# DRAFT DECISION

## AusNet Services
## Distribution Determination
## 2021 to 2026

## Attachment 7
## Corporate income tax

September 2020

AUSTRALIAN
ENERGY
REGULATOR

# Note

This attachment forms part of the AER's draft decision on the distribution determination that will apply to AusNet Services for the 2021–26 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

Attachment 9 – Capital expenditure sharing scheme

Attachment 10 – Service target performance incentive scheme

Attachment 11 – Demand management incentive scheme and demand management innovation allowance mechanism

Attachment 12 – Customer service 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

Attachment 19 – Tariff structure statement

Attachment A – Victorian f-factor incentive scheme

# Contents

# 7 Corporate income tax

Our determination of the annual revenue requirement includes the estimated cost of corporate income tax for AusNet Services' 2021–26 regulatory control period.[1] Under the post-tax framework, a corporate income tax amount is calculated as part of the building block assessment using our post-tax revenue model (PTRM). This amount allows AusNet Services to recover the estimated cost of corporate income tax during the 2021–26 regulatory control period.

This attachment presents our assessment of AusNet Services' proposed corporate income tax amount for the 2021–26 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 zero for AusNet Services in the 2021–26 regulatory control period. This is consistent with AusNet Services' proposal.

We expect AusNet Services to incur a forecast tax loss over the 2021–26 regulatory control period.[2] For this reason, our final decision is to set the cost of corporate income tax at zero for the 2021–26 regulatory control period. We have determined that $266.2 million in tax losses as at 30 June 2026 will be carried forward to the 2026–31 regulatory control period where it can be used to offset future tax liabilities. The forecast tax loss arises because of AusNet Services' forecast tax expenses will exceed its revenue for tax assessment purposes over the 2021–26 regulatory control period. This is mostly due to the implementation of our findings from the 2018 *Review of the regulatory tax approach*, where the introduction of immediate expensing of capital expenditure (capex) and diminishing value method of tax depreciation have resulted in a significant increase of forecast tax depreciation.

For this draft decision, we have:

- increased the proposed forecast immediately expensed capex (section 7.4.1)

- adjusted the proposed opening TAB as at 1 July 2021 (section 7.4.2), including amendments and updates for actual and estimated capex, and a reallocation for accelerated tax depreciation consistent with the accelerated depreciation approach for the regulatory asset base (RAB).[3]

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

[2]    A forecast tax loss occurs when the forecast taxable income is lower than the forecast tax expense. In this event no tax is payable. Any residual amount of tax loss will be carried forward over to future regulatory control periods to offset future taxable income until the tax loss is fully exhausted.

[3]    This is discussed in section 4.4.2, attachment 4 of this draft decision.

We accept AusNet Services' proposed standard tax asset lives for its asset classes, with the exception of the 'In-house software' and 'Secondary systems (pre 2016) asset classes. The proposed standard tax asset lives are broadly consistent with the tax asset lives prescribed by the Commissioner for taxation in Australian Tax Office (ATO) taxation ruling 2020/3 and/or are the same as the approved standard tax asset lives for the 2016–20 regulatory control period.

We also accept AusNet Services' proposed weighted average method to calculate the remaining tax asset lives as at 1 July 2021. This method is a continuation of the approved approach used in the 2016–20 regulatory control period and applies the approach as set out in our roll forward model (RFM). Further, we accept AusNet Services' proposed remaining tax asset life for its new 'Secondary systems (pre 2016)' asset class. However, we determine alternative remaining tax asset lives for the 'Accelerated depr - distr assets (contingent project 3)' and 'Accelerated depr - distr assets (other)' 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 attachment 1.

## 7.2 AusNet Services' proposal

AusNet Services proposed an estimated cost of corporate income tax of zero ($ nominal) using our PTRM,[4] with the following inputs:[5]

- an opening TAB value as at 1 July 2021 of $3732.8 million ($ 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 $734.8 million ($2020–21)

- remaining tax asset lives of assets in existence as at 30 June 2021 calculated using a weighted average remaining life approach as set out in our RFM[6]

- the same standard tax asset lives for tax depreciation purposes of new assets for its existing asset classes in the 2021–26 regulatory control period as approved for the 2016–20 distribution determination

- standard tax asset lives of 4 years and 40 years respectively for the new 'In-house software' and 'Buildings' asset classes

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[4] This model now uses the diminishing value (DV) tax depreciation approach for all the assets with the exception of in-house software, buildings (capital works) and equity raising costs.

[5] AusNet Services, 2021–26 Regulatory Proposal – Supporting document, ASD - Distribution Proposal PTRM model (2022–26), January 2020.

[6] As discussed in attachment 4, AusNet Services proposed to continue the year-by-year tracking depreciation for its regulatory asset base. At the same time, it has proposed to do continue with the weighted average remaining life approach for its tax asset base.

- standard tax asset lives of 23.7 years for the new asset class of 'Non-network leasehold land & buildings - 2021–22' and 5.0 years for the new asset class of 'Non-network leasehold land & buildings - 2025–26'. It also included three new 'Non-network leasehold land & buildings' asset classes for the 2022–25 period but with no forecast capex allocated to them.

Consistent with its RAB accelerated depreciation, AusNet Services reallocated some existing assets to the new asset classes of 'Secondary systems (pre 2016)' for TAB accelerated depreciation purposes, assigning a standard tax asset life of 10 years and remaining tax asset life of 5.3 years. However, AusNet Services did not reallocate any assets to the existing asset class of 'Accelerated depr - distr assets (contingent project 3)' and the new asset class of 'Accelerated depr - distr assets (other)' for TAB accelerated depreciation purposes.

Table 7.1 sets out AusNet Services' proposed TAB roll forward over the 2016–20 regulatory control period and a further roll forward for six months (the 1 January to 30 June 2021 period)[7] in accordance with our RFM.[8]

**Table 7.1    AusNet Services' proposed TAB roll forward for the 2016–21 period ($ million, nominal)**

|  | 2016 | 2017 | 2018 | 2019[a] | 2020[a] | 2021[b] |
|---|---|---|---|---|---|---|
| Opening TAB | 2191.8 | 2403.8 | 2649.8 | 2942.4 | 3279.3 | 3598.2 |
| Capital expenditure[c] | 311.7 | 358.2 | 411.9 | 457.9 | 469.4 | 222.3 |
| *Less*: tax depreciation | 99.6 | 112.2 | 119.4 | 120.9 | 150.5 | 87.7 |
| **Closing TAB** | **2403.8** | **2649.8** | **2942.4** | **3279.3** | **3598.2** | **3732.8** |

Source:     AusNet Services, 2021–26 Regulatory Proposal – Supporting document, ASD - Distribution Proposal RFM (2016–21), January 2020.

(a)          Based on estimated capex.

(b)          The half year period of 1 January to 30 June 2021. Based on estimated capex.

(c)          Net of disposals.

## 7.3 Assessment approach

We make an estimate of taxable income for each regulatory year as part of our determination of the annual revenue requirement for AusNet Services' 2021–26

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[7]     The additional roll forward for 6 months is due to the decision by the Victorian government to change the timing of the annual Victorian electricity network price changes to financial year basis from calendar year basis. This change means the current regulatory control period of 2016–20 is extended by 6 months and the next regulatory control period will commence on 1 July 2021.

[8]     We have provided AusNet Services with a set of amended regulatory models and a summary of modelling requirements for use in the Victorian 2021–26 regulatory determinations. This includes a RFM for the 2016–20 regulatory control period and the RFM for the 2016–21 period.

regulatory control period.[9] Our estimate is the taxable income a benchmark efficient entity would earn for providing standard control services if it operated AusNet Services' business, which is determined in accordance with the PTRM.[10]

In May 2018, we commenced a review of our regulatory tax approach. We released the final report of the tax review in December 2018, which identified some required changes to our approach to estimating tax depreciation expenses in our regulatory models (PTRM and RFM).[11] The changes to our regulatory tax approach require amending our models to:[12]

- recognise immediate tax expensing of some capex forecast for a regulatory control period

- adopt the diminishing value (DV) method for tax depreciation to all future capex except for a limited number of assets which must be depreciated using the straight-line (SL) tax depreciation method, under the tax law.[13]

In April 2019, we published a new version of the PTRM (version 4) which implements the changes to the tax depreciation approach. The tax review final report stated that the required changes to the tax depreciation approach would apply to new assets only. Therefore, only changes to the PTRM are required in the first regulatory control period when adopting the new tax approach. In this case, the RFM approach that applied for AusNet Services' 2016–20 distribution determination remains appropriate for use in the roll forward of the TAB to 1 July 2021. The amended RFM (version 3) will be required at the next reset to roll forward the TAB during the 2021–26 regulatory control period with capex being depreciated using the DV method.

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

Our approach for calculating a distributor'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 distributor's business. This is the approved forecast revenues for the distributor that we determined using the

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9     NER, cl. 6.5.3.

10    NER, cl. 6.5.3.

11    AER, *Final report, Review of regulatory tax approach*, December 2018, pp. 6–20; The PTRM specifies the manner in which the estimated cost of corporate income tax is to be calculated. The RFM calculates the distributor's tax asset base at the start of the next regulatory control period, which is an input to the PTRM for the calculation of the tax building block.

12    Capping of gas asset tax lives was also a finding from the final report, but does not require a model change.

13    We will continue to apply SL tax depreciation for assets acquired prior to 1 July 2021 for the 2021–26 regulatory control period until they are fully depreciated.

14    AER, *Distribution PTRM (version 4)*, April 2019.

15    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).

building block approach.[16] It includes capital contributions where these are subject to taxation.

2. We then estimate the benchmark tax expenses such as operating expenditure (opex), interest expense, tax depreciation in the following ways:

   o operating expense is set equal to the opex building block[17]

   o interest expense is a function of the size of the RAB, the benchmark gearing assumption (60 per cent) and the regulated cost of debt

   o tax depreciation expense is calculated using a separate value for the TAB, and standard and remaining tax asset lives for taxation purposes. Previously, the PTRM applied the SL method for calculating tax depreciation for all assets. Consistent with the findings of the tax review, the amended PTRM (version 4) applies the SL tax depreciation method for existing assets and the DV tax depreciation method[18] for all assets acquired after 30 June 2021 except for in-house software, buildings and equity raising costs. The expenditure for these assets are to be depreciated using the SL method under Australian tax law. The amended 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 incurred.[19] The immediately expensed amount is then included in the total tax depreciation amount for the relevant year.

   There may be other revenue adjustments, but the assessment of whether they should give rise to a tax payable 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 distributor's business by subtracting the benchmark estimates of tax expenses (step 2) from the approved forecast revenues for the distribution network business (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

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[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. It may also include other revenue adjustments, but the assessment of whether they should give rise to a tax payable 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 DV method, please see: AER, *Distribution PTRM handbook*, April 2019, pp. 22–23.

[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.

expected value of imputation credits represents the estimated cost of corporate income tax and is included as a separate building block in determining the distributor's annual revenue requirement.

## How we assess the tax inputs to the PTRM

The estimated cost of corporate income tax is an output of our PTRM. We therefore assess the distributor's proposed cost of corporate 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 2016–20 regulatory control period, our amended PTRM (version 4) 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 DV method of tax depreciation. Our assessment approach for each of the tax inputs required in the PTRM including the two new sets of inputs are discussed in turn below:

- **the opening TAB as at the commencement of the 2021–26 regulatory control period:** We consider that the roll forward of the opening TAB should be based on the approved opening TAB as at 1 January 2016 and AusNet Services' actual/estimated capex incurred during the 2016–21 period, and the final year (2015) of the previous regulatory control 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 2016–20 regulatory determination which applied SL tax depreciation to capex incurred during that period as prescribed in the PTRM.

  The roll forward of the opening TAB for 2016–21 is calculated in our 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 determination for the purposes of this draft decision. We have published the amended RFM (version 3) to implement the findings of the tax review.[21] We expect that this version of the RFM will be used for the purposes of the TAB roll forward for 2021–26 at the next reset.

  This opening TAB value is used to estimate forecast tax depreciation for the 2021–26 regulatory control period, including new assets to be added to the TAB over this period. We will continue to apply the SL method of tax depreciation for the opening TAB value. However, for all assets forecast to be added to the TAB in the 2021–26 regulatory control period (with some exceptions discussed further below), we will apply the DV method of tax depreciation.

- **the standard tax asset life for each asset class:** Our assessment of a distributor's proposed standard tax asset lives is generally guided by the effective

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[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 reset.

[21] See https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/electricity-roll-forward-models-transmission-and-distribution-2020-amendment/final-decision.

life of depreciating assets determined by the Commissioner for Taxation. We consider that the standard tax asset lives for the majority of AusNet Services' asset classes should be consistent with the ATO taxation ruling 2020/3 regarding the effective life of depreciating assets where possible.[22]

As discussed above, the amended PTRM (version 4) applies the DV tax depreciation method for all new assets except for in-house software, buildings and equity raising costs. It provides designated asset classes for these assets to be depreciated using the SL method for tax purposes.[23] We note that the tax effective lives for in-house software, buildings and equity raising costs are not covered under the ATO taxation ruling 2020/3. 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:

- o 40 years for buildings – This is consistent with the number of years required to completely depreciate a capital works asset such as buildings for tax purposes when applying sections 43.15, 43.140 and 43.210 of the ITAA.

- o 5 years for in-house software – This is consistent with section 40.95(7) of the ITAA.

- o 5 years for equity raising costs – This is consistent with section 40.880 of the ITAA.

- **the income tax rate:** The statutory income tax rate is 30 per cent per year for businesses of the size we regulate, which was adopted in AusNet Services' proposal.

- **the value of gamma:** The gamma input for AusNet Services 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 adopted in AusNet Services' proposal.[24] 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 2021:** Where a business has tax losses under our benchmark approach, we require the provision of this value to determine the appropriate estimated taxable income for a regulatory control period. If there is an amount of tax losses accumulated, the forecast taxable income for the regulatory control period will be reduced by this amount. AusNet Services does not have any accumulated tax losses as at the start of the 2021–26 regulatory control period.[25]

- **forecast immediate expensing of capex:** The amended PTRM (version 4) requires a forecast for immediately deductible capex to be provided for each

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22   ATO, *Taxation Ruling TR2020/3– Income tax: effective life of depreciating assets (applicable from 1 July 2019)*.

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

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

25   AusNet Services, 2021–26 Regulatory Proposal – Supporting document, ASD - Distribution Proposal PTRM model (2022–26)*,* January 2020.

regulatory year of the 2021–26 regulatory control period. Our assessment of forecast immediate expensing of capex will be guided by the distributor's actual immediate expensing of capex from the previous regulatory control period.[26] We will collect actual data relating to this expenditure in our annual reporting regulatory information notices (RINs) to further inform our decision on the amount of forecast immediate expensing of capex in future regulatory determinations. Benchmarking may also be considered going forward.[27]

- **diminishing value multiplier:** The amended PTRM (version 4) applies the following formula to calculate the tax depreciation under the DV method:[28]

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

where:

$D_t$ is the tax depreciation in year $t$

$D_0 = 0$

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

$i = year\ 0$

The PTRM provides an input section for the 'DV multiplier' in the above formula to be recorded for each year of the regulatory control period. This is labelled as the 'diminishing value multiplier' in the PTRM. We note that 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 amended PTRM (version 4) applies the DV method for tax depreciation purposes to all new depreciable assets except for certain assets. It provides for asset classes 47 to 50 to be depreciated using the SL method for tax purposes rather than the DV method. These asset classes are to contain new assets associated with in-house software, buildings and equity raising costs.

We consider that the benchmark equity raising costs should not be depreciated using the DV method. We note that section 40.880 of the ITAA and the ATO's taxation ruling 2011/6[29] require that businesses claim deductions on equity raising costs in equal proportions over a five-year period. Therefore, in the PTRM, we apply the SL method for calculating the tax depreciation for equity raising costs,

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[26]   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.

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

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

[29]   ATO, *Taxation Ruling 2011/6*, July 2016.

consistent with the ITAA and ATO's requirements.[30] Further, the distributor may propose capex associated with buildings and in-house software to be exempted from the DV method of tax depreciation in the PTRM if the proposal satisfies the following requirements:

- o **buildings**: We consider that capex for buildings may be exempted from the DV 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.[31] We note that this includes new buildings and structural improvements to existing buildings.[32] 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 DV method in the PTRM.

- o **in-house software**: We consider that capex for in-house software may be exempted from the DV 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.[33] We note that this includes computer software, or the right to use computer software that the distributor acquires, develops or has someone else develop for the distributor's business use.[34] 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 DV method in the PTRM.

## 7.3.1 Interrelationships

The cost of corporate income tax building block feeds directly into the annual revenue requirement. This cost 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.

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[30] The benchmark equity raising cost is determined within the PTRM.
[31] ATO, *Taxation Ruling 97/25*, July 2017.
[32] ITAA, s43.20.
[33] ATO, *Taxation Ruling 2016/3*, October 2018.
[34] ITAA, s 995.1.

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

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.[35] Depending on the source of the revenue increase, the tax increase may be equal to or less than proportional to the company tax rate.[36]

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 RAB funded through debt. It also depends on the allowed return on debt and the size of the RAB.

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

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

## 7.4 Reasons for draft decision

We determine a cost of corporate income tax of zero for AusNet Services over the 2021–26 regulatory control period. This is consistent with AusNet Services' proposal. While AusNet Services has no forecast tax loss at the beginning of the 2021–26 regulatory control period, we forecast a tax loss of $42.2 million ($ nominal) by the end of 2021–22, increasing to $266.2 million by the end of 2025–26.

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[35]    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 amounts become stable.

[36]    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 payable in proportion to the company tax rate.

We accept AusNet Services' proposed method to establish the opening TAB as at 1 July 2021. However, we increased AusNet Services' proposed opening TAB value as at 1 July 2021 to $3733.7 million ($ nominal)—an increase of $0.9 million (or less than 0.1 per cent).

We also reallocated $3.5 million of the opening TAB from AusNet Services' asset class of 'Distribution system assets' to its existing class of 'Accelerated depr - dist assets (contingent project 3)' and its proposed new asset class of 'Accelerated depr - distr assets (other)'. We also revised the opening TAB value for the 'Secondary systems (pre 2016)' asset class to $114.7 million, following our revision to its opening RAB value for this class.

We have amended AusNet Services' approach to forecast its immediately expensed capex. As a consequence, we have increased AusNet Services' amount of forecast immediately expensed capex to $768.4 million ($2020–21).

We accept AusNet Services' proposed standard tax asset lives for all of its existing asset classes. We also accept AusNet Services' proposed approach to calculating the remaining tax asset lives as at 1 July 2021 for all its existing asset classes, with the exception of the asset class for 'Accelerated depr - dist assets (contingent project 3)', because they are calculated based on the weighted average method as set out in our RFM. For its proposed new asset classes:

- We accept the standard tax asset life of 40 years for the 'Buildings - capital works' that is subject to the SL method of tax depreciation. However, for the 'In-house software' asset class that is subject to the SL method of tax depreciation we have amended the proposed standard tax asset life to 5 years from 4 years.

- We accept the standard tax asset lives for the Non-network leasehold land & buildings – 2021–22' and 'Non-network leasehold land & buildings – 2025–26' asset classes because they are consistent with the RAB standard lives, which reflect the economic lives of the assets.[37]

- We consolidate the 'Non-network leasehold land & buildings - 1 Apr 2019', 'Non-network leasehold land & buildings - CY20' and 'Non-network leasehold land & buildings - Jan-Jun 2021' asset classes into a single 'Non-network leasehold land & buildings - 1 July 2021' asset class. We accept a remaining tax asset life of 9.3 years based on the weighted average of existing tax values at 1 July 2021 for capitalised leases.

- We accept the remaining tax asset life of 5.3 years for the 'Secondary systems (pre 2016)' asset class, as it reflects the weighted average remaining economic lives of the assets allocated to this class. However, we have amended the standard

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[37]   We have removed the other three new 'Non-network leasehold land & buildings' asset classes for the 2022–25 period that AusNet Services included in its proposed PTRM because they have no forecast capex allocated to them.

tax asset life and record 'n/a' because there is no forecast capex allocated to this asset class.

- We determine the remaining tax asset life of 2 years for both the 'Accelerated depr - distr assets (contingent project 3)' and 'Accelerated depr - distr assets (other)' asset classes. This reflects the economic lives of the assets and follows our decision to reallocate opening TAB values to these asset classes for accelerated depreciation purposes.

Discussed in other attachments and the overview, our draft decision on AusNet Services' proposed return on capital (attachments 2, 3, 5 and section 2.2 of the overview) and the regulatory depreciation (attachment 4) building blocks affect total revenues, and therefore also impact the forecast corporate income tax amount.

## 7.4.1 Implementation of the tax review

We published the amended PTRM (version 4) in April 2019. Specifically, we made the following two changes which affect the calculation of tax depreciation in the PTRM:

- **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 DV method for tax depreciation purposes to all new depreciable assets except for capex associated with in-house software, equity raising costs and buildings.[38]

AusNet Services has used our amended PTRM (version 4) which implemented the changes identified from the final report of the tax review to estimate the corporate income tax for its proposal.[39] Our assessment of the tax inputs submitted by AusNet Services are discussed below.

### Forecast immediate expensing of capex

AusNet Services proposed forecast capex of $734.8 million ($2020–21, or 40.4 per cent of total capex)[40] that will be immediately expensed for tax purposes in the 2021–26 regulatory control period.[41]

We do not accept AusNet Services' proposed method to calculate its forecast immediate expensing of capex. For this draft decision, we have applied an approach that is informed by AusNet Services' current immediate expensing rate. This results in our forecast immediate expensing of capex to be $768.4 million, which is an increase

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[38]   The buildings asset class may be classified as system or non-system assets in the PTRM.
[39]   AusNet Services, 2021–26 Regulatory Proposal – Supporting document, ASD - Distribution Proposal PTRM model (2022–26), January 2020.
[40]   Compared with the proposed gross capex of $1820.2 million ($2020–21).
[41]   AusNet Services, 2021–26 Regulatory Proposal – Supporting document, ASD - Distribution Proposal PTRM model (2022–26), January 2020.

of $33.7 million. Our substitute estimate for the immediate expensing of capex is proportional to the overall substitute estimate of forecast capex.[42]

AusNet Services' proposed forecast immediate expensing of capex over the 2021–26 regulatory control period was based on a simple average of the actual immediately expensed capex claimed over 2015–2019.[43] The proposed approach provides a forecast for immediate expensing that is disproportionate to overall forecast capex, as it results in a fixed amount irrespective of total forecast capex. We do not agree with the proposed approach as it does not take into account the rate of immediate expensing of capex relative to actual capex (immediate expensing rate).

Consistent with the tax review findings and our previous decisions,[44] we consider that a distributor's actual immediate expensing rate, over the most representative years, should inform its forecast rate. It is reasonable to expect that the same proportion of capex will also be deducted immediately by AusNet Services for its annual tax returns during the 2021–26 regulatory control period.

As discussed in attachment 5, we have reduced AusNet Services' proposed forecast capex by 4.4 per cent.[45] We requested AusNet Services to provide a mapping of its recent immediate expensing proportions applied to its overall forecast capex. In response to our request, AusNet Services provided actual/estimated immediately deductible capex data for the 2016–20 regulatory control period and relevant mapping.[46] AusNet Services also noted its tax principles for determining its immediately expensed capex that is attributable to capitalised overheads. We have considered this information in making our decision on the amount of immediate expensing of capex.

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 regulatory determination for AusNet Services.

### Assets exempt from the diminishing value method

The amended PTRM (version 4) continues to apply the SL tax depreciation method to the opening TAB at 1 July 2021, but applies the DV method as the new regulatory benchmark for tax depreciation to all new capex.[47] However, as discussed above, there are some exceptions to this approach under the tax law such as assets relating

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42   AER, *Draft decision – AusNet Services distribution determination 2021–26 - Capex model*, 30 September 2020.

43   AusNet Services, *Regulatory proposal 2021–2026 part III*, January 2020, p. 227.

44   AER, *Draft decision - Energex Distribution Determination 2020 to 2025 - Attachment 7 - Corporate income tax*, October 2019, p. 12; AER, *Draft decision - Ergon Energy Distribution Determination 2020 to 2025 - Attachment 7 - Corporate income tax*, October 2019, p. 12; AER, *Draft decision - SA Power Networks Distribution Determination 2020 to 2025 - Attachment 7 - Corporate income tax*, October 2019, p. 13.

45   AER, *Draft decision – AusNet Services Distribution Determination 2021 to 2026 - Attachment 5 – Capital Expenditure*, 30 September 2020, p. 7.

46   AusNet Services, *Response to AER information request 004 – Q7*, 14 April 2020.

47   AER, *Final report, Review of regulatory tax approach*, December 2018, p. 76.

to in-house software, buildings and equity raising costs.[48] In the PTRM, the benchmark equity raising costs is determined within the model and depreciated using the SL tax depreciation method as default.

In its proposal, AusNet Services submitted that $155.0 million ($2020–21) of forecast capex associated with in-house software and $13.8 million forecast capex associated with buildings are to be exempted from the DV tax depreciation method.

We accept AusNet Services' proposed allocation of forecast capex for in-house software and buildings (capital works) to be depreciated using the SL method for tax depreciation purposes, while approving a lower capex amount of $148.9 million and $13.3m respectively. This is because the proposed forecast capex for:

- in-house software satisfies the definition under section 995.1 of the ITAA and in ATO taxation ruling 2016/3[49]

- buildings satisfies the definition of a capital work under section 43.20 of the ITAA and in ATO taxation ruling 97/25.[50]

Therefore, these assets are not required to be depreciated using the DV method for tax purposes.

## 7.4.2 Opening tax asset base as at 1 July 2021

We accept AusNet Services' proposed method to establish the opening TAB as at 1 July 2021. Based on the proposed approach, we have determined AusNet Services' opening TAB value as at 1 July 2021 of $3733.7 million ($ nominal). This represents an increase of $0.9 million (or less than 0.1 per cent) 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 2016–20 decision models. However, we made the following amendments to AusNet Services' proposed inputs to the RFM which explains the difference in our draft decision opening TAB value and the value proposed by AusNet Services:

- amended the historical capex inputs for 2018[51]

- updated the 2019 estimated capex with actuals[52]

- amended the opening TAB value for the 'Non-network leasehold land & buildings - 1 July 2021' asset class:[53]

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[48]   Asset classes 47, 48, 49 and 50 in the PTRM (version 4) provide for this.

[49]   ATO, *Taxation Ruling* 2016/3, October 2018.

[50]   ATO, *Taxation Ruling* 97/25, July 2017.

[51]   AusNet Services, *Response to AER information request 019*, 05 May 2020, pp. 4−5.

[52]   AER, *Draft decision – AusNet Services Distribution Determination 2021 to 2026 - Attachment 2 - Regulatory Asset Base*, 30 September 2020, p. 17.

- o Consistent with our draft decision on the RAB roll forward, we do not accept AusNet Services' proposal to add the value of its capitalised leases as annual capex over the 2019 to 2021 period allocated to three new asset classes of 'Non-network leasehold land & buildings - 1 Apr 2019', 'Non-network leasehold land & buildings - CY20' and 'Non-network leasehold land & buildings - Jan-Jun 2021' in the TAB roll forward process. For the reasons discussed in attachment 2, the three new asset classes AusNet Services proposed should instead be consolidated into a single new 'Non-network leasehold land & buildings - 1 July 2021' asset class for TAB roll-in at the end of the period. We therefore removed the proposed capex entries for the three new asset classes over the 2019–21 period and recorded them as a single capitalised lease value at 30 June 2021 (end of period).

- removed the 'Non-network - metering related IT' asset class and reallocated the 2019–21 forecast capex to the existing 'Non-network general assets - IT' asset class:[54]

  - o Consistent with our draft decision on the RAB roll forward, we accept AusNet Services' revision to the allocation of its IT system upgrade costs in the 2019–21 capex entries for the RFM. For the reasons discussed in attachment 2, the capex for that period should be allocated to the 'Non-network general assets - IT' asset class instead.

- amended the proposed end of period reallocation for the 'Secondary systems (pre 2016)' asset class in relation to accelerated depreciation of SCADA/Network control assets:

  - o AusNet Services' proposal included a TAB reallocation for its 'Secondary systems (pre 2016) asset class. However, we reduced the RAB reallocation for this asset class to $196.6 million from $209.1 million. Consistent with the reasons set out in attachment 4, we have reduced the TAB reallocation to $114.7 million from $122.0 million, reflecting our draft decision reduction to the RAB reallocation.[55]

- reallocated opening TAB values to the existing asset class of 'Accelerated depr - distr assets (contingent project 3)' and the new asset class of 'Accelerated depr - distr assets (other)' in relation to accelerated depreciation of certain high bushfire risk assets, which have been, or are forecast to be replaced:

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[53] This asset class is a consolidation of the proposed three new asset classes of 'Non-network leasehold land & buildings - 1 Apr 2019', 'Non-network leasehold land & buildings - CY20' and 'Non-network leasehold land & buildings - Jan-Jun 2021'.

[54] AusNet Services supported this amendment in response to our information request: see AusNet Services, *Response to AER information request 028*, 24 June 2020; AusNet Services, *Response to AER information request 046*, 2 July 2020.

[55] AER, *Draft decision – AusNet Services Distribution Determination 2021 to 2026 - Attachment 4 - Regulatory Depreciation*, 30 September 2020, pp. 13–15.

- o AusNet Services' proposal did not include a TAB reallocation for these asset classes. We noted in an information request to AusNet Services that the accelerated depreciation associated with the 'Accelerated depr - distr assets (contingent project 3)' and 'Accelerated depr - distr assets (other)' asset classes in the RAB should also apply to these assets in the TAB. In its response, AusNet Services provided a TAB reallocation of $2.2 million for the 'Accelerated depr - distr assets (contingent project 3)' asset class and $1.2 million for the 'Accelerated depr - distr assets (other)' asset class.[56] For the reasons discussed in attachment 4, we accept the reallocations of these assets for RAB accelerated depreciation purposes. We therefore also accept the TAB reallocations submitted by AusNet Services for accelerated tax depreciation purposes.[57]

We note that the opening TAB as at 1 July 2021 may be updated to reflect actual capex and any revised 1 January to 30 June 2021 capex estimate as part of the final decision.

Table 7.2 sets out our draft decision on the roll forward of AusNet Services' TAB values over the 2016–21 period.

**Table 7.2    AER's draft decision on AusNet Services' TAB roll forward for the 2016–21 period ($ million, nominal)**

|  | 2016 | 2017 | 2018 | 2019 | 2020[a] | 2021[b] |
|---|---|---|---|---|---|---|
| Opening TAB | 2191.8 | 2403.8 | 2649.8 | 2942.3 | 3240.1 | 3566.7 |
| Capital expenditure[c] | 311.7 | 358.2 | 411.9 | 418.7 | 469.0 | 222.2 |
| *Less*: tax depreciation | 99.6 | 112.2 | 119.4 | 120.9 | 142.4 | 83.1 |
| **Closing TAB** | **2403.8** | **2649.8** | **2942.3** | **3240.1** | **3566.7** | **3733.7** |

Source:     AER analysis.

(a)          Based on estimated capex. We expect to update the TAB roll forward for actual capex in the final decision.

(b)          The half year period of 1 January to 30 June 2021. Based on estimated capex. We expect to update the TAB roll forward with a revised capex estimate in the final decision,

(c)          Net of disposals.

## 7.4.3 Remaining tax asset lives

We accept AusNet Services' proposed weighted average method to calculate the remaining tax asset lives as at 1 July 2021. The proposed method is a continuation of the approved approach used in the 2016–20 regulatory control period and applies the approach as set out in our RFM.

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[56]    AusNet Services, *Response to AER information request 041*, 24 June 2020, pp. 1–2.

[57]    AER, *Draft decision – AusNet Services Distribution Determination 2021 to 2026 - Attachment 4 - Regulatory Depreciation*, 30 September 2020, p. 15.

In accepting the weighted average method, we have updated AusNet Services' proposed remaining tax asset lives to reflect our adjustments to AusNet Services' opening TAB value as at 1 July 2021 (section 7.4.2). 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.[58]

For the proposed new 'Non-network leasehold land & buildings – 2021–22', 'Non-network leasehold land & buildings – 2025–26', 'In-house software' and 'Buildings - capital works' asset classes we have not assigned remaining tax asset lives as there are no opening tax values for these asset classes, only forecast capex are being allocated to these asset classes over the 2021–26 regulatory control period. We therefore record 'n/a' in the PTRM for these asset classes.

For the asset class of 'Accelerated depr - distr assets (contingent project 3)' and the proposed new asset class of 'Accelerated depr - distr assets (other)', AusNet Services proposal did not assign remaining tax asset lives as it did not include the reallocation of existing tax assets discussed in section 7.4.2. In response to our information request, AusNet Services submitted a remaining tax asset life of 2 years would apply to the reallocated values for both these asset classes.[59] We accept that it is appropriate to adopt a remaining life of these assets for tax purposes that reflects the effective economic lives for these assets. This is consistent with the ATO's guidance on determining the effective life of an asset.[60]

For the newly established 'Non-network leasehold land & buildings - 1 July 2021' asset class discussed in section 7.4.2, we have determined a remaining tax asset life of 9.3 years based on the weighted average of existing tax values at 1 July 2021 for capitalised leases. This approach is consistent with: the remaining tax asset life AusNet Services proposed for its capitalised leases, and the ATO's guidance on determining the effective life of an asset.

For the proposed new 'Secondary systems (pre 2016)' asset class discussed in section 7.4.2, we accept AusNet Services' proposal to assign a remaining tax asset life of 5.3 years. This life reflects the weighted average effective economic lives of the assets allocated to this asset class. We are satisfied this approach is consistent with the ATO's guidance on determining the effective life of an asset.

Table 7.3 sets out our draft decision on the remaining tax asset lives at 1 July 2021 for AusNet Services. We are satisfied that the remaining tax asset lives are appropriate for application over the 2021–26 regulatory control period. We are also satisfied that the remaining tax asset lives provide an estimate of the tax depreciation amount that would

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[58]    At the time of this draft decision, the roll forward of AusNet Services' TAB includes estimated capex values for 2020 and 2021. We may further update the estimate of 2020 and 2021 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 AusNet Services' remaining tax asset lives as at 1 July 2021 using the method approved in this draft decision.

[59]    AusNet Services, *Response to AER information request 041*, 24 June 2020.

[60]    ATO, *Taxation Ruling TR2020/3– Income tax: effective life of depreciating assets,* p. 9*;* ITAA 1997, Section 40.105.

be consistent with the tax expenses used to estimate the annual taxable income for a benchmark efficient service provider.[61]

## 7.4.4 Standard tax asset lives

We accept AusNet Services' proposed standard tax asset lives for its existing asset classes because they are:

- broadly consistent with the tax asset lives prescribed by the Commissioner for taxation in ATO taxation ruling 2020/3[62]

- the same as the approved standard tax asset lives for the 2016–20 regulatory control period.

Discussed in section 7.4.1, as part of the implementation of the new tax depreciation approach, AusNet Services proposed to reallocate forecast capex associated with buildings (capital works) and in-house software to the prescribed SL tax depreciation asset classes in the amended PTRM. It proposed to assign the standard lives of 40 years for buildings (capital works) and 4 years for in-house software. We accept the standard tax asset life of 40 years for the 'Buildings - capital works' asset class, as this is consistent with the number of years required to completely depreciate a capital works asset such as buildings under the ITAA.[63] We consider the appropriate standard tax asset life for the 'In-house software' asset class is 5 years, as this is consistent with the ITAA.[64] In its response to our information request, AusNet Services agreed that this life is appropriate for tax depreciation purposes.[65]

We also accept AusNet Services' proposed standard tax asset lives for its new asset classes of Non-network leasehold land & buildings – 2021–22' and 'Non-network leasehold land & buildings – 2025–26' because they are consistent with the RAB standard lives, which reflect the economic lives of the assets. We are satisfied that this approach is consistent with the ATO's guidance on determining the effective life of an asset.[66]

Table 7.3 sets out our draft decision on the standard tax asset lives for AusNet Services. We are satisfied that the standard tax asset lives are appropriate for application over the 2021–26 regulatory control 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.[67]

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[61] NER, cl 6.5.3.
[62] ATO, *Taxation Ruling TR2020/3– Income tax: effective life of depreciating assets* (applicable from 1 July 2019).
[63] ITAA, s 43.15, 43.140, 43.210.
[64] ITAA, s 40.95(7).
[65] AusNet Services, *Response to AER information request 041*, 24 June 2020.
[66] ATO, *Taxation Ruling TR2020/3– Income tax: effective life of depreciating assets,* p. 9*;* ITAA 1997, s 40.105.
[67] NER, cl. 6.5.3.

**Table 7.3    AER's draft decision on AusNet Services' standard and remaining tax asset lives as at 1 July 2021 (years)**

| Asset class | Standard tax asset life | Remaining tax asset lives as at 1 July 2021[b] |
|---|---|---|
| Subtransmission | 43.0 | 36.3 |
| Distribution system assets | 46.0 | 35.1 |
| SCADA/Network control | 10.0 | 8.2 |
| Non-network general assets - IT | 4.0 | 3.1 |
| Non-network general assets - other | 12.0 | 7.3 |
| Land | n/a | n/a |
| Secondary systems (pre 2016) | n/a | 5.3 |
| Accelerated depr - distr assets (contingent project 3) | n/a | 2.0 |
| Accelerated depr - distr assets (other) | n/a | 2.0 |
| Non-network leasehold land & buildings - 1 July 2021 | n/a | 9.3 |
| Non-network leasehold land & buildings – 2021–22 | 23.7 | n/a |
| Non-network leasehold land & buildings – 2025–26 | 5.0 | n/a |
| Buildings - capital works | 40.0[a] | n/a |
| In-house software | 5.0[a] | n/a |
| Equity raising costs | 5.0[a] | 3.1 |

Source:    AER analysis.

(a)    These are the only asset classes used for the straight-line method of tax depreciation for new assets. All new assets for other asset classes used the diminishing value method of tax depreciation.

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

n/a    not applicable. We have not assigned a standard tax asset life and remaining tax asset life to the 'Land' asset class because the assets allocated to it are non-depreciating assets. We have not assigned a standard tax asset life to the Accelerated depr - distr assets (contingent project 3), Accelerated depr - distr assets (other), 'Non-network leasehold land & buildings - 1 July 2021' and 'Secondary systems (pre 2016)' asset classes, because there are no new capex being allocated to these asset classes in the future. We also have not assigned a remaining tax asset life to the 'Non-network leasehold land & buildings – 2021–22', 'Non-network leasehold land & buildings – 2025–26', 'Buildings - capital works' and 'In-house software' asset classes, because they have no opening TAB values as at 1 July 2021.

# Shortened forms

| Shortened form | Extended form |
| --- | --- |
| AER | Australian Energy Regulator |
| ATO | Australian Tax Office |
| capex | capital expenditure |
| DV | diminishing value |
| ITAA | Income Tax Assessment Act 1997 |
| NER | National Electricity Rules |
| PTRM | post-tax revenue model |
| opex | operating expenditure |
| RAB | regulatory asset base |
| RFM | roll forward model |
| RIN | regulatory information notices |
| SL | straight-line |
| TAB | tax asset base |