THE TAX INSTITUTE

THE MARK OF EXPERTISE

30 May 2014

Ms Teresa Dyson
Chair of Board of Taxation
Chair of the Working Group
Review of the Debt and Equity Tax Rules
The Board of Taxation
c/ The Treasury
Langton Crescent
CANBERRA ACT 2600

By email: taxboard@treasury.gov.au

Dear Ms Dyson,

Review of the Debt and Equity Tax Rules

The Tax Institute is pleased to have the opportunity to make a submission to the Board of Taxation (**Board**) in relation to its Discussion Paper dated March 2014 on the Review of the Debt and Equity Tax Rules (**Discussion Paper**).

Our responses to the specific questions listed in the Discussion Paper are contained in Appendix A. These responses focus on the questions in Chapter 4 of the Discussion Paper and we have not provided answers to all questions in Chapter 4.

We refer you to Appendix B of this submission in respect of questions in Chapter 5 of the Discussion Paper on section 974-80 of the *Income Tax Assessment Act 1997*. Appendix B contains a joint professional bodies submission to Treasury dated 30 May 2013 on the implementation of the Government's 2011-12 Budget announcement to clarify the scope of the integrity provision in section 974-80.

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If you would like to discuss this submission, please contact either me or Tax Counsel, Thilini Wickramasuriya, on 02 8223 0044.

Yours sincerely,

Michael Flynn
President

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Appendix A

Specific responses to Chapter 4 of the Discussion Paper

Question 4.1a. Whether there are any major practical difficulties in applying Division 974 to commercially significant arrangements?

Members of the Tax Institute have experienced significant practical difficulties in the application of Division 974 to:

- limited recourse debt arrangements;
- stapled structures (particularly, in the context of s.974-80); and
- construction contracts.

The difficulties in relation to limited recourse debt and stapled structures are discussed separately in response to Question 4.4d and 4.5b respectively.

The practical difficulties in the application of Division 974 to construction contracts stems from the treatment of advance progress payments received by the entity undertaking the construction work under such contracts. Taxpayers who are engaged in construction projects are typically entitled, under the terms of their contracts, to receive progress payments from their customers in advance of work performed under the project. These advance payments are generally recorded in the taxpayer's statement of financial position as an offset against the "work-in-progress" asset, and they are generally released to the statement of financial performance under a profit-emerging basis in accordance with the accounting standards.

On one view, the purpose of the taxpayer's receipt of the advance payments is to raise finance for the taxpayer's construction activities (which involve the incurrence of construction expenditure by the contractor). Accordingly, it is possible that a construction contract may be regarded as giving rise to a "financing arrangement" for the taxpayer, and the other elements of the "debt test" in s.974-20 may also be satisfied. The "short term trade credit" exception in s.974-25 may not apply, depending on how the milestones in the construction contract are structured.

In many cases, this leads to uncertainty as to whether a construction contract gives rise to a debt interest in the construction company for the purposes of Division 974. Even if it were to give rise to a debt interest, there is uncertainty as to whether it carries a "debt deduction" as defined in s.820-40. Typically, under the terms of a construction contract, the contractor is required to procure bank guarantees in favour of the customer to secure the performance of the contractor's obligation to perform the works and services. The contractor pays guarantee fees to the bank as consideration for the provision of the guarantee. It is not clear whether the guarantee fees could be regarded as debt deductions.

Classification of such arrangements as debt interests would have unintended consequences, for example, it may have an adverse impact on the thin capitalisation position of the contractor.

Therefore, it is submitted that the treatment of advance payments under construction contracts should be clarified, perhaps by way of a regulation under Division 974 to make it clear that such arrangements do not give rise to debt interests.

Question 4.1b. Whether there are any commercially significant arrangements that are neither a debt or equity interest under Division 974; and if so, whether a tie-breaker rule that deems an interest to be either debt or equity would assist?

Although members of the Tax Institute have seen instances of arrangements that are neither debt nor equity under Division 974, we are not sure that this has raised any significant practical problems (and indeed recognise that some instruments/arrangements should not be characterised as either debt or equity).

We recommend against adopting any tie-breaker rule which, we consider could have a number of unintended outcomes – for instance, (i) if all such instruments were classified as equity interests then generally the TOFA provisions in Division 230 would not apply to the instruments (as the TOFA rules only have very limited application for equity interests) and (ii) under the thin capitalisation provisions.

Question 4.2a. In light of the decision in Blank, whether the distinction between raising finance and raising capital in the context of the 'financing arrangement' concept is problematic. If so, how could this be addressed.

The recent Federal Court decision in *Blank v Federal Commissioner of Taxation* [2014] FCA 87 (*Blank*) suggested a distinction between raising finance (which gives rise to a financing arrangement in the context of Division 974) and raising capital (which does not) for the purpose of section 974-130(1).

The existence of any such distinction seems to be at odds with the comments in the relevant Explanatory Memorandum, particularly the following comment in paragraph 2.7:

> *"The raising of finance generally entails a contribution to the capital of an entity, whether by way of money, property or services, in respect of which a return is paid to the entity, be it contingent (connoting equity) or non-contingent (connoting debt)."*

Therefore, a distinction between raising finance and raising capital does not seem to have been in contemplation when Division 974 was enacted. The approach in the Explanatory Memorandum at paragraph 2.7, which does not distinguish between the raising of capital and the raising of finance, should be maintained.

The comment in *Blank* at [71] (extracted in paragraph 4.15 of the Discussion Paper) suggests that a tracing of the funds raised to its expenditure is required, which adds complexity to determining whether there a "financing arrangement" exists. We are not aware of the meaning of "financing arrangement" previously being construed as narrowly in practice as that suggested in *Blank*.

The Tax Institute understands that the distinction which was suggested by the Federal Court in Blank has caused confusion and uncertainty for taxpayers, tax administrators and tax practitioners alike. If this uncertainty is unable to be resolved by administrative means, then consideration should be given to amending the definition of financing arrangement by legislation to put it beyond doubt that it includes the raising of capital.

Question 4.2b. the treatment under Division 974 of non-share equity and shares that are granted to employees is problematic. If not, how could this be addressed?

Section 974-130(3)(b) has the effect that "contracts for personal services" entered into in the ordinary course of business are not generally financing arrangements. The provision is unclear as to what constitutes a "contract for personal services" and whether this is limited to an employment contract or merely requires a causal connection with employment. For example, in *Blank*, the employee was entitled to a share of profit under a profit participation plan, in addition to receiving a salary in accordance with his employment contract. Example 2.4 in the Explanatory Memorandum suggests that a contract carrying a return commensurate with the profitability of the company thereby acting as a substitute for shares in the company is not within section 974-130(3)(b). If the legislation is not clarified in line with this legislative intention, it could result in further inconsistency in the treatment of non-share equity interests and equity interests under Division 974. In response to Question 8.5, we submit that non-share equity interests and shares should also be treated consistently for the purpose of Division 83A.

Questions 4.2c. the application of the 'financial arrangement' concept to personal services contracts is problematic. If so, how could it be addressed?

As noted above, paragraph 974-130(3)(b) provides that a contract for personal services entered into in the ordinary course of a business is an example of a scheme that is generally not entered into or undertaken to raise finance. This leaves room for certain types of contracts for the provision of non-personal services to potentially be regarded as giving rise to financing arrangements. A pertinent example is construction contracts (which are discussed under Question 4.1a. above).

It is submitted that the concept of financing arrangement in Division 974 should be elaborated further to make it clear that it does not apply to service arrangements such as these which were not intended to be captured by Division 974.

Question 4.3a. the 'pricing, terms and conditions' are the best determinants of the existence of an ENCO? If not, should the determinants be?

Division 974, as presently drafted, does not require a far-reaching examination of the substance or effects of an arrangement to determine whether there is an ENCO under the arrangement; rather, the enquiry is limited to the "pricing, terms and conditions" of the arrangement.

The Tax Institute does not believe that the limitation of the enquiry in this manner has resulted in any significant difficulties in practice.

Question 4.3b. differences between other regulatory regimes and the limited nature of the inquiry as to whether an obligation is an ENCO are problematic or whether this is something that stakeholders seek.

As the Discussion Paper has noted at paragraph 4.28, "the limited nature of the enquiry as to whether an obligation is an ENCO may lead to disconnects between the income tax characterisation and that of other regulatory regimes, such as, accounting standards and ratings agencies".

The Tax Institute does not consider that the income tax characterisation of an arrangement for income tax purposes should necessarily be consistent with its

characterisation for other non-tax purposes (e.g. accounting purposes or ratings agency purposes). Other regulatory regimes serve various different objectives. As such, it is submitted that it would not be appropriate to amend Division 974 merely for the sake of achieving greater alignment between the income tax classification of an arrangement and its classification for other purposes.

Question 4.4a. the phrase 'ability or willingness to meet the obligation' is problematic. If so, whether the removal of that phrase would clarify the operation of the law. Whether the phrase should only apply to consideration of the possibility that an issuer might be unable or unwilling to meet an obligation to provide a financial benefit that is due and payable.

The Tax Institute is of the view that a literal interpretation of the phrase "ability or willingness to meet the obligation" is problematic because it can lead to surprising outcomes.

If the literal interpretation were correct, the debt test in Division 974 would be satisfied if a lender advances moneys to a borrower on terms that the borrower would only be obliged to repay the loan if it is willing or able to repay the loan. It seems clear that the phrase "ability or willingness to meet the obligation" was not intended to be applied in this way.

As the Discussion Paper has pointed out at paragraph 4.35, a very similarly worded "ability or willingness" expression is used in s.974-85(1)(a) for the purpose of the equity test. Paragraph 2.30 of the Explanatory Memorandum explains what is intended by that expression in the context of the equity test:

> *"The right that a creditor has to a return may be said to be contingent on the debtor company being able to meet its debts when they fall due. That by itself will not be taken as meaning that the right is contingent on the economic performance of the company."*

The above paragraph refers to a situation in which a creditor has a debt that will fall due and payable, but the debtor may not be able to satisfy the debt (i.e. to perform its obligation to pay). The provision recognises that the mere fact that the debtor may be unable or unwilling to satisfy its obligation to pay the amount when it becomes due and payable does not of itself mean that the amount is contingent on the economic performance of the debtor.

It is submitted that this interpretation of the "ability or willingness" expression should also be appropriate for its role in s.974-135(3). That is, in contexts, the "ability or willingness" exception was enacted to prevent an argument that an obligation is contingent on its performance.

To the extent that there is any doubt regarding the proper interpretation of the "ability or willingness" expression, consideration should be given to a legislative modification of the phrase (rather than a removal of the entire phrase from the legislation).

Question 4.4b. the treatment of the degree of subordination in Division 974 is problematic. If so, how could this be addressed?

The Tax Institute endorses the comments made in the Discussion Paper at paragraphs 4.42 to 4.44 regarding subordinated debts. It is submitted that the subordination of a particular debt to the satisfaction of some or all other creditors should be covered by the "ability or willingness" exception (as presently drafted).

To the extent that there is any doubt about this conclusion, then it would be appropriate to make either legislative amendments or a regulation to clarify that the subordination of a debt should not, of itself, prevent the finding of ENCO in respect of the debt.

Question 4.4c. the treatment of interests that rank in a winding up with ordinary shares, or with other equity interests, in Division 974 is problematic. If so, how could this be addressed?

In the context of Example 3 (which is discussed in paragraph 4.44 of the Discussion Paper), it is submitted that the borrower should be regarded as having an ENCO to repay the loan because its obligation to repay the full amount is contingent only on its having sufficient assets at the time of winding-up. In other words, the borrower's obligation is contingent only on its ability to meet the obligation.

To the extent that there is any uncertainty as to whether the "ability or willingness" exception (as currently drafted) is adequate to cover interests that rank in a winding-up with ordinary shares or with other equity interests, then it would be appropriate to make either legislative amendments or a regulation to remove any doubt.

Question 4.4d. the application of Division 974 to limited recourse loan arrangements is problematic. If so, how could this be addressed?

As the Board has acknowledged (at paragraph 4.51), limited recourse debt is a common mode of finance, particularly in project finance.

Limited recourse debt is one instance where members of the Tax Institute have often experienced practical difficulties in the application of Division 974. The limited recourse feature of such arrangements can be drafted in many different ways. As the Discussion Paper has noted (at paragraphs 4.45 and following), some limited recourse loan agreements will give rise to an ENCO, while others will not, depending on the manner in which the agreement is drafted.

This is not a desirable outcome. A stated object of Division 974 is to classify an arrangement for tax purposes as debt or equity on the basis of the economic substance of the rights and obligations arising under the arrangement, rather than their legal form (refer s.974-10). Accordingly, it is submitted that limited recourse loans should be treated as giving rise to an ENCO for the purposes of Division 974. The income tax character of a limited recourse loan should not turn upon the various possible means of legal drafting.

Rather, the Tax Institute is of the view that Division 974 should be amended to clearly state that the limited recourse feature of an arrangement does not, of itself, prevent the arrangement from giving rise to the requisite ENCO under Division 974.

Even if the requisite ENCO exists there remains a further hurdle in terms of debt interest characterisation – i.e. that it must be substantially more likely than not that the value of the financial benefits provided must be greater than the value of the financial benefits received. Clearly, this test will still need to be satisfied having regard to the expected performance of the underlying assets.

Furthermore, if it ultimately transpires that the full amount of the limited recourse loan is not repaid, then income tax consequences would be triggered at that time under other regimes in the tax legislation, for example the "commercial debt forgiveness" rules in Division 245, the "limited recourse debt" provisions in Division 243, and the TOFA provisions in Division 230.

Question 4.4f. the application of Division 974 to solvency clauses is problematic. If so, how could this be addressed?

The debate in relation to the ramifications of solvency clauses for the classification of instruments under Division 974 originally arose because a view was expressed that, in the case of an instrument which contains a solvency clause, the obligation to make a payment could be seen as contingent on the continuing solvency of the issuer and, therefore, contingent on the economic performance of the entity having the obligation.

If this view were adopted, subordinated debt instruments containing solvency clauses would fail to satisfy the debt test in Division 974, despite the fact that these instruments have been commonly understood to be debt.

The Tax Institute is of the view that at least the usual type of solvency clauses should be covered by the "ability or willingness" exception. In circumstances where an obligation to make a payment is dependent on the solvency of the debtor, it is clear that the only relevant event, condition or circumstance affecting this will be the debtor's "ability" to meet the relevant obligation. This conclusion is reinforced by s.95A of the Corporations Act 2001, which states that a person is solvent if, and only if, the person is able to pay all the person's debts as and when they become due and payable. Accordingly, where an issuer's obligation to make a payment is made contractually contingent on its solvency, the issuer's obligation to pay should remain non-contingent for the purposes of s.974-135(3). Any amendment which clarified this position would be welcome.

In any case, Regulations 974-135D and 974-135E of the Income Tax Assessment Regulations 1997 (which are not actually referred to in the Discussion Paper) should cover many instruments that contain solvency clauses. These regulations were made after an extended period of uncertainty had arisen from the stance taken by the ATO and Treasury regarding the effect of solvency clauses. The effect of these regulations is that the solvency condition contained in certain types of instruments does not in itself prevent the relevant obligation under the instrument from being a non-contingent obligation. Regulation 974-135D applies to certain term cumulative subordinated notes issued by any type of entity (including, but not limited to, Lower Tier 2 term subordinated notes issued by ADIs). Regulation 974-135E applies to certain perpetual cumulative subordinated notes issued by ADIs.

In the Tax Institute's view, major revision to the current rules is not necessarily warranted, as it might actually lead to unexpected changes in administrative views or practices.

Question 4.4g. the application of Division 974 treatment of structural contingencies problematic. If so how could this be addressed?

The Tax Institute considers that changes to the current treatment of structural contingencies under Division 974 are not warranted. As mentioned above, the Tax Institute is of the view that the present limitation of the ENCO enquiry to the "pricing, terms and conditions" of the arrangement has not resulted in any significant difficulties in practice. It should not be necessary to undertake a far-reaching examination of the substance or effects of an arrangement to identify a structural or effective contingency.

Question 4.5a. the interaction between the single scheme and related scheme provisions in Division 974 is problematic. If so, how could this be addressed?

The Tax Institute endorses the comments made in the Discussion Paper about the difficulties which arise from the "related scheme" provisions, including the comment (at paragraph 4.84) that the rules can result in unnecessary uncertainty, and the comment (at paragraph 4.93) that these complex rules can be difficult to apply in practice. This is perhaps because:

- the rules are drafted in very broad terms;
- the application of the rules relies on the exercise (or otherwise) of the Commissioner's discretion; and
- there is limited guidance on the practical application of the rules.

In *Blank*, for example, the Commissioner sought to treat two contractual agreements as part of a single scheme giving rise to an equity interest without resort to the related schemes provisions. The applicant argued that this was impermissible because the agreements constituted two related but separate schemes requiring the application of section 974-70(2) to (5) in order to be aggregated. Justice Edmonds, noted that the argument that the related scheme provisions of ss 974-70(2) to (5) 'cover the field' on aggregation of schemes is 'undoubtedly arguable' but did not decide the point: see [62]. Accordingly, following Blank there is a lack of clarity around how section 974-70(2) to (5) interact with the broad definition of scheme in section 995-1.

A further problem demonstrated by *Blank* concerns schemes to be aggregated or treated as one broad scheme where the arrangements are entered into between more than two entities. In *Blank*, the applicant entered into a Profit Participation Agreement with Glencore International and a shareholders agreement with Glencore Holdings. Even where such schemes are treated as one scheme or aggregated schemes, there is an issue as to whether the wording of section 974-75 leads to two such arrangements together giving rise to a single interest (see for example references to "the company" in the table in section 974-75(1).

Question 4.5b. there are any practical examples of where the application of the related scheme provisions is difficult.

Members of the Tax Institute have experienced difficulties in the practical application of the related scheme provisions to stapled securities comprising multiple instruments issued by separate entities.

The manner in which the related scheme provisions are currently drafted makes it difficult to apply the provisions to instruments (sometimes stapled instruments) that are issued by different entities. Furthermore, additional complexities can arise when the relevant aggregated instrument encompasses both liabilities issued and assets held by a single entity (or different entities within a group). Although in this type of situation, it is intuitively attractive to treat the arrangements as part of a single related scheme, difficulties frequently only arise when other provisions within the Act are then applied to that single scheme. For instance, if the relevant instruments are aggregated and form a single equity interest under the related scheme provisions then how TOFA and other provisions apply to the individual parts of the scheme can be very difficult – again,

especially, if the combined instrument comprises both an asset and a liability of an entity.

We have discussed below two aspects of the operation of the related scheme provisions which, in our view, should be considered in further detail.

Stapled securities comprising multiple instruments issued by separate entities

Members of the Tax Institute have experienced difficulties in the practical application of the related scheme provisions to stapled securities comprising multiple instruments issued by separate entities.

The manner in which the related scheme provisions are currently drafted makes it difficult to apply the provisions to instruments (sometimes stapled instruments) that are issued by different entities. Furthermore, additional complexities can arise when the relevant aggregated instrument encompasses both liabilities issued and assets held by a single entity (or different entities within a group). Although in this type of situation, it is intuitively attractive to treat the arrangements as part of a single related scheme, difficulties frequently only arise when other provisions within the Act are then applied to that single scheme. For instance, if the relevant instruments are aggregated and form a single equity interest under the related scheme provisions then how TOFA and other provisions apply to the individual parts of the scheme can be very difficult – again, especially, if the combined instrument comprises both an asset and a liability of an entity.

The disconnect between the related scheme provisions in Division 974 and the aggregation/disaggregation rules in Division 230

Another source of practical difficulty arises from the differences between:

- the related scheme provisions in Division 974; and
- the rules in Division 230 relating to the aggregation and disaggregation of "financial arrangements" for the purposes of the TOFA regime (refer s.230-55).

These differences can lead to inconsistencies between the scope and characterisation of a debt interest or equity interest under Division 974, and the scope and characterisation of a TOFA financial arrangement under Division 230. For example, it is possible for two separate but related schemes to be aggregated into a single debt interest under Division 974, but not grouped into a single financial arrangement under Division 230. That is, it is possible for two separate Division 230 financial arrangements to constitute a single debt interest. (It is acknowledged that s.230-50 prevents this outcome where the aggregated schemes form a single equity interest.) Conversely, it is possible for s.230-55 to group as a single financial arrangement related schemes which are not aggregated under Division 974.

These outcomes are likely to create particular issues when the relevant instrument is an equity interest under Division 974 as the instrument will then not be subject to TOFA (unless the instrument is an asset which the taxpayer is recognising on a fair value basis in its accounts and has made the TOFA fair value election).

The Tax Institute recommends that consideration be given to whether there should be a greater alignment between the two sets of provisions. This could also be considered as part of the proposed Treasury review of the TOFA provisions.

Question 4.7 The Board seeks stakeholder comment on whether any significant practical difficulties arise in relation to valuation, discounting and the benchmark rate of return

The return on a debt interest can be deducted notwithstanding that the return is

- is contingent on the economic performance of the entity, or a connected entity of the entity (paragraph 25-85(2)(a));
- secures a permanent or enduring benefit for the entity or a connected entity of the entity (paragraph 25-85(2)(b)); or
- is a dividend (subsection 25-85(3)).

However, as a revenue safeguard, deductions for such returns are capped by subsection 25-85(5) at the benchmark rate of return for the interest, increased by 150 basis points.

The benchmark rate of return for a debt interest is determined by reference to the annually compounded interest rate of return on an ordinary debt interest that is issued by the entity, or an equivalent entity, to an entity that is not a connected entity, and which satisfied certain requirements. If there is no such ordinary debt interest, the benchmark rate of return is determined by reference to the annually compounded internal rate of return on an interest that is closest to the debt interest in respect of the certain requirements. The regulations can provide for a different method of determining the benchmark rate of return, but to date no such regulations have been promulgated.

Accordingly, taxpayers who have such debt interests are required to undertake benchmarking analysis to determine the benchmark rate of returns, so in turn the deduction for the return on the debt interest can be determined. Such benchmarking analysis can be costly and the results of it are not beyond challenge by the Australian Taxation Office.

Whilst it was not a matter canvassed in the Discussion Paper, the Tax Institute recommends that the Board give consideration to introduction of an 'opt-in' safe harbor benchmark rate of return to provide taxpayers with the opportunity to reduce compliance cost and obtain certainty. Such a safe harbour could be based on a base rate (e.g. BBSW rate or Treasury Bond rate) plus an appropriate margin.

Question 4.8 The Board seeks stakeholder comment on whether any significant practical difficulties arise in relation to the application of the equity test

As a starting point, we note that in a post TOFA environment the classification of an instrument as an equity interest has become increasingly important. This arises from the fact that if an arrangement is an equity interest then, except in very limited

circumstances, the TOFA provisions in Division 230 will have no practical application to the instrument. In this regard, whether the relevant instrument is treated as an equity interest has become of greater significance than whether it is classified as a debt interest (unless it is, prima facie, classified as both an equity interest and a debt interest in which case the tie-breaker rule will apply).

This approach is evident in the way in which the ATO has sometimes administered the provisions in a post-TOFA world. By way of example, members have experienced situations where in applying for a private ruling on the deductibility of returns on notes issued by taxpayers, the ATO has only been willing to confirm that the relevant instrument is not an equity interest (i.e. rather than confirming that the notes are debt interests). This has resulted from the fact that the returns on the notes should be deductible under TOFA provided that the notes are not equity interests (the debt interest classification being irrelevant for Division 230 purposes). The reason that the ATO did not want to rule on the debt interest characterisation was due to problems in relation to solvency clauses and subordination issues (see the discussion above).

In relation to the equity interest test, members of the Tax Institute have experienced practical difficulties particularly in the application of the concept of "contingent on economic performance".

By way of example, when a return on an instrument (Instrument 1) issued by a taxpayer tracks a return received by the taxpayer from an underlying investment (for instance shares in an unrelated entity) then it does not seem entirely clear whether the returns on Instrument 1 should be treated as contingent on the economic performance of the taxpayer. In this regard, it should be the case that the returns should only be regarded as contingent on economic performance if the taxpayer is only required to pay the returns on Instrument 1 if it receives the relevant underlying returns on the shares (i.e. if the taxpayer was required to pay the returns on Instrument 1 irrespective of whether it held the underlying shares or received returns/dividends on those shares then the returns on Instrument 1 should not be regarded as contingent on the economic performance of the taxpayer).

Furthermore, even in the situation where the returns were regarded as contingent on economic performance (i.e. returns on Instrument 1 were only required to be paid if the taxpayer held the underlying shares and received returns/dividends on those shares) then the receipts/turnover exclusion in s.974-85(1)(b) should apply.

Section 974-85(1)(b) provides that an exception to a return being contingent on the economic performance of an entity is if the return is contingent merely on "the receipt or turnover of the entity or the turnover generated by those activities".

The only guidance provided in the Explanatory Memorandum regarding the scope of the turnover exception is the following passage (in paragraph 2.32):

> *"An example is a lease contract where part of the rentals are based on the lessee's turnover. Generally speaking, turnover-based returns will be excluded from being regarded as contingent on economic performance in the relevant sense."*

Members have experienced difficulties in the application of this receipts/turnover exception to financial instruments of the type considered in the example above – i.e. where the return is linked to, or tracks, the cash flow on an underlying asset held by the issuer. Common examples of such instruments include total return swaps and property-linked notes. Under such instruments, the issuer merely passes through to investors the cash flow on the underlying asset on a gross basis (i.e. without offsetting any direct or indirect costs incurred by the issuer). We consider that the

receipts/turnover exclusion does apply to these types of arrangements and would welcome any amendments or guidance which confirmed this position.

Appendix B

Joint bodies submission to Treasury dated 30 May 2013 relevant to Chapter 5 of the Discussion Paper

THE TAX INSTITUTE
THE MARK OF EXPERTISE

Institute of
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30 May 2013

Ms Christine Barron
General Manager
Corporate & International Tax Division
The Treasury
Langton Crescent
Parkes ACT 2600

Email: Christine.Barron@treasury.gov.au

Dear Ms Barron

The Tax Institute, Institute of Chartered Accountants in Australia and CPA Australia (together the "**Joint Professional Bodies**") are pleased to present our views on the implementation of the Government's 2011-12 Budget announcement to clarify the scope of the integrity provision in section 974-80 of the *Income Tax Assessment Act 1997* ("**ITAA1997**").

The integrity provision

Section 974-80 was included in the debt/equity provisions in Division 974 as an integrity provision to allow the re-characterisation of instruments that satisfy the debt test in that Division but are used to fund an effective equity interest held by an ultimate investor.

After consultation with industry (including the joint Professional Bodies), the Government acknowledged that the potential scope of operation of this provision is wider than its policy intent and announced in the 2011-12 Budget that the law would be amended to bring the provision in line with its policy intent.

We are broadly supportive of the Government's efforts to restrict the application of section 974-80 to intended circumstances only, as set out in the relevant 2011-12 Budget announcement.

However, we are concerned that the proposed extent of reforms will not achieve their stated intent or resolve much of the current uncertainty for taxpayers.

These concerns are exemplified by the Australian Taxation Office's recent release of TR 2012/D5 in relation to the application of section 974-80 in the stapled entity context, which clearly demonstrates the ATO's view of the extent of application of section 974-80, both under the current and proposed section. The uncertainty caused by this draft tax ruling has caused widely reported market volatility.

The professional bodies' submissions:

- to the ATO on the 2007 draft Discussion Paper;
- to Treasury in response to Treasury's 2010 Consultation Paper; and
- to the ATO on TR 2012/D5;

raised a host of issues with both the current legislation and the ATO's interpretation. These submissions are attached to this letter as Appendices A, B and C for your ease of reference.

If the extent of proposed changes to section 974-80 is limited to those factors outlined in recent discussions, including at the ATO's NTLG Finance and Investment Sub-committee, it is our view that the proposed changes will not provide the necessary certainty. Our submission sets out our understanding of the changes proposed by Treasury, as well as further changes that are in our view necessary to clarify and restrict the application of this section to only those situations which give rise to an integrity concern.

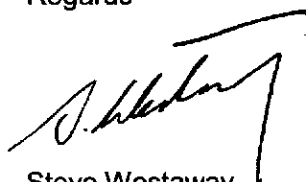
We are cognisant that Treasury's remit to propose changes to section 974-80 is limited by the Government's 2011-12 Budget announcement. As such, we have also copied this letter to the Assistant Treasurer, The Hon. David Bradbury, MP.

We would be pleased to discuss the contents of this letter directly with Treasury prior to the public release of the relevant Exposure Draft.

* * * *

Should you wish to discuss the contents of this letter, please do not hesitate to contact The Tax Institute's Tax Counsel, Deepti Paton, in the first instance on (02) 8223 0044.

Regards



Steve Westaway	Paul Stacey	Mark Morris
President	Head of Tax Policy	Senior Tax Counsel
The Tax Institute	The Institute of Chartered Accountants in Australia	CPA Australia

CC: The Hon. David Bradbury, MP, Assistant Treasurer and Minister Assisting for Deregulation

CC: Ms Nan Wang, Manager, Corporate & International Tax Division, The Treasury

SUBMISSION

POLICY INTENTION OF SECTION 974-80

In applying the bright line tests in Division 974 to classify in-substance debt or equity instruments, section 974-80 is intended to protect the integrity of the debt and equity tests from the use of back-to-back instruments.

Specifically, it is our understanding that section 974-80 was introduced against the background of certain financing arrangements that sought to obtain tax deductions for interest payments, but provided contingent returns to the ultimate investor (e.g. certain Tier 1 arrangements entered into by financial institutions).

In this regard the policy intention of section 974-80 is succinctly outlined in paragraphs 2.41 – 2.45 of the Explanatory Memorandum to the *New Business Tax System (Debt and Equity) Bill 2001* (**the Explanatory Memorandum**).

Importantly, paragraph 1.28 of the Supplementary Explanatory Memorandum stated that section 974-80 is intended to operate "*only in those cases where the scheme or schemes are deliberately designed so that the return to the connected entity is in turn used to fund either directly or indirectly a return to the ultimate recipient.*"

As the abovementioned paragraphs from the Explanatory Memorandum and Supplementary Explanatory Memorandum indicate, section 974-80 was intended to apply to schemes which were deliberately (or, in our view, predominantly) designed to ensure an equity-like return is paid on a debt interest to a connected entity, which then on-pays that return (including via one or more back-to-back payments) to an ultimate investor.

Section 974-80 was never intended to be applicable to re-characterise all related-party debt funding arrangements as equity.

ATO APPROACH

Notwithstanding, in 2007 the ATO issued a Draft Discussion Paper indicating that in its view section 974-80 applied to a wider range of circumstances than those set out in the paragraphs above. For example, the ATO stated in paragraph 47 of that Draft Discussion Paper that section 974-80 may apply even in circumstances where there is no effective equity interest in the company. The ATO even opined that section 974-80 may apply where one debt instrument is designed to fund another debt instrument held by the ultimate recipient.

Similarly, in the context of the funding arrangements of stapled groups, under which a trust raises funds by issuing units, and then lends those funds to stapled company, with the objective being to use interest on the loan to fund distributions to unit holders (as outlined in TR 2012/D5) the ATO's interpretation would result in an equity characterisation for almost any such intra-stapled group lending arrangements in which the stapled entities are regarded as connected entities.

For example, even if the returns on the loan from the trust and the company are non-discretionary and not contingent on the economic performance of the company (i.e. the trust does not have any equity-like interest in the company), it would appear that by adopting the type of interpretation taken by the ATO in the Draft Discussion Paper, subsection 974-

80(2)(a)(iii) would invariably be satisfied because technically the rights to distributions from the unit trust are based on the net income of the unit trust (that is, the unit holder's right to income distributions under most trust deeds are technically contingent on the economic performance of the unit trust).

Such an interpretation would be inappropriate because the funding arrangements of stapled groups are actually intended to provide debt-like returns to the ultimate investors, rather than seeking to provide an equity-like exposure to the stapled company. Stapled structures have historically been favoured in the infrastructure and other industries that encounter significant early stage losses; these early stage losses restrict the ability of the company to pay dividends for a number of years. The stapled structure provides a solution to this commercial problem by providing for bond-like cash returns to be paid to investors notwithstanding the loss-making status of the company. Thus, rather than facilitating a disguised equity investment in an underlying company, the investor's interest in the funding trust is intended to provide debt-like returns.

A stapled group's funding arrangements therefore contrast quite starkly with the Example under s 974-80(2) and Examples 2.9 and 2.10 in the Explanatory Memorandum - in those Examples the schemes are clearly designed to procure deductibility for amounts that are used to fund an ultimate investor's return on an effective equity interest in the underlying company.

EFFECT OF ONGOING UNCERTAINTY AND ATO VIEW

It is our view that the ATO's interpretation of section 974-80 has become too strict, and importantly, the ATO's interpretation (as expressed in the 2007 Draft Discussion Paper) is being applied with retrospective effect to arrangements that were entered into many years preceding the release of that Draft Discussion Paper and were originally thought not to offend section 974-80. This has generated significant uncertainty which has had a detrimental impact on investment into Australia.

Moreover, the ATO has been utilising its interpretation of the connected entity issue in TR 2012/D5 as a springboard upon which to base audit activity in relation to the funding activities of many stapled groups.

To this end, we are aware that the ATO has formed a "Stapled Security Project Team" whose remit is to review almost all stapled group funding arrangements in the particular context of section 974-80. This is a significant development, especially given the amounts that have been invested in infrastructure and utilities via stapled structures prior the release of the ATO Draft Discussion Paper. The analyst reports and media reports [refer to Appendices 1, 2 and 3] illustrate the material impact that the ATO's approach to section 974-80 has had in the particular context of stapled groups. Of particular note is the report attached at Appendix 2 shows an analyst's assessment that the ATO's audit activity in relation to Sydney Airport could result in ongoing distributions being reduced by as much as one-third.

Other stapled groups have upwards of $2 billion in funding arrangements that could be adversely impacted by what now appears to be a change in the interpretation of the reach of section 974-80.

Moreover, the interpretation of section 974-80 makes the characterisation of even straightforward funding arrangements excessively confusing. Take for example the situation

under which a holding company makes an interest bearing loan (which otherwise satisfies the definition of a debt interest) to a wholly-owned subsidiary. As the interest paid on that loan might be used to fund dividends to the holding company's shareholders, section 974-80 could be applied to re-characterise that loan as an equity interest.

It is one thing to apply section 974-80 to the loan where the arrangement is simply a back-to-back arrangement similar to the Tier 1-capital arrangements that section 974-80 was designed to address, but in practice the application (or non-application) of section 974-80 in this straightforward example is made even more confusing by the "designed to operate" requirement – for example, to what extent is the analysis impacted where the holding company has other sources of income from which to fund dividends, or where the company distributes some of the interest receipts as dividends and retains or reinvests the balance? It is our view that there needs to be greater clarity on such arrangements to ensure that taxpayers are not inappropriately impacted by section 974-80.

POLICY CONSISTENCY IS REQUIRED

Our understanding of the policy intention of section 974-80 is set out above.

Whilst the policy intent of section 974-80 is to re-characterise a debt interest issued by a company if the return on such a debt interest has certain equity-like features, it does so only if the returns are paid to a connected entity under a back-to-back arrangement culminating with those returns being on-paid to an ultimate investor.

By contrast, if the ultimate investor instead directly held that same debt interest in the underlying company (with its attendant equity-like returns), section 974-80 would not be enlivened. Thus section 974-80 is not actually offended by debt interests that are deliberately designed to have equity-like returns; instead section 974-80 is only concerned with the use of connected entities to on-pay such returns to third parties.

The Professional Bodies submit that there needs to be policy consistency across the board on the treatment of debt interests that are structured to include equity-like returns, irrespective of whether those interests are held by connected entities or are part of a back-to-back arrangement.

In this regard, it seems anomalous that there are two integrity provisions that address equity-like returns arising on debt interests (namely section 25-85 and section 974-80), but each have quite different outcomes even though they both seek to address what is essentially the same problem.

Section 25-85 applies in relation to debt interests that feature certain equity-like returns (irrespective of whether or not those debt interests are held by related or unrelated parties) not by re-characterising the entire debt interest, but instead by restricting the amount of the debt deduction to the benchmark rate of return for the debt interest plus 150 basis points.[1] Section 25-85 implicitly recognises that such instruments consist of both a debt-like return and an equity-like return, and only disallows a debt deduction for the part of the return that is equity-like. As the Explanatory Memorandum notes:

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[1] Section 25-85 is replicated for Division 230 financial arrangements via subsections 230-15(4) – (6). References in this paper to section 25-85 apply equally to the corresponding provisions in subsections 230-15(4) – (6).

2.138 As a revenue safeguard it is necessary to prevent excessive deductible payments on debt/equity hybrids that satisfy the debt test. The risk to the revenue is that a company could distribute its profits as deductible payments in lieu of frankable dividends by making the distribution in respect of a hybrid that has been artificially characterised as debt. The artificiality of the characterisation would be indicated by a return on the interest considerably in excess of the interest payable on an equivalent interest without any equity component (i.e. straight debt).

2.139 Therefore the deduction for returns on debt/equity hybrids is capped by reference to the rate of return on an equivalent straight debt interest, increased by a margin to recognise the premium paid for the increased risk of non-payment because of the contingency. That rate of return is referred to as the 'benchmark rate of return', and the margin is 150 basis points...

Thus there are currently two integrity provisions that address debt interests that have equity-like returns. However the outcomes of those two provisions are very different and it is unclear as to why such different approaches are needed to address what is essentially the same problem.

TREASURY'S PROPOSALS

We understand from earlier discussions, including at the ATO's Finance and Investment Sub-group, that Treasury is currently of the view that the scope of section 974-80 would be adequately clarified by amending the provision to include the following modifications:

- a **debt override rule:** under which section 974-80 would not apply where the interest held by the ultimate recipient is a debt interest;

- a **purpose and effect rule:** under which 974-80 would apply only if would be concluded there is a purpose of the ultimate recipient having, in substance or effect, an equity interest in the company or connected entity of the company; and

- **allowing Commissioner's discretion:** under which the Commissioner would be given a discretion not to apply section 974-80 where it is reasonable to conclude that the scheme was not designed to produce an effective equity interest in the company.

Whilst each of these proposals would be positive developments, they are unlikely to resolve fully the uncertainties associated with section 974-80 for the following broad reasons:

- The debt override rule would not assist in many straightforward scenarios where the ultimate investor does not hold a debt interest, such as the simple holding/subsidiary company funding arrangement described on pages 4 - 5; nor would it be of assistance in many straightforward funding arrangements undertaken by stapled groups as discussed on pages 4 and 8 - 9.

- The purpose and effect rule would likely create a new source of uncertainty and possible expansion (as opposed to a "restriction") of the application of section 974-80 because it would essentially rest upon:

- an inquiry into the "purpose" of an arrangement – in this regard it should be noted that other provisions that require a conclusion as to purpose (e.g. sections 177D, 177EA and 45B of the *Income Tax Assessment Act 1936*) are inherently uncertain; and

- an assessment as to whether an arrangement resulted in an "in-substance" equity interest – this would present its own complexities in interpreting what actually constitutes an "in-substance" equity interest given that the question would arise only where the underlying investor does not have an actual equity interest in the underlying company.

- Given the Commissioner's current views in relation to the potential wide application of this provision, it is difficult to see how the Commissioner's discretion would in a practical sense assist.

SUGGESTED AMENDMENTS

In light of the above, we recommend that Treasury also consider the need for broader amendments that would rectify this ongoing uncertainty, as set out below. It is our view that such amendments would appropriately restrict section 974-80 to its policy intention.

Given section 974-80 is an integrity provision, a "dominant purpose" test (rather than the "purpose and effect" test) should be introduced, which would be a similar threshold to that required for the application of section 177D.

Alternatively, and as we have highlighted above, there are currently two integrity provisions (sections 25-85 and 974-80) that address debt interests that are structured to have equity-like returns. However the outcomes of these two provisions are very different and it is unclear as to why such different approaches are needed to address what is essentially the same problem.

A simple means of achieving greater certainty and policy consistency would be to include an amendment to the effect that section 974-80 does not apply where the return on the relevant debt interest issued by the underlying company does not exceed the benchmark rate of return for the relevant debt interest plus 150 basis points.

Such an amendment would be consistent with the Budget announcement that "the changes [to section 974-80] will ensure that this provision will only apply to arrangements where both the substance and effect is that the ultimate investor has, in substance, an equity interest in the issuer company." This is because, under a back-to-back arrangement which is designed to procure deductibility for equity-like returns paid on debt interests, it is only the excessive interest payments (i.e. the amount that exceeds the benchmark rate of return plus 150 basis points) that should be regarded as simulating an in-substance equity interest.

Thus, where a relevant debt interest caries a return that is less than that benchmark amount, the debt interest should be regarded as being sufficiently debt-like not to enliven section 974-80.

APPLICATION DATE OF REQUIRED AMENDMENTS

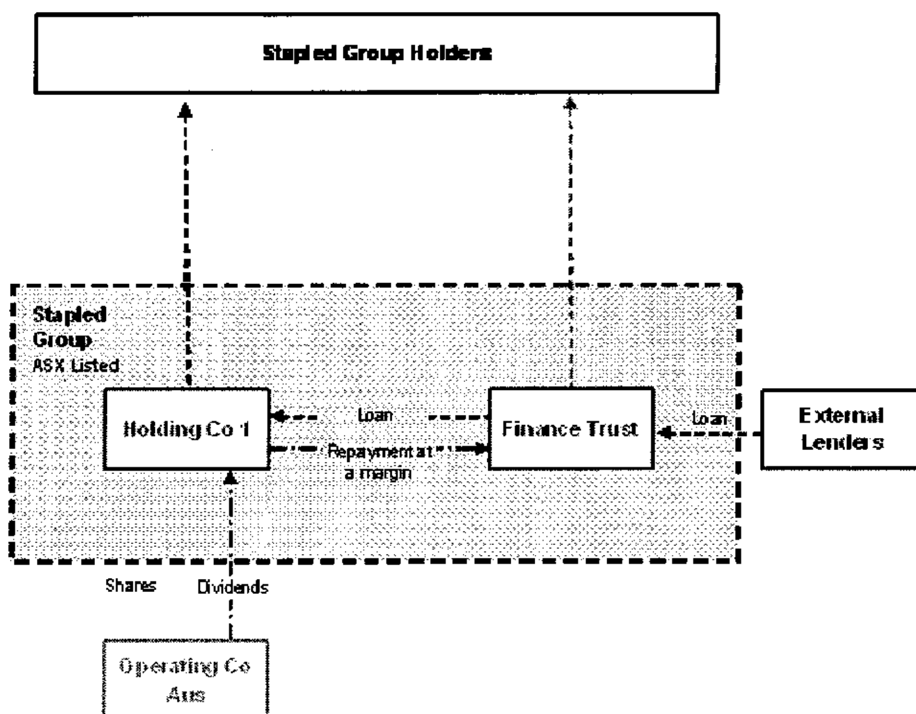
Many funding arrangements have been in existence for a long time and in many cases pre-date the section 974-80 controversy that has been brought about as a result of the ATO's Draft Discussion Paper and the release of TR 2012/D5.

While the impact of the current section 974-80 controversy on stapled groups in particular is illustrated by the media and analyst reports provided in Appendices 1, 2 and 3, as noted above, other funding structures and industry sectors also continue to be affected.

Given the delay in enacting this measure, the retrospective nature of the amendments and ongoing confusion as to the extent and nature of the amendments especially as between the ATO and taxpayers, we recommend that the amendments have retrospective effect, but be subject to a no detriment rule.

As noted in our joint submission of 2010, we recommend that the restated provision be treated as elective for instruments on foot as at the date of Royal Assent to the Act which makes the amendment. That is, in the period from 1 July 2001 to the date of Royal Assent, the issuing company may elect to apply the current section 974-80 (rather than the revised version) until the relevant instrument is either terminated or materially varied. Such an election could be made at the issuing company's discretion by the first due date for lodgment of that company's tax return after the date of Royal Assent.

DEMONSTRATED APPLICATION – STAPLED ENTITIES



The ATO uses this Example in TR 2012/D5 to consider whether Holding Co 1 and Finance Trust are connected entities. In this example, the Finance Trust borrows from External Lenders and on-lends those funds to Holding Co 1 at a margin, with the margin to be distributed to unit holders.

Although TR 2012/D5 only considers whether Finance Trust and Holding Co 1 are connected entities for the purposes of section 974-80, the fact that the ATO chose to use such an example in that Draft Ruling illustrates the potentially startling reach of section 974-80 to stapled groups. Broadly, the diagram appears to suggest that the ATO might consider that the loan from Finance Trust to Holding Co 1 could be subject to section 974-80, notwithstanding that the funds were sourced from External Lenders.

In light of the ATO's views in its Draft Discussion Paper on section 974-80, there is a risk that the loan between Finance Trust and Holding Co 1 could be re-characterised as equity under section 974-80, given that the margin derived by the Finance Trust will fund distributions to the unit holders (and thus could be covered by section 974-80(1)(d)), and given the risk that the distribution to unit holders could be construed to be covered by section 974-80(2)(a)(iii).

It is one thing to analyse the application of section 974-80 to the lending of the unit capital to the stapled company, however it is startling that section 974-80 could have potential application to the repayment of the Finance Trust loan that was sourced from External Lenders, as the on-lending of the funds borrowed from External Lenders at a margin to Holding Co 1 cannot be regarded as a scheme to provide an effective equity interest in Holding Co 1for the unit holders.

The effect of such an interpretation is that the external interest payments would effectively become non-deductible for no reason other than the fact that a related unit trust was used to intermediate the loan – this would be a capricious and absurd result.

The above example illustrates the risk that, if stapled structures are not properly addressed in the design of the amendments to section 974-80, the result could be that the ATO might take the view that section 974-80 could apply to all intra-stapled group lending and would undermine the conduit approach to trust taxation. However, if it is the case that either the Government or the ATO has an overriding concern with all related party loans, or with the concept of character flow through for trusts that undertake related party transactions, we would submit that this policy intention should be clearly stated, rather than relying on a provision such as section 974-80 to re-characterise such transactions.

Appendix 1

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Regulated Utilities

Sector outlook

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12 February 2013

Australia
Infrastructure

Spark Infra	SKI AU
Rec	**Outperform**
Market cap	US$2,300m
Price	$1.65
Target	$1.85
Up/downside	+10.1%

SP Ausnet	SPN AU
Rec	**Outperform**
Market cap	US$4,117m
Price	$1.19
Target	$1.25
Up/downside	+5%

Yielding solid returns

We initiate coverage on Spark & SP Ausnet with Outperform recommendations and TP$1.85 and $1.25 respectively. Regulated returns locked in until 2015 underpin distribution yields of ~6.3% and ~7% and deliver 3yr DPS CAGR of 4.4% and 2.5% for SKI and SPN respectively. Risks to our distribution forecast stem from ATO tax ruling TR2012/D5 as well as ongoing tax review processes at the asset level. Post 2015 expectations of lower growth of peak demand, and recent AEMC rule changes are a risk to RAB growth and earnings outperformance vs. regulated allowances. For defensive high quality yield we prefer TCL.

Regulated returns expected to drive outperformance

- On our numbers SKI and SPN are trading on ~6.3% and 7.0% yield respectively, escalating to ~7.5% and 7.7% by CY16 respectively.
- We prefer SKI to SPN for its stronger distribution growth at ~4.4% 3-yr cagr vs. SPN with 2.5%.
- SPN relative growth is diluted by the access arrangement, finalised by Mar-13.

TR2012/D5 is a key risk to our distribution forecast

- Sydney Airport (SYD AU) highlights the risk posed to the sector by draft tax ruling TR2012/D5 and we believe SKI and SPN's corporate structures carry a similar risk.
- SKI's distribution is more sensitive to a loss of shareholder loan and preferred capital interest deductions than its peers.
- A worst case impact, SKI's FY12 DPS would fall ~5cps, & SPN would fall by 1-2cps.

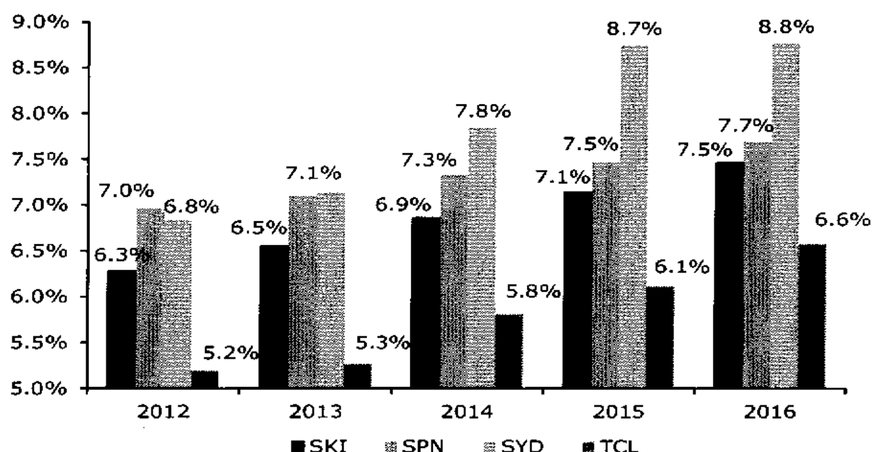
Sustained demand weakness is a risk to RAB growth post 2015

- Weak demand driven by lower macro growth and increased solar generation is a risk to investment allowances and RAB growth post the current regulatory periods.
- Regulator expectations of peak demand growth has supported ongoing capex investment over the past 2 determinations.
- The 2010 determination was finalised with continued investment despite weakening demand but persistent weakness is likely to result in a slowdown of investment.

AEMC rule changes make for a tougher regulatory game post 2015

- AEMC rules changes provide for greater regulatory powers and are a risk to SKI & SPN's ability to outperform regulatory returns.
- Cost-of-capital set with a view to a less codified overall rate of return reduces the impact of market volatility and the ability to challenge discrete WACC assumptions.
- Capex and Opex allowance benchmarking will likely position SKI and SPN as benchmarks in the industry and increase scrutiny on these businesses.

Forecast distribution yield: 3yr DPS CAGR SKI 4.4% vs. SPN 2.4%



Source: CLSA Asia-Pacific Markets

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Share price underpinned by yield

Distribution growth is underpinned by growth in regulated cashflows

We initiate coverage on Spark & SP Ausnet with Outperform recommendations and TP$1.85 and $1.25 respectively. Regulated returns locked in until 2015 underpin distribution yields of ~6.3% and ~7% and deliver 3yr DPS CAGR of 4.4% and 2.5% for SKI and SPN respectively.

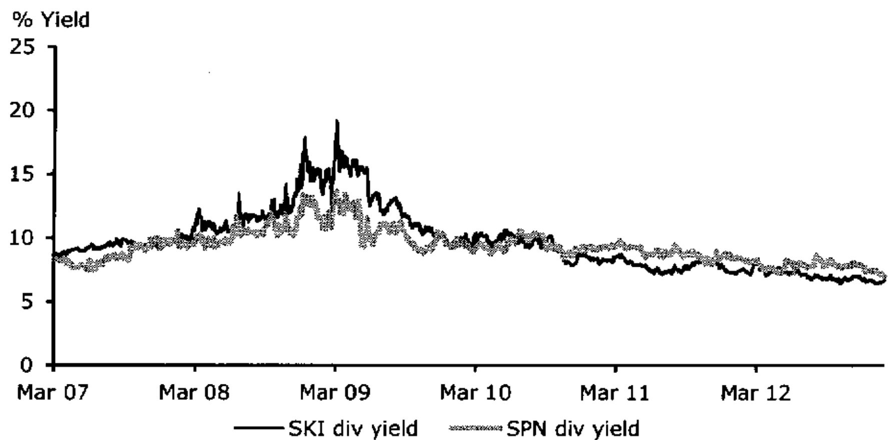
Risks to our distribution forecast stem from ATO tax ruling TR2012/D5 as well as ongoing tax review processes at the asset level. Post 2015 expectations of lower growth of peak demand, and recent AEMC rule changes are a risk to RAB growth and opportunity to outperform regulated allowances. For defensive high quality yield we prefer TCL.

Preference for SKI vs SPN based on DPS growth of 4.4% vs 2.5%

The chart below highlights SKI and SP Ausnet have traded on an average yield of 7.1% and 7.9% respectively since 2012.

Figure 1

Historically SPN has traded at a yield premium to SKI



Source: CLSA Asia-Pacific Markets

Forecast DPS falls with company guidance

SKI has traded at a discount yield to SPN since 2010 which reflects the higher growth associated with the SKI distribution profile.

We forecast a 3yr DPS cagr of 4.4% for SKI and 2.5% for SPN, and prefer SKI for its stronger growth profile, and note the higher growth in the distributions is driven by higher comparative regulated rates of return, without regulatory reset risk until the end of 2015.

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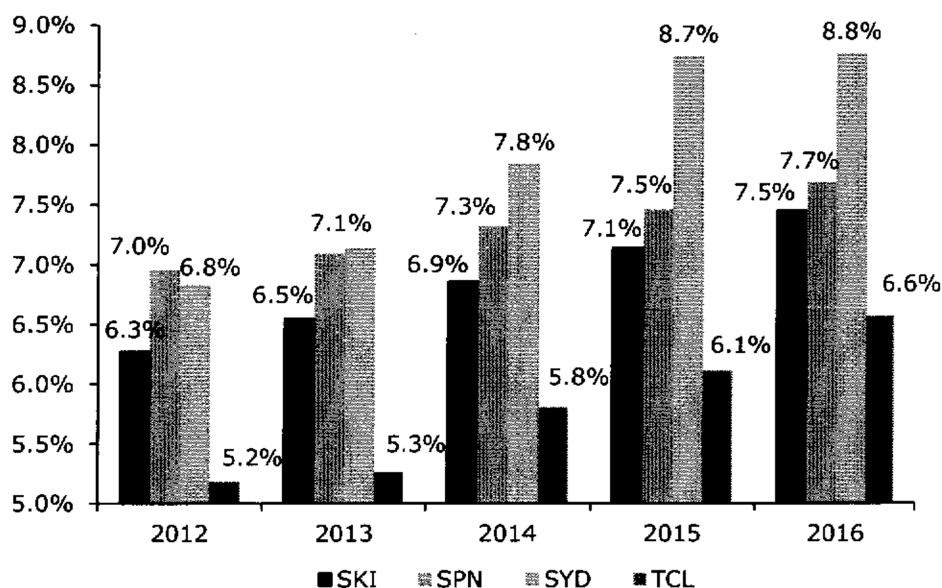
SYD has similar growth to TCL but is a lower quality yield

Figure 2

Forecast distribution yield: SKI vs. SPN vs. SYD vs. TCL



Source: CLSA Asia-Pacific Markets

The previous chart highlights the relative yields across the sector. SYD and TCL have the strongest expected yield growth at 6.1% and 6.4% respectively on a 3yr CAGR basis. However SYD's tax risk, re-gearing through capitalised interest bonds results in a lower quality yield. Accordingly for a high quality defensive yield we prefer TCL.

SKI & SPN DPS forecast is broadly in line with guidance

Note our SKI and SPN distribution forecast is broadly in line with company guidance. SKI has guided to 10.5cps distribution for FY12, and distribution growth of 3-5%. SPN has guided to FY13 distributions of 8.2cps and 2% distribution growth in FY14.

With regulated returns locked in until 2015, our analysis of each stock is focused on the risks to our distribution forecast. While we do not include these issues in our numbers, we highlight the following risks to our medium term forecast:

1. **Recent actions by the ATO stemming from TR 2012/D5**, are a negative for the sector. SYD has likely been targeted in the first instance by the ATO as a more aggressive tax structure. If the ATO proves has a win against SYD we expect other names in the sector to face review. SKI and SPN are a potential target. In a worst case scenario SKI's distribution could be impacted by up to 5cps while SPN faces a 1-2cps impact. SPN's distribution faces the smaller impact as 30% of the dividend is already funded by franked dividends which in turn minimises the risk of ATO review.

2. **Continued weakness in demand will impact regulated capex allowances** post the current regulatory period. RAB growth has averaged 7% in Victoria and 5% in South Australia in recent history. We expect a slowdown in peak demand growth, on the back of a weaker economic growth outlook and increase solar generation. Regulator expectations of

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slower growth will crimp future capex allowances. We assume ~CPI indexation of RAB post 2015.

3. **New rules from the AEMC** provide for increased regulator power, and positions both Spark and SP Ausnet as benchmarks for the industry. On this basis we expect these businesses to face increased regulatory scrutiny and outperformance of regulated allowances will be increasingly difficult.

Note Class Action proceedings are expected to commence in March against SP Ausnet. In the event SPN was found to be negligent, we expect the claims to be largely covered by insurance.

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Another tax risk to distributions

SKI & SPN have ATO reviews separate to the TR2012/D5 ongoing

We have received a number of incoming queries around tax issues at Sydney Airport and its implications for the infrastructure and utilities sector. The ATO proceedings at Sydney Airport in connection with the release of draft tax ruling TR2012/D5 highlights a risk for the sector, however we expect the risk is fact specific with respect to the individual structures employed.

Spark Infrastructure and SP Ausnet both employ stapled trust structures although both have key differences with the Sydney Airport RPS structure as well as the worked examples highlighted within the ATO Draft Ruling TR2012/D5.

However investors should be aware the ATO action at Sydney Airport presents an additional potential risk to the tax position of these businesses and the outcome at Sydney may have implications for these stocks.

Sector background

Stapled trusts structures and shareholder loans are the norm for the sector

Over the past decade the infrastructure, utilities and property sectors have used stapled unit trusts and shareholder loans to maximise tax efficiency and facilitate capital liquidity. Remember that the assets are typically highly cash generative but due to the capital intensity of the investment are characterised by very high depreciation charges which would limit payment of ordinary distributions.

These unit trust structures do not permanently "avoid" tax, but instead the tax liability is shifted to the security-holder. The combination of the trust structures and shareholder loans meant that:

- Tax was not paid at the asset company level due to deductibility;
- The stapled security investment vehicles (the listed entities) paid little/no tax as long as all free cash was distributed to holders; and
- The holder of the stapled security would receive an unfranked distribution and so paid tax on the income at their respective marginal tax rate.

What has changed?

Deductions generated from interest of equity like returns are at risk

The ATO released Draft Taxation Ruling TR 2012/D5 in July 2012. In its ruling, the Australian Tax Commissioner focussed on the differentiation between debt and equity interests in unit trusts such as those employed by Sydney Airport, Spark Infrastructure, SP Ausnet, Asciano and Transurban. It looks to deny income tax deductions on debt interest returns paid in relation to "de facto" equity interests in the company.

The key principle applied to differentiate between debt and equity capital within these unit trusts is the Commissioner's interpretation of 'connected entity' rules. Simplistically, if the entities are found to be connected, then there is scope for the ATO to characterise interest received on shareholder loans within the stapled structure as an equity return. Where the returns are equity-like in substance or contingent on economic performance they would not be deductible under Australian taxation law.

The ATO has so far focussed on preferred capital & RPS structures

So far the ATO has focussed on the preferred capital or redeemable preference share investments within these structures as they are more like equity than debt. This is the case for Sydney Airport particularly.

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Now, why does Sydney Airport have an issue?

ATO position paper provided to SYD on 20 Dec 2012

Following the release of TR 2012/D5, on 20 December 2012 the ATO delivered Sydney Airport with a position paper on the deductibility of interest paid on its redeemable preference share structure.

To understand the issue at play is easiest when done in conjunction with the figure below. It outlines the Sydney Airport structure and the flow of distributions from the asset company to SYD security holders by way of RPS.

ATO issue is above the asset level RPS structure

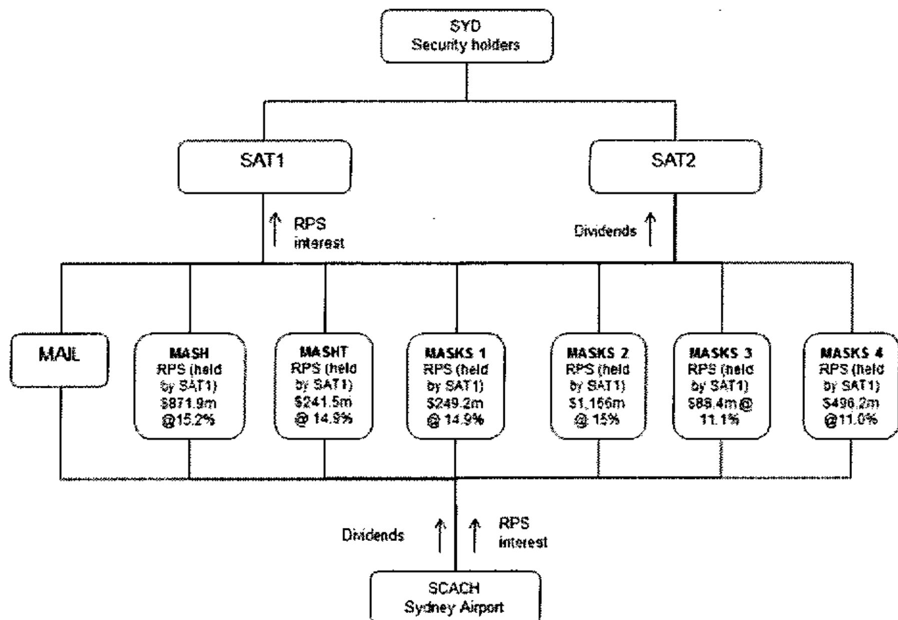
In total Sydney Airport has six separate RPS facilities (MASH, MASHT, MASK1, MASK2, MASK3, & MASK4). In total, the amount outstanding is ~A$3.1bn. Sydney Airport's release on the ATO position paper stated that the quantum of RPS principal in question in the position paper is A$872m, which corresponds with the MASH notes. These have an interest rate of 15.2%, generating a tax shield of ~$39m pa, in line with the $79m liability for two years to Dec-11 set out in the Sydney Airports' press release.

Tax liability is incurred on RPS interest payments to SAT1

If incurred, this liability equates to ~4cps as a one-off payment. But more importantly, the loss of interest charges on the MASH notes equates to a ~2cps impact to cash available for distribution to SYD security holders on the basis that SYD management continues to pay ~100% of free cash flow to equity as a distribution.

Figure 3

Sydney Airport structure diagram



Source: CLSA Asia-Pacific Markets

Appears to fit in the ATO's target tax structure

For its part, Sydney Airport is confident in the deductibility. But we note that the structure does appear to fit closely with the ATO's worked examples included in the draft ruling and highlight the following key hurdles being applied by the ATO review:

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(i) Security holders have the right to a variable fixed rate of return, the RPS interest generates interest income at average interest rate of 15%/annum. The variable nature implies a link to profitability and therefore akin to an equity return.

(ii) SAT1, is a controlling entity of the RPS issuing vehicles.

(iii) RPS interest is used to fund the distributions to equity investors in Sydney Airport.

(iv) The RPS were issued under a scheme, which gave rise to the interest payments.

But the issue could be broader than this

Little evidence to differentiate the tranches of RPS

In our view there is no clear differentiator between the tranches of RPS issued, and based on discussions with a range of interested parties we believe the ATO could reach a similar conclusion with respect of all tranches of RPS held by SAT1.

In this worst case scenario whereby all RPS interest is non-deductible, interest of ~$442.3m is paid annually on the $3.1bn of RPS. The loss of this interest deduction would add $132m to the SYD annual cash tax liability, which equates to ~7cps or ~30% of the current distribution.

Transurban has a similar but different structure

TCL seems to be sufficiently differentiated from the ATO examples in TR2012/D5

The ATO reviewed the Transurban structure in 2011. The tax structure is considered different to Sydney Airport because, the trust receives income in the form of rent, interest and franked dividends.

We believe that because income is generated in these multiple forms it would be difficult for the ATO to demonstrate the shareholder loans are funding the equity returns.

The table below outlines the Transurban structure, and we highlight the following additional key differences between Transurban and Sydney Airport also includes:

- No RPS or hybrid financing is used within the TCL structure
- Majority of the interest received by the trusts is passed on to external lenders as the trusts borrow on behalf of the operating entities
- Interest component of the TCL distribution includes interest received from the WSO investment which would not be caught by the issue raised in TR2012/D5, because the WSO entities are not 'connected entities' of Transurban (TCL owns 50%) and do not include a unit trust.

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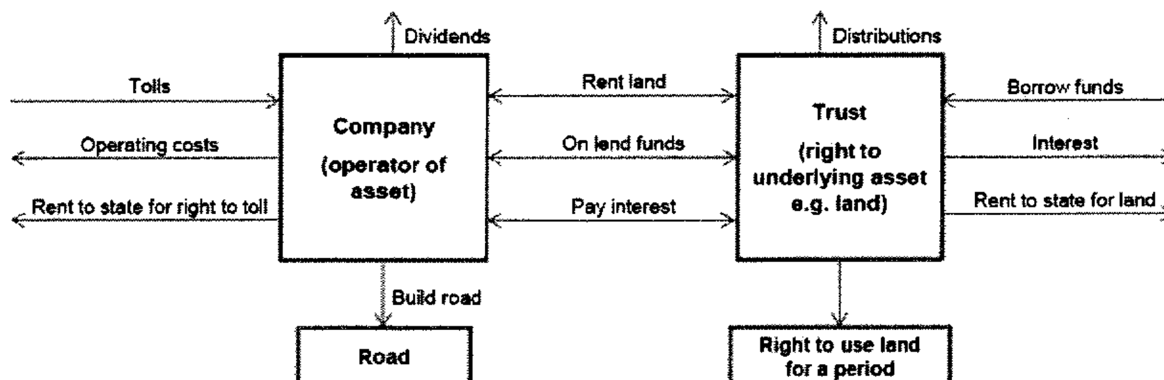
Figure 4

Transurban has a differentiated capital structure



Source: Transurban Group

ATO success at Sydney could see this issue spread further

ATO will have targetted those with the highest probablity of success first

So far the key listed stocks which have been impacted are Asciano (AIO AU) and Sydney Airport (SYD AU). These stocks are likely to have been the most aggressive structures in the ATO's view.

A win for the ATO at SYD, would lead us to expect the ATO to cast its net wider in the next round of reviews.

Spark Infrastructure and SP Ausnet both employ triple stapled structures combined with shareholder loans within the connected entities of the trusts.

SKI also employs a preferred capital structure

Spark has also adopted a preferred capital structure for its investment in SA Power Networks.

For these reasons, we believe these companies would be candidates for a future ATO review under TR2012/D5.

SKI DPS sensitivity to TR2012/D5

Spark invests in SA Power Networks and Victorian Power Networks alongside majority shareholder Cheung Kong Infrastructure (CKI). The investments in each asset are made in the following structure:

(i) VPN: $1.522bn of sub-ordinated loans with a coupon of 10.85%, (of which SKI has a 49% interest). At an interest rate of 10.85%, these notes generate deductible interest of $165m/annum, and a tax shield of ~$50m.

(ii) SA Power Networks:

a. SKI Preferred Capital $622m with interest payable of 10.85%, with annual deductible interest of $68m, and a tax shield of ~$20m;

b. CKI/PAH sub-debt of $648m with interest payable at 11.19%, with annual deductible interest of ~$200m, and a tax shield of ~$60m

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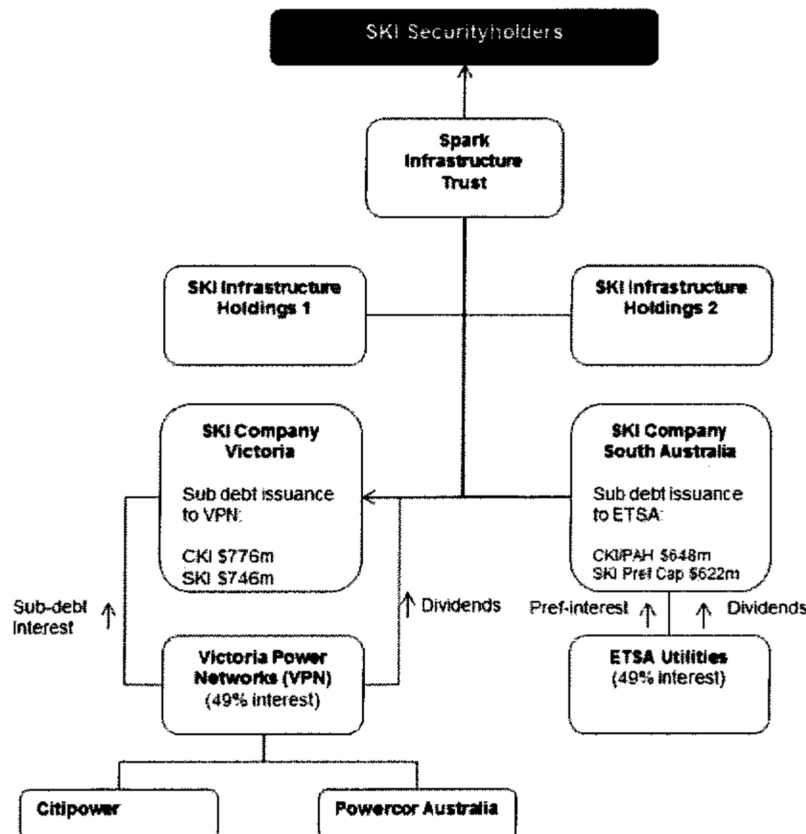
A worst case scenario implies a 4-5cps impact to SKI DPS

As a worst case scenario and excluding the impact of other ongoing audit processes at the asset companies - a loss of the deductions earned on the shareholder loan interest at both the VPN and SA Power Networks asset companies is expected to result in a proportionate impact to cash flow of ~$65m per annum or 4-5cps, which equates to ~50% of current distributions.

Existing audit processes underway at SA Power Networks and VPN are not reliant on the TR2012/D5. We note that audit processes at the asset level may further mitigate the risk of audit elsewhere in the structure. However we note the SYD tax liability is generated above the asset level entity and so this issue is not covered by the existing audit processes.

Figure 5

SKI capital structure is similar to the Sydney Airport structure



Source: CLSA Asia-Pacific Markets

SPN sensitivity to TR2012/D5

SP Ausnet finances its investments via a Finance Trust. The Finance trust on lends shareholder loans of $1.1bn and $1.0bn to the asset companies including the Distribution assets and Transmission assets respectively.

A worst case scenario implies a 1-2cps impact to SPN DPS

These loans generated interest payments of $130m in FY12. This interest is currently generating a tax shield of ~$40m/annum which if no longer deductible could lower distributions by 1-2cps or ~15%.

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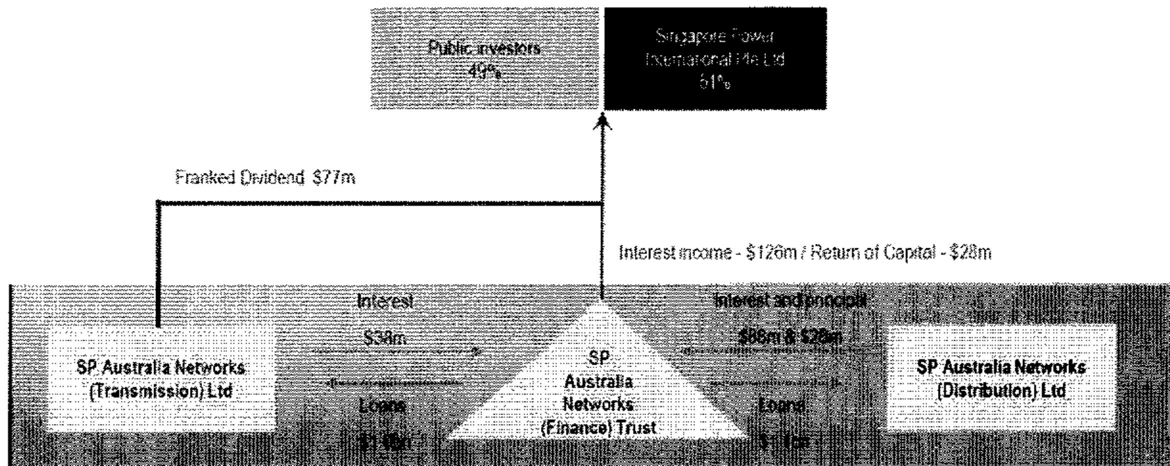
Figure 6

SP Ausnet capital structure



Source: CLSA Asia-Pacific Markets

SPN has a differentiated structure

The SP Ausnet differentiates itself from the other structures in the following way:

(i) Shareholder loan interest is set at BBSW+ a margin. This margin has historically resulted in an all-in-rate of 8-9%, which is reflective of a debt return instead of an equity or equity like return;

(ii) SPN shareholder loans are a fixed maturity of 10 years and are repayable in that time period. The longer duration and perpetual instrument are more akin to equity than debt.

Tax risk will ultimately be fact specific on the individual structures reviewed

(iii) 30% of SPN distributions are franked distributions and the company maintains a cash tax paying profile.

Domestic investors should be agnostic to the issue

A switch from distributing unfranked to franked distributions should have an immaterial impact to domestic investor valuations able to utilise franking credits.

Impact to domestic investors offset by franking credits

The following table considers the last full year of distributions paid by Sydney Airport, Spark Infrastructure, SP Ausnet and Transurban, and compares the impact to past tax returns for both Australian residents and non-residents for tax purposes.

Foreign investors face the most significant downside risk to returns from an increase in tax paid, as they cannot ascribe value to the franking credits, but would benefit from a lower rate of withholding tax.

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Figure 7

TR2012/D5 implications are more material for Australian non-resident investors

ASX Stock ticker		SYD		SKI		SPN		TCL	
Scenario		Status quo	New TR	Status quo	New TR	Status quo	New TR	Status quo	New TR
Tax leakage under TR 2012/D5	[cps]	-	7.0	-	5.0	-	1.2	-	-
Interest income		22.0	-	7.05	-	4.37	-	22.5	22.5
Return of capital		-	-	2.95	-	0.96	-	-	-
Full franked distribution		-	15.0	-	5.00	2.67	6.80	7.0	7.0
Total distribution	[cps]	22.0	15.0	10.0	5.00	8.00	6.80	29.5	29.5
Franking credit assumption		0%	100%	0%	100%	33%	100%	24%	24%
Post tax yield implied for:									
(i) Aust residents (Tax @ 30%)									
Tax payable	[cps]	6.6	0.0	3.0	0.0	1.6	0.0	6.8	6.8
DPS post-tax		15.4	15.0	7.0	5.0	6.4	6.8	22.8	22.8
% impact on post DPS			**(3%)**		**(29%)**		**6%**		**0%**
(ii) Australian non-residents									
Withholding tax rate		10%	0%	10%	0%	10%	0%	10%	10%
Withholding tax paid		2.2	-	1.0	-	0.8	-	3.0	3.0
DPS post tax, credits & withholding		19.8	15.0	9.0	5.0	7.2	6.8	26.6	26.6
% impact on post DPS			**(24%)**		**(44%)**		**(6%)**		**0%**

Source: CLSA Asia-Pacific Markets

Large offshore investor bases pose a risk to performance

As discussed earlier, the most material change in annual post tax distribution returns is expected to be to non-resident investors receiving a distribution which was unfranked.

SYD & SKI have the largest liquid foreign shareholder bases at risk

Accordingly TR2012/D5 has the greatest implications for Sydney Airport and Spark Infrastructure who both have a combination of high foreign ownership levels and a 100% unfranked distribution yield.

Sydney Airport foreign ownership has already reduced from ~37% in August 2012 to 33% this month. The table below sets out the estimated offshore investor base for each company.

Figure 8

Foreign ownership holdings

Company	Domestic	Foreign
Sydney Airport	67%	33%
Spark Infrastructure	66%	34%
SP Ausnet (Singapore Power 51% interest)	30%	70%
Transurban Group	70%	30%

Source: CLSA Asia-Pacific Markets

Note the SKI foreign ownership statistics includes CKI's 8.5% interest in Spark Infrastructure the listed entity however CKI is also a 51% investor in SA Power Networks and VPN with SKI. Distributions received by CKI from its direct interest in these assets will face the same basis of tax leakage as set out in the Australian non-resident post tax distributions in the previous table.

SP Ausnet's foreign ownership holding includes the 51% interest held by Singapore Power.

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Implications of weakening demand

RAB growth is a key driver of regulated earnings

While short term weakness in earnings from a slowdown in demand can be offset by X-factors and other revenues, a slowdown in the outlook for demand driven by increasing penetration of solar power combined with a weaker macro growth outlook is a risk to regulator appetite for ongoing investment rates relative to recent history. We assume RAB growth in line with CPI indexation post the current regulatory period.

A key driver of regulated returns and in turn the distribution profile is continued growth of the regulated asset base.

RAB growth of ~8% is provided in current capex allowances

Since 2005 Spark has delivered regulated asset base growth of ~7% and ~5% CAGR in both Victoria and South Australia respectively. Both Spark and SP Ausnet are expect to deliver RAB growth from 2012 to 2015 of ~8% CAGR.

The growth in investment in the infrastructure is driven by (i) historical under-investment in the networks as well as (ii) an expectation of continued growth in the peak demand.

Slowdown in peak demand growth should see a reduced regulator appetite for investment

The charts below highlight the link between demand growth, expected demand growth and investment in infrastructure.

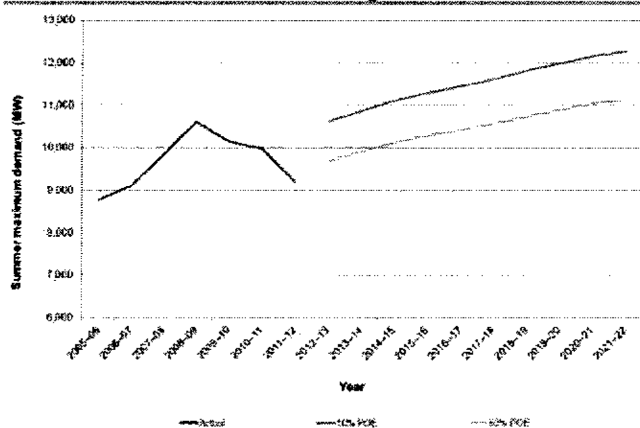
The 2009 dip in demand was not associated with a dip in investment. The 2010 determination was based on AEMO's forecast which factored in an expectation of continued growth.

We assume RAB growth in line with CPI indexation post the current reg periods

Recent historical investment in Victorian infrastructure has outpaced investment in the South Australia, reflecting the higher expected rate of peak demand growth in Victoria.

Figure 9

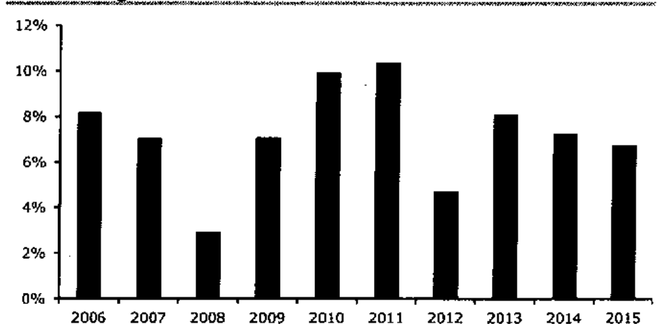
Victorian max summer demand growth



Source: AEMO

Figure 10

VPN RAB growth



Source: CLSA Asia-Pacific Markets

Demand growth in South Australia has been subdued, and has resulted in a lower level of investment.

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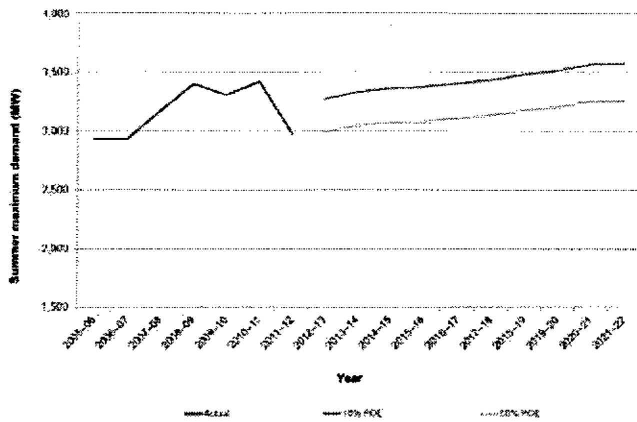
Figure 11

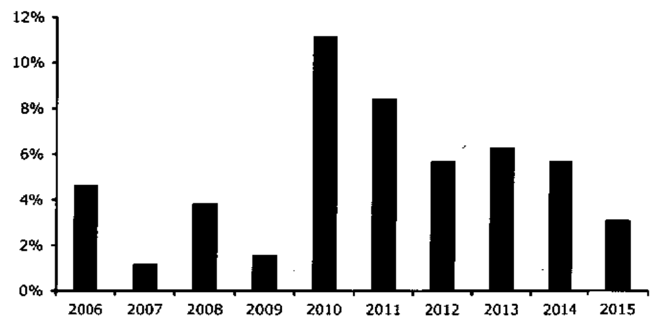
South Australian max summer demand growth



Source: AEMO – Statement of opportunities, 2012

Figure 12

SA Power Networks RAB growth

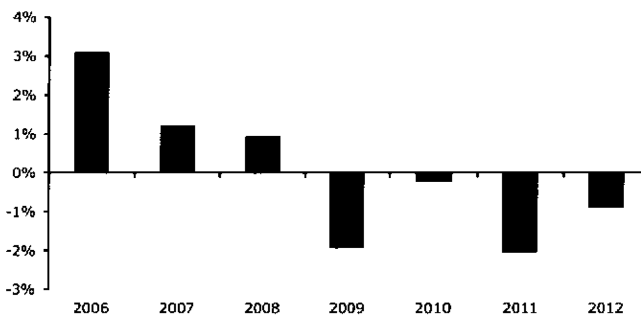


Source: CLSA Asia-Pacific Markets

Since the 2010 electricity distribution determinations, demand for electricity has weakened further. The chart below outlines the decline in demand for electricity in Victoria and South Australia over the past 2 years.

Figure 13

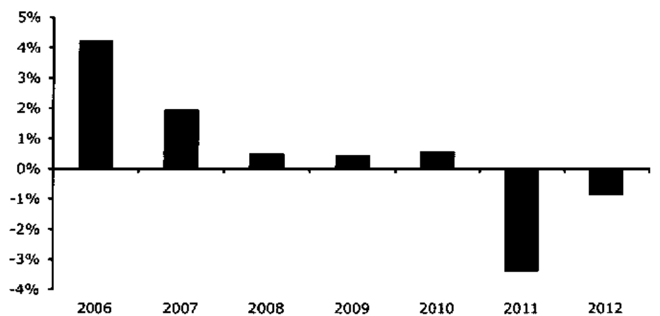
Yoy electricity demand growth - Victoria



Source: CLSA Asia-Pacific Markets

Figure 14

Yoy electricity demand growth – South Australia



Source: CLSA Asia-Pacific Markets

2010 determinations continued to factor in AEMO's growth expectations

We believe a continued anaemic growth of electricity demand, driven by increased solar generation as well as lower regional economic growth will result in a slowdown in investment in the networks, and underlying regulated earnings.

Accordingly we apply a long term RAB growth assumption in line with CPI indexation. The chart below outlines our RAB growth forecast to the end of the next regulatory period in 2015.

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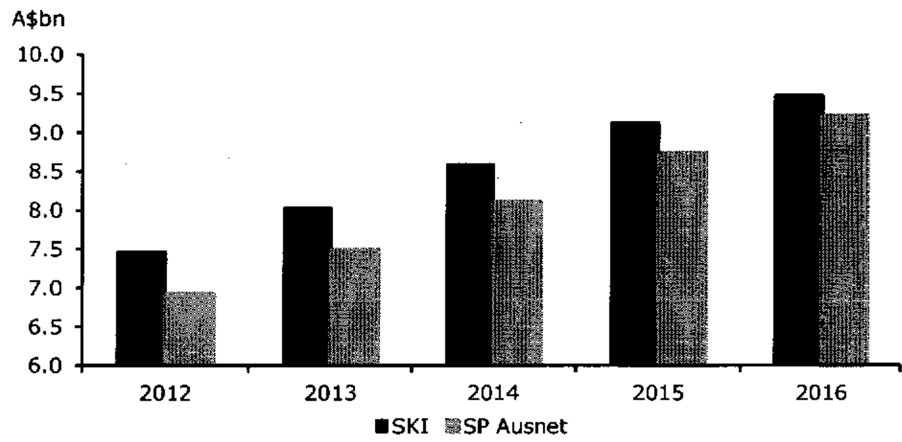
RAB growth to 2015 is locked in under current determinations

Figure 15

Forecast RAB growth to 2016



Source: CLSA Asia-Pacific Markets

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AEMC rule changes make a tougher game

New rules give greater powers to the regulator and a new approach to allowances

The AEMC rule changes announced in November 2012 are a risk to regulated returns post the next reset. The rule changes are being adopted in response to the AER's review of past allowance proposals, versus actual spend, and overall regulatory outcomes. Through this process the AER identified deficiencies in the existing regulatory frameworks.

Accordingly the AEMC has responded with a rule determination to both the Economic Regulation of Network Service Providers and the Price and Revenue Regulations of Gas Services. These rules changes are set out in the National Electricity Amendment Rule 2012 and the National Gas Amendment Rule 2012.

Rule changes have implications or cost-of-capital, capex & opex allowances

The AEMC rule changes provide increased powers to the regulator and are designed to change the way the AER prepares its cost-of-capital, capex and opex allowances. These changes may to lead to lower growth of regulated returns and crimp a business's ability to outperform regulated allowances.

Key changes to the framework include:

1. **An overall rate-of-return approach to cost of capital allowances**

Market conditions have significantly diverged from WACC returns applied in the electricity distribution and transmission determinations finalised in 2010. The table below is a comparison of the regulators assessment of costs of capital from 2010 to 2012.

Comparison of 2010 and 2012 cost-of-capital assumptions highlights the issue

By way of sensitivity adjusting the real risk free rate by 100bps would reduce equity cash flows by 1.2cps and 1.9cps for Spark and SP Ausnet respectively.

Figure 16

Movement in cost-of-capital assumptions since 2010

Timing	**2010**	**2012**
Nominal risk free	5.89%	2.98%
Real risk free	**3.29%**	**0.96%**
Inflation	**2.52%**	**2.00%**
Gearing	60.00%	60.00%
Market risk	**6.50%**	**6.00%**
Debt premium	**2.98%**	**3.76%**
Beta	0.80	0.80
Post-tax WACC	9.76%	7.16%
Regulator	AER	AER

Source: CLSA Asia-Pacific Markets

A 100bps change in risk free would have a ~10% impact on SKI FY13 DPS

The AER has highlighted that historically the highly codified nature of regulation left little flexibility for determining cost of capital inputs in a volatile market.

The AEMC rules changes facilitate the AER in taking a more flexible approach to setting the cost of capital and allows for consideration of the overall rate of return.

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We expect that the less prescriptive approach will reduce the ability of regulated businesses to boost regulatory returns by appealing discrete components of the cost of capital and WACC components allowed.

AER will take a view on overall rate-of-return going forward

The table below sets our assumptions of cost of capital post the current regulatory periods.

Figure 17

Spark Infrastructure cost-of-capital assumptions

Asset	SA Power Networks		Citipower		Powercor	
Reg period	2011-2015	Post 2015	2011-2015	Post 2015	2011-2015	Post 2015
Nom risk free	5.89%	5.58%	5.08%	5.58%	5.08%	5.58%
Real risk free	**3.29%**	**3.00%**	**2.45%**	**3.00%**	**2.45%**	**3.00%**
Inflation	2.52%	2.50%	2.57%	2.50%	2.57%	2.50%
Gearing	60%	60%	60%	60%	60%	60%
Market risk	6.50%	6.50%	6.50%	6.50%	6.50%	6.50%
Debt premium	2.98%	1.50%	3.89%	1.50%	3.89%	1.50%
Beta	0.80	0.80	0.80	0.80	0.80	0.80
Post-tax WACC	**9.76%**	**8.56%**	**9.50%**	**8.56%**	**9.50%**	**8.56%**
Regulator	AER		AER		AER	

Source: CLSA Asia-Pacific Markets

Figure 18

SP Ausnet cost-of-capital assumptions

Asset	Dist. Elec		Dist. Gas		Trans. Elec	
Reg period	2011-15	Post 2015	2013-17(D)	Post 2017	2009-14	Post 2014
Nom risk free	5.08%	5.58%	2.98%	5.58%	6.09%	5.58%
Real risk free	**2.45%**	**3.00%**	**0.96%**	**3.00%**	**3.50%**	**3.00%**
Inflation	2.57%	2.50%	2.00%	2.50%	2.50%	2.50%
Gearing	60%	60%	60%	60%	60%	60%
Market risk	6.50%	6.50%	6.00%	6.50%	6.00%	6.50%
Debt premium	3.89%	1.50%	3.76%	1.50%	2.11%	1.50%
Beta	0.80	0.80	0.80	0.80	1.00	1.00
Post-tax WACC	**9.50%**	**8.56%**	**7.16%**	**8.56%**	**9.76%**	**9.08%**
Regulator		AER		AER		AER

Source: CLSA Asia-Pacific Markets

2. Capex and Opex allowances

Key changes to the capex and opex allowance setting are:

New powers of interrogation have been given to the AER

(i) New and increased the powers for the AER to interrogate, review and amend capital expenditure and operating expenditure allowances;

An implication of this is the ability to "top-up" or amend an allowance. This gives the regulator the flexibility to approve a low level capex allowances and allow firms to request a top-up or amendment to the allowance should it be required through the regulatory period.

(ii) The adoption of benchmarking to determine regulatory allowances is expected to position Spark Infrastructure and SP Ausnet as the industry benchmarks, and as such will face increased scrutiny on financial and productive metrics as they are compared against the government owned peers.

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Note Transitional rules apply

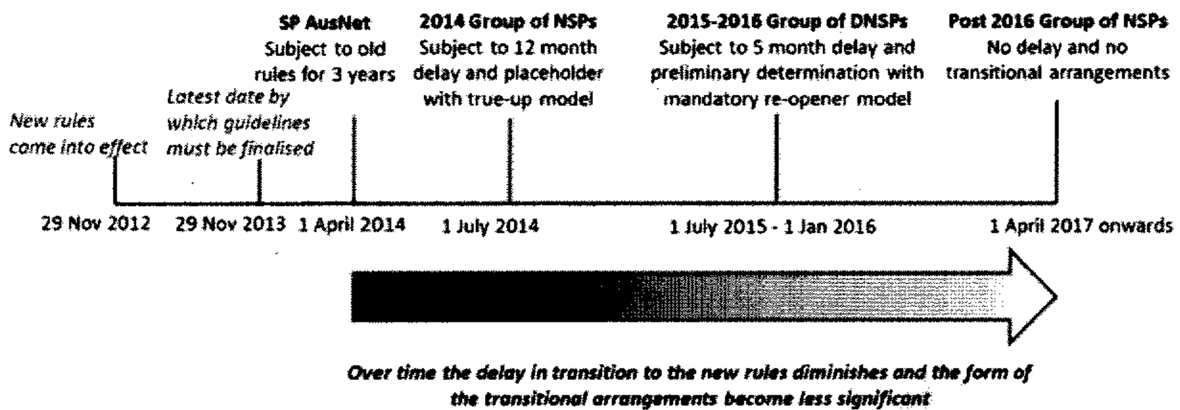
Effectiveness of rules changes will be evident in 2014 at the earliest

The release of the AEMC rule changes coincided with the release of the Access arrangement draft decision for SP Ausnet's Gas distribution business.

The new rules will not apply to the latest SPN gas access determination. The first listed asset to face regulation under the new rules will be SPN's electricity transmission business in 2014.

Figure 19

New rules will apply to SKI and SPN's next determinations



Source: CLSA Asia-Pacific Markets

As outlined in the table below the first assets to face the new rules will be Transgrid in NSW from the transmission assets, while ActewAGL, Endeavour Energy, Essential Energy and Ausgrid will be the first distribution business to receive a determination under the new rules.

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Figure 20

New rules and consultation process require a new regulatory timetable for assets

NSP		Form of Transitional Arrangement	Next Regulatory Period		Framework and Approach		Regulatory Process			
			Length	Dates	Consultation Commences*	Paper Published	Regulatory Proposal Due	Draft Decision*	Final Decision	Length
Transmission										
SP AusNet (Vic)	Next Determination	Old rules for 3 years	3 years	1 Apr 2014 - 31 Mar 2017	n.a.	n.a.	28 Feb 2013	31 Aug 2013*	31 Jan 2014	11 months
	Subsequent Determination	New rules	5 years	1 Apr 2017-30 Mar 2022	30 Sep 2014§	30 Apr 2015	31 Oct 2015	30 Jun 2016*	31Jan 2017	15 months!
TransGrid, Transend (NSW and Tas)	Placeholder Determination	Placeholder with true-up	1 year	1 Jul 2014- 30 Jun 2015	n.a.	n.a.	31 Jan 2014	n.a.	31 Mar 2014	2 months
	Full Determination		4 years~	1 Jul 2015- 30 Jun 2019	30 Nov 2013	31 Jan 2014	31 May 2014	30 Nov 2014*	30 Apr 2015	11 months^
Directlink (Interconnector btw Qld and NSW)		New rules	9 years~	1 Jul 2015-30 Jun 2024	30 Nov 2013§	31 Jan 2014	31 May 2014	30 Nov 2014*	30 Apr 2015	11 months^
Powerlink (Qld)		No transitional arrangements§	5 years	1 Jul 2017- 30 Jun 2022	31 Dec 2014§	31 Jul 2015	31 Jan 2016	30 Sep 2016*	30 Apr 2017	15 months!
ElectraNet (SA)			5 years	1 Jul 2018- 30 Jun 2023	31 Dec 2015§	31 Jul 2016	31 Jan 2017	30 Sep 2017*	30 Apr 2018	15 months!
Muarraylink (Interconnector btw Vic and SA)			10 years~	1 Jul 2023- 30 Jun 2033	31 Dec 2020§	31 Jul 2021	31 Jan 2022	30 Sep 2022*	30 Apr 2023	15 months!
Distribution										
ActewAGL, Endeavour Energy, Essential Energy and Ausgrid (ACT and NSW)	Placeholder Determination	Placeholder with true-up	1 year	1 Jul 2014-30 Jun 2015	n.a.	n.a.	31 Jan 2014	n.a.	30 Apr 2014	3 months
	Full Determination		4 years~	1 Jul 2015-30 Jun 2019	Part 1: 31 Oct 2012 Part 2: 30 Nov 2013	Part 1: 31 Mar 2013 Part 2: 31 Jan 2014	31 May 2014	30 Nov 2014*	30 Apr 2015	11 months^
Ergon, Energex and SA Power Networks (Qld and SA)		Preliminary Determination with mandatory re-opener	5 years~	1 Jul 2015-30 Jun 2020	30 Sep 2013	30 Apr 2014	31 Oct 2014	30 Apr 2015*	31 Oct 2015	12 months*
Jemena, United Energy, CitiPower, Powercor and SP AusNet (Vic)			5 years~	1 Jan 2016-31 Dec 2020	31 Mar 2014	31 Oct 2014	30 Apr 2015	31 Oct 2015*	30 Apr 2016	12 months*
Aurora Energy (Tas)		No transitional arrangements	5 years	1 Jul 2017- 30 Jun 2022	31 Dec 2014	31 Jul 2015	31 Jan 2016	30 Sep 2016*	30 Apr 2017	15 months!

Source: CLSA Asia-Pacific Markets

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Valuation underpinned by yield

Preference for SKI's DPS growth versus SPN's higher overall yield

We initiate coverage of SKI and SPN with target prices of $1.85 and $1.25 respectively. Our valuation factors in the following:

(i) Sum-of-the-parts based on DCF valuations of the underlying assets

(ii) A comparison of RAB transaction multiples.

Sum-of-the-parts

We value each asset on a DCF of our 20-year cash flow, and assume a terminal value equal to the closing balance of the RAB. We assume each business has a target gearing of ~70% and apply a pre-tax cost of debt of ~7%. Our overall cost-of-capital assumptions are as set out below:

Figure 21

Cost of capital assumptions	
Risk free rate	**4.5%**
Market risk premium	5.5%
Tax rate	30%
Leveraged Beta	1.09
WACC	**7.0%**

Source: CLSA Asia-Pacific Markets

SKI is an unlikely takeover target with CKI holding 8.5% in SKI and 51% of SKI's assets

Our Spark Infrastructure valuation is outlined in the table below.

Figure 22

Spark Infrastructure SOTPs valuation

Sum-of-the-parts	DCF	RAB(x)	RAB	RAB(x)	EV
Vic Power Networks (incl AMI)	5,885	1.27x	4,634	1.50x	6,951
SA Power Networks	5,145	1.34x	3,831	1.50x	5,746
Non-prescribed	854				854
EV	**11,885**		**8,465**		**13,551**
Net debt	6,805				6,805
Equity	5,080				6,746
SKI interest	**2,489**				**3,306**
Corp costs	(67)				(67)
SKI Equity	**2,422**				**3,238**
per share	**$1.85**				**~$2.45**

Source: CLSA Asia-Pacific Markets

Singapore Power retains a 51% interest in SPN

Our SP Ausnet valuation is outlined in the table below.

Figure 23

SP Ausnet SOTPs valuation

Sum-of-the-parts	DCF	RAB(x)	RAB	RAB(x)	EV
Dist - Electricity	3,567	1.22x	2,920	1.5x	4,380
Dist - Gas	1,443	1.16x	1,242	1.5x	1,863
Trans - Electricity	3,782	1.24x	3,052	1.5x	4,579
Select	272				272
EV	**9,036**				**11,094**
Net debt	4,966				4,966
Equity	**4,098**				**6,128**
per share	**~$1.25**				**~$1.85**

Source: CLSA Asia-Pacific Markets

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Comparable RAB multiples

On our numbers the Spark and SP Ausnet are current trading on ~1.3x and 1.2x RAB.

RAB premiums pre-GFC in 2008 reflect a higher capacity for asset gearing

The table below outlines an average of historical RAB acquisition multiples of 1.5x RAB, which is a 15% premium to the current trading multiples.

Our DCF valuation is in line with current market multiples.

Figure 24

Australian transaction RAB Multiples

Date	Entity/Asset Acquired	Acquirer	RAB Multiple
Dec-06	DirectLink	APA	1.45x
Oct-06	Allgas	APA	1.64x
Aug-06	GasNet	APA	2.19x
Apr-06	AGL Infrastructure assets	Alinta	1.47x
Mar-06	Murraylink	APA	1.47x
Aug-04	Dampier to Bunbury NGP	DUET	1.20x
Aug-04	Southern Cross Pipeline	APA	1.47x
Apr-03	AlintaGas Networks	Alinta	1.35x
Apr-03	Multinet Gas	Alinta	1.44x
Apr-03	United Energy	Alinta	1.52x
Aug-02	Citipower	CKI	1.69x
Average			**1.54x**

Source: CLSA Asia-Pacific Markets

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evalu@tor
The Asia-Pacific Market Database

Spark Infrastructure summary financials

Stapled trust structure distorts statutory earnings

Capex spend is captured within the asset accounts

Debt is typically project finance linked to the regulated asset base

3yr DPS CAGR is 4.4%

Year to 31 December	2010A	2011A	2012CL	2013CL	2014CL
Summary P&L forecast (A$m)					
Revenue	**284**	**288**	**285**	**242**	**269**
Op Ebitda	261	226	275	237	264
Op Ebit	261	226	275	237	264
Interest income	5	3	2	2	2
Interest expense	(187)	(104)	(103)	(103)	(103)
Other items	0	0	-	-	0
Profit before tax	**78**	**124**	**174**	**136**	**163**
Taxation	3	(42)	(7)	(29)	(22)
Minorities/Pref divs	-	-	-	-	-
Net profit	**81**	**83**	**167**	**107**	**141**
Summary cashflow forecast (A$m)					
Operating profit	**261**	**226**	**275**	**237**	**264**
Operating adjustments	(80)	(12)	(51)	7	7
Depreciation/amortisation	0	0	0	0	0
Working capital changes	-	-	-	-	-
Net interest/taxes/other	(46)	(25)	(19)	(15)	(15)
Net operating cashflow	**134**	**189**	**205**	**229**	**256**
Capital expenditure	-	-	-	-	-
Free cashflow	**134**	**189**	**205**	**229**	**256**
Acq/inv/disposals	0	(52)	0	0	0
Int, invt & associate div	-	-	-	-	-
Net investing cashflow	**0**	**(52)**	**0**	**0**	**0**
Increase in loans	(300)	(40)	0	0	0
Dividends	(140)	(154)	(167)	(182)	(190)
Net equity raised/other	280	0	0	0	0
Net financing cashflow	**(160)**	**(194)**	**(167)**	**(182)**	**(190)**
Incr/(decr) in net cash	**(25)**	**(56)**	**38**	**47**	**66**
Exch rate movements	-	-	-	-	-
Opening cash	**114**	**89**	**33**	**71**	**119**
Closing cash	**89**	**33**	**71**	**119**	**184**
Summary balance sheet forecast (A$m)					
Cash & equivalents	89	33	71	119	184
Debtors	29	11	11	11	11
Inventories	-	-	-	-	-
Other current assets	1	1	1	1	1
Fixed assets	0	0	0	0	0
Intangible assets	-	-	-	-	-
Other term assets	2,358	2,271	2,295	2,295	2,295
Total assets	**2,477**	**2,316**	**2,379**	**2,427**	**2,492**
Short-term debt	-	-	-	-	-
Creditors	9	4	4	4	4
Other current liabs	111	53	50	79	101
Long-term debt/CBs	959	920	920	920	920
Provisions/other LT liabs	0	6	5	5	5
Minorities/other equity	0	0	0	0	0
Shareholder funds	1,398	1,334	1,400	1,418	1,462
Total liabs & equity	**2,477**	**2,316**	**2,379**	**2,427**	**2,492**
Ratio analysis					
Revenue growth (% YoY)	1.1	1.3	(1.2)	(14.9)	11.1
Ebitda growth (% YoY)	(2.9)	(13.2)	21.5	(13.8)	11.3
Ebitda margin (%)	91.7	78.5	96.6	97.8	98.0
Net profit margin (%)	28.5	28.7	58.6	44.1	52.3
Dividend payout (%)	222.3	185.9	83.5	170.2	135.4
Effective tax rate (%)	(3.4)	33.6	4.0	21.4	13.5
Ebitda/net int exp (x)	1.4	2.2	2.7	2.3	2.6
Net debt/equity (%)	62.2	66.5	60.6	56.5	50.3
ROE (%)	8.2	6.0	12.2	7.6	9.8
ROIC (%)	-	-	-	-	-
EVA®/IC (%)	0.0	0.0	0.0	0.0	0.0

Source: CLSA Asia-Pacific Markets

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SP Ausnet summary financials

SPN does not employ preference share capital within its structure

SPN maintains a cash tax profile and franked dividends account for 30% of equity returns

RAB/Net debt of ~65% maintained over the forecast period

FY13 DPS guidance of 8.2cps and 2% DPS growth in FY14

Year to 31 March	2012A	2013CL	2014CL	2015CL	2016CL
Summary P&L forecast (A$m)					
Revenue	**1,535**	**1,664**	**1,749**	**1,830**	**1,853**
Op Ebitda	907	993	1,052	1,108	1,122
Op Ebit	613	681	730	776	781
Interest income	14	21	17	17	17
Interest expense	(347)	(348)	(370)	(398)	(423)
Other items	0	0	0	0	-
Profit before tax	**280**	**354**	**377**	**395**	**375**
Taxation	(25)	(80)	(113)	(119)	(112)
Minorities/Pref divs	-	-	-	-	-
Net profit	**255**	**273**	**264**	**277**	**262**
Summary cashflow forecast (A$m)					
Operating profit	**613**	**681**	**730**	**776**	**781**
Operating adjustments	(40)	(36)	0	0	0
Depreciation/amortisation	294	312	321	331	341
Working capital changes	-	-	-	-	-
Net interest/taxes/other	(441)	(416)	(483)	(517)	(536)
Net operating cashflow	**427**	**541**	**568**	**591**	**586**
Capital expenditure	-	-	-	-	-
Free cashflow	**427**	**541**	**568**	**591**	**586**
Acq/inv/disposals	(691)	(805)	(728)	(687)	(583)
Int, invt & associate div	4	10	17	17	17
Net investing cashflow	**(688)**	**(795)**	**(711)**	**(670)**	**(566)**
Increase in loans	365	483	423	368	274
Dividends	(135)	(247)	(280)	(288)	(294)
Net equity raised/other	-	427	0	-	-
Net financing cashflow	**230**	**662**	**143**	**79**	**(20)**
Incr/(decr) in net cash	**(31)**	**408**	**0**	**-**	**-**
Exch rate movements	-	-	-	-	-
Opening cash	**50**	**19**	**428**	**428**	**427**
Closing cash	**19**	**428**	**428**	**427**	**427**
Summary balance sheet forecast (A$m)					
Cash & equivalents	19	428	428	428	427
Debtors	48	48	48	48	48
Inventories	16	17	17	17	17
Other current assets	317	364	364	364	364
Fixed assets	7,847	8,344	8,752	9,107	9,349
Intangible assets	370	370	370	370	370
Other term assets	115	132	132	132	132
Total assets	**8,731**	**9,701**	**10,108**	**10,464**	**10,706**
Short-term debt	976	-	-	-	-
Creditors	213	230	230	230	230
Other current liabs	126	102	102	102	102
Long-term debt/CBs	3,566	5,012	5,435	5,802	6,076
Provisions/other LT liabs	923	999	999	999	999
Minorities/other equity	0	0	0	0	0
Shareholder funds	2,928	3,358	3,342	3,330	3,298
Total liabs & equity	**8,731**	**9,701**	**10,108**	**10,464**	**10,706**
Ratio analysis					
Revenue growth (% YoY)	-	8.4	5.1	4.7	1.2
Ebitda growth (% YoY)	-	9.4	6.0	5.3	1.3
Ebitda margin (%)	59.1	59.6	60.1	60.5	60.5
Net profit margin (%)	16.6	16.4	15.1	15.1	14.2
Dividend payout (%)	90.9	100.2	105.8	104.3	112.2
Effective tax rate (%)	9.0	22.7	30.0	30.0	30.0
Ebitda/net int exp (x)	2.7	3.0	3.0	2.9	2.8
Net debt/equity (%)	154.4	136.5	149.8	161.4	171.3
ROE (%)	8.7	8.7	7.9	8.3	7.9
ROIC (%)	6.8	6.2	5.7	5.8	5.6
EVA®/IC (%)	(1.4)	(1.7)	(2.0)	(1.9)	(2.1)

Source: CLSA Asia-Pacific Markets

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Companies mentioned

Spark Infra (SKI AU - A$1.70 - O-PF)

SP Ausnet (SPN AU - A$1.18 - O-PF)

Key to CLSA investment rankings: BUY: Total return expected to exceed market return AND provide 20% or greater absolute return; **O-PF**: Total return expected to be greater than market return but less than 20% absolute return; **U-PF**: Total return expected to be less than market return but expected to provide a positive absolute return; **SELL**: Total return expected to be less than market return AND to provide a negative absolute return. For relative performance, we benchmark the 12-month total return (including dividends) for the stock against the 12-month forecast return (including dividends) for the local market where the stock is traded.

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Appendix 2

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Sydney Airport

A$3.20 - UNDERPERFORM

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12 February 2013

Australia
Transport

Reuters	SYD.AX
Bloomberg	SYD AU

Priced on 12 February 2013
ASX200 @ 4,959.0

12M hi/lo A$3.61/2.54

12M price target A$2.95
±% potential -8%

Shares in issue 1,861.2m
Free float (est.) 100.0%

Market cap US$6,107m

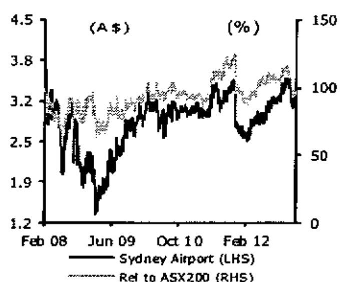
3M average daily volume
A$24.4m (US$25.5m)

Foreign s'holding 39.5%

Major shareholders
Macquarie Group Limited 22.4%

Stock performance (%)

	1M	3M	12M
Absolute	3.9	(5.6)	21.7
Relative	(1.3)	(15.3)	4.2
Abs (US$)	1.2	(6.8)	17.0



Source: Bloomberg

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Evaluating tax risk

Company update

We have received a number of incoming queries around tax risks at Sydney Airport, as well as the remainder of the infrastructure and utilities sector. Coinciding with Baden Moore's initiation on Spark Infrastructure and SP Ausnet, we aim to identify tax risks in the sector. Sydney Airport carries the most obvious risk and the issue could be drawn out. For a defensive high quality yield we prefer Transurban. After the FY12 result we will reassess the fundamentals of the Sydney Airport business.

The draft ATO ruling in July 2012 changed its approach

The Australian Tax Office (ATO) is set to deny income tax deductions on debt interest returns paid in relation to "de facto" equity interests in the company. This is an issue across the infrastructure and utility sector, with a particular focus on preferred capital or redeemable preference share (RPS) investments. The latter is the issue for Sydney Airport. It is worth remembering we are in an election year and the government is looking to offset lower tax receipts.

What is the issue for Sydney Airport?

On 20 Dec-12, the ATO delivered Sydney Airport with a position paper on the deductibility of interest paid on its RPS. For its part, Sydney Airport is confident in the deductibility, but the structure does appear to fit closely with the ATO's worked examples included in the draft ruling. The ATO position paper appears to relate to one of six RPS facilities (A$872m of A$3.1bn total). If incurred this liability equates to ~4cps as a one-off back-payment but more importantly loss of deductibility would reduce the distribution by ~2cps.

But the issue could broaden from here

The differentiator between the tranches of RPS is not readily apparent. Based on discussions with contacts we believe the ATO could reach a similar conclusion with respect of all six tranches of RPS. The worse-case scenario would equate to ~7cps or one-third of the FY12 distribution.

So what can SYD do?

Sydney Airport is likely to vigorously defend its position. This could be a drawn-out process. Transurban's structure proves it is possible to avoid the ATO's focus but the cost of restructuring could be considerable and may be closely scrutinised by government in any case. Sydney Airport could become a "normal" tax-paying corporate. Its distribution would be franked and Australians with tax rate >30% would be ambivalent. International shareholders (33% of holders, down from 37%) could be >20% worse off.

Financials

Year to 31 December	10A	11A	12CL	13CL	14CL
Revenue (A$m)	976	957	1,030	1,094	1,165
Net profit (A$m)	(68)	69	76	117	155
EPS (A¢)	(3.6)	3.7	4.1	6.3	8.3
CL/consensus (9) (EPS%)	-	-	50	70	95
EPS growth (% YoY)	nm	nm	9.6	54.5	32.3
PE (x)	nm	86.3	78.8	51.0	38.5
Dividend yield (%)	9.1	6.6	6.6	6.9	7.5
FCF yield (%)	19.9	30.8	20.3	24.2	29.3
PB (x)	1.1	2.6	3.1	3.8	4.9
ROE (%)	(1.2)	1.8	3.6	6.6	11.1
Net debt/equity (%)	91.3	237.9	296.5	375.6	501.7

Source: CLSA Asia-Pacific Markets

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Assessing tax risks

We have received a number of incoming queries around tax risks at Sydney Airport, as well as the remainder of the infrastructure and utilities sector. Coinciding with Baden Moore's initiation on Spark Infrastructure and SP Ausnet, we aim to identify tax risks in the sector. See Australia Regulated Utilities (Yielding solid returns). Sydney Airport carries the most obvious risk and the issue could be drawn out. For a defensive high quality yield we prefer Transurban. After the FY12 result we will reassess the fundamentals of the Sydney Airport business.

Sector background

Maximising tax efficiency has been a feature of the sector

Over the past decade the infrastructure, utilities and property sectors have used stapled unit trusts and shareholder loans to maximise tax efficiency and facilitate capital liquidity. Remember that the assets are typically highly cash generative but due to the capital intensity of the investment are characterised by very high depreciation charges which would limit payment of ordinary distributions.

Shifts tax liability to security-holder

These unit trust structures do not permanently "avoid" tax, but instead the tax liability is shifted to the security-holder. The combination of the trust structures and shareholder loans meant that:

- Tax was not paid at the asset company level due to deductibility;
- The stapled security investment vehicles (the listed entities) paid little/no tax as long as all free cash was distributed to holders; and
- The holder of the stapled security would receive an unfranked distribution and so paid tax on the income at their respective marginal tax rate.

What has changed?

ATO draft ruling in July 2012 targeting deductibility of "de facto" equity

The ATO released Draft Taxation Ruling TR 2012/D5 in July 2012. In its ruling, the Australian Tax Commissioner focussed on the differentiation between debt and equity interests in unit trusts such as those employed by Sydney Airport, Spark Infrastructure, SP Ausnet, Asciano and Transurban. It looks to deny income tax deductions on debt interest returns paid in relation to "de facto" equity interests in the company.

The key principle applied to differentiate between debt and equity capital within these unit trusts is the Commissioner's interpretation of 'connected entity' rules. Simplistically, if the entities are found to be connected, then there is scope for the ATO to characterise interest received on shareholder loans within the stapled structure as an equity return. Where the returns are equity-like in substance or contingent on economic performance they would not be deductible under Australian taxation law.

RPS investments have been a focus

So far the ATO has focussed on the preferred capital or redeemable preference share investments within these structures as they are more like equity than debt. This is the case for Sydney Airport particularly.

It is worth remembering that the federal government, in an election year, is under pressure to find ways to offset lower tax receipts as a result of a weaker economy and a poorly designed MRRT (resource tax).

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Why does Sydney Airport have an issue?

ATO delivered a position paper on 20 Dec-12

Following the release of TR 2012/D5, on 20 December 2012 the ATO delivered Sydney Airport with a position paper on the deductibility of interest paid on its redeemable preference share structure.

To understand the issue at play is easiest when done in conjunction with the figure below. It outlines the Sydney Airport structure and the flow of distributions from the asset company to SYD security holders by way of RPS.

Specific issue identified around A$872m of total A$3.1bn of RPS principal

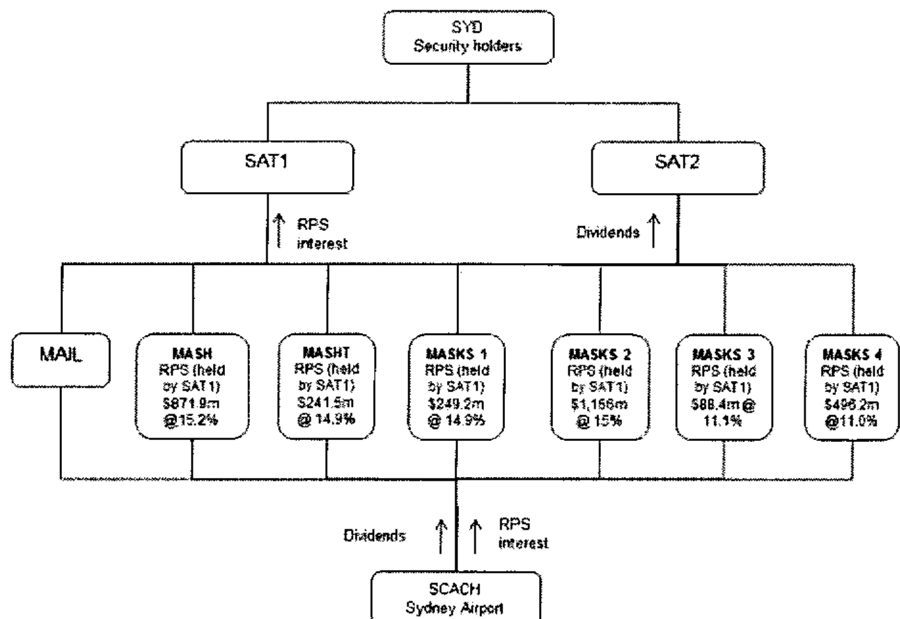
In total Sydney Airport has six separate RPS facilities (MASH, MASHT, MASK1, MASK2, MASK3, & MASK4). In total, the amount outstanding is ~A$3.1bn. Sydney Airport's release on the ATO position paper stated that the quantum of RPS principal in question in the position paper is A$872m, which corresponds with the MASH notes. These have an interest rate of 15.2%, generating a tax shield of ~$39m pa, in line with the $79m liability for two years to Dec-11 set out in the Sydney Airports' press release.

If deductibility lost this would amount to ~2cps potential distribution impact

If incurred, this liability equates to ~4cps as a one-off payment. But more importantly, the loss of interest charges on the MASH notes equates to a ~2cps impact to cash available for distribution to SYD security holders on the basis that SYD management continues to pay ~100% of free cash flow to equity as a distribution.

Figure 1

Sydney Airport structure diagram



Source: CLSA Asia-Pacific Markets

Appears to fit in the ATO's target tax structure

Sydney Airport confident but does appear to resemble ATO's worked examples

For its part, Sydney Airport is confident in the deductibility. But we note that the structure does appear to fit closely with the ATO's worked examples included in the draft ruling and highlight the following key hurdles being applied by the ATO review:

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(i) Security holders have the right to a variable fixed rate of return, the RPS interest generates interest income at average interest rate of 15%/annum. The variable nature implies a link to profitability and therefore akin to an equity return.

(ii) SAT1, is a controlling entity of the RPS issuing vehicles.

(iii) RPS interest is used to fund the distributions to equity investors in Sydney Airport.

(iv) The RPS were issued under a scheme, which gave rise to the interest payments.

But the issue could be broader than this

No clear differentiator between tranches of RPS and worst-case could be ~7cps

In our view there is no clear differentiator between the tranches of RPS issued, and based on discussions with a range of interested parties we believe the ATO could reach a similar conclusion with respect of all tranches of RPS held by SAT1.

In this worst case scenario whereby all RPS interest is non-deductible, interest of ~$442.3m is paid annually on the $3.1bn of RPS. The loss of this interest deduction would add $132m to the SYD annual cash tax liability, which equates to ~7cps or ~30% of the current distribution.

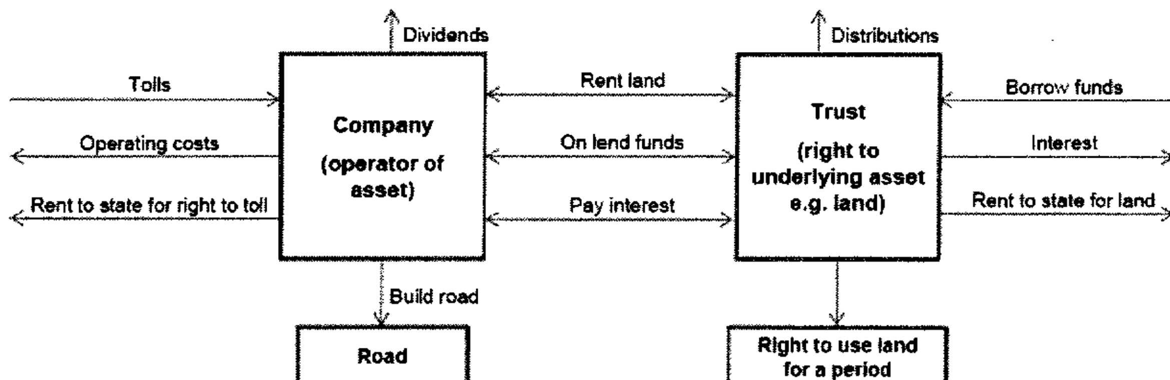
Can SYD react? Yes, but...

Transurban has a tax-efficient structure

Transurban has a structure that is tax efficient but that does not seem to be on the ATO's radar. Essentially this is because the trust receives income in the form of both rent and interest and was reviewed by the ATO in 2011. The chart outlines Transurban's structure. The key differences between it and Sydney Airport include (i) an absence of preferred capital and (ii) a receipt of rental income in addition to franked dividends and shareholder loan interest. It will be more difficult for the ATO to demonstrate the shareholder loans are funding an equity return.

Figure 2

Transurban has a differentiated capital structure



Source: Transurban Group

So it is clearly possible for Sydney Airport to restructure itself. However there are two potential limitations:

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Restructuring could be possible but would involve upfront costs and may not be allowed

- Upfront costs. A significant restructuring in its financial structure may incur considerable upfront costs. Such upfront costs would likely pale into comparison with ongoing tax liability.
- Government policy. As above, the Australian government appears focused on increasing tax receipts due to leakage elsewhere. So there is a potential for a restructuring to not be successful in any case.

So SYD may become a "normal" corporate, offshore 24% worse off

Domestic holders will get franking, offshore could be >20% worse off post tax

If Sydney Airport's RPS structure is no longer deductible, there is a possibility that it becomes a tax-paying Australian corporate. In such a case its dividend would be franked, meaning Australian shareholders with a tax rate >30% would be ambivalent between the current or lower distribution. Clearly this is not as attractive for international shareholders, but it would mean the withholding tax would not be paid. As set out in Australia Regulated Utilities (Yielding solid returns), international shareholders could be >20% worse off after tax on the distribution received.

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SYD currently trading on >30x PER

Capex forecasts are a key focus

Debt issues appear fine

Margins are world-best

Summary financials

Year to 31 December	2010A	2011A	2012CL	2013CL	2014CL
Summary P&L forecast (A$m)					
Revenue	**976**	**957**	**1,030**	**1,094**	**1,165**
Op Ebitda	759	712	840	900	960
Op Ebit	449	407	543	606	671
Interest income	-	-	-	-	-
Interest expense	(472)	(415)	(444)	(489)	(516)
Other items	(49)	(19)	(55)	0	-
Profit before tax	**(72)**	**(28)**	**44**	**117**	**155**
Taxation	54	97	32	-	-
Minorities/Pref divs	(49)	-	-	-	-
Net profit	**(68)**	**69**	**76**	**117**	**155**
Summary cashflow forecast (A$m)					
Operating profit	**449**	**407**	**543**	**606**	**671**
Operating adjustments	854	1,305	578	717	960
Depreciation/amortisation	310	306	297	294	289
Working capital changes	-	-	-	-	-
Net interest/taxes/other	10	(12)	-	-	-
Net operating cashflow	**1,623**	**2,005**	**1,417**	**1,617**	**1,919**
Capital expenditure	(435)	(172)	(207)	(176)	(176)
Free cashflow	**1,188**	**1,834**	**1,211**	**1,441**	**1,743**
Acq/inv/disposals	346	770	-	-	-
Int, invt & associate div	(104)	(95)	(34)	-	-
Net investing cashflow	**(193)**	**503**	**(241)**	**(176)**	**(176)**
Increase in loans	93	814	(465)	209	206
Dividends	(586)	(391)	(427)	(482)	(526)
Net equity raised/other	(391)	(1,563)	(49)	-	-
Net financing cashflow	**(885)**	**(1,140)**	**(941)**	**(273)**	**(320)**
Incr/(decr) in net cash	**545**	**1,368**	**236**	**1,168**	**1,424**
Exch rate movements	-	-	-	-	-
Opening cash	**712**	**(244)**	**151**	**(820)**	**(1,127)**
Closing cash	**1,257**	**1,124**	**387**	**349**	**297**
Summary balance sheet forecast (A$m)					
Cash & equivalents	1,257	1,124	387	349	297
Debtors	490	507	94	94	94
Inventories	-	-	-	-	-
Other current assets	6	6	5	5	5
Fixed assets	12,509	9,754	9,657	9,539	9,426
Intangible assets	-	688	688	688	688
Other term assets	64	55	54	54	54
Total assets	**14,326**	**12,135**	**10,886**	**10,730**	**10,565**
Short-term debt	-	947	-	-	-
Creditors	186	764	351	351	351
Other current liabs	644	124	138	138	138
Long-term debt/CBs	6,181	5,964	6,452	6,661	6,867
Provisions/other LT liabs	1,920	1,903	1,899	1,899	1,899
Minorities/other equity	0	139	103	103	103
Shareholder funds	5,394	2,294	1,943	1,578	1,207
Total liabs & equity	**14,326**	**12,135**	**10,886**	**10,730**	**10,565**
Ratio analysis					
Revenue growth (% YoY)	172.7	(1.9)	7.6	6.2	6.4
Ebitda growth (% YoY)	nm	(6.2)	17.9	7.1	6.7
Ebitda margin (%)	77.8	74.4	81.5	82.2	82.4
Net profit margin (%)	(6.9)	7.2	7.3	10.7	13.3
Dividend payout (%)	-	566.6	516.9	350.6	289.0
Effective tax rate (%)	74.4	348.5	(73.4)	0.0	0.0
Ebitda/net int exp (x)	1.6	1.7	1.9	1.8	1.9
Net debt/equity (%)	91.3	237.9	296.5	375.6	501.7
ROE (%)	(1.2)	1.8	3.6	6.6	11.1
ROIC (%)	0.9	(9.0)	9.3	6.1	6.8
EVA®/IC (%)	(6.4)	(9.0)	(1.9)	(3.2)	(2.4)

Source: CLSA Asia-Pacific Markets

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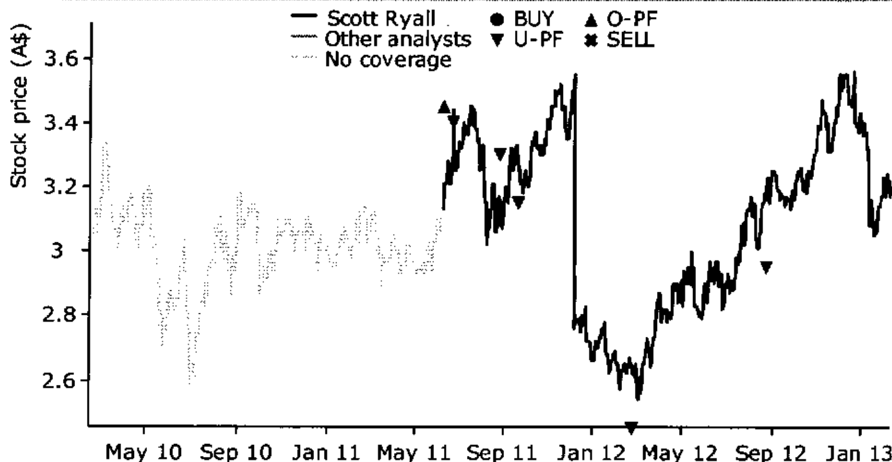
Companies mentioned

Sydney Airport (SYD - A$3.20 - UNDERPERFORM)

Recommendation history of Sydney Airport SYD AU



Date	Rec	Target	Date	Rec	Target
23 August 2012	U-PF	2.95	25 August 2011	U-PF	3.30
23 February 2012	U-PF	2.45	22 June 2011	U-PF	3.40
20 September 2011	U-PF	3.15	09 June 2011	O-PF	3.45

Source: CLSA Asia-Pacific Markets

Key to CLSA investment rankings: BUY: Total return expected to exceed market return AND provide 20% or greater absolute return; **O-PF**: Total return expected to be greater than market return but less than 20% absolute return; **U-PF**: Total return expected to be less than market return but expected to provide a positive absolute return; **SELL**: Total return expected to be less than market return AND to provide a negative absolute return. For relative performance, we benchmark the 12-month total return (including dividends) for the stock against the 12-month forecast return (including dividends) for the local market where the stock is traded.

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Note: In the interests of timeliness, this document has not been edited.

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Appendix 3

THE AUSTRALIAN

Billions at risk in ATO showdown over infrastructure financing

ANDREW WHITE THE AUSTRALIAN JANUARY 02, 2013 12:00AM

AUSTRALIAN companies are preparing to do battle with the Australian Taxation Office over deductions on billions of dollars worth of financing for significant infrastructure assets as the government looks for extra revenue to bolster sagging corporate tax receipts.

The ATO has warned companies including Sydney Airport, Spark Infrastructure, Southern Cross Austereo and Asciano that it may disallow certain deductions, resulting in assessments for hundreds of millions of dollars in extra tax and penalties on hybrid financing structures.

But the companies that have disclosed the ATO audits said they planned to "vigorously defend their position", setting the scene for protracted legal battles with the tax office.

And tax experts said there may be many other companies facing similar reviews, as the financing structures being targeted were widely used for a number of years before the ATO made its views public. The new approach could throw into doubt financing for necessary infrastructure projects by changing the tax deductions available in such structures.

The looming battle comes as the government concedes it will not be able to meet its commitment of returning the budget to surplus this financial year because of lower than expected corporate tax receipts, which have been undermined by lower commodity prices and higher deductions from the mining investment boom.

In October, it shifted corporate tax payments from quarterly to monthly instalments in a move expected to bring forward $8.3 billion of company tax.

This followed a decision by the ATO in July to reconsider deductions claimed on financings by companies with stapled securities and trusts. Companies using those structures had issued redeemable preference shares and claimed the typically double-digit percentage dividends payments on those securities as deductible interest.

But the draft ATO ruling and a series of specific issue audits have questioned whether those payments are actually dividends and therefore not eligible for deduction from a company's taxable income if they are paid between companies that are "associates".

Tax experts said it was "disappointing" that the ATO had taken so long to issue the draft ruling because companies could face retrospective tax bills.

A lawyer at a leading law firm, who declined to be named, said the ATO appeared to be targeting companies that had taken advantage of the stapled security and trust structure without first getting a private ruling from the ATO on whether the structure could be used.

Infrastructure and property companies used the structures to separate the financing of "passive" assets such as land, and active assets such as power stations and airports on that land, with the deductions helping to deliver returns to investors holding securities that "staple" those interests together.

Sydney Airport became the latest company to have its financing questioned by the ATO, which issued a position paper questioning deductions on $872 million of redeemable preference shares issued in 2002-3 by the Sydney Airport Trust 2.

The company estimated that it could face a bill for $79m plus interest and penalties if the conclusions in the ATO position paper held true.

But the liability could be much higher as there is another $2.24bn worth of redeemable preference shares on issue that the ATO is also reviewing as part of its so-called "specific issue tax audit".

Sydney Airport said it was "confident that the relevant distributions on RPS (redeemable preference shares) are tax deductible" and that it would "pursue all available options to protect the interests of investors".

It said the ATO had confirmed that it was not reviewing any years earlier than 2009-10.

Spark Infrastructure, which owns 49 per cent each of the regulated electricity distribution companies, SA Power Networks in South Australia and CitiPower and Powercor in Victoria in partnership with the Cheung Kong group, has admitted that the ATO is seeking "material" adjustments to its income tax assessments.

The ATO was "reviewing a number of matters in respect of the tax years from December 31, 2006, as a result of a large business audit notified in December 2010", Spark said in its annual report.

Several entities in Spark have been audited and amended assessments issued because rent instalments, financing arrangements and labour and vehicle costs on "self-constructed" assets are either partially or fully non-deductible. Spark lodged objections but said no tax was payable anyway because of tax losses carried forward.

As a result of legal advice, the Spark entities "disagree with the ATO's position and based on all available information will vigorously defend their position", Spark said.

Transport and logistics group Asciano has already provided $15.4m for a likely assessment from the ATO on the trust financing structure. Southern Cross Austereo, meanwhile, faces an amended assessment for primary tax of $32.8m and shortfall interest charge of $10.9m on payments made on the $519m of redeemable preference shares issued to the Southern Cross Media Trust in 2005.

Southern Cross said the redeemable preference shares had been treated as liabilities in the balance sheet and the dividends treated as an income expense. Southern Cross cancelled the shares in 2010.

THE AUSTRALIAN

Sydney Airport may face $79m tax bil over trustsl

ANDREW WHITE THE AUSTRALIAN DECEMBER 22, 2012 12:00AM

SYDNEY Airport may face a tax bill of $79 million after being caught up in a tax office sweep of financing for "stapled" investment structures involving trusts.

The majority owner and operator of Sydney's domestic and international gateway joins ports and rail group Asciano and electricity distributor Spark Infrastructure among companies targeted by the Australian Taxation Office over deductions claimed on their financing.

Stapled structures are widely used in infrastructure and property companies to join passive assets such as land to the active assets of the business.

But an audit by the ATO has raised questions over deductions on payments made on redeemable preference shares issued by Sydney Airport to one of its two trusts.

Sydney Airport said it received a position paper on Thursday from the ATO covering more than a quarter of its redeemable preference shares for the 2010 and 2011 tax years.

The disclosure to the market just hours after the position paper was received yesterday falls short of a profit warning and the company expects to report progress on the issue when it announces its half-year profit in February.

"This is a position paper relating to the financial years ending December 31, 2010 and December 31, 2011, which we've voluntarily disclosed to the market," Sydney Airport chief executive Kerrie Mather said. "We will be commencing discussions with the ATO next year to assist it in forming a final position."

Sydney Airport had treated the 15 per cent annual coupon payments on $872m of redeemable preference shares as interest rather than dividends, and therefore deductible. It said the ATO had not quantified the amount, but if the conclusions of the position paper carried through, the company estimated it could face a bill of $79m plus any interest and penalties. The preference shares were issued in 2002 and 2003 and deductions on the coupon have not previously been challenged.

But the ATO revised its view in July and has issued position papers to a number of companies which have stapled securities involving a trust, including Asciano and Spark Infrastructure.

Money advanced between stapled entities may not qualify as "debt for tax purposes, where the economic group arrangements result in the stapled entities being connected entities for tax purposes", law firm Minter Ellison wrote in a note on the change in July. Sydney Airport said the ATO was continuing its specific issues audit on the rest of the redeemable preference shares issued by the firm, but had confirmed no tax years prior to the year ended December 31, 2010, were subject to audit in respect of RPS distributions.

It said it was confident of its legal position and would take legal action to protect its investors' interests, but had debt facilities in place to meet any liability.

Sydney Airport shares fell 6c to $3.40 in a weaker market.

For information on Appendix A, B, & C
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