

ATTA Paper: The Effectiveness of the National Tax Equivalent Regime (NTER) in Encouraging Competitive Neutrality

This paper is based on a PhD I am currently studying through Curtin University. The following are extracts of my research so far.

The National Tax Equivalent Regime (NTER) is an administrative intergovernmental arrangement under which, for competitive neutrality purposes, the Federal income tax laws are notionally applied to selected government business entities owned by the State and Territories. This regime seeks to notionally apply the tax laws to those entities as though they were subject to income tax. The resulting NTER tax is a liability owed and paid by these entities directly to their Owner State and Territory Governments – it does not form part of the actual Federal income tax base as it does for privately owned companies. Apart from some specific modifications, NTER entities have the same tax obligations as their federal counterparts. This paper will briefly explore why these government owned entities are subject to tax when, essentially, the result of the structure of the NTER and government is that they pay tax and a dividend to their shareholder.

The National Competition Policy and Competitive Neutrality

Competition policy plays a substantial role in encouraging efficiency.¹ The need for a national competition policy arose because government owned entities have advantages over their privately owned counterparts. These advantages include exemptions from taxation and charges; government guarantee on debts; lower interest rates on loans; and no requirement to achieve a commercial rate of return.² Further advantages of government ownership include cross-subsidisation, protection from bankruptcy, and favourable regulatory conditions.³

Where a government-owned entity has a net advantage, it is able to set its prices below private sector rivals, even though it is not necessarily more efficient than those entities.⁴ This main advantage that public sector entities have over private sector entities might lead them to be able to undercut private sector entities, and possibly put a barrier to entry for potential competitors.⁵ In other words, the government owned entity is able to use the advantages by virtue of its ownership to be able to price out privately owned entities that may have, in effect, been more efficient than the entity in question.

However, there are also disadvantages associated with being a government owned entity. These disadvantages include greater accountability obligations; requirements to provide various community service obligations; and a greater superannuation

¹ Philip Clarke and Stephen Corones, *Competition Law and Policy: Cases & Materials* (Oxford University Press, 2nd Edn, 2005) 14.

² National Competition Council, *National Competition Policy*, (1993) 296.

³ Zahirul Hoque and Jodie Moll, 'Public sector reform: Implications for accounting, accountability and performance of state-owned entities – an Australian perspective' (2001) 14(4) *The International Journal of Public Sector Management* 304, 310.

⁴ National Competition Council, *National Competition Policy*, (1993) 297.

⁵ The Treasury, *Australian Government National Competition Policy Report 2005-07*, (2007) 46.

expense.⁶ Further disadvantages of government ownership include government control over employee matters (including wages and industrial matters) and the management and running of the organisation.⁷

The Organisation for Economic Co-operation and Development (OECD) recommends that the best way to implement a competitive neutrality framework is by starting with an evaluation of current legislation and administration in which the state-owned entities operate, and then to make changes that will attempt to have those entities operating in the same legislative and administrative environment as privately owned entities. This is important in order to be able to compare the costs of the public and private sectors.⁸

The principle of competitive neutrality therefore requires that: “government owned businesses competing with private sector businesses should compete on the same footing: business activities of government owned bodies should not enjoy any net competitive advantage simply as a result of their public sector ownership.”⁹ This includes making both government owned business and privately owned entities subject to the same taxation and regulatory regimes.

There will be times when tax neutrality is either not an option or not achievable. In these circumstances, the OECD recommends using the before and after tax rate of return targets.¹⁰ Using an after tax rate of return on assets will give state owned corporations an advantage. This is because an after tax rate of return will include an inbuilt allowance for tax liabilities. Where a government owned corporation pays no tax, this tax allowance will give that corporation an advantage over its privately owned counterparts since the government owned corporations receives an allowance for tax that it has not paid and is not liable to pay. However, if a before tax rate of return is used to determine prices, both privately owned and publicly owned corporations are put on the same level playing field because a before tax rate of return does not allow a state owned corporation to set prices lower than privately owned corporations as a result of a tax allowance it does not and is not liable to pay.¹¹

The Hilmer Report and the Background of the National Competition Policy

In October 1992, Paul Keating, the then Prime Minister formed a Committee of Inquiry whose task it was to formulate a national competition policy. Headed by Professor Frederick Hilmer, *The National Competition Policy* (‘The Hilmer Report’)

⁶ National Competition Council, *National Competition Policy*, (1993) 297.

⁷ Zahirul Hoque and Jodie Moll, ‘Public sector reform: Implications for accounting, accountability and performance of state-owned entities – an Australian perspective’ (2001) 14(4) *The International Journal of Public Sector Management* 304, 310.

⁸ OECD, *State owned enterprises and the principle of competitive neutrality*, (2009) 326.

⁹ Department of Treasury and Finance (Vic), *Guide to National Competition Policy*, (n.d.) 3.

¹⁰ OECD, *Competitive neutrality: Maintaining a level playing field between public and private business*, (2012) 79.

¹¹ OECD, *Competitive neutrality: Maintaining a level playing field between public and private business*, (2012) 79.

was released in 1993.¹² The policy sought to implement a consistent national approach to encourage greater competition in the Australian economy. One of the ways it sought to do this was by the removal of any competitive advantage government owned businesses might have by the way of tax advantages (among a number of other things).¹³

The Hilmer Report (1993) made recommendations regarding the implementation of a national competition policy in Australia. At the time, it was hoped that the removal of any net advantages enjoyed by government businesses, and the creation of a level playing field would result in a fair market environment and improved efficiency and productivity.¹⁴

Tax Neutrality in Australia

Under the Australian Competitive Neutrality Guidelines, there are three methods of achieving tax neutrality in Australia. The first involves the government business paying actual tax. Many government owned businesses are already separate legal entities which pay Commonwealth and State tax. The second method of achieving tax neutrality is through a taxation equivalent regime. This method involves calculating a tax liability according to current taxation legislation and making tax equivalent payments to the Official Public Account. The third method of achieving tax neutrality is through making tax neutrality adjustments. This method involves calculating tax as though it were payable, but no actual physical tax payment is made.¹⁵ This paper will examine the second method – achieving competitive neutrality using a tax equivalent regime.

The National Tax Equivalent Regime (NTER)

As a result of the recommendations of the Hilmer Report, the Tax Equivalent Regime (TER) was introduced. The TER was introduced to ensure that government owned entities were subject to paying tax equivalents. A number of years later, in 2001, the National Tax Equivalent Regime (NTER) was introduced. Whilst both regimes are still in operation and have the same objectives, they do have their differences. The NTER is administered nationally by the Australian Taxation Office and is based on the *Income Tax Assessment Act 1936* and *Income Tax Assessment Act 1997*. On the other hand, TERs use an Accounting Profit Model and are administered by each State's Office of State Revenue.¹⁶

Competition Policy Review

There have been many changes in the Australian economy since the Hilmer Report and the introduction of the National Competition Policy. At the time of the release of the Hilmer Report, global competition was only new to Australia and technology was not as advanced. With the advances in technology and greater availability of

¹² National Competition Council, *National Competition Policy*, (1993) v.

¹³ Department of Treasury and Finance (Vic), *Guide to National Competition Policy*, (n.d.) 3.

¹⁴ Department of Treasury and Finance (Vic), *Competitive Neutrality Policy Victoria*, (2000) 4.

¹⁵ Australian Competitive Neutrality Guidelines (2004) cited in OECD, *Competitive neutrality: Maintaining a level playing field between public and private business*, (2012).

¹⁶ New South Wales Treasury, *Tax Equivalent Regimes for Government Business*, (2003) 6.

information, competition policy and law needed to be updated to reflect these changes. Competition policy and law needs to “*be flexible to new products and modes of delivery*” and not stand in the way of new sources of competition.¹⁷

On 4 December 2013, the Prime Minister and Minister for Small Business announced that there would be a review of the competition policy. It had been twenty years since the Hilmer Report and the Government felt that it was time to re-examine the role of competition in the economy and update the competition policy for the all changes that had occurred over the last twenty years. This review has been referred to as a “Hilmer Mark II” review. The review was intended to be a “root and branch” review with the aim of increasing productivity and efficiency. It was hoped that the review would uncover a means in which to improve the economy, create more jobs and encourage investment. The ultimate outcome was hoped to result in improved living standards in Australia.

The review was being led by Professor Ian Harper, and is supported by a Review Panel (“The Panel”).

The Terms of Reference paper was released on 27 March 2014 by the Minister for Small Business. This was closely followed by an Issues Paper on 14 April 2014. This Paper sought submissions by interested parties by 10 June 2014.

The Draft Report was issued at the end of September 2014, with the Final Report released on 31 March 2015.

The Review Panel concentrated on three main areas. The first of these was concerned with covering the remaining unfinished National Competition Policy reforms. In particular the panel considered areas in which competition can be applied further. Secondly, the Review Panel examined institutional and governance arrangements. This was done with the intention of directing the path of the reform for the next twenty years. Lastly, the Panel focused on competition law and whether it was adequate for the required objectives.¹⁸

The Competition Review Final Report highlighted three main driver of change in the future. The first is the industrialisation of developing nations, the rise of Asia and the expanding middle class in Asia. The second is the ageing Australian population. Lastly, the effect digital technology has on the economy has been identified as a major driver of change in the future.¹⁹

The top five issues raised in the submissions from interested parties and the general public were competition law, competitive neutrality, misuse of market power, small business concerns, and the operation of the ACCC.²⁰

¹⁷ Professor Ian Harper, ‘Key issues for the Competition Policy Review’ (Speech delivered at the University of New South Wales, 6 August 2014).

¹⁸ Professor Ian Harper, ‘Key issues for the Competition Policy Review’ (Speech delivered at the University of New South Wales, 6 August 2014).

¹⁹ Commonwealth of Australia, *Competition Policy Review: Final report March 2015* (Canberra: 2015) 20.

²⁰ Commonwealth of Australia, *Competition Policy Review: Draft report September 2014* (Canberra: 2014) 1.

The National Tax Equivalent Regime (NTER)

The Water Services Association of Australia (WSAA) discussed the NTER in their submission. They submit that the NTER has been largely successful and outline that, as a result, each respective State government receives two streams of payment – one resulting from a dividend payment for the SOC to the State, and the other from the NTER tax equivalent payments to the State.

However, as a result of privatisation, the State stops receiving the NTER tax equivalent payments as these tax payments are no longer tax equivalents and become “real” tax payments to the Federal government once an entity is privatised. Once privatised, the State forgoes the tax equivalents that were received by the SOC when it was under their ownership and, as a result, loses an income stream.

WSAA argues that the loss of the income stream reduces the incentive for State governments to privatise and recommends that tax payments by privatised entities should continue to be made to the State.

Further, WSAA reasons that there is no loss of value associated with privatisation – that the taxation income stream is transferred from the State government to the Federal government. This author argues that this is incorrect. Various elections, especially around the tax depreciation of assets, at the time of privatisation can result in a large difference in tax deductions claimed, and as such, result in a much lower tax income stream, particularly where the entity being privatised has a large asset base (which is often the case in government businesses, especially infrastructure).

Price Regulation

The regulator’s main objective is to make sure those in a monopoly market do not overcharge for these essential services. It does this by:

- Ensuring that prices are charged based on an efficient, well-managed, privately owned organisation; and
- Imposing competitive prices on corporation which might not, due to the nature of their industry, have any competition.

A price regulator can choose a pre-tax pricing model, or a post-tax pricing model. Under a pre-tax pricing model, tax is assumed to be a straight 30% of profit and is incorporated in the WACC. Under a post-tax pricing model, the price regulator makes an estimate based on data provided by the corporation, and based on what the price regulator considers to be efficient, of tax which should be paid by the organisation if it were well-managed, efficient, and privately owned. Most pricing regulators in Australia currently operate using a post-tax pricing model.

Given that the aim of the pricing regulator is to only allow prices based on efficient use of resources thereby achieving competitive neutrality, and that the aim of the NTER is to ensure that NTER entities remain competitive and efficient by imposing a tax equivalent, one would expect that the amount of tax paid by an NTER entity should closely mirror the amount of tax allowance allowed by a pricing regulator (and any differences between the two should be due to inefficiencies).

Background of Price Regulation in Australia

Similar to the NTER, price regulation in Australia was introduced as a result of a recommendation of the Hilmer Report. In the terms of reference, set out in Annex A of the Final Report, paragraph 3(c) states that the Committee needs to consider “*the best structure for regulation including price regulation, in support of:*

- (i) *Pro-competitive conduct by government business and trading enterprises and in areas currently outside the scope of the Trade Practices Act 1972; and*
- (ii) *The interests of consumers and users of goods and services.*²¹

Price regulation is used in industries where natural monopolies generally occur. Price regulation is used where there is no competition, and therefore the potential for inefficient use of resources and higher prices.

Calculating the annual revenue requirement (ARR) is the first step in determining prices. The ARR is made up of three main components:

- The return on assets;
- The return of assets (depreciation); and
- Operating expenses.

In addition to these components, in a post-tax framework, there is also a tax allowance and a return on working capital, where allowed by the price regulator.

The return on assets is derived by reference to the regulated asset base (RAB) and the weighted average cost of capital (WACC). The RAB only includes assets that are both regulated and either bought or built.

The ARR is then divided by demand to estimate a price which will fully recover the ARR. The resulting price therefore has two components – a capital and an operating component.

Case Study

This case study will discuss a utility which compared the tax allowance granted by the price regulator to the amount of actual tax paid. This case study serves to illustrate why the NTER is still required and why the use of the tax allowance determined by the price regulator cannot replace a system which is based on actual tax laws and administered by the tax office.

In comparing the tax allowance granted by the price regulator with the actual tax paid by the regulator, the utility found some significant differences. These were due to:

- Higher than forecast revenue, resulting in a higher taxable income and therefore a higher tax payable;
- Lower operating expenses, resulting in lower tax deductions, and a resulting higher amount of tax paid;

²¹ <http://www.australiancompetitionlaw.org/reports/1993hilmer.html>

- Tax depreciation included in the tax return was higher than the tax depreciation forecast at the time of the price submission, therefore resulting in a higher tax deduction and reduced taxable income and tax payable;
- The inclusion of abnormal items, for example large gains resulting from the sale of significant assets; and
- The inclusion of non-regulated and unregulated revenue/gains in the actual tax expense.

Although the price regulator aimed to base its calculation of the tax building block on actual tax laws, further investigation revealed that a number of items were not allowed for, despite being subject to tax under current tax law.

Capital gains

The RAB is similar to an asset register for pricing purposes. However, the RAB does not allow gifted assets or developer contributions to be included, as the regulated entity did not pay to acquire these assets. In addition, when assets are sold, rather than factoring in a gain on sale in determining prices, the regulator deducts the sale proceeds from the total value of the RAB. The oversight is when it comes to the tax regulatory treatment of these property sales. After deducting the sale proceeds from the RAB, the regulator did not make an allowance or adjustment for the tax treatment on these gains on sale. Essentially, the utility missed out on recovering capital gains tax as a result of the sale of these assets.

Gifted assets

Gifted assets are typically received when:

- Developers build assets on common land which, due to the nature of the industry, the developer is not permitted to own or operated such assets. This means that these assets are required to be surrendered to the utility, most often at no cost to the developer, and at a loss to the developer.
- Government agencies undertake public works that require the utilities' assets to be moved or rebuilt. When these assets have been moved or rebuilt, they are often transferred to the utility at no cost to the utility.

The regulatory treatment for such assets is that they are not included in the RAB, and no allowance is made for them in prices because the utility has not paid for these assets.

However, the tax treatment is to assess the value of these assets as assessable income under section 21A – Non-cash business benefits (ITAA 1936).

In that price determination, the price regulator did not allow for tax on these assets (although the regulator has since changed this treatment).

Other

There are a number of other issues which make the use of the tax allowance set by the price regulator unsuitable as a substitute for the NTER; and illustrate why having both the NTER and pricing regulation is not doubling-up on the same thing.

A price determination is calculated based on future forecasts. No adjustments are made in the following price determination for anything which might have been over- or under-recovered.

Also, in calculating prices based on what an efficient, well managed, privately owned organisation, the price regulator can set a debt to equity ratio which may not reflect the utility's actual debt to equity ratio. In the case study above, the debt to equity ratio set by the price regulator resulted in a much higher theoretical interest expense than was actually the case. This in turn drove down the tax allowance.

References

Books

Clarke, Philip and Stephen Corones, *Competition Law and Policy: Cases & Materials* (Oxford University Press, 2nd ed, 2005)

Policies/Manuals

Commonwealth of Australia, *Competition Policy Review: Draft report September 2014* (Canberra: 2014)

Commonwealth of Australia, *Competition Policy Review: Final report March 2015* (Canberra: 2015)

Department of Treasury and Finance (Vic), *Competitive Neutrality Policy Victoria* (Melbourne: DTF 2000)

Department of Treasury and Finance (Vic), *Guide to National Competition Policy* (Melbourne: DTF, n.d.)

National Competition Council, *National Competition Policy* (Canberra: AGPS, 1993)

New South Wales Treasury, *Tax Equivalent Regimes for Government Business*, (2003)

OECD, *Competitive neutrality: Maintaining a level playing field between public and private business* (Organisation for Economic Co-operation and Development, 2012)

OECD, *State owned enterprises and the principle of competitive neutrality* (Organisation for Economic Co-operation and Development, 2009)

The Treasury, *Australian Government National Competition Policy Report 2005-07* (Canberra: AGPS 2007)

Journal Articles

Hoque, Zaihrul and Jodie Moll, 'Public sector reform: Implications for accounting, accountability and performance of state-owned entities – an Australian perspective' (2001) 14(4) *The International Journal of Public Sector Management* 304