DRAFT DECISION
Ausgrid
Distribution determination

2019–24

Attachment 7 – Corporate income tax

November 2018

AUSTRALIAN ENERGY REGULATOR

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Note

This attachment forms part of the AER's draft decision on the distribution determination that will apply to Ausgrid for the 2019–24 regulatory control period. It should be read with all other parts of the draft decision.

The draft decision includes the following attachments:

Overview

Attachment 1 – Annual revenue requirement

Attachment 2 – Regulatory asset base

Attachment 3 – Rate of return

Attachment 4 – Regulatory depreciation

Attachment 5 – Capital expenditure

Attachment 6 – Operating expenditure

Attachment 7 – Corporate income tax

Attachment 8 – Efficiency benefit sharing scheme

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Attachment 10 – Service target performance incentive scheme

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Attachment 12 – Classification of services

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Attachment 18 - Tariff structure statement

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Shortened forms

Shortened form	Extended form
AER	Australian Energy Regulator
ATO	Australian Taxation Office
capex	capital expenditure
CESS	capital expenditure sharing scheme
distributor	distribution network service provider
NER	National Electricity Rules
opex	operating expenditure
PTRM	post-tax revenue model
RAB	regulatory asset base
RFM	roll forward model
RIN	regulatory information notice
TAB	tax asset base

7 Corporate income tax

Our determination of the annual revenue requirement includes the estimated cost of corporate income tax for Ausgrid's 2019–24 regulatory control period.[1] Ausgrid's dual function assets are high voltage assets which support the broader NSW/ACT transmission network owned and operated by TransGrid. The AER has decided to apply transmission pricing to these assets.[2] 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 allows Ausgrid to recover the costs associated with the estimated corporate income tax payable during the 2019–24 regulatory control period.

This attachment presents our assessment of Ausgrid's proposed corporate income tax allowance for the 2019–24 regulatory control 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.

7.1 Draft decision

We determine an estimated cost of corporate income tax of $206.1 million and $13.8 million ($ nominal) for Ausgrid in the 2019–24 regulatory control period for its distribution and transmission networks respectively. This represents reductions of $106.9 million (or 34.2 per cent) for its distribution network and $3.3 million (or 19.1 per cent) for its transmission network compared to Ausgrid's proposal of $313.0 million and $17.1 million ($ nominal) respectively.

The reductions to the tax allowance made in this decision reflect our amendments to Ausgrid's proposed inputs for forecasting the cost of corporate income tax, including:

- the opening TAB (section 7.4.1)
- remaining tax asset lives (section 7.4.2)
- the value of imputation credits—gamma (section 2.2 of the overview), which is the main driver of the reduced allowance.

Our adjustments to the return on capital (attachments 2, 3 and 5) and the regulatory depreciation (attachment 4) building blocks affect revenues, which in turn impacts the tax calculation. These changes affecting revenues are discussed in attachment 1.

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1 NER, cl. 6.4.3(a)(4).

2 AER, *Framework and approach Ausgrid, Endeavour Energy and Essential Energy Regulatory control period commencing 1 July 2019,* July 2017, p. 13.

Table 7.1 and Table 7.2 set out our draft decision on the estimated cost of corporate income tax allowance for Ausgrid over the 2019–24 regulatory control period for its distribution and transmission networks respectively.

Table 7.1 AER's draft decision on Ausgrid's cost of corporate income tax allowance for the 2019–24 regulatory control period – distribution ($ million, nominal)

	2019–20	2020–21	2021–22	2022–23	2023–24	Total
Tax payable	68.3	77.6	80.8	97.1	88.3	412.1
Less: value of imputation credits	34.1	38.8	40.4	48.5	44.2	206.1
Net corporate income tax allowance	**34.1**	**38.8**	**40.4**	**48.5**	**44.2**	**206.1**

Source: AER analysis.

Table 7.2 AER's draft decision on Ausgrid's cost of corporate income tax allowance for the 2019–24 regulatory control period – transmission ($ million, nominal)

	2019–20	2020–21	2021–22	2022–23	2023–24	Total
Tax payable	4.1	4.6	5.1	6.6	7.3	27.6
Less: value of imputation credits	2.0	2.3	2.5	3.3	3.6	13.8
Net corporate income tax allowance	**2.0**	**2.3**	**2.5**	**3.3**	**3.6**	**13.8**

Source: AER analysis.

Application of the tax review in the final decision

For this draft decision, we have used our current regulatory models (PTRM and RFM) to calculate the various components required to estimate Ausgrid's cost of corporate income tax for the 2019–24 regulatory control period. Our assessment approach for this draft decision is discussed in section 7.3 below. We are currently undertaking a review of our regulatory tax approach (the tax review). As discussed in the initial report to the tax review published on 28 June 2018, we intend to apply any changes to our regulatory models arising from the tax review to the final decision for Ausgrid's 2019–24 regulatory control period in April 2019.[3]

As indicated in the initial report, it is intended that any required changes to our regulatory models will be proposed in December 2018 as part of the final position of the tax review. After consultation on the proposed amended models, final model amendments will be released by April 2019. Ausgrid is due to submit its revised

[3] AER, *Initial Report–Review of regulatory tax approach*, June 2018, pp. 4–5.

regulatory proposal in January 2019. This means that any proposed changes to our regulatory models will be published shortly before the submission of the revised regulatory proposal.

We will provide further consultation on possible changes in our upcoming discussion paper for the tax review. We will also consult with Ausgrid directly on specific implementation issues and possible interactions with other aspects of the revenue determination as soon as the likely direction of the tax review and any model changes are evident. We consider that early and extensive consultation on any proposed changes to the regulatory models will ensure that Ausgrid and other stakeholders have sufficient opportunity to comment on the changes to the regulatory models before the final decision is made.

7.2 Ausgrid's proposal

Ausgrid proposed a forecast cost of corporate income tax of $313.0 million and $17.1 million ($ nominal) for its distribution and transmission networks respectively using the AER's PTRM, which adopted a straight-line tax depreciation approach and the following inputs:[4]

- opening TAB values as at 1 July 2019 of $9727.4 million and $1532.9 million for its distribution and transmission networks respectively ($ nominal)
- an expected statutory income tax rate of 30 per cent per year
- a value for gamma of 0.40
- remaining tax asset lives of assets in existence as at 30 June 2019 calculated using a weighted average approach as set out in the AER's RFM
- the same standard tax asset lives for tax depreciation purposes of new assets for the 2019–24 regulatory control period as approved for the 2014–19 distribution determination.

Table 7.3 and Table 7.4 set out Ausgrid's proposed corporate income tax allowance for the 2019–24 regulatory control period for its distribution and transmission networks respectively.

[4] Ausgrid, *Attachment 4.02 - Distribution PTRM*, April 2018; and Ausgrid, *Attachment 4.05 - Transmission PTRM*, April 2018.

Table 7.3 Ausgrid's proposed cost of corporate income tax allowance for the 2019–24 regulatory control period – distribution ($ million, nominal)

	2019–20	2020–21	2021–22	2022–23	2023–24	Total
Tax payable	87.4	98.0	102.2	121.3	112.7	521.6
Less: value of imputation credits	34.9	39.2	40.9	48.5	45.1	208.7
Net corporate income tax allowance	**52.4**	**58.8**	**61.3**	**72.8**	**67.6**	**313.0**

Source: Ausgrid, *Attachment 4.02 - Distribution PTRM*, April 2018.

Table 7.4 Ausgrid's proposed cost of corporate income tax allowance for the 2019–24 regulatory control period – transmission ($ million, nominal)

	2019–20	2020–21	2021–22	2022–23	2023–24	Total
Tax payable	4.0	4.6	5.2	6.9	7.8	28.5
Less: value of imputation credits	1.6	1.8	2.1	2.8	3.1	11.4
Net corporate income tax allowance	**2.4**	**2.7**	**3.1**	**4.1**	**4.7**	**17.1**

Source: Ausgrid, *Attachment 4.05 - Transmission PTRM*, April 2018.

7.3 AER's assessment approach

We make an estimate of taxable income for each regulatory year as part of our determination of the annual revenue requirement for Ausgrid's 2019–24 regulatory control period.[5] Our estimate is the taxable income a benchmark efficient entity would earn for providing standard control services if it operated Ausgrid's business. Our approach for calculating a distributor's cost of corporate income tax allowance is set out in our PTRM and involves the following steps:[6]

1. We estimate the annual taxable income that would be earned by a benchmark efficient entity operating the distributor's business. A distributor's taxable income is calculated by subtracting from the approved forecast revenues the benchmark estimates of tax expenses. Using the PTRM, we model the distributor'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 value for the TAB, and standard and remaining tax asset lives for taxation purposes. The PTRM (and RFM) uses the

[5] NER, cl. 6.5.3.

[6] The PTRM must specify the manner in which the estimated cost of corporate income tax is to be calculated: NER, cl. 6.4.2(b)(4).

straight-line method for tax depreciation. All tax expenses (including other expenses such as opex) are offset against the distributor's forecast revenue to estimate the taxable income.

2. The statutory income tax rate is then applied to the estimated annual taxable income (after adjustment for any tax loss carried forward) 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 distributor's annual revenue requirement.

The cost of corporate income tax allowance is an output of our PTRM. We therefore assess the distributor's proposed cost of corporate 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 2019–24 regulatory control period:** We consider that the roll forward of the opening TAB should be based on the approved opening TAB as at 1 July 2014 and Ausgrid's actual capex incurred during the 2014–19 regulatory control period, and the final year (2013–14) of the previous regulatory control period.[7]
- **The remaining tax asset life for each asset class at the commencement of the 2019–24 regulatory control period:** Our standard method for determining the remaining tax asset lives is the weighted average method. The weighted average method rolls forward the remaining tax asset life as at 1 July 2014 for an asset class in order to take into account the actual capex for the 2014–19 regulatory control period. This approach reflects the mix of assets within that tax asset class, when they were acquired over that period and the remaining tax asset lives of existing assets at the end of that period. The residual asset values of all assets are used as weights at the end of the period.
- **The standard tax asset life for each asset class:** We assess Ausgrid's proposed standard tax asset lives against those prescribed by the Commissioner for Taxation in tax ruling 2018/4 and the approved standard tax asset lives in the distributor's distribution determination for the 2014–19 regulatory control period.[8]
- **The income tax rate:** The statutory income tax rate is 30 per cent per year.
- **The value of gamma:** The gamma input for Ausgrid is 0.50. Refer to section 2.2 of the overview for further discussion on this matter.
- **The size and treatment of any tax losses as at 1 July 2019:** Where a business has tax losses, we require the provision of this value to determine the appropriate

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7 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.

8 ATO, *TR 2018/4—Income tax: effective life of depreciating assets (applicable from 1 July 2018)*, July 2018.

estimated taxable income for a regulatory control period. If there is an amount of tax losses accumulated, the forecast taxable income for the regulatory period will be reduced by this amount.

7.3.1 Interrelationships

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

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

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.[9] Depending on the source of the revenue increase, the tax increase may be equal to or less than proportional to the company tax rate.[10]

The tax expenses (or deductions) 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 this offset 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 businesses 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

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9 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.

10 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.

indexation. The TAB is also affected by the depreciation rate and asset lives assigned for tax depreciation purposes.

For Ausgrid, a 10 per cent increase in the corporate income tax allowance causes revenues to increase by about 0.4 per cent. An increase in the gamma from 0.40 to 0.50 would decrease the corporate income tax allowance by 19.6 per cent and total revenues by about 0.7 per cent.[11]

7.4 Reasons for draft decision

We determine an estimated cost of corporate income tax allowance of $206.1 million and $13.8 million ($ nominal) for Ausgrid in the 2019–24 regulatory control period for its distribution and transmission networks respectively. This represent reductions of $106.9 million (or 34.2 per cent) for the distribution network and $3.3 million (or 19.1 per cent) for the transmission network.

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

- the opening TAB value at 1 July 2019 (section 7.4.1)
- remaining tax asset lives (section 7.4.2)
- the value of imputation credits—gamma (section 2.2 of the overview), which is the main driver of the reduced allowance.

Our adjustments to the return on capital (attachments 2, 3 and 5)[12] and the return of capital (attachment 5) building blocks affect revenues, and therefore also impact the forecast corporate income tax allowance.

7.4.1 Opening tax asset base as at 1 July 2019

We accept Ausgrid's proposed method to establish the opening TAB as at 1 July 2019 because it is based on the approach set out in our RFM. Based on the proposed approach, we have determined the opening TAB values as at 1 July 2019 of $9901.2 million and $1331.2 million ($ nominal) for Ausgrid's distribution and transmission networks respectively. This represents an increase or $173.8 million (or 1.8 per cent) for its distribution network and a reduction of $201.7 million (or 13.2 per cent) for its transmission network compared to its proposal.

We have reviewed the inputs to the TAB roll forward and found that they were mostly correct and reconcile with relevant data sources such as annual reporting RINs and the 2014–19 decision models.

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[11] We have analysed the sensitivity of the corporate income tax allowance relative to total revenue, and compared the effects of the two gamma values based on input data from Ausgrid's proposed PTRM.

[12] The forecast capex amount is a key input for calculating the return of and return on capital building blocks. Attachment 5 sets out our draft decision on Ausgrid's forecast capex.

The difference in the opening TAB values is due to adjustments for capitalised provisions (discussed in attachment 2) and reclassification of services. As discussed in attachment 2, Ausgrid reallocated certain assets from its transmission to distribution networks due to reclassification of services. Despite undertaking this reallocation for the RAB, Ausgrid did not do a similar reallocation for the TAB. We consider a similar reallocation should occur for the tax assets. After raising this matter with Ausgrid, it agreed to this amendment.[13]

We also note that these opening TABs as at 1 July 2019 may be updated to reflect actual capex for 2017–18 and any updated 2018–19 capex estimates as part of the final decision.[14]

Table 7.5 and Table 7.6 set out our draft decision on the roll forward of Ausgrid's TAB values over the 2014–19 regulatory control period for its distribution and transmission networks respectively.

Table 7.5 AER's daft decision on Ausgrid's TAB roll forward for the 2014–19 regulatory control period – distribution ($ million, nominal)

	2014–15	2015–16	2016–17	2017–18[a]	2018–19[a]
Opening TAB	8559.3	8785.1	8804.5	8902.6	9226.5
Capital expenditure	563.8	375.9	446.0	664.0	837.5
Less: tax depreciation	338.0	356.6	347.9	340.1	364.4
Plus: assets transferred to distribution from transmission	–	–	–	–	201.7
Closing TAB	8785.1	8804.5	8902.6	9226.5	9901.2

Source: AER analysis.

(a) Based on estimated capex.

[13] Ausgrid, *Email RE: AER - Ausgrid information request IR#042 - 2019 TAB adjustment*, 10 September 2018.

[14] At the time of this draft decision, the roll forward of Ausgrid's TABs includes estimated capex values for 2017–18 and 2018–19. We expect Ausgrid will provide actual capex for 2017–18 and the 2018–19 capex estimates may be revised based on more up to date information in its revised proposal. We will update these values in the final decision accordingly.

Table 7.6 AER's daft decision on Ausgrid's TAB roll forward for the 2014–19 regulatory control period – transmission ($ million, nominal)

	2014–15	2015–16	2016–17	2017–18[a]	2018–19[a]
Opening TAB	1502.1	1511.7	1453.5	1486.8	1500.3
Capital expenditure	58.3	–7.2	84.3	63.8	86.0
Less: tax depreciation	48.8	51.0	51.0	50.2	53.4
Less: assets transferred to distribution from transmission	–	–	–	–	201.7
Closing TAB	1511.7	1453.5	1486.8	1500.3	1331.2

Source: AER analysis.

(a) Based on estimated capex.

7.4.2 Standard and remaining tax asset lives

We accept Ausgrid's proposed standard tax asset lives for its asset classes because they are:

- broadly consistent with the values prescribed by the Commissioner for taxation in tax ruling 2018/4[15]
- the same as the approved standard tax asset lives over the 2014–19 regulatory control period.

We accept Ausgrid's proposed weighted average method to calculate the remaining tax asset lives as at 1 July 2019. The proposed method applies the approach as set out in our RFM. In accepting the weighted average method, we have updated Ausgrid's remaining tax asset lives reflecting the transfer of assets between distribution and transmission. We note we will update the remaining tax asset lives for the final decision for any changes to any estimated capex values in the RFM because they are used as inputs for calculating the remaining tax asset lives.[16]

Table 7.7 and Table 7.8 set out our draft decision on the standard and remaining tax asset lives for Ausgrid for its distribution and transmission networks respectively. We consider the standard and remaining tax asset lives are appropriate for application over the 2019–24 regulatory control period. We are satisfied the approved standard and remaining tax asset lives provide an appropriate estimate of the tax depreciation

[15] ATO, *TR 2018/4—Income tax: effective life of depreciating assets (applicable from 1 July 2018)*, July 2018.

[16] At the time of this draft decision, the roll forward of Ausgrid's TAB includes estimated capex values for 2017–18 and 2018–19. We will update the 2017–18 estimated capex values with the actual values for the final decision, and may further update the estimate of 2018–19 capex. The capex values are used to calculate the weighted average remaining tax asset lives in the RFM. Therefore, for the final decision we will recalculate Ausgrid's remaining tax asset lives as at 1 July 2019 using the method approved in this draft decision.

amount that would be consistent with the tax expenses used to estimate the annual taxable income for a benchmark efficient service provider as required by the NER.[17]

[17] NER, cl. 6.5.3.

Table 7.7 AER's draft decision on Ausgrid's standard and remaining tax asset lives – distribution (years)

Asset class	Standard tax asset life	Remaining tax asset lives as at 1 July 2019
Sub-transmission lines and cables	47.5	33.6
Cable tunnel (dx)	40.0	33.9
Distribution lines and cables	48.7	37.8
Substations	40.0	28.1
Transformers	42.0	26.5
Low voltage lines and cables	45.8	35.3
Customer metering and load control	25.0	9.5
Customer metering (digital)[a]	n/a	1.0
Communications (digital) - dx	10.0	7.9
Total communications	7.4	5.4
System IT (dx)	7.0	6.5
Ancillary substation equipment (dx)	15.0	11.2
Land and easements	n/a	n/a
Furniture, fittings, plant and equipment	10.6	6.2
Land (non-system)[b]	n/a	5.0
Other non-system assets	10.5	7.5
IT systems	4.0	3.5
Motor vehicles	20.0	10.6
Buildings	40.0	33.0
Equity raising costs	5.0	38.4

Source: AER analysis.

n/a: not applicable. We have not assigned a standard tax asset life to some asset classes because the assets allocated to those asset classes are not subject to tax depreciation.

(a) This asset class has a very small residual value. We have set the remaining tax asset life to 1 year to fully depreciate the amount and remove it remove it from the TAB in the 2019–24 regulatory control period. We do not expect this asset class to be used in subsequent regulatory control periods because metering expenditure is classified as alternative control services.

(b) This asset class has a negative value. The remaining tax asset life is 5 years to remove it from the TAB by the end of the 2019–24 regulatory control period.

Table 7.8 AER's draft decision on Ausgrid's standard and remaining tax asset lives – transmission (years)

Asset class	Standard tax asset life	Remaining tax asset lives as at 1 July 2019
Transmission & zone land & easements	n/a	n/a
Transmission buildings 132/66kV	40.0	30.3
Zone buildings 132/66kV	40.0	29.0
Transmission transformers 132/66kV	40.0	28.2
Zone transformers 132/66kV	45.0	30.7
Transmission substation equip 132/66kV	40.0	29.4
Zone substation equip 132/66kV	40.0	30.0
Ancillary substation equipment (tx)	15.0	10.5
132kV tower lines	47.6	34.7
132kV concrete & steel pole lines	47.6	36.5
132kV wood pole lines	47.6	33.2
132kV feeders underground	47.0	35.3
Cable tunnel (tx)	47.6	35.9
Network control & com systems	37.2	12.5
Communications (digital) - tx	10.0	3.4
System IT (tx)	7.0	6.6
IT systems	4.0	3.6
Furniture, fittings, plant and equipment	10.6	6.3
Motor vehicles	20.0	10.9
Buildings	40.0	33.2
Land (non-system)[a]	n/a	5.0
Other non-system assets	10.5	7.5
Equity raising costs	5.0	36.7

Source: AER analysis.

n/a: not applicable. We have not assigned a standard tax asset life to some asset classes because the assets allocated to those asset classes are not subject to tax depreciation

(a) This asset class has a negative value. The remaining tax asset life is 5 years to remove it from the TAB by the end of the 2019–24 regulatory control period.