resource project in the required timeframe, if at all.

Aurizon Network notes that the Resources Sector's concerns on the barriers to developing new infrastructure was identified in the Chamber of Minerals and Energy of Western Australia submission to the Commission on its Public Infrastructure inquiry:

The taxation treatment of gifted assets creates a barrier to developing new infrastructure. In a number of cases resources sector companies have financed infrastructure improvements however, when gifting the asset to the state, companies are required to contribute beyond the cost of the asset in order to cover intra-government tax cash flows. Capital contributions or gifted assets from resources sector companies creates a taxable income for the recipient of that asset equivalent to the arms length value of any monetary or non-monetary consideration, which is usually assessable at the time of receipt⁸.

Correcting this situation to provide for tax neutrality would remove this impediment and should enable greater investment in infrastructure and resource projects. Aurizon Network recommends that the Inquiry Report include a recommendation to remove the tax inefficiencies in the user funding of major public and private infrastructure.

Should you have any questions in relation to our submission, please contact Alison Feather, Manager Group Tax, by email at Alison.Feather@aurizon.com.au.

Kind regards,



Loretta Lynch
Head of Finance and Regulation
Aurizon Network

⁸ PWC (2014) Investment in Resources Sector Infrastructure, A Report for the Chamber of Minerals and Energy of Western Australia, January, Submitted as Attachment A to Submission No: 36 to Productivity Commission Inquiry into Public Infrastructure.

Extension Provisions in Access Regulation

A number of access regimes and economic regulatory models include the option or requirement for a customer of the service to make a capital contribution towards the extension of the facility. Many of these regimes and models are relevant to the expansion of capacity to support resource projects.

Under various access regimes the regulator is empowered to make an enforceable and binding determination requiring the service provider to extend the facility (both linearly and capacity) provided the service provider does not bear any costs of that extension. The rationale for these powers is summarised by the Productivity Commission in its Inquiry into the National Access Regime:

The economic rationale for the ACCC's powers to direct extensions is to prevent service providers undermining the objective of the regime by deliberately delaying infrastructure investment, or constructing facilities with suboptimal capacity, to limit competition and extract monopoly rents⁹.

The Productivity Commission also recognised that these powers are very strong and it is appropriate that safe guards are in place to protect the legitimate business interests of the service provider noting that:

Regulatory risk associated with access regulation could impede efficient investment in infrastructure facilities. Infrastructure developments typically involve large, sunk and lumpy capital investments and a requirement to extend a facility could pose a significant risk for prospective infrastructure developers. Appropriate safeguards are therefore needed to protect the infrastructure service provider's legitimate business interests, reduce risks and preserve investment incentives¹⁰.

This appendix summarises the relevant arrangements within a sample of regulatory framework where these provisions are enshrined.

National Access Regime

The National Access Regime (**NAR**) is contained in Part IIIA of the *Competition and Consumer Act 2010 (Cwth)* (**CCA**). The regime applies to essential facilities which have been subject to declaration and an obligation to negotiate third party access to their facilities.

⁹ Productivity Commission (2013) *National Access Regime*, Inquiry Report no. 66, Canberra, p 129

¹⁰ *Ibid.* p. 131

In the event of arbitration of a dispute between the service provider and an access seeker regarding the terms of access the Australian Competition and Consumer Commission (**ACCC**) may, under clause 44V(2), make a determination which:

- requires the provider to extend the facility

However, clause 44W(1) requires that the determination must not have the effect of:

- resulting in the third party becoming the owner (or one of the owners) of any part of the facility, or of extensions of the facility, without the consent of the provider; or
- requiring the provider to bear some or all of the costs of extending the facility or maintaining extensions of the facility.

National Electricity Rules

The regulatory framework governing the achievement of the objectives of the National Electricity Market includes provision for a person wishing to connect to a declared network making a capital contribution to the augmentation of that network. This is evident in clause 50E(3) of the *National Electricity (South Australia) Act 1996* which requires that if

- a person to whom this section applies (the applicant) wants to connect to a declared shared network; but
 - *the fault levels at the proposed connection point would, if the connection were allowed, be likely to exceed the limits fixed under the Rules; then*
 - *AEMO may, as a condition of entering into a connection agreement with the applicant, require the applicant to make a contribution to the cost of carrying out the augmentation to the declared shared network necessary to reduce fault levels to an acceptable level.*

Similarly, clause 6.21.2 of the National Electricity Rules allows for:

- *the Distribution Network Service Provider may receive a capital contribution, prepayment and/or financial guarantee up to the provider's future revenue related to the provision of direct control services for any new assets installed as part of a new connection or modification to an existing connection, including any augmentation to the distribution network*

Comparable arrangements are also contained within clause 6A.28.2 for Transmission Network Service Providers.

These provisions are usually given effect through a Capital Contributions Policy approved by the regulator. These policies may include a requirement that the customer provide additional compensation to the service provider for any additional tax liability as show in the following extract from the approved policy for Western Power.

- *The receipt by Western Power of a contribution may result in Western Power incurring a tax liability (whether under Commonwealth or State income tax and other legislation or under a tax equivalent regime applicable to Western Power as*

a government owned enterprise) and Western Power may recover from the applicant, as part of the contribution payable by the applicant, Western Power's forecast of the net tax liability it will incur as a result of the receipt of such contribution

Alternatively, the service provider incurs the upfront tax liability with recovery included in the tax asset base used to derive the annual allowable revenue.

National Gas Rules

The National Gas Rules also includes various obligations and restrictions that potentially result in access seeker being required to fund expansions of pipeline capacity. In this regard, clause 104(5) states;

- *The extension and expansion requirements cannot require the service provider to provide funds for work involved in making an extension or expansion unless the service provider agrees.*

Furthermore, in the event of an access dispute, section 118 of the rules allow for an access determination to

- *require the service provider to carry out an expansion of the capacity of the access dispute pipeline*

However, in respect of that determination:

- *the service provider cannot be required to carry out an expansion of the capacity of a light regulation pipeline unless the prospective user funds the capacity expansion in its entirety; and*
- *the service provider cannot be required to fund, in whole or part, an expansion of the capacity of a full regulation pipeline unless the extension and expansion requirements of the applicable access arrangement provide for the relevant funding;*

AustralAsia Railway (Third Party Access) Code

The AustralAsia Railway (Third Party Access) Code covers the facilities necessary for the operation of the railway from Tarcoola to Darwin. The access regime is certified as an effective regime for the purpose of the Competition Principles Agreement.

The access regime establishes the right to negotiate access to use the railway infrastructure between Tarcoola and Darwin. It sets out the rights and responsibilities of both access seekers and the infrastructure owner, covering matters such as terms and conditions of access, the negotiation process, and dispute resolution.

The dispute resolution procedures provide for a commercial arbitrator may, under clause 19(2) make an award which:

- *require the access provider to extend the railway infrastructure facilities*

However, clause 20(1) does not allow the arbitrator to make an award which would:

- *have the effect of requiring the access provider to bear any of the capital cost of any addition or extension to the railway infrastructure facilities, unless the access provider agrees.*

Queensland Rail Access Regime

The Queensland Rail access regime is contained in Part 5 of the *Queensland Competition Authority Act 1997 (Qld)*. The regime was certified as effective for the purpose of the Competition Principles Agreement in 2010. The regime includes a negotiate-arbitrate model where the Queensland Competition Authority (**QCA**) may make a determination in the arbitration of a dispute under clause 118(1) which may include:

- *require the access provider to extend, or permit the extension of, the facility*

However, clause 119(2) precludes the QCA from making an access determination which would have the effect of:

- *resulting in the access seeker, or someone else, becoming the owner, or 1 of the owners, of the facility, without the existing owner's agreement; or*
- *requiring an access provider to pay some or all of the costs of extending the facility.*

South Australian Rail Access Regime

The South Australian Rail Access Regime is embodied in the *Railways Operations and Access Act 1997 (SA)*. The regime is a negotiate arbitrate model with commercial arbitration. In making an award, clause 52(1) requires that arbitrator cannot:

- *make an award that would have the effect of requiring the operator to bear any of the capital cost of any addition or extension to railway infrastructure unless the operator agrees*