DRAFT DECISION

Powercor
Distribution Determination
2021 to 2026

Attachment 7
Corporate income tax

September 2020

AUSTRALIAN ENERGY REGULATOR

Inquiries about this publication should be addressed to:

Australian Energy Regulator
GPO Box 520
Melbourne Vic 3001

Tel: 1300 585 165
Email: VIC2021-26@aer.gov.au

Note

This attachment forms part of the AER's draft decision on the distribution determination that will apply to Powercor 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 – Attachment 11 – Demand management incentive scheme and demand management innovation allowance mechanism

Attachment 12 – Not applicable to this distributor

Attachment 13 – Classification of services

Attachment 14 – Control mechanisms

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Attachment 18 – Connection policy

Attachment 19 – Tariff structure statement

Attachment A – Victorian f-factor incentive scheme

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7 Corporate income tax

Our determination of the annual revenue requirement includes the estimated cost of corporate income tax for Powercor's 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 Powercor to recover the estimated cost of corporate income tax during the 2021–26 regulatory control period.

This attachment presents our assessment of Powercor's 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 Powercor in the 2021–26 regulatory control period, compared to Powercor's proposal of $3.3 million ($ nominal).

We expect Powercor 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 $167.2 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 Powercor's 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.

The key reasons for the decrease to Powercor's proposed costs of corporate income tax is due to our:

- reduction to the return on capital, which is influenced by our adjustments on other building block components (attachments 2, 3 and 5)
- reduction to regulatory depreciation (attachment 4)
- reduction to customer contributions (attachment 5).

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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.

Further, in 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]

We accept Powercor's proposed standard tax asset lives for all of its asset classes, with the exception of the 'In-house software' asset class. 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 Powercor's 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 determine a remaining tax asset life for the new asset class of 'Accelerated depreciation assets'.

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 Powercor's proposal

Powercor proposed an estimated cost of corporate income tax of $3.3 million ($ nominal) using our PTRM,[4] with the following inputs:[5]

- an opening TAB value as at 1 July 2021 of $4074.9 million ($ 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 $676.2 million ($ 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]

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

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 Powercor, 2021–26 Regulatory Proposal – Supporting document, PAL MOD 10.02 - PTRM 2021–26, January 2020 (Updated 1 June 2020).

6 As discussed in attachment 4, Powercor 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.

- 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 life of 4 years for the new 'In-house software' asset class.

Although it reallocated some existing assets to the new asset class of 'Accelerated depreciation assets' for RAB purposes, Powercor did not provide any such reallocation for TAB purposes. As such, Powercor did not assign a remaining tax life for this asset class.[7]

Table 7.1 sets out Powercor's 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)[8] in accordance with our RFM.[9]

Table 7.1 Powercor's proposed TAB roll forward for the 2016–21 period ($ million, nominal)

	2016	2017	2018	2019[a]	2020[a]	2021[b]
Opening TAB	2356.5	2580.6	2872.7	3174.5	3508.0	3813.8
Capital expenditure[c]	331.8	419.4	446.9	484.8	474.4	352.4
Less: tax depreciation	107.7	127.2	145.1	151.3	168.6	91.3
Closing TAB	**2580.6**	**2872.7**	**3174.5**	**3508.0**	**3813.8**	**4074.9**

Source: Powercor, 2021–26 Regulatory Proposal – Supporting document, PAL MOD 10.01 – RFM 5.5 year 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.

Table 7.2 sets out Powercor's proposed cost of corporate income tax for the 2021–26 regulatory control period.

7 Powercor also did not allocate any forecast capex to the asset class of 'Accelerated depreciation assets' and so it did not require a standard tax asset life for this class.

8 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.

9 We have provided Powercor 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.

Table 7.2 Powercor's proposed cost of corporate income tax for the 2021–26 regulatory control period ($ million, nominal)

	2021–22	2022–23	2023–24	2024–25	2025–26	Total
Tax payable	8.1	0.0	0.0	0.0	0.0	8.1
Less: value of imputation credits	4.7	0.0	0.0	0.0	0.0	4.7
Net corporate income tax	**3.3**	**0.0**	**0.0**	**0.0**	**0.0**	**3.3**

Source: Powercor, 2021–26 Regulatory Proposal – Supporting document, PAL MOD 10.02 - PTRM 2021–26, January 2020 (Updated 1 June 2020).

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 Powercor's 2021–26 regulatory control period.[10] Our estimate is the taxable income a benchmark efficient entity would earn for providing standard control services if it operated Powercor's business, which is determined in accordance with the PTRM.[11]

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).[12] The changes to our regulatory tax approach require amending our models to:[13]

- 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.[14]

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

10 NER, cl. 6.5.3.

11 NER, cl. 6.5.3.

12 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.

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

14 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.

Powercor's 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[15] and involves the following steps:[16]

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 building block approach.[17] 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:
    - operating expense is set equal to the opex building block[18]
    - interest expense is a function of the size of the RAB, the benchmark gearing assumption (60 per cent) and the regulated cost of debt
    - 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[19] 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.[20] The immediately expensed

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

16 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).

17 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.

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

19 For more explanation of how we calculate depreciation using the DV method, please see: AER, *Distribution PTRM handbook*, April 2019, pp. 22–23.

20 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.

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 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 Powercor's actual/estimated capex incurred during the 2016–21 period, and the final year (2015) of the previous regulatory control period.[21] 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

[21] 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.

purposes of this draft decision. We have published the amended RFM (version 3) to implement the findings of the tax review.[22] 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 life of depreciating assets determined by the Commissioner for Taxation. We consider that the standard tax asset lives for the majority of Powercor's asset classes should be consistent with the ATO taxation ruling 2020/3 regarding the effective life of depreciating assets where possible.[23]
- 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.[24] 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:
    - 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.
    - 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.
- **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 Powercor's proposal.
- **the value of gamma:** The gamma input for Powercor is 0.585 for this draft decision. This is consistent with the 2018 *Rate of return instrument,* which requires

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

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

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

us to use a gamma value of 0.585, and adopted in Powercor's proposal.[25] 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. Powercor does not have any accumulated tax losses as at the start of the 2021–26 regulatory control period.[26]
- **forecast immediate expensing of capex:** The amended PTRM (version 4) requires a forecast for immediately deductible capex to be provided for each 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.[27] 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.[28]
- **diminishing value multiplier:** The amended PTRM (version 4) applies the following formula to calculate the tax depreciation under the DV 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 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

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

26 Powercor, 2021–26 Regulatory Proposal – Supporting document, PAL MOD 10.02 - PTRM 2021–26, January 2020 (Updated 1 June 2020).

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.

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[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 SL method for calculating the tax depreciation for equity raising costs, consistent with the ITAA and ATO's requirements.[31] 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:

  - **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.[32] We note that this includes new buildings and structural improvements to existing buildings.[33] Powercor did not propose this type of capex for the 2021–26 regulatory control period.
  - **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.[34] 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.[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 DV method in the PTRM.

30 ATO, *Taxation Ruling 2011/6*, July 2016.
31 The benchmark equity raising cost is determined within the PTRM.
32 ATO, *Taxation Ruling 97/25*, July 2017.
33 ITAA, s 43.20.
34 ATO, *Taxation Ruling 2016/3*, October 2018.
35 ITAA, s 995.1.

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.

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.[36] Depending on the source of the revenue increase, the tax increase may be equal to or less than proportional to the company tax rate.[37]

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

[36] 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.

[37] 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.

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 Powercor over the 2021–26 regulatory control period, compared to the cost of corporate income tax of $3.3 million from Powercor's proposal. While Powercor has no forecast tax loss at the beginning of the 2021–26 regulatory control period, we forecast a tax loss of $48.7 million ($ nominal) by the end of 2021–22, increasing to $167.2 million by the end of 2025–26.

We accept Powercor's proposed method to establish the opening TAB as at 1 July 2021. However, we reduced Powercor's proposed opening TAB value as at 1 July 2021 to $3986.0 million ($ nominal)—a reduction of $88.9 million (or 2.2 per cent).

We also reallocated $25.5 million of the opening TAB from Powercor's asset class of 'Distribution system assets' to its proposed new asset class of 'Accelerated depreciation assets'.

We have amended Powercor's approach to forecast its immediately expensed capex. As a consequence, we have increased Powercor's amount of forecast immediately expensed capex to $741.1 million ($ 2020–21).

We accept Powercor's proposed standard tax asset lives for all of its existing asset classes. Further, we determine a standard tax asset life of 5 years for the new asset class of 'In-house software' that is subject to the SL method of tax depreciation.

We also accept Powercor's proposed approach to calculating the remaining tax asset lives as at 1 July 2021 for all asset classes, because they are calculated based on the weighted average method as set out in our RFM. We determine a remaining tax asset life of 5 years for the new asset class of 'Accelerated depreciation assets'.

Discussed in other attachments and the overview, our draft decision on Powercor's 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]

Powercor 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 new tax inputs submitted by Powercor are discussed below.

Forecast immediate expensing of capex

Powercor proposed forecast capex of $676.2 million ($2020–21, or 25.1 per cent of total capex)[40] to be immediately expensed for tax purposes in the 2021–26 regulatory control period.[41]

We do not accept Powercor's proposed method to calculate its forecast immediate expensing of capex. For this draft decision, we have applied an approach that is informed by Powercor's current immediate expensing rate. This results in our forecast immediate expensing of capex to be $741.1 million which is an increase of $65.0 million. Our substitute estimate for the immediate expensing of capex is proportional to the overall substitute estimate of forecast capex.[42]

Powercor's 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 2016–2018.[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 Powercor for its annual tax returns during the 2021–26 regulatory control period.

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38 The buildings asset class may be classified as system or non-system assets in the PTRM.

39 Powercor, 2021–26 Regulatory Proposal – Supporting document, PAL MOD 10.02 - PTRM 2021–26, January 2020 (Updated 1 June 2020).

40 Compared with the proposed gross capex of $2694.3 million ($2020–21).

41 Powercor, 2021–26 Regulatory Proposal – Supporting document, PAL MOD 10.02 - PTRM 2021–26, January 2020 (Updated 1 June 2020).

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

43 Powercor, *Regulatory proposal 2021–2026*, January 2020, p. 146; Powercor, *PAL RIN001 - Workbook 1 – Regulatory determination*, January 2020

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.

As discussed in attachment 5, we have reduced Powercor's proposed forecast capex by 27 per cent.[45] We requested Powercor to provide a mapping of its recent immediate expensing proportions applied to its overall forecast capex. In response to our request, Powercor provided actual/estimated immediately deductible capex data for the 2016–20 regulatory control period and relevant mapping.[46] Powercor also noted its tax principles for determining its immediately expensed capex that is attributable to repairs, network overheads and embedded 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 Powercor.

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 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, Powercor submitted that $133.2 million ($2020–21) of forecast capex associated with in-house software is to be exempted from the DV tax depreciation method, while approving a lower capex amount of $118.2 million. Powercor confirmed in an information request that it has not proposed any capex for buildings that would be exempt from the DV tax depreciation method.[49]

We accept Powercor's proposed allocation of forecast capex for in-house software to be depreciated using the SL method for tax depreciation purposes. 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.[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 Powercor's proposed method to establish the opening TAB as at 1 July 2021. Based on the proposed approach, we have determined Powercor's opening TAB

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45 AER, *Draft decision – Powercor Distribution Determination 2021 to 2026 - Attachment 5 – Capital Expenditure*, 30 September 2020, p. 8.

46 Powercor, *Response to AER information request #024*, 22 May 2020.

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

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

49 Powercor, *Response to AER information request 040*, 18 June 2020.

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

value as at 1 July 2021 of $3986.0 million ($ nominal). This represents a reduction of $88.9 million (or 2.2 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 Powercor's proposed inputs to the RFM which explains the difference in our draft decision opening TAB value and the value proposed by Powercor:

- amended the historical capex inputs for 2018[51]
- updated the 2019 estimated capex with actuals[52]
- reduced the half year 2021 estimated capex:[53]
    - Powercor's proposal contained an estimated capex of $352.4 million for the 1 January to 30 June 2021 period.[54] We requested further information from Powercor on these inputs noting that the figures from the reset RIN may be more appropriate.[55] Powercor agreed in its response that the half year capex estimate should be reduced to $267.6 million to be consistent with the reset RIN.[56]
- reallocated the opening TAB value to the new asset class of 'Accelerated depreciation assets' from the existing asset class of 'Distribution system assets' in relation to accelerated depreciation of assets which are expected to be redundant by end of the 2021−26 regulatory control period:[57]
- Powercor's proposal did not include a TAB reallocation for this asset class. We noted in an information request to Powercor that the accelerated depreciation associated with the asset class of 'Distribution system assets' in the RAB should also apply to these assets in the TAB. In its response, Powercor provided a TAB reallocation of $64.4 million based on its proposed RAB reallocation.[58] For this draft decision, we accept this TAB reallocation. However, for the reasons discussed in attachment 4, we have reduced the RAB reallocation and therefore we made a corresponding reduction for the TAB reallocation to $25.5 million.

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51 Powercor, *Response to AER information request 007*, 14 April 2020, pp. 1, 2.

52 AER, *Draft decision - Powercor Distribution Determination 2021 to 2026 - Attachment 2 - Regulatory Asset Base*, 30 September 2020, p. 16.

53 AER, *Draft decision - Powercor Distribution Determination 2021 to 2026 - Attachment 2 - Regulatory Asset Base,* 30 September 2020, p. 16.

54 Powercor, 2021–26 Regulatory Proposal – Supporting document, PAL MOD 10.01 - RFM 5.5 year 2016–21, January 2020.

55 AER, *Information request 007B*, 12 June 2020.

56 Powercor, *Response to AER information request 007B*, 19 June 2020.

57 Powercor, *Regulatory proposal 2021–2026,* January 2020, p. 143.

58 Powercor, *Response to AER information request #040*, 18 June 2020, p. 1.

- removed the 'Standard metering' asset class as the assets have effectively been fully depreciated and there is no new capex allocated to it for the 2021–26 regulatory control period.[59]

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 7.3 sets out our draft decision on the roll forward of Powercor's TAB values over the 2016–21 period.

Table 7.3 AER's draft decision on Powercor's TAB roll forward for the 2016–21 period ($ million, nominal)

	2016	2017	2018	2019	2020[a]	2021[b]
Opening TAB	2356.5	2580.3	2872.5	3174.5	3502.1	3807.9
Capital expenditure[c]	331.8	419.4	447.1	478.9	474.4	269.3
Less: tax depreciation	107.9	127.2	145.1	151.3	168.5	91.3
Closing TAB	**2580.3**	**2872.5**	**3174.5**	**3502.1**	**3807.9**	**3986.0**

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 Powercor's 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.

In accepting the weighted average method, we have updated Powercor's proposed remaining tax asset lives to reflect our adjustments to Powercor's 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.[60]

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[59] Powercor supported this amendment in response to our information request; Powercor, *Response to AER information request 052*, 8 July 2020.

[60] At the time of this draft decision, the roll forward of Powercor's 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 Powercor's remaining tax asset lives as at 1 July 2021 using the method approved in this draft decision.

For the proposed new 'In-house software' asset class we have not assigned a remaining tax asset life as there is no opening tax value for this asset class, only forecast capex is being allocated to this asset class over the 2021–26 regulatory control period. We therefore record 'n/a' in the PTRM for this asset class.

For the proposed new asset class of 'Accelerated depreciation assets', Powercor's proposal did not assign a remaining tax asset life as it did not include the reallocation discussed in section 7.4.2. In response to our information request, Powercor submitted a remaining tax asset life of 5 years would apply to the reallocated assets.[61] We consider this is appropriate for tax purposes as it reflects the effective economic lives for these assets, which are forecast to be replaced over the 2021–26 regulatory control period. This is consistent with the ATO's guidance on determining the effective life of an asset.[62]

Table 7.4 sets out our draft decision on the remaining tax asset lives at 1 July 2021 for Powercor. 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 be consistent with the tax expenses used to estimate the annual taxable income for a benchmark efficient service provider.[63]

7.4.4 Standard tax asset lives

We accept Powercor's 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[64]
- 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, Powercor proposed to reallocate forecast capex associated with in-house software to the prescribed SL tax depreciation asset class in the PTRM and assigned a standard life of 4 years. 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.[65] In its response to our information request, Powercor agreed that this life is appropriate for tax depreciation purposes.[66]

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61 Powercor, *Response to AER information request 040*, 18 June 2020.

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

63 NER, cl 6.5.3.

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

65 ITAA, s 40.95(7).

66 Powercor, *Response to AER information request 040*, 18 June 2020.

Table 7.4 sets out our draft decision on the standard tax asset lives for Powercor. 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]

Table 7.4 AER's draft decision on Powercor's 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	44.0	36.1
Distribution system assets	46.0	33.1
SCADA/Network control	10.0	7.8
Non-network general assets - IT	4.0	3.1
Non-network general assets - Other	12.0	9.1
VBRC	n/a	39.4
Land	n/a	n/a
Accelerated depreciation assets	n/a	5.0
In-house software	5.0[a]	n/a
Equity raising costs	5.0[a]	3.0

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 asset classes of 'VBRC' and 'Accelerated depreciation assets' because there is no forecast capex allocated to these classes. We also have not assigned a remaining tax asset life to the 'In-house software' asset class prescribed for SL tax depreciation because it has no opening TAB value as at 1 July 2021.

[67] NER, cl. 6.5.3.

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 notice
SL	straight-line
TAB	tax asset base