



Draft decision

Endeavour Energy distribution determination

2015–16 to 2018–19

Attachment 8: Corporate income tax

November 2014

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Note

This attachment forms part of the AER's draft decision on Endeavour Energy's 2015–19 distribution determination. It should be read with other parts of the draft decision.

The draft decision includes the following documents:

Overview

Attachment 1 – Annual revenue requirement

Attachment 2 – Regulatory asset base

Attachment 3 – Rate of return

Attachment 4 – Value of imputation credits

Attachment 5 – Regulatory depreciation

Attachment 6 – Capital expenditure

Attachment 7 – Operating expenditure

Attachment 8 – Corporate income tax

Attachment 9 – Efficiency benefit sharing scheme

Attachment 10 – Capital expenditure sharing scheme

Attachment 11 – Service target performance incentive scheme

Attachment 12 – Demand management incentive scheme

Attachment 13 – Classification of services

Attachment 14 – Control mechanisms

Attachment 15 – Pass through events

Attachment 16 – Alternative control services

Attachment 17 – Negotiated services framework and criteria

Attachment 18 – Connection policy

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Shortened forms

Shortened form	Extended form
AARR	aggregate annual revenue requirement
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
ASRR	aggregate service revenue requirement
augex	augmentation expenditure
capex	capital expenditure
CCP	Consumer Challenge Panel
CESS	capital expenditure sharing scheme
CPI	consumer price index
CPI-X	consumer price index minus X
DRP	debt risk premium
DMIA	demand management innovation allowance
DMIS	demand management incentive scheme
distributor	distribution network service provider
DUoS	distribution use of system
EBSS	efficiency benefit sharing scheme
ERP	equity risk premium
expenditure assessment guideline	expenditure forecast assessment guideline for electricity distribution
F&A	framework and approach
MRP	market risk premium

Shortened form	Extended form
NEL	national electricity law
NEM	national electricity market
NEO	national electricity objective
NER	national electricity rules
NSP	network service provider
opex	operating expenditure
PPI	partial performance indicators
PTRM	post-tax revenue model
RAB	regulatory asset base
RBA	Reserve Bank of Australia
repex	replacement expenditure
RFM	roll forward model
RIN	regulatory information notice
RPP	revenue pricing principles
SAIDI	system average interruption duration index
SAIFI	system average interruption frequency index
SLCAPM	Sharpe-Lintner capital asset pricing model
STPIS	service target performance incentive scheme
WACC	weighted average cost of capital

8 Corporate income tax

We are required to make a decision on the estimated cost of corporate income tax for Endeavour Energy's 2014–19 period.¹ Under the post-tax framework, a corporate income tax allowance is calculated as part of the building block assessment using our post-tax revenue model (PTRM). This amount enables Endeavour Energy to recover the costs associated with the estimated corporate income tax payable during the 2014–19 period.

This attachment presents our assessment of Endeavour Energy's proposed corporate income tax allowance for the 2014–19 period. It also presents our assessment of its proposed opening tax asset base (TAB), and the standard and remaining tax asset lives used to estimate tax depreciation for the purpose of calculating tax expenses.

8.1 Draft decision

We do not accept the estimated cost of corporate income tax of \$333.8 million (\$ nominal) proposed by Endeavour Energy. Our draft decision on the estimated cost of corporate income tax is \$195.1 million (\$ nominal) for Endeavour Energy's 2014–19 period, a reduction of \$138.7 million (or 41.6 per cent) from its proposal.

The reduction reflects our amendments to some of Endeavour Energy's proposed inputs for forecasting the cost of corporate income tax such as the opening TAB (section 8.4.1), and the standard and remaining tax asset lives (sections 8.4.2 and 8.4.3 respectively). It also reflects our draft decision on the value of imputation credits—gamma—(attachment 4). Changes to building block costs affect revenues, which also impact the tax calculation. The changes affecting revenues are discussed in attachment 1.

Table 8-1 sets out our draft decision on the estimated cost of corporate income tax allowance for Endeavour Energy. Based on the approach to modelling the cash flows in the PTRM, we have derived an effective tax rate of 29.3 per cent for Endeavour Energy.

Table 8-1 AER's draft decision on Endeavour Energy's cost of corporate income tax allowance for the 2014–19 period (\$ million, nominal)

	2014–15	2015–16	2016–17	2017–18	2018–19	Total
Tax payable	59.3	61.2	68.1	67.8	68.8	325.1
Less: value of imputation credits	23.7	24.5	27.2	27.1	27.5	130.1
Corporate income tax allowance	35.6	36.7	40.8	40.7	41.3	195.1

Source: AER analysis.

8.2 Endeavour Energy's proposal

Endeavour Energy proposed a forecast cost of corporate income tax of \$333.8 million (\$ nominal) using the AER's PTRM and the following inputs:²

- an opening TAB as at 1 July 2014 of \$4557 million (\$ nominal)

¹ NER, cl 6.4.3(a)(4).

² Endeavour Energy, *Regulatory proposal*, May 2014, Attachment 4.02.

- an expected statutory income tax rate of 30 per cent per year
- a value for gamma of 0.25.
- the weighted average remaining tax asset lives of assets in existence as at 30 June 2014 derived from the AER's RFM. Endeavour Energy proposed a change to the remaining tax asset life for the 'Customer metering and load control' asset class to 15.3 years from 18.8 years
- the same standard tax asset lives for depreciating new assets for the 2014–19 period as approved for the 2009–14 regulatory control period. However, Endeavour Energy proposed to update the standard tax asset life for the 'Equity raising costs' asset class to 42.6 years, based on the weighted average standard asset lives of the opening RAB.

Table 8-2 sets out Endeavour Energy's proposed cost of corporate income tax allowance for the 2014–19 period.

Table 8-2 Endeavour Energy's proposed cost of corporate income tax allowance (\$ million, nominal)

	2014–15	2015–16	2016–17	2017–18	2018–19	Total
Tax payable	79.9	83.6	92.2	93.4	95.9	445.1
Less: value of imputation credits	20.0	20.9	23.1	23.4	24.0	111.3
Corporate income tax allowance	59.9	62.7	69.2	70.1	71.9	333.8

Source: Endeavour Energy, *Regulatory proposal*, May 2014, Attachment 4.02.

8.3 AER's assessment approach

Under clause 6.5.3 of the NER, we must make an estimate of taxable income for each regulatory year. Our estimate must be for the taxable income a benchmark efficient entity would earn for providing standard control services if it operated Endeavour Energy's business. The estimate is required to be determined in accordance with the PTRM. Our approach for calculating a service provider's cost of corporate income tax allowance is set out in our PTRM and involves the following steps:

1. We estimate the annual taxable income that would be earned by a benchmark efficient entity operating the service provider's business. A service provider's taxable income is calculated by subtracting the benchmark estimates of tax expenses from the approved forecast revenues. Using the PTRM, we model the service provider's benchmark tax expenses, including interest tax expense and tax depreciation, over the regulatory control period. The interest tax expense is estimated using the benchmark 60 per cent gearing used for the rate of return calculation. Tax depreciation is calculated using a separate TAB, and standard and remaining tax asset lives for taxation purposes. All tax expenses (including expenses such as opex) are offset against the service provider's forecast revenue to estimate the taxable income.
2. The statutory income tax rate is then applied to the estimated annual taxable income to arrive at a notional amount of tax payable.
3. We apply a discount to that notional amount of tax payable to account for the utilisation of imputation credits (gamma) by investors.

4. The tax payable net of assumed utilised imputation credits represents the corporate income tax allowance and is included as a separate building block in determining the service provider's annual revenue requirement.

The cost of corporate income tax allowance is an output of our PTRM. We therefore assess the service provider's proposed cost of corporate income tax allowance by analysing the proposed inputs to the PTRM for calculating that allowance. These inputs include:

- **The opening TAB as at the commencement of the 2014–19 period:** We consider that the roll forward of the opening TAB should be based on the approved opening TAB as at commencement of the 2009–14 regulatory control period and the service provider's actual capex incurred during the 2009–14 regulatory control period.³
- **The remaining tax asset life for each asset class at the commencement of the 2014–19 period:** Our preferred method to determine the remaining tax asset lives is the weighted average method. We consider the weighted average method provides a better reflection of the mix of asset lives within an asset class. We will assess the outcomes of other approaches against the outcomes of this preferred method.
- **The standard tax asset life for each asset class:** We assess the service provider's proposed standard tax asset lives, where necessary, against those prescribed by the Commissioner for taxation in tax ruling 2014/4 and the approved standard tax asset lives in the service provider's distribution determination for the 2009–14 regulatory control period.
- **The corporate income tax rate:** The statutory income tax rate is 30 per cent per year.
- **The value of gamma:** The gamma input for Endeavour Energy is 0.40. Refer to attachment 4 for detailed discussion on this matter.

8.3.1 Interrelationships

The cost of corporate income tax building block feeds directly into the annual revenue requirement (ARR). This cost of corporate income tax allowance is determined by four factors:

- pre-tax revenues
- tax expenses (including tax depreciation)
- the corporate income tax rate
- gamma—the expected proportion of company tax that is returned to investors through the utilisation of imputation credits—which offsets against the corporate income tax allowance. This is discussed further at attachment 4.

Of these four factors, the corporate tax rate is set externally by the Government. The higher the tax rate the higher the required tax allowance.

The pre-tax revenues depend on all the building block components. Any factor that affects revenue will therefore affect pre-tax revenues. Higher pre-tax revenues can increase the tax allowance.⁴

³ The tax depreciation is therefore recalculated based on actual capex. The same tax depreciation approach of using actual capex applies to the roll forward of the TAB at the next reset.

⁴ In fact, there is an iterative relationship between tax and revenues. That is, revenues lead to tax being applied, which increases revenues and leads to slightly more tax and so on. The PTRM is therefore set up to run an iterative process until the revenue and tax allowances become stable.

Depending on the source of the revenue increase, the tax increase may be equal to or less than proportional to the company tax rate.⁵

The tax expenses depend on various building block components and their size. Some components give rise to tax expenses, such as opex, interest payments and tax depreciation of assets. However, others do not, such as increases in return on equity. Higher tax expenses offset revenues as deductions in the tax calculation and therefore reduce the cost of corporate income tax allowance (all things being equal). Tax expenses include:

- Interest on debt – Interest is a tax offset. The size of which depends on the ratio of debt to equity and therefore the proportion of the RAB funded through debt. It also depends on the allowed return on debt and the size of the RAB.
- General expenses – In the main these expenses will match the opex allowance.
- Tax depreciation – A separate TAB is maintained for the service provider reflecting tax rules. This TAB is affected by many of the same factors as the RAB, such as capex, although unlike the RAB value it is maintained at its historical cost with no indexation. The TAB is also affected by the depreciation rate and asset lives assigned for tax depreciation purposes.

A ten per cent increase in the corporate income tax allowance causes revenues to increase by about 0.6 per cent. The proposed gamma of 0.25, compared to the value in the AER's draft decision of 0.4, would increase the corporate income tax allowance by 24 per cent and total revenues by about 1.6 per cent.

8.4 Reasons for draft decision

We do not accept Endeavour Energy's proposed estimated cost of corporate income tax. We have instead determined a cost of corporate income tax allowance of \$195.1 million (\$ nominal). This represents a reduction of \$138.7 million (or 41.6 per cent) from Endeavour Energy's proposal.

This is because we adjusted the following proposed inputs to the PTRM for tax purposes:

- the opening TAB value at the commencement of the 2014–19 period (section 8.4.1)
- the standard and remaining tax asset lives (sections 8.4.2 and 8.4.3 respectively)
- the value of gamma (attachment 4)
- other building block components including forecast opex (attachment 7) and forecast capex (attachment 6) that impact revenues, and therefore also impact the forecast corporate income tax allowance.⁶

8.4.1 Opening tax asset base

We accept Endeavour Energy's proposed method to establish the opening TAB as at 1 July 2014 as it is based on the approach set out in our RFM. However, we do not accept Endeavour Energy's proposed opening TAB value as at 1 July 2014 of \$4577 million (\$ nominal). Instead we determine an opening TAB value as at 1 July 2014 of \$4580 million (\$ nominal). This represents an increase of \$3.1

⁵ For example, although increased opex adds to revenue requirement, these expenses are also offset against the revenues as deductions in determining tax, so there is no net impact in this case. A higher return on equity, in contrast, gives rise to no offsetting tax expenses and therefore increases the tax allowance in proportion to the company tax rate.

⁶ NER, cl 6.5.3.

million (\$ nominal) or 0.1 per cent. This increase is due to the adjustments made to the net capex values in Endeavour Energy's proposed RFM as discussed in attachment 2.⁷

Table 8-3 sets out our draft decision on the roll forward of Endeavour Energy's TAB values over the 2009–14 regulatory control period.

Table 8-3 AER's draft decision on Endeavour Energy's TAB roll forward (\$ million, nominal)

	2009–10	2010–11	2011–12	2012–13	2013–14 ^b
Opening TAB	2382.7	2703.4	3129.0	3676.4	4156.5
Capital expenditure ^a	442.0	535.6	677.3	623.7	609.1
Less: tax depreciation	121.3	110.0	129.9	143.5	156.4
Closing TAB	2703.4	3129.0	3676.4	4156.5	4609.2
Meters moved to alternative control services					–28.8
Opening TAB as at 1 July 2014					4580.4

Source: AER analysis.

(a) Net of disposals.

(b) Based on estimated capex.

8.4.2 Standard tax asset lives

We accept the majority of Endeavour Energy's proposed standard tax asset lives because they are:

- broadly consistent with the values prescribed by the Commissioner for taxation in tax ruling 2014/4⁸
- the same as those approved standard tax asset lives for the 2009–14 regulatory control period.

We are satisfied that the proposed standard tax asset lives remain appropriate for applying over the 2014–19 period.

However, we have changed the standard tax asset life for the 'Equity raising costs' asset class to 5 years from Endeavour Energy's proposed 42.6 years for tax depreciation purposes. This is because the Australian Taxation Office (ATO) requires equity raising costs to be amortised over a five-year period on a straight-line basis.⁹ In recent determinations, we adopted a standard tax asset life of 5 years for amortising equity raising costs for tax depreciation purposes.¹⁰ Therefore, for this draft decision we will apply the standard tax asset life of 5 years for tax depreciation purposes. We consider this standard tax asset life provides a better estimate of the tax depreciation amount for a benchmark efficient service provider as required by the NER.¹¹

⁷ At the time of this draft decision, the roll forward of Endeavour Energy's TAB includes estimated capex values for 2013–14. We will update the 2013–14 estimated capex values with the actual values for the final decision.

⁸ ATO, *Taxation Ruling Income tax: effective life of depreciating assets* (applicable from 1 July 2014), August 2014, <http://law.ato.gov.au/atolaw/view.htm?docid=%22TXR%2FTR20144%2FNAT%2FATO%2F00001%22>, accessed on 25 September 2014.

⁹ ATO, *Guide to depreciating assets 2001-02: Business related costs—section 40-880 deductions*, ATO reference; NO NAT7170, p. 25.

¹⁰ AER, *Draft decision: Powerlink transmission determination 2012–13 to 2016–17*, 2011, p. 265–266; AER, *Draft decision: ElectraNet transmission determination 2013–14 to 2017–18*, 2013, p. 193–194.

¹¹ NER, cl 6.5.3.

Table 8-4 sets out our draft decision on the standard tax asset lives for Endeavour Energy.

8.4.3 Remaining tax asset lives

We accept Endeavour Energy's proposed weighted average method to calculate the remaining tax asset lives as at 1 July 2014. The proposed method is consistent with our preferred approach as set out in the RFM.

We do not accept Endeavour Energy's proposed weighted average remaining tax life of 15.3 years for the 'Customer metering and load control' asset class. We accept that in principle an adjustment to the remaining tax asset life for this asset class may be required to account for the removal of assets from standard control services to alternative control services. However, we do not accept Endeavour Energy's approach to calculating the proposed adjustment to the remaining tax asset life. This is because Endeavour Energy's approach does not result in a better estimate of the tax depreciation amount in respect of this asset class for a benchmark efficient service provider.¹² Our draft decision is to apply a remaining tax life of 18.8 years for this asset class. This is consistent with the approach of the other NSW distribution service providers to apply the remaining life set out in the RFM for this asset class.

In accepting the weighted average method, we have updated the proposed remaining tax asset lives to reflect our adjustments to Endeavour Energy's net capex in its proposed RFM, as discussed in attachment 2.¹³ This is because the net capex values are inputs for calculating the weighted average remaining tax asset lives in the RFM.

¹² NER, cl 6.5.3.

¹³ At the time of this draft decision, the roll forward of Endeavour Energy's TAB includes estimated capex values for 2013–14. We will update the 2013–14 estimated capex values with the actual values for the final decision. The 2013–14 capex values are used to calculate the weighted average remaining tax asset lives in the RFM. Therefore, for the final decision we will recalculate Endeavour Energy's remaining tax asset lives as at 1 July 2014 using the method approved in this draft decision.

Table 8-4 sets out our draft decision on remaining tax asset lives for Endeavour Energy.

Table 8-4 AER's draft decision on Endeavour Energy's standard and remaining tax asset lives (years)

Asset class	Standard tax asset life	Remaining tax asset life as at 1 July 2014
Sub-transmission lines and cables	46.8	38.8
Distribution lines and cables	47.9	39.0
Substations	40.0	33.8
Transformers	40.0	27.3
Low Voltage lines and cables	47.8	33.0
Customer metering and load control	25.0	18.8
Communication	10.0	8.0
Land	n/a	n/a
Easements	n/a	n/a
Equity raising costs	5.0	37.0
Emergency spares (major plant, excludes inventory)	n/a	n/a
Information & communication technology	2.9	2.1
Furniture, fittings, plant and equipment	8.6	4.9
Motor vehicles	12.1	7.2
Buildings	40.0	33.4
Land (non-system)	n/a	n/a
Other non-system assets	n/a	n/a

Source: AER analysis.
n/a: not applicable.