Draft Decision

APA Victorian Transmission System (VTS)

Access Arrangement 2023 to 2027

(1 January 2023 to 31 December 2027)

Attachment 7
Corporate income tax

June 2022

AUSTRALIAN ENERGY REGULATOR

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Note

This attachment forms part of the AER's draft decision on the access arrangement that will apply to APA's Victorian Transmission System (VTS) for the 2023–27 access arrangement period. It should be read with all other parts of the draft decision.

The draft decision includes the following documents:

Overview

Attachment 1 – Services covered by the access arrangement

Attachment 2 – Capital 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 – Operating expenditure incentive mechanism

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Attachment 11 – Non-tariff components

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7 Corporate income tax

Our determination of the total revenue for APA's Victorian Transmission System (VTS) includes the estimated cost of corporate income tax for the 2023–27 access arrangement period (2023–27 period).[1] Under the post-tax framework, a corporate income tax amount is calculated as part of the building blocks assessment using our post-tax revenue model (PTRM). This amount allows APA to recover the estimated cost of corporate income tax for the 2023–27 period.

This attachment presents our assessment of APA's proposed corporate income tax amount for the 2023–27 period. It also presents our assessment of the proposed opening tax asset base (TAB), and the standard and remaining tax asset lives as at 1 January 2023 used to estimate tax depreciation for the purpose of calculating tax expenses.

7.1 Draft decision

We accept APA's proposed approach to calculate its forecast cost of corporate income tax. APA has used our PTRM for gas pipeline service providers which implemented the findings from our 2018 *Review of the regulatory tax approach* (2018 tax review).[2]

Our draft decision is to determine an estimated cost of corporate income tax of zero for APA over the 2023–27 period, consistent with its proposal. This is due to APA VTS incurring a forecast tax loss over the 2023–27 period.[3] We have determined that $79.3 million ($ nominal) in tax losses as at 30 December 2027 will be carried forward to the 2028–32 period where it can be used to offset future tax liabilities. The forecast tax loss arises because APA's forecast tax expenses are expected to exceed its revenue for tax assessment purposes over the 2023–27 period. This is largely driven by the implementation of our findings from the 2018 tax review, involving the introduction of immediate expensing of capital expenditure (capex) and diminishing value method of tax depreciation, which resulted in an increase to forecast tax depreciation.[4]

For our draft decision, we are satisfied that APA's proposed approach for determining the forecast immediate expensing of its capex over the 2023–27 period is reasonable. However, we amended the proposed amount of the forecast immediately expensed capex to $46.5 million ($2022) from $140.6 million reflecting our draft decision on the overall forecast capex (section 7.4.1).

We determine an opening TAB as at 1 January 2023 of $452.9 million for APA. This is $0.8 million lower than the amount proposed by APA due to:

- a correction to the proposed value of 2017 actual capex to bring it in line with the audited 2017 regulatory accounts data

1 NGR, r. 76(c).

2 AER, *Final report: Review of regulatory tax approach*, December 2018.

3 A forecast tax loss occurs when the forecast assessable income (taxable revenue) is lower than the forecast tax expense. In this event no tax is payable. Any residual amount of tax loss will be carried forward to future access arrangement periods to offset future tax liabilities until the tax loss is fully exhausted.

4 The third key finding from the 2018 tax review relates to capping tax lives for gas assets to 20 years. However, APA has historically assigned tax asset lives of 20 years to its pipeline asset classes, with the exception of buildings and land, hence this change does not affect APA.

- the update to the proposed estimated value for 2021 capex with actual 2021 capex that has become available
- the update to the proposed estimated value for 2022 capex based on our capex assessment.

We accept APA's proposed standard tax asset lives for all of its existing asset classes as they are broadly consistent with the tax asset lives prescribed by the Australian Taxation Office's (ATO) taxation ruling 2021/3, and are the same as the approved standard tax asset lives for the 2018–22 period (section 7.4.4).[5]

We accept the creation of a new asset class for 'Integrity inspections' and its proposed standard asset life of 10 years. However, we do not accept the creation of new asset classes for 'Hydrogen safety', 'WORM' and 'SWP_570'. They are unnecessary because the capex have not been accepted or the capex can be reallocated to existing asset classes.[6]

We also accept APA's proposed weighted average method to calculate the remaining tax asset lives as at 1 January 2023. This method is a continuation of the approved approach used in the 2018–22 period and applies the approach as set out in our roll forward model (RFM).

Our draft decision relabels the existing 'Other' asset class to 'Other – short life' for the 2023–27 period. This change does not affect the remaining tax asset life for this asset class, as calculated in the RFM. We also create a new 'Other – long life' asset class for depreciating assets allocated to this class. These changes better distinguish the different asset lives assigned to the two asset classes.

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. The changes affecting revenues are discussed in the Overview.

7.2 APA's proposal

APA proposed an estimated cost of corporate income tax of zero ($ nominal) for the 2023–27 period using our PTRM,[7] with the following inputs:[8]

- an opening TAB as at 1 January 2023 of $453.7 million ($ nominal)
- an expected statutory income tax rate of 30 per cent per year
- a value of imputation credits (gamma) of 0.585
- immediately expensed capex amount of $140.6 million ($2022)
- the same standard tax asset lives for tax depreciation purposes of new assets for its existing asset classes in the 2023–27 period as approved for the 2018–22 access arrangement

5 ATO, *Taxation Ruling TR2021/3 – Income tax: effective life of depreciating assets (applicable from 1 July 2021),* p. 177.

6 Please see section 4.4.2 of attachment 4 of this draft decision for details.

7 Our published gas PTRM uses the diminishing value tax depreciation approach for all assets with the exception of in-house software, buildings and equity raising costs.

8 APA, *VTS 2023–27 Access Arrangement Proposal – Post tax revenue model*, December 2021.

- the remaining tax asset lives which were calculated using a weighted average remaining life approach as contained in its proposed RFM.

In addition, APA proposed four new asset classes for 'WORM', 'SWP_570', 'Integrity inspections' and 'Hydrogen safety'. The 'WORM' asset class was proposed to group all assets associated to the WORM project, while the 'SWP_570' asset class was proposed to group assets relating to the proposed expansion works on the South West Pipeline, both with a standard tax asset life of 20 years. The 'Integrity inspection' asset class was proposed for capex associated with inline inspection works with 10 years standard tax asset life. The 'Hydrogen safety' asset class was proposed for a program of works to assess the VTS network's ability to handle hydrogen blended gas with a tax standard life of 5 years. APA proposed to include all the forecast capex for 'Integrity inspection' and 'Hydrogen safety' asset classes as immediately expensed capex for tax purposes.

Table 7.1 sets out APA's proposed TAB roll forward over the 2017–22 period.

Table 7.1 APA's proposed tax asset base roll forward for the VTS over the 2018–22 period ($ million, nominal)

	2018	2019	2020	2021[a]	2022[a]
Opening TAB	498.8	494.0	478.5	469.2	469.2
Capital expenditure[b]	28.6	20.2	27.9	39.7	27.2
Less: tax depreciation	33.5	35.7	37.1	39.7	42.8
Closing TAB	**494.0**	**478.5**	**469.2**	**469.2**	**453.7**

Source: APA, *VTS 2023–27 Access Arrangement Proposal – Roll forward model*, December 2021.

(a) Based on estimated capex.

(b) As-commissioned, net of disposals.

7.3 Assessment approach

We make an estimate of taxable income for each regulatory year of the access arrangement period in accordance with the formula in the NGR as part of our determination of the total revenue requirement for APA's 2023–27 access arrangement period.[9] Our estimate is the taxable income a benchmark efficient entity would earn for providing reference services if it operated APA's business and is determined in accordance with the PTRM.

In April 2020, we published our first versions of the RFM and PTRM for gas pipeline service providers under new provisions in the National Gas Rules (NGR).[10] The gas models have been developed using our published electricity distribution and transmission regulatory models, which incorporate relevant findings from our final report on the tax review.[11] They also incorporate several amendments to account for gas specific requirements. Gas pipeline

9 NGR, r. 87A(1).

10 NGR, r. 75A.

11 AER, *Final report: Review of regulatory tax approach*, December 2018, p. 76. The PTRM specifies the manner in which the estimated cost of corporate income tax is to be calculated. The RFM calculates the gas pipeline service provider's tax asset base which is an input to the PTRM for the calculation of the tax building block.

service providers are required to use the gas models for the purposes of their access arrangement proposals.[12]

In April 2021, we published a new version (version 2.1) of our gas transmission PTRM that applied the same regulatory tax approach as version 1, and implemented the changes set out in our final position paper on the treatment of inflation under the regulatory framework.[13]

How the estimated cost of corporate income tax is calculated in the PTRM

Our approach for calculating a gas pipeline service provider's estimated cost of corporate income tax is set out in our PTRM[14] and involves the following steps:[15]

1. We estimate the annual assessable income (taxable revenue) that would be earned by a benchmark efficient entity operating the gas pipeline service provider's business. This is the approved forecast revenues for the gas pipeline service provider that we determined using the building block approach.[16]
2. We then estimate the benchmark tax expenses such as operating expenditure (opex), interest expense and tax depreciation in the following ways:
    - operating expense is set equal to the opex building block[17]
    - interest expense is a function of the size of the capital base, the benchmark gearing assumption (60 per cent) and the regulated cost of debt
    - tax depreciation expense is calculated using a TAB that is separate to the capital base, and standard and/or remaining tax asset lives for taxation purposes. Previously, APA's access arrangements applied the straight-line method for calculating tax depreciation for all assets. Consistent with the findings of the tax review, the published gas PTRM applies the straight-line tax depreciation method for existing assets and the diminishing value tax depreciation method[18] for all assets acquired after 31 December 2022 except for in-house software, buildings and equity raising costs. The expenditure for these assets is to be depreciated using the straight-line method under Australian tax law. The PTRM also accounts for the value of certain forecast capex to be immediately expensed when estimating the benchmark tax expense. The value of immediately expensed capex is deducted from the net capex being depreciated for tax purposes for the year in which it is forecast to be commissioned.[19] The immediately expensed amount is then included in the total tax depreciation amount for the relevant year.

12 NGR, r. 75A.

13 AER, *Final position: Regulatory treatment of inflation*, December 2020, pp. 6–8.

14 AER, *Gas Transmission PTRM,* April 2021.

15 The PTRM must specify the manner in which the estimated cost of corporate income tax is to be calculated: NGR, r. 75B(2)(e).

16 The total revenue for tax purposes is the sum of the building blocks including return on capital, return of capital, operating expenditure and cost of corporate taxation (and any capital contributions if applicable). It may also include other revenue adjustments, but the assessment of whether they should give rise to a cost of corporate tax will occur on a case-by-case basis.

17 Our assessment approach for the opex building block is discussed in Attachment 6 of the draft decision.

18 For more explanation of how we calculate depreciation using the diminishing value method, please see: AER, *Transmission PTRM handbook*, April 2021, pp. 23–24.

19 That is, the net capex to be added to the TAB for tax depreciation purposes is the amount of gross capex, less disposals, less the immediately deductible capex.

There may be other revenue adjustments, but the assessment of whether they should give rise to a corporate tax amount occurs on a case-by-case basis.

3. We estimate the annual taxable income that would be earned by a benchmark efficient entity operating the gas pipeline service provider's business by subtracting the benchmark estimates of tax expenses (step 2) from the approved forecast revenues for the service provider (step 1).
4. We apply the statutory income tax rate to the estimated annual taxable income (after adjustment for any tax loss carried forward) to arrive at a notional amount of tax payable.
5. We deduct the expected value for the utilisation of imputation credits (gamma) by investors from the notional amount of tax payable. The tax payable net of the expected value of imputation credits represents the corporate income tax amount and is included as a separate building block in determining the gas pipeline service provider's total revenue requirement.

How we assess the tax inputs to the PTRM

The estimated cost of corporate income tax is an output of the PTRM. We therefore assess the gas pipeline service provider's proposed cost of corporate income tax by analysing the proposed inputs to the PTRM for calculating that cost. While our assessment approach for most of the tax inputs remain largely the same as the determination for the current (2018–22) period, our gas PTRM requires two new sets of inputs for the calculation of tax depreciation—the forecast immediate expensing of certain capex and the assets to be exempted from the diminishing value method of tax depreciation.

Our assessment approach for each of the tax inputs required in the PTRM, including the two new inputs are discussed in turn below:

- **Opening TAB as at the commencement of the 2023–27 period:** We consider that the roll forward of the opening TAB should be based on the approved opening TAB as at 1 January 2018 and APA's actual capex incurred during the 2018–22 period, and the final year (2017) of the previous access arrangement period.[20] We do not adjust the TAB value for immediate expensing of past capex in the roll forward process. This is consistent with our 2018–22 access arrangement that the benchmark efficient entity at the time will not immediately expense any capex during that period.

  The roll forward of the opening TAB for the 2018–22 period is calculated in APA's RFM. The tax review final report set out that the required changes to the tax depreciation approach would apply to new assets only. As such, the approach for determining the opening TAB value remains the same as the previous access arrangement for the purposes of this draft decision. We have published the new gas RFM to implement the findings of the tax review.[21] We expect that this RFM will be used for the purposes of the TAB roll forward for 2023–27 at the next review.

[20] 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 review.

[21] See https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/gas-financial-models-roll-forward-and-revenue-2020.

The opening TAB value is used to estimate forecast tax depreciation for the 2023–27 period, including new assets to be added to the TAB over this period. We will continue to apply the straight-line method of tax depreciation for the opening TAB value.[22] However, for all assets forecast to be added to the TAB in the 2023–27 period (with some exceptions discussed further below), we will apply the diminishing value method of tax depreciation.

- **Standard tax asset life for each asset class:** Our assessment of a gas pipeline service provider's proposed standard tax asset lives is generally guided by the effective life for depreciating assets determined by the Commissioner of Taxation. The ATO sets a statutory life cap of 20 years on certain classes of gas transmission and distribution assets.[23] We consider that the standard tax asset lives for APA should be consistent with the ATO taxation ruling 2021/3 regarding the effective life of depreciating assets where possible.[24]

  As discussed above, the PTRM applies the diminishing value tax depreciation method for all new assets except for in-house software, buildings and capital works, and equity raising costs. It provides for these assets to be depreciated using the straight-line method for tax purposes.[25] The tax effective lives for in-house software, buildings and capital works, and equity raising costs are not covered under the ATO taxation ruling 2021/3. Therefore, our assessment of the standard tax asset lives for these asset classes are guided by the *Income Tax Assessment Act 1997* (ITAA). Specifically, we consider that the standard tax asset life should be:

  - 40 years for buildings and capital works – This is consistent with the number of years required to completely depreciate capital works assets such as buildings for tax purposes when applying sections 43.15, 43.140 and 43.210 of the ITAA.
  - 5 years for in-house software – This is consistent with section 40.95(7) of the ITAA.
  - 5 years for equity raising costs – This is consistent with section 40.880 of the ITAA.
- **Income tax rate:** The statutory income tax rate is 30 per cent per annum for businesses of the size we regulate, which was adopted in APA's proposal.
- **Value of gamma:** The gamma input for APA is 0.585 for this draft decision. This is consistent with the 2018 *Rate of Return Instrument*, which requires us to use a gamma value of 0.585, and was adopted in APA's proposal.[26] Refer to attachment 3 of this draft decision for further discussion on this matter.
- **Size and treatment of any tax losses as at 1 January 2023:** Where a business has tax losses under our benchmark approach, we require the provision of this value to

22 The tax review final report stated that the required changes to the tax depreciation approach would apply to new assets only. Therefore, the straight-line approach to tax depreciation that applied for APA's 2018–22 access arrangement remains appropriate for use in the roll forward of the TAB to 1 January 2023.

23 ATO, *Taxation Ruling TR2021/3 – Income tax: effective life of depreciating assets (applicable from 1 July 2021)*, p. 177. For transmission assets: compressor station assets, gas pipeline LNG station assets, pipelines–transmission, spur or lateral, regulators and underground gas storage asset. For distribution assets: low pressure gas storage holders, pipelines (high, medium and low-pressure trunks, primary or secondary mains or services) and regulators.

24 ATO, *Taxation Ruling TR2021/3 – Income tax: effective life of depreciating assets (applicable from 1 July 2021),* p. 177.

25 Our assessment approach on new assets to be exempted from the DV method is discussed in detail below.

26 AER, *Rate of return instrument*, December 2018, p. 19.

determine the appropriate estimated taxable income for an access arrangement period. Any tax losses accumulated at the end of the current 2018–22 access arrangement are to be carried over to the start of the 2023–27 access arrangement, which will offset any forecast taxable income for that period. Consistent with the final decision PTRM for the 2018–22 period, our draft decision determines no accumulated tax loss is applicable at the start of the 2023–27 period for APA.

- **Forecast immediate expensing of capex:** The PTRM requires a forecast for immediately deductible capex to be provided for each regulatory year of the 2023–27 period. Our assessment of forecast immediate expensing of capex is guided by the gas pipeline service provider's actual immediate expensing of capex from the previous access arrangement period.[27] We will collect actual data relating to this expenditure in our annual reporting regulatory information notices (RIN) to further inform our decision on the amount of forecast immediate expensing of capex in future access arrangements. Benchmarking may also be considered going forward.[28]
- **Diminishing value multiplier:** The PTRM applies the following formula to calculate the tax depreciation under the diminishing value method:[29]

$$D_t = \left(Nominal\ net\ capex_i - \sum_{n=0}^{t-1} D_n \right) \times DV\ multiplier \div standard\ tax\ asset\ life$$

where:

D_t is the tax depreciation in year t

$D_0 = 0$

$t = 1,2,3, \ldots$

$i = year\ 0$

The PTRM provides an input section for the 'DV multiplier' in the above formula to be recorded for each year of the access arrangement period. This is labelled as the 'diminishing value multiplier' in the PTRM. Currently, the DV multiplier is set at 200 per cent by the ATO. Our assessment approach for the standard tax asset life inputs is discussed above. The assessment approach for capex is discussed in Attachment 5.

- **New assets to be exempted from the diminishing value method:** The PTRM applies the diminishing value method for tax depreciation purposes to all new depreciable assets except for certain assets. It provides for the PTRM asset classes 47 to 50 to be depreciated using the straight-line method for tax purposes rather than the diminishing value method. These asset classes are to contain new assets associated with in-house software, buildings and equity raising costs.

27 In the tax review final report, we labelled our approach to determining the amount of capex that is to be immediately expensed as an 'actuals informed approach'. AER, *Final report, Review of regulatory tax approach*, December 2018, p. 66.

28 AER, *Final report, Review of regulatory tax approach*, December 2018, pp. 66–67.

29 This formula shows how the tax depreciation for capex in a particular year is calculated under the DV method in the PTRM.

We consider that the benchmark equity raising costs should not be depreciated using the diminishing value method. Section 40.880 of the ITAA and the ATO's taxation ruling 2011/6[30] require that businesses claim deductions on equity raising costs in equal proportions over a five-year period. Therefore, in the PTRM, we apply the straight-line method for calculating the tax depreciation for equity raising costs, consistent with the ITAA and ATO's requirements.[31] Further, the gas pipeline service provider may propose capex associated with buildings and in-house software to be exempted from the diminishing value method of tax depreciation in the PTRM if the proposal satisfies the following requirements:

- **Buildings**: We consider that capex for buildings may be exempted from the diminishing value method in the PTRM, consistent with sections 43.15, 43.140 and 43.210 of the ITAA. However, such capex must be consistent with the definition of a capital work under section 43.20 of the ITAA and in ATO taxation ruling 97/25.[32] This includes new buildings and structural improvements to existing buildings.[33] However, capex on separate assets within a building such as air-conditioning units, transformers and converters are not consistent with the definition of a capital work, and therefore are required to be depreciated using the diminishing value method in the PTRM. APA did not propose this type of capex for the 2023–27 period.
- **In-house software**: We consider that capex for in-house software may be exempted from the diminishing value method in the PTRM, consistent with section 40.72 of the ITAA. However, such capex must be consistent with the definition of in-house software under section 995.1 of the ITAA and in ATO taxation ruling 2016/3.[34] This includes computer software, or the right to use computer software that the gas pipeline service provider acquires, develops or has someone else develop for the gas pipeline service provider's business use.[35] However, capex associated with other IT assets such as computer hardware is not consistent with the definition of in-house software, and therefore is required to be depreciated using the diminishing value method in the PTRM. APA did not propose this type of capex for the 2023–27 period.

In assessing APA's proposal, we have had regard to the National Gas Objective (NGO) and the revenue and pricing principles.[36] The NGR also require that any forecast must be arrived at on a reasonable basis and must represent the best forecast or estimate possible in the circumstances.[37]

30 ATO, *Taxation Ruling 2011/6*, July 2016.

31 The benchmark amount for equity raising costs is determined within the PTRM.

32 ATO, *Taxation Ruling 97/25*, July 2017.

33 ITAA, section 43.20.

34 ATO, *Taxation Ruling 2016/3*, October 2018.

35 ITAA, section 995.1.

36 National Gas Law (NGL), s. 28; NGR, r. 100(1). The NGO is set out in NGL, s. 23. The revenue and pricing principles are set out in NGL, s. 24.

37 NGR, r. 74(2).

7.3.1 Interrelationships

The cost of corporate income tax building block feeds directly into the total revenue requirement. This amount is determined by five factors:

- pre-tax revenues
- tax expenses (including tax depreciation)
- the corporate tax rate
- any tax losses carried forward
- 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 payable.

Of these five factors, the corporate tax rate is set externally by the Government. The higher the tax rate, the higher the required cost of corporate tax.

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 payable.[38] Depending on the source of the revenue increase, the tax increase may be equal to or less than proportional to the company tax rate.[39]

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 (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 capital base funded through debt. It also depends on the allowed return on debt and the size of the capital base.
- General expenses – These expenses generally will match the opex forecast including any revenue adjustments, but the assessment of whether they should be treated as a tax expense occurs on a case-by-case basis.
- Tax depreciation – A TAB that is separate to the capital base is maintained for the service provider reflecting tax rules. This TAB is affected by many of the same factors as the capital base, such as capex, although unlike the capital base value it is maintained at its historical cost with no indexation. The TAB is also affected by the depreciation rate/method and asset lives assigned for tax depreciation purposes.

[38] 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 corporate tax amounts become stable.

[39] 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 corporate tax amount in proportion to the company tax rate.

A business that has tax expenses which are greater than its taxable revenue in a period would not be subject to pay tax and instead will generate a tax loss. A tax loss from the previous period(s) can be carried forward to offset against tax payable in the current period.

7.4 Reasons for the draft decision

We determine a cost of corporate income tax of zero for APA over the 2023–27 period, consistent with its proposal. Our draft decision forecast a tax loss of $72.0 million ($nominal) at the end of the 2023–27 period. The tax loss will be carried forward to future access arrangement periods to offset future tax liabilities until the tax loss is fully exhausted.

We determine an opening TAB of $452.9 million as at 1 January 2023 for APA. We accept APA's approach for establishing the opening TAB. However, we corrected a minor error in the proposed actual 2017 capex, updated the proposed estimated value for 2021 capex with actual 2021 capex that has become available, and updated the proposed estimated value for 2022 capex based on our capex assessment.[40]

We are satisfied that APA's proposed approach for determining the forecast immediate expensing of its capex over the 2023–27 period is reasonable. However, we amended the proposed amount of the forecast immediately expensed capex to $46.5 million ($2022) from $140.6 million based on our draft decision on the overall forecast capex (attachment 5).

We accept APA's proposed standard tax asset lives for all of its existing asset classes. However, we partly accept APA's proposal to create new asset classes and standard asset lives for tax depreciation of certain new assets. We also accept APA's proposal to calculate forecast tax depreciation of its existing assets using the weighted average remaining life method. This method is a continuation of the approved approach used in the 2018–22 period and applies the approach as set out in our RFM.

Discussed in other attachments, our draft decision on APA's proposed return on capital (Attachments 2, 3 and 5) and the regulatory depreciation (Attachment 4) building blocks affect total revenues, and therefore also impact the forecast corporate income tax amount.[41]

7.4.1 Implementation of the tax review

We published the latest version of the gas PTRM in April 2021. Specifically, the PTRM includes the following two components which affect the calculation of tax depreciation:

- **immediate expensing of capex –** we allow for certain capex to be immediately expensed when estimating the benchmark tax expense
- **diminishing value depreciation method –** we apply the diminishing value method for tax depreciation purposes to all new depreciable assets except for capex associated with in-house software, equity raising costs and buildings.

[40] The correction to actual 2017 capex on an as-commissioned basis increased the opening TAB by less than $0.1 million. The update to estimated 2021 capex on an as-commissioned basis with actual capex increased the opening TAB by $4.5 million, and the update to 2022 estimated capex on an as-commissioned basis reduced the opening TAB by $5.1 million

[41] NGR, r. 87A.

APA has used our PTRM which implemented the changes identified from the final report of the tax review to estimate the corporate income tax for its proposal.[42] Our assessment of the tax inputs submitted by APA are discussed below.

Forecast immediate expensing of capex

APA proposed that $140.6 million ($2022) of forecast capex (28.3 per cent of total capex)[43] will be immediately expensed for tax purposes for the 2023–27 period.[44] This includes all forecast capex amounts for the 'Integrity inspections' and 'Hydrogen safety' asset classes,[45] and the majority (greater than 99%) of capex for the 'Other' asset class.[46]

As discussed in attachment 5, we have not accepted any capex for projects associated with the 'Hydrogen safety' asset class. Therefore, the proposed capex for this asset class was excluded from our assessment of immediate expensing of capex.[47]

Our draft decision is to accept APA's proposal to include all forecast capex for the 'Integrity inspections' and the majority of capex for the 'Other – short life' and 'Other – long life' asset classes to be immediately expensed for tax purposes over the 2023–27 period. This is the same approach APA used to calculate the value of immediate expensing of capex for tax purposes during the 2018–22 period.[48] We consider it reasonable to expect that the same type of capex will also be deducted immediately by APA for tax purposes during the 2023–27 period.

As discussed in attachment 5, we have reduced APA's proposed forecast capex for projects allocated to the 'Other – short life' and 'Other – long life' asset classes by $24.0 million ($2022) to $46.5 million ($2022), while we accepted the forecast capex of $29.6 million ($2022) for the 'Integrity inspection' asset class.[49] Therefore, our draft decision is to make a corresponding reduction to APA's proposed amount of forecast immediate expensing capex to $54.3 million ($2022) for the 2023–27 period.[50]

We will collect actual data relating to the immediately expensing of capex in our annual reporting RINs to further inform our decision for this type of expenditure in the next access arrangement for APA.

42 APA, *VTS 2023–27 Access Arrangement – Post-tax revenue model*, December 2021.

43 Compared with the proposed gross capex of $29.3 million ($2022).

44 APA, *VTS 2023–27 Access Arrangement – Post-tax revenue model*, December 2021.

45 APA, *VTS 2023–27 Access Arrangement – RIN Response,* December 2021, pp.78–82.

46 We re-labelled the 'Other' asset class approved in the 2018–22 access arrangement to 'Other – short life' asset class for the 2023–27 access arrangement period. This is because of our decision to create a new 'Other – long life' asset class for the 2023–27 period. The relabelling of existing 'Other' asset class to 'Other – short life' is to better distinguish the different standard asset lives assigned to the two asset classes. This is discussed in section 4.4.2 of attachment 4 of this draft decision.

47 This reduces the immediate expensing capex by around $40 million.

48 The new 'Integrity inspection' asset class for the 2023–27 period includes forecast capex associated with the undertaking of integrity management inspections of APA's pipelines. This type of costs were previously included in the 'Other' asset class in the 2018–22 period, and all of which is immediately expensed for tax purposes.

49 Please see section 5.1 of attachment 5 of this draft decision for details.

50 All else being equal, a reduction of immediately expensed capex will increase the forecast cost of corporate income tax (or in this case reduce the amount of forecast tax loss for APA).

Assets exempt from the diminishing value method

The gas PTRM continues to apply the straight-line tax depreciation method to the opening TAB at 1 January 2023, but applies the diminishing value method as the new regulatory benchmark for calculating tax depreciation to all new capex.[51] However, as discussed above, there are some exceptions to this approach under the tax law such as assets relating to in-house software, buildings and equity raising costs. In the PTRM, the benchmark equity raising costs are determined within the model and depreciated using the straight-line tax depreciation method.

APA has not proposed any forecast capex that relates to the above categories which would be required to be depreciated using the straight-line method for tax depreciation purposes. As a result, all of APA's assets acquired after 31 December 2022 are subject to the diminishing value method of tax depreciation. We accept APA's proposal to not allocate any forecast capex to be depreciated under the straight-line method for tax depreciation.

Gas asset life caps

Our new regulatory tax approach applies a 20-year cap on the tax asset lives for certain new gas assets. This is consistent with ATO's tax ruling which sets a statutory life cap of 20 years on certain classes of gas transmission and distribution assets.[52]

We note that APA has historically capped its standard tax asset lives for its gas pipeline assets at 20 years with the exception of general buildings (60 years) and general land (non-depreciable). APA has proposed to continue this in the 2023–27 period, reflecting our new regulatory tax approach. We therefore accept APA's capped standard tax asset lives for its gas pipeline assets.

7.4.2 Opening tax asset base as at 1 January 2023

We accept APA's proposed method to establish the opening TAB as at 1 January 2023. This is because APA's proposed approach is based on our RFM and consistent with that previously approved for the 2018–22 period. Based on the proposed approach, we have determined APA's opening TAB value as at 1 January 2023 of $452.9 million ($nominal). This represents a reduction of $0.8 million compared to APA's proposal.

We have reviewed the inputs to the TAB roll forward. We found all inputs were correct and reconciled with relevant data sources, such as historical data RINs and the 2018–22 decision models, with the exception of the value for the 2017 actual capex.[53] Using the data sourced from the 2017 RIN we corrected the value of the actual capex for that year. This increased the opening TAB as at 1 January 2023 by less than $0.1 million. We updated the proposed estimated value for 2021 capex with the actual 2021 capex sourced from the 2021 annual RIN that has become available after APA's lodgement of its proposal. This resulted in a $4.5 million increase to the opening TAB as at 1 January 2023. We also updated the proposed

[51] AER, *Final report, Review of regulatory tax approach*, December 2018, p. 76.

[52] ATO, *Taxation Ruling TR2021/3 – Income tax: effective life of depreciating assets (applicable from 1 July 2021)*, p. 177. For transmission assets–compressor station assets, gas pipeline LNG station assets, pipelines– transmission, spur or lateral, regulators and underground gas storage asset. For distribution assets low pressure gas storage holders, pipelines (high, medium and low-pressure trunks, primary or secondary mains or services) and regulators.

[53] We identified some other required input changes that affected the capital base roll forward (Attachment 2) but not the TAB roll forward.

estimated value for 2022 capex based on our capex assessment. This resulted in a $5.1 million reduction to the opening TAB as at 1 January 2023.

After the above changes, we are satisfied with the 2018–22 capex used to roll forward the TAB for the purposes of this draft decision. We note that the opening TAB as at 1 January 2023 may be updated to reflect any revised 2022 capex estimates as part of the final decision.

Table 7.2 sets out our draft decision on the roll forward of APA's TAB values over the 2018–22 period.

Table 7.2 AER's draft decision on APA's VTS TAB roll forward for 2018–22 period ($million, nominal)

	2018	2019	2020	2021	2022[a]
Opening TAB	498.8	494.0	478.5	469.2	474.2
Capital expenditure[b]	28.6	20.2	27.9	44.7	22.0
Less: tax depreciation	33.5	35.7	37.1	39.7	43.3
Closing TAB	**494.0**	**478.5**	**469.2**	**474.2**	**452.9**

Source: AER analysis.

(a) Based on estimated capex.

(b) As-commissioned, net of disposals.

7.4.3 Remaining tax asset lives

We accept APA's proposed weighted average method to calculate the remaining tax asset lives as at 1 January 2023. The proposed method is a continuation of the approved approach used in the 2018–22 period and applies the approach as set out in our RFM.

We will update the remaining tax asset lives for the final decision for any changes to the estimated capex values in the RFM because they are used as inputs for calculating the remaining tax asset lives.

Our draft decision relabels the existing 'Other' asset class to 'Other – short life' for the 2023–27 period. This change does not affect the remaining tax asset life for this asset class, as calculated in the RFM. We also create a new 'Other – long life' asset class for depreciating assets allocated to this class. These changes better distinguish the different asset lives assigned to the two asset classes. This is discussed further in attachment 4 of this draft decision.

Table 7.3 sets out our draft decision on the remaining tax asset lives at 1 January 2023 for APA. We are satisfied that the remaining tax asset lives are appropriate for application over the 2023–27 period. We are also satisfied that the remaining tax asset lives provide an estimate of the tax depreciation amount that would be consistent with the tax expenses used to estimate the annual taxable income for a benchmark efficient service provider.[54]

[54] NGR, r. 87A(1).

7.4.4 Standard tax asset lives

We accept APA's proposed standard tax asset lives assigned to its existing asset classes for the 2023–27 period, because they are:

- broadly consistent with the tax asset lives prescribed by the Commissioner of Taxation in ATO Taxation Ruling 2021/3[55]
- the same as the approved standard tax asset lives for the 2018–22 period
- consistent with the statutory cap on the effective life of 20 years for gas pipeline assets under the ITAA.[56]

We accept APA's proposal to create a new 'Integrity inspections' asset class for the 2023–27 period. This is because we consider capex associated with this asset class has a different economic life and depreciation schedule compared to existing asset classes. Our draft decision is to assign a standard tax asset life of 10 years for this asset class, consistent with our draft decision for its economic life. We consider this economic life indicates the period over which the asset class is intended for use and reflects the effective life. This is consistent with the ATO's guidance on determining the effective life of an asset.[57] However, we do not accept the creation of new asset classes for 'Hydrogen safety', 'WORM' and 'SWP_570'. They are unnecessary because the capex has not been accepted or the capex can be reallocated to existing asset classes.[58] Therefore, no standard tax asset lives for these asset classes are required for approval.

As discussed in section 7.4.2, our draft decision relabelled the existing 'Other' asset class with a tax standard life of 7.5 years to 'Other – short life' and created a new 'Other – long life' asset class. We have assigned a 15 year standard tax asset life for the 'Other – long life' asset class, consistent with the economic life we assigned for this asset class.[59] We consider this economic life indicates the period over which the asset class is intended for use and reflects the effective life. This is consistent with the ATO's guidance on determining the effective life of an asset.[60]

Our draft decision on APA's standard tax asset lives for each of its asset classes is set out in Table 7.3. We are satisfied that the standard tax asset lives are appropriate for application over the 2023–27 period. We are also satisfied that the standard tax asset lives provide an estimate of the tax depreciation amount that would be consistent with the tax expenses used to estimate the annual taxable income for a benchmark efficient service provider.[61]

55 ATO, *Taxation Ruling TR2021/3 – Income tax: effective life of depreciating* assets *(applicable from 1 July 2021),* p. 177.

56 With the exception of general land and general buildings.

57 ATO, *Taxation Ruling TR2021/3 – Income tax: effective life of depreciating assets*, p. 8; ITAA 1997, Section 40.105.

58 Our assessment of this issue and the reasons for our decision are set out in attachment 4.

59 Please see section 4.4.2 of attachment 4 of this draft decision for details.

60 ATO, *Taxation Ruling TR2021/3 – Income tax: effective life of depreciating assets*, p. 8; ITAA 1997, Section 40.105.

61 NGR, r. 87A(1).

Table 7.3 AER's draft decision on APA's VTS standard and remaining tax asset lives as at 1 January 2023 (years)

Asset class	Standard tax asset life[a]	Remaining tax asset life as at 1 January 2023[b]
Pipelines	20.0	14.6
Compressors	20.0	11.1
City gates & field regulators	20.0	11.5
Odourant plants	20.0	8.0
Gas quality	20.0	16.7
Other - short life	7.5	5.4
General building	60.0	52.9
General land	n/a	n/a
Integrity inspections	n/a	n/a
Other - long life	15.0	n/a
Equity raising costs[c]	5.0	n/a

Source: AER analysis.

(a) All new assets use the diminishing value method of tax depreciation.

(b) Used for straight-line method of tax depreciation.

(c) For this draft decision, the forecast capex determined for APA does not meet a level to trigger any benchmark equity raising costs

n/a Not applicable. We have not assigned a standard tax asset life and remaining tax asset life to some asset classes because all forecast capex are immediately expensed or because the assets allocated to them are non-depreciating assets.

A Shortened forms

Shortened form	Extended form
AER	Australian Energy Regulator
APA / APA VTS	APA VTS Australia (Operations) Pty Ltd and APA VTS Australia (NSW) Pty Ltd
ATO	Australian Tax Office
Capex	Capital Expenditure
Gamma	Value of Imputation Credits
IT	Information technology
ITAA	Income Tax Assessment Act 1997
NGL	National Gas Law
NGO	National Gas Objective
NGR	National Gas Rules
NPV	Net present value
Opex	Operating Expenditure
PTRM	Post-tax revenue model
TAB	Tax asset base
RFM	Roll forward model
RIN	Regulatory Information Notice
RPP	revenue and pricing principles
VTS	Victorian Transmission System