DRAFT DECISION
AusNet Services
Gas access arrangement
2018 to 2022

Attachment 8 – Corporate income tax

July 2017

AUSTRALIAN ENERGY REGULATOR

Director, Corporate Communications
Australian Competition and Consumer Commission
GPO Box 4141, Canberra ACT 2601

or publishing.unit@accc.gov.au.

Inquiries about this publication should be addressed to:

Australian Energy Regulator
GPO Box 520
Melbourne Vic 3001

Tel: 1300 585 165

Email: AERInquiry@aer.gov.au

Note

This attachment forms part of the AER's draft decision on the access arrangement for AusNet Services for 2018-22. 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 - Value of imputation credits

Attachment 5 - Regulatory depreciation

Attachment 6 - Capital expenditure

Attachment 7 - Operating expenditure

Attachment 8 - Corporate income tax

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Attachment 13 - Demand

Attachment 14 - Other incentive schemes

Contents

Shortened forms

Shortened form	Extended form
AER	Australian Energy Regulator
ATO	Australian Tax Office
capex	capital expenditure
CAPM	capital asset pricing model
CESS	Capital Expenditure Sharing Scheme
CPI	consumer price index
DRP	debt risk premium
ECM	(Opex) Efficiency Carryover Mechanism
ERP	equity risk premium
Expenditure Guideline	Expenditure Forecast Assessment Guideline
gamma	Value of Imputation Credits
MRP	market risk premium
NGL	National Gas Law
NGO	national gas objective
NGR	National Gas Rules
NPV	net present value
opex	operating expenditure
PTRM	post-tax revenue model
RBA	Reserve Bank of Australia
RFM	roll forward model
RIN	regulatory information notice
RPP	revenue and pricing principles
SLCAPM	Sharpe-Lintner capital asset pricing model
STTM	Short Term Trading Market
TAB	Tax asset base
UAFG	Unaccounted for gas
WACC	weighted average cost of capital
WPI	Wage Price Index

8 Corporate income tax

When determining the total revenue for AusNet, we include an estimate of AusNet's cost of corporate income tax.[1] AusNet has adopted the post-tax framework to derive its revenue requirement for the 2018–22 access arrangement period.[2] Under the post-tax framework, a separate corporate income tax allowance is calculated as part of the building blocks assessment.

8.1 Draft decision

We accept AusNet's proposed approach to calculate its forecast corporate income tax allowance. AusNet's proposed approach is consistent with the AER’s post-tax revenue model (PTRM) for electricity service providers and the approach previously approved in gas access arrangement decisions. However, we do not accept AusNet's proposed corporate income tax allowance of $80.9 million ($nominal) for the 2018–22 access arrangement period. Our draft decision on AusNet's corporate income tax allowance over the 2018–22 access arrangement period is $46.1 million ($ nominal). This represents a reduction of $34.8 million ($nominal) or 43.1 per cent of AusNet's proposed forecast corporate income tax allowance.

Our draft decision reflects amendments to AusNet's proposed inputs for forecasting the cost of corporate income tax, including:

- the opening tax asset base (TAB) (section 8.4.2)
- remaining tax asset lives (section 8.4.3)
- the value of imputation credits (gamma) (attachment 4).

Our adjustments to the rate of return on capital (attachments 2, 3 and 6)[3], return of capital (attachment 5) and forecast opex (attachment 7) building block costs also affect revenues, which in turn impact the tax calculation.[4]

In assessing AusNet’s proposal, we have had regard to the requirement of the NGO and the revenue and pricing principles.[5] Table 8.1 sets out our draft decision on the estimated cost of corporate income tax allowance for AusNet over the 2018–22 access arrangement period.

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1 NGR, r. 76(c).

2 AusNet, *Access arrangement information 2018-2022*, December 2016, p. 256.

3 The forecast capex amount is a key input for calculating the return of and return on capital building blocks. Attachment 6 sets out our draft decision on AusNet's forecast capex.

4 The changes affecting revenues are discussed in the overview.

5 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.

Table 8.1 AER's draft decision on corporate income tax allowance for AusNet ($million, nominal) over the 2018–22 access arrangement period

	2018	2019	2020	2021	2022	Total
Tax payable	16.7	11.1	11.5	18.8	18.8	76.8
Less: value of imputation credits	6.7	4.4	4.6	7.5	7.5	30.7
Net corporate income tax allowance	10.0	6.6	6.9	11.3	11.3	46.1

Source: AER analysis.

8.2 AusNet's proposal

AusNet proposed a corporate income tax allowance of $80.9 million ($ nominal) for the 2018–22 access arrangement period as set out in Table 8.2. It used the AER's PTRM to calculate the corporate income tax allowance for each year of the 2018–22 access arrangement period.[6] In estimating its corporate income tax allowance, AusNet used the following inputs:[7]

- an opening TAB of $708.1 million ($ nominal) as at 1 January 2018 (as shown in Table 8.3)
- an expected statutory income rate of 30 per cent per year
- a value for the assumed utilisation of imputation credits (gamma) of 0.25
- standard tax asset lives calculated using a weighted average of relevant tax categories from the July 2015 ATO tax ruling (TR 2015/2).
- remaining tax asset lives of assets in existence as at 31 December 2017, calculated based on the standard tax asset life for an asset class multiplied by the ratio of the capital base remaining asset life to the capital base standard asset life.

Table 8.2 AusNet's proposed corporate income tax allowance for the 2018–22 access arrangement period ($million, nominal)

	2018	2019	2020	2021	2022	Total
Tax payable	23.3	17.2	17.4	25.1	25.0	107.9
Less: value of imputation credits	5.8	4.3	4.4	6.3	6.2	27.0
Net corporate income tax allowance	**17.5**	**12.9**	**13.1**	**18.8**	**18.7**	**80.9**

Source: AusNet, *Distribution GAAR Proposed PTRM*, December 2016.

6 AusNet, *Distribution GAAR Proposed PTRM,* December 2016.

7 AusNet, *Access arrangement information 2018-22*, December 2016, pp. 254–256.

AusNet's proposed roll forward of its TAB over the 2013–17 access arrangement period is set out in Table 8.3.

Table 8.3 AusNet's proposed tax asset base roll forward over the 2013–17 access arrangement period ($million, nominal)

	2013	2014	2015	2016	2017
Opening tax asset base	504.4	542.9	606.4	645.3	669.7
Capex	93.8	119.1	95.7	83.4	101.8
Less: tax depreciation	55.3	55.6	56.8	58.9	62.4
Closing tax asset base	542.9	606.4	645.3	669.7	709.2
End of period adjustment					–1.0
Opening tax asset base as at 1 January 2018					**708.1**[a]

Source: AusNet, *Distribution GAAR Proposed PTRM*, December 2016.

(a) AusNet's proposed PTRM contains an end of period adjustment of $1.03 million ($ nominal) applied to the opening TAB as at 1 January 2018. This adjustment relates to asset disposals in 2012.

8.3 AER's assessment approach

Our approach to calculate AusNet's cost of corporate income tax begins with an estimate of taxable income that would be earned by a benchmark efficient company operating AusNet's pipeline. As part of this calculation, tax expenses such as interest and depreciation need to be estimated. Interest tax expense should be estimated using a benchmark 60 per cent gearing, rather than AusNet's actual gearing. Tax depreciation is calculated using a separate TAB. All tax expenses (including other expenses such as operating expenditure) are offset against the service provider's forecast revenue to estimate the taxable income. The statutory income tax rate of 30 per cent is then applied to the estimated taxable income to arrive at a notional amount of tax payable. We then apply a discount to that notional amount of tax payable to account for the value of imputation credits (gamma). The value of imputation credits attachment (attachment 4) details our draft decision on gamma. The discounted nominal amount of tax payable is then included as a separate building block in determining AusNet's total revenue.[8]

The corporate income tax allowance is an output of the AER's PTRM, which has been adopted by AusNet. We have therefore assessed AusNet's proposed corporate income tax allowance by analysing its proposed inputs to the PTRM for calculating the tax allowance. These inputs include:

8 NGR, r. 76(c).

- the opening TAB as at 1 January 2018
- the standard tax asset life for each asset class
- the remaining tax asset life for each asset class as at 1 January 2018
- the corporate income tax rate
- the value of imputation credits (gamma).

In assessing AusNet's proposal, we have had regard to the NGO and the revenue and pricing principles.[9]

The rules 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.[10]

We consider that the roll forward of the opening TAB to 1 January 2018 should be based on the approved opening TAB as at 1 January 2013 and AusNet's actual capex in the 2013–17 access arrangement period. We consider that the calculation of the tax depreciation should be based on the actual capex over the 2013–17 access arrangement period. The value of the actual capex used for rolling forward the TAB is subject to our assessment of these values as discussed in attachment 6.

We assess AusNet's proposed standard tax asset lives, where appropriate, by comparing them against the values approved in the 2013–17 access arrangement and for similar asset classes for other service providers, as well as those prescribed by the Commissioner for taxation in tax ruling 2016/1.[11]

For the 2018–22 access arrangement period, AusNet has proposed to transition to our standard straight-line tax depreciation approach. AusNet's corporate income tax allowance for the 2013–17 regulatory control period was calculated based on a combination of straight line depreciation for some tax asset classes and diminishing value depreciation for other tax asset classes. This is consistent with the method established by the previous regulator, the Essential Services Commission (ESC). Adoption of our standard approach requires the establishment of remaining tax asset lives at 1 January 2018. We have recently approved a method in our determination for Ausgrid and the Victorian electricity distribution network service providers to establish remaining tax asset lives for existing assets.[12] This involves using the standard tax asset life for the asset class multiplied by the ratio of the capital base remaining asset

9 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.

10 NGR, r. 74(2).

11 Australian Taxation Office, *Taxation Ruling Income tax: effective life of depreciating assets (applicable from 1 July 2016)*: https://www.ato.gov.au/law/view/view.htm?docid=%22TXR%2FTR20161%2FNAT%2FATO%2F00001%22 accessed 9 March 2017.

12 AER, *Draft decision, Ausgrid distribution determination 2015–16 to 2018–19, Attachment 8: Corporate income tax*, November 2014, pp. 17–19. AER, *Preliminary decision, CitiPower distribution determination 2016 to 2020, Attachment 8: Corporate income tax*, October 2015, pp. 13–14.

life to the capital base standard asset life. We will assess AusNet's proposed remaining tax asset lives against the outcomes of this approved method.

8.3.1 Interrelationships

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

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

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

The pre-tax revenues depend on all the building block components. Any factor that affects revenue will therefore affect pre-tax revenues. Higher pre-tax revenues can increase the corporate income tax allowance.[13] Depending on the source of the revenue increase, the tax increase may be equal to or less than proportional to the company tax rate.[14]

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

- Interest on debt – Interest is a tax offset. The size of which depends on the ratio of debt to equity and therefore the proportion of the capital base funded through debt. It also depends on the allowed return on debt and the size of the capital base.
- General expenses – In the main these expenses will match the opex allowance.
- Tax depreciation – A separate TAB is maintained for the service provider reflecting tax rules. This TAB is affected by many of the same factors as the capital base, such as capex, although unlike the capital base value it is maintained at its

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[13] 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 revenue model should therefore be set up to run an iterative process until the revenue and tax allowances become stable.

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

historical cost with no indexation. The TAB is also affected by the depreciation rate and/or asset lives assigned for tax depreciation purposes.

A ten per cent increase in the corporate income tax allowance would cause revenues to increase by about 0.7 per cent. Our draft decision gamma of 0.4 compared to the proposed gamma of 0.25 decreases the corporate income tax allowance by 24.4 per cent and total revenues by about 1.7 per cent.[15]

8.4 Reasons for draft decision

Our draft decision on AusNet's corporate income tax allowance is $46.1 million ($ nominal), which is a reduction of $34.8 million ($ nominal) or 43.1 per cent of AusNet's proposal.

We accept AusNet's proposed approach for calculating the corporate income tax allowance. However, we adjusted several inputs in AusNet's proposed PTRM for calculating the corporate income tax allowance. These relate to:

- changes to the opening TAB as at 1 January 2018 (section 8.4.2)
- changes to the remaining tax asset lives as at 1 January 2018 (section 8.4.4)
- changing the value of gamma to 0.4 from 0.25 (attachment 4)
- changes to other building block components, such as the rate of return on capital (attachments 2, 3 and 6)[16], return of capital (attachment 5) and forecast opex (attachment 7) that affect revenues, which in turn impacts the tax calculation.[17]

8.4.1 Transition to AER preferred straight-line tax depreciation

We accept AusNet's proposal to transition to our preferred straight-line tax depreciation approach to calculate the corporate income tax allowance for the 2018–22 access arrangement period.

AusNet's corporate income tax allowance for the 2013–17 access arrangement period was calculated based on straight-line depreciation for some tax asset classes and diminishing value depreciation for other tax asset classes. This method was established by the previous regulator, the ESC, and adopted by the AER for the 2013–17 access arrangement period. AusNet's proposed PTRM uses our preferred straight-line depreciation approach to calculating tax depreciation as set out in our PTRM template. We consider this approach is consistent with the NGO and the revenue and

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

16 The forecast capex amount is a key input for calculating the return of and return on capital building blocks. Attachment 6 sets out our draft decision on AusNet's forecast capex.

17 NGR, r. 87A.

pricing principles.[18] Therefore, we accept AusNet's proposal to transition to the straight-line tax depreciation approach for the 2018–22 access arrangement period.

8.4.2 Opening tax asset base as at 1 January 2018

We accept AusNet's approach to determine the opening TAB. This is because AusNet's proposed approach is consistent with the approach previously approved for the 2013–17 access arrangement. However, we do not approve AusNet's proposed opening TAB of $708.1 million ($nominal) as at 1 January 2018. We determine an opening TAB value of $708.3 million ($nominal) as at 1 January 2018. This is because of our correction to the treatment of the asset disposals for the 'Buildings' asset class incurred in 2012 in the proposed RFM which impacts on the opening TAB.

We assessed the inputs AusNet used to roll forward the TAB over the 2013–17 access arrangement period. This includes the opening TAB as at 1 January 2013, and actual capex for 2012 and the 2013–17 access arrangement period.

We do not accept AusNet's proposed opening TAB as at 1 January 2013 of $504.4 million ($nominal) as it was not correctly updated for actual net capex in 2012. In our review of the proposed data, we identified that the 2012 actual capex in the proposed TAB roll forward in the RFM did not correctly account for the assets disposed of in that year. AusNet's proposed TAB roll forward accounts for disposals incurred in 2012 with an end of period adjustment of –$1.03 million ($ nominal) applied to the opening TAB at 1 January 2018. Our standard approach is to account for asset disposals (net from capex) in the TAB roll forward in the year the disposal occurred—in this case, in 2012. In its response to our information request, AusNet accepted this change.[19] Our draft decision therefore, is to determine an opening TAB as at 1 January 2013 of $503.3 million ($ nominal). With this change, we are satisfied the actual capex inputs for 2012 and the 2013–17 period, reflect the requirements of the NGR.[20] Our detailed assessment of this conforming capex is set out in attachment 6.

Table 8.4 sets out our draft decision on the roll forward of AusNet's TAB values.

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18 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.

19 AusNet, *Response to IR006*, 8 March 2017

20 NGR, r. 79. We note that the capex determined in this draft decision for 2016 and 2017 are estimates. Therefore the 'approved' capex in this draft decision for 2016 and 2017 are placeholder amounts. We expect AusNet will provide actual capex for 2016 and the 2017 capex estimates may be revised based on more up to date information in its revised proposal. We will assess whether the actual capex for 2016 are conforming capex in our final decision. We will undertake the assessment of whether the 2017 amounts are conforming capex as part of the next access arrangement review.

Table 8.4 AER's draft decision on AusNet's tax asset base roll forward for the 2013–17 access arrangement period ($million, nominal)

	2013	2014	2015	2016	2017
Opening tax asset base	503.3	541.9	605.5	644.4	668.8
Capex	93.8	119.1	95.7	83.4	101.8
Less: tax depreciation	55.3	55.5	56.8	58.9	62.3
Closing tax asset base	541.9	605.5	644.4	668.8	708.3

Source: AER analysis.

8.4.3 Standard tax asset lives

We approve AusNet's proposed standard tax asset lives assigned to each of its asset classes for the 2018–22 access arrangement period. AusNet has referenced the ATO's tax ruling 2015/2 in its proposal[21] for its proposed standard tax asset lives. We consider the proposed standard tax asset lives are consistent with this ruling and also consistent with the standard tax asset lives prescribed in the more recent tax ruling 2016/1.[22]

Our draft decision on AusNet's standard tax asset lives for each of its asset classes for the 2018–22 access arrangement period is set out in Table 8.5.

8.4.4 Remaining tax asset lives as at 1 January 2018

Our 2013–17 access arrangement for AusNet did not contain remaining tax asset lives for depreciating its opening TAB as at 1 January 2013.[23] Instead, it adopted the same tax depreciation methodology as used by the ESC for the 2008–12 access arrangement period to calculate tax depreciation over the 2013–17 access arrangement period. As discussed in section 8.4.1, we accept AusNet's proposal to transition to our standard straight-line depreciation approach to calculate the corporate income tax allowance for the 2018–22 access arrangement period. This requires us to determine remaining tax asset lives for depreciating the opening TAB as at 1 January 2018.

We accept AusNet's proposed method of setting the remaining tax asset lives equal to the standard tax asset life for the asset class multiplied by the ratio of the capital base remaining asset life to the capital base standard asset life. We are satisfied that

21 AusNet, *Access arrangement information 2018-2022*, December 2016, p. 255.

22 Australian Taxation Office, *Taxation Ruling Income tax: effective life of depreciating assets (applicable from 1 July 2016)*: https://www.ato.gov.au/law/view/view.htm?docid=%22TXR%2FTR20161%2FNAT%2FATO%2F00001%22 accessed 9 March 2017.

23 AER, *Access arrangement draft decision, AusNet Gas (DB No.1) Pty Ltd, AusNet Gas (DB No.2) Pty Ltd 2013–17 Part 2 Attachments, Attachment 8 Corporate income tax*, September 2012, pp. 185–194.

AusNet's proposed approach provides reasonable estimates of remaining tax asset lives for its asset classes. We note the proposed approach is consistent with the method approved in our recent determinations for Ausgrid and the Victorian electricity distributors.[24]

In accepting AusNet's approach for calculating the remaining tax asset lives as at 1 January 2018, we have corrected the calculation of the capital base remaining lives to account for the actual depreciation of assets. AusNet's approach for calculating the remaining tax asset lives as at 1 January 2018 requires estimating the remaining capital base asset life as at the same date. The change to the year-by-year tracking approach means that the capital base remaining lives are no longer recorded in the PTRM.[25] However, capital base remaining lives are still estimated in the RFM for use in calculating the remaining tax asset lives as at 1 January 2018.[26]

AusNet's proposed remaining tax asset lives were based on capital base remaining asset lives that were calculated using depreciation forecast in the 2013–17 access arrangement. Our preferred method for calculating remaining asset lives is to use actual depreciation as we consider this to provide a better indication of the profile of the underlying assets.[27] Accordingly, for this draft decision we have updated the remaining tax asset lives to reflect this change.

At the time of this draft decision, the capital base remaining asset lives used in this calculation include estimated capex values for 2016 and 2017. As part of the final decision, we expect the estimate of capex for 2016 to be replaced by actuals. We also expect the estimate of capex for 2017 to be revised based on more up to date information and that AusNet would provide this revision in its revised proposal. Therefore, for the final decision, we will update AusNet's remaining tax asset lives at 1 January 2018 using the method approved in this draft decision for any revisions to the capital base remaining asset lives.

Our draft decision on AusNet's remaining tax asset lives for each of its asset classes for the 2018–22 access arrangement period is set out in Table 8.5.

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[24] AER, *Draft decision, Ausgrid distribution determination 2015–16 to 2018–19, Attachment 8: Corporate income tax*, November 2014, pp. 17 to 19. AER, *Preliminary decision, CitiPower distribution determination 2016 to 2020, Attachment 8: Corporate income tax*, October 2015, pp. 13 to 14.

[25] Instead, as set out section 5.4.1 of attachment 5, the capital base depreciation amounts are calculated in a separate model and directly entered into the PTRM.

[26] Having established the remaining tax asset lives as at 1 January 2018 for this access arrangement review, we consider that when rolling forward these remaining tax asset lives to 1 January 2023 at the next review our preferred weighted average method should be used. This method is described in our draft decision access arrangement for Australian Gas Networks (South Australia) for the 2016–21 period. AER, *Draft Decision, Australian Gas Networks (South Australia) Access Arrangement 2016 to 2021, Attachment 8 – Corporate income tax*, November 2015, pp. 8–9.

[27] This issue was discussed in greater detail in our 2015 final decision to the electricity transmission roll forward model. See: *AER, Final decision - Amendments to the electricity transmission roll forward model*, October 2015, p. 7.

Table 8.5 AER's draft decision on AusNet's standard tax asset lives and remaining tax asset lives as at 1 January 2018 for the 2018–22 access arrangement period

Tax asset class	Standard tax asset life	Remaining tax asset life as at 1 January 2018
Transmission pipelines	50	18.5
Distribution pipelines	50	27.8
Service pipes	50	32.2
Cathodic protection	50	21.4
Supply regulators/valve stations	40	28.8
Meters	15	9.4
SCADA and remote control	10	6.5
Buildings	35	17.7
Other - IT	4	2.9
Other - non IT	4	3.0
Land	n/a	n/a
Equity raising costs	5	n/a

Source: AER analysis.
n/a Not applicable.

8.5 Revisions

We require the following revisions to make the access arrangement proposal acceptable:

Revision 8.1	Make all necessary amendments to reflect this draft decision on the proposed corporate income tax allowance for the 2018–22 access arrangement period, as set out in Table 8.1.
Revision 8.2	Make all necessary amendments to reflect this draft decision on the opening tax asset base as at 1 January 2018, as set out in Table 8.4.
Revision 8.3	Make all necessary amendments to reflect this draft decision on the remaining tax asset lives for the 2018–22 access arrangement period, as set out in Table 8.5.