



DRAFT DECISION
Powerlink transmission
determination
2017–18 to 2021–22

Attachment 8 – Corporate
income tax

September 2016

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Note

This attachment forms part of the AER's draft decision on Powerlink's transmission determination for 2017–22. It should be read with all other parts of the draft decision.

The draft decision includes the following documents:

Overview

Attachment 1 – Maximum allowed revenue

Attachment 2 – Regulatory asset 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

Attachment 9 – Efficiency benefit sharing scheme

Attachment 10 – Capital expenditure sharing scheme

Attachment 11 – Service target performance incentive scheme

Attachment 12 – Pricing methodology

Attachment 13 – Pass through events

Attachment 14 – Negotiated services

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Shortened forms

Shortened form	Extended form
AARR	aggregate annual revenue requirement
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
ASRR	annual service revenue requirement
augex	augmentation expenditure
capex	capital expenditure
CCP	Consumer Challenge Panel
CESS	capital expenditure sharing scheme
CPI	consumer price index
DMIA	demand management innovation allowance
DRP	debt risk premium
EBSS	efficiency benefit sharing scheme
ERP	equity risk premium
MAR	maximum allowed revenue
MRP	market risk premium
NEL	national electricity law
NEM	national electricity market
NEO	national electricity objective
NER	national electricity rules
NSP	network service provider
NTSC	negotiated transmission service criteria
opex	operating expenditure
PPI	partial performance indicators
PTRM	post-tax revenue model
RAB	regulatory asset base
RBA	Reserve Bank of Australia
repex	replacement expenditure
RFM	roll forward model
RIN	regulatory information notice

Shortened form	Extended form
RPP	revenue and pricing principles
SLCAPM	Sharpe-Lintner capital asset pricing model
STPIS	service target performance incentive scheme
TNSP	transmission network service provider
TUoS	transmission use of system
WACC	weighted average cost of capital

8 Corporate income tax

Our revenue determination includes the estimated cost of corporate income tax for Powerlink's 2017–22 regulatory control period.¹ Under the post-tax framework, a corporate income tax allowance is calculated as part of the building block assessment using our post-tax revenue model (PTRM). This amount allows Powerlink to recover the costs associated with the estimated corporate income tax payable during the 2017–22 regulatory control period.

This attachment sets out our draft decision on Powerlink's proposed corporate income tax allowance for the 2017–22 regulatory control period. It also presents our assessment of the 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.

8.1 Draft decision

We do not accept Powerlink's proposed cost of corporate income tax allowance of \$111.5 million (\$ nominal). Our draft decision on the estimated cost of corporate income tax is \$82.2 million (\$ nominal) over the 2017–22 regulatory control period. This represents a reduction of \$29.3 (or 26.2 per cent) from Powerlink's proposal.

The reduction reflects our amendments to Powerlink's proposed inputs for forecasting the cost of corporate income tax including the opening TAB (section 8.4.1), and the remaining tax asset lives (section 8.4.3). Our adjustments to the return on capital (attachments 2, 3 and 6)² and the return of capital (attachment 5) building blocks affect revenues, which in turn impact the tax calculation. The changes affecting revenues are discussed in attachment 1.

¹ NER, cl. 6A.5.4(a)(4).

² 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 Powerlink's forecast capex.

Table 8.1 sets out our draft decision on the estimated cost of corporate income tax allowance for Powerlink over the 2017–22 regulatory control period.

Table 8.1 AER's draft decision on Powerlink's cost of corporate income tax allowance for the 2017–22 regulatory control period (\$ million, nominal)

	2017–18	2018–19	2019–20	2020–21	2021–22	Total
Tax payable	19.5	23.7	29.6	31.9	32.2	137.0
Less: value of imputation credits	7.8	9.5	11.8	12.8	12.9	54.8
Net corporate income tax allowance	11.7	14.2	17.7	19.2	19.3	82.2

Source: AER analysis.

8.2 Powerlink's proposal

Powerlink proposed a forecast cost of corporate income tax of \$111.5 million (\$ nominal) using the AER's PTRM, which adopts a straight-line tax depreciation approach and the following inputs:³

- an opening TAB as at 1 July 2017 of \$5024.3 million (\$ nominal)
- an expected statutory income tax rate of 30 per cent per year
- a value for gamma of 0.4
- remaining tax asset lives for each asset class in existence as at 1 July 2017 calculated using a weighted average approach
- standard tax asset lives as approved at the 2012–17 transmission determination.

Table 8.2 sets out Powerlink's proposed corporate income tax allowance for the 2017–22 regulatory control period.

Table 8.2 Powerlink's proposed corporate income tax allowance for the 2017–22 regulatory control period (\$ million, nominal)

	2017–18	2018–19	2019–20	2020–21	2021–22	Total
Tax payable	31.4	32.8	38.7	41.2	41.6	185.8
Less: value of imputation credits	12.6	13.1	15.5	16.5	16.6	74.3
Net corporate income tax allowance	18.9	19.7	23.2	24.7	25.0	111.5

Source: Powerlink, *Revenue proposal*, p. 94.

³ Powerlink, *Revenue proposal*, January 2015, PTRM.

8.3 Assessment approach

We make an estimate of taxable income for each regulatory year as part of our revenue determination.⁴ Our estimate is for the taxable income a benchmark efficient entity would earn for providing prescribed transmission services if it operated Powerlink's business. Our approach for calculating a TNSP's cost of corporate income tax is set out in our PTRM and involves the following steps:⁵

1. We estimate the annual taxable income that would be earned by a benchmark efficient entity operating the TNSP's business.⁶ A TNSP's taxable income is calculated by netting the approved forecast revenues by benchmark estimates of tax expenses. Using the PTRM, we model the TNSP's benchmark tax expenses, including interest tax expense and tax depreciation, over the regulatory control period. The interest tax expense is estimated using the benchmark 60 per cent gearing. Tax depreciation is calculated using a separate value for the TAB, and standard and remaining tax asset lives for taxation purposes. All tax expenses (including other expenses such as opex) are offset against the TNSP's forecast revenue to estimate the taxable income.
2. The statutory income tax rate is then applied to the estimated annual taxable income (after adjustment for any tax loss carried forward) to arrive at a notional amount of tax payable.
3. We apply a discount to that notional amount of tax payable to account for the assumed utilisation of imputation credits (gamma) by investors.
4. The tax payable net of assumed utilised imputation credits represents the corporate income tax allowance and is included as a separate building block in determining the TNSP's annual building block revenue requirement.

The corporate income tax allowance is an output of our PTRM. We therefore assess the TNSP's proposed cost of corporate income tax allowance by analysing the proposed inputs to the PTRM for calculating that allowance. These inputs include:

- **The opening TAB as at the commencement of the 2017–22 regulatory control period:** We consider that the roll forward of the opening TAB should be based on the approved opening TAB as at commencement of the 2012–17 regulatory control period and the TNSP's actual capex incurred during that period and the final year (2011–12) of the previous regulatory control period.⁷
- **The standard tax asset life for each asset class:** We assess the TNSP's proposed standard tax asset lives, where necessary, against those prescribed by

⁴ NER, cl. 6A.6.4.

⁵ The PTRM must specify the manner in which the estimated cost of corporate income tax is to be calculated: NER, cl. 6A.5.3(b)(4).

⁶ NER, cl. 6A.6.4.

⁷ The tax depreciation is therefore recalculated based on actual capex. The same tax depreciation approach of using actual capex applies to the roll forward of the TAB at the next reset.

the Commissioner for taxation in tax ruling 2016/1⁸ and the approved standard tax asset lives in the TNSP's transmission determination for the 2012–17 regulatory control period.

- **The remaining tax asset life for each asset class at the commencement of the 2017–22 regulatory control period:** Our roll forward model (RFM) determines the remaining tax asset lives using the weighted average method.⁹ We consider the weighted average method provides a better reflection of the mix of assets within an asset class. We will assess the outcomes of other approaches against the outcomes of this standard method in the RFM.
- **The income tax rate:** The statutory income tax rate is 30 per cent per year.
- **The value of gamma:** We have accepted the gamma input proposed by Powerlink of 0.4. Refer to attachment 4 for detailed discussion on this matter.

8.3.1 Interrelationships

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

- pre-tax revenues
- tax expenses (including tax depreciation)
- the corporate tax rate
- gamma—the expected proportion of company tax that is returned to investors through the utilisation of imputation credits—which is offset against the corporate income tax allowance. 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 tax allowance.¹⁰

Depending on the source of the revenue increase, the tax increase may be equal to or less than proportional to the company tax rate.¹¹

⁸ ATO, *Taxation Ruling Income tax: effective life of depreciating assets (applicable from 1 July 2016)*, July 2016, <http://law.ato.gov.au/atolaw/view.htm?docid=%22TXR%2FTR20161%2FNAT%2FATO%2F00001%22>, accessed on 24 August 2016.

⁹ The weighted average method involves weighting the remaining life of each capital stream within an asset class (that is, the opening tax capital value and the capital expenditures for each year) by the closing tax capital value of that capital stream as a proportion of the total closing tax capital value of the asset class as a whole. The resulting individual values for each capital stream are then added together to obtain the overall weighted average remaining life of the asset class.

¹⁰ In fact, there is an iterative relationship between tax and revenues. That is, revenues lead to tax, being applied, which increases revenues and leads to slightly more tax and so on. The PTRM is therefore set up to run an iterative process until the revenue and tax allowances become stable.

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

- Interest on debt – Interest is a tax offset. The size of which depends on the ratio of debt to equity and therefore the proportion of the RAB funded through debt. It also depends on the allowed return on debt and the size of the RAB.
- General expenses – In the main these expenses will match the opex allowance.
- Tax depreciation – A separate TAB is maintained for the TNSPs 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 and 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 0.5 per cent.

8.4 Reasons for draft decision

We do not accept Powerlink's proposed cost of corporate income tax of \$111.5 million (\$ nominal). We have instead determined a cost of corporate income tax of \$82.2 million. This represents a reduction of \$29.3 million (or 26.2 per cent) from Powerlink's proposal.

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

- the opening TAB value at 1 July 2017 (section 8.4.1)
- the remaining tax asset lives (section 8.4.3).

Our adjustments to the return on capital (attachments 2, 3 and 6)¹² and the return of capital (attachment 5) building blocks affect revenues, and therefore also impact the forecast corporate income tax allowance.

We have accepted the following proposed inputs to the PTRM for tax purposes:

- the standard tax asset lives (section 8.4.2)

¹¹ 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.

¹² 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 Powerlink's forecast capex.

- the value for gamma (attachment 4)

8.4.1 Opening tax asset base at 1 July 2017

We accept Powerlink's proposed method to establish the opening TAB at 1 July 2017 as it is based on the approach set out in our RFM. Based on the proposed approach we have determined the opening TAB value as at 1 July 2017 of \$5024.3 million (\$ nominal) for Powerlink. This is slightly lower than the proposed amount. It reflects our correction for minor input errors for the 2012–13 and 2014–15 capex proposed by Powerlink. This is discussed in attachment 2 of this draft decision.¹³

Table 8.3 sets out our draft decision on the roll forward of Powerlink's TAB values.

Table 8.3 AER's draft decision on Powerlink's TAB roll forward for the 2012–17 regulatory control period (\$ million, nominal)

	2012–13	2013–14	2014–15	2015–16 ^b	2016–17 ^b
Opening TAB	4465.1	4765.1	5128.8	5139.2	5070.8
Capital expenditure ^a	482.2	567.0	236.1	162.7	187.5
Less: tax depreciation	182.3	203.3	225.7	231.2	234.0
Closing TAB	4765.1	5128.8	5139.2	5070.8	5024.3

Source: AER analysis.

(a) As commissioned, net of disposals.

(b) Based on estimated capex.

8.4.2 Standard tax asset lives

We accept Powerlink's proposed standard tax asset lives because they are:

- broadly consistent with the values prescribed by the Commissioner for taxation in tax ruling 2016/1¹⁴
- the same as those approved standard tax asset lives for the 2012–17 regulatory control period.

We are satisfied that the proposed standard tax asset lives are appropriate for applying over the 2017–22 regulatory control period. We are also satisfied the proposed standard tax asset lives provide an appropriate estimate of the tax depreciation amount

¹³ See section 2.4.1 of attachment 2 of this draft decision. At the time of this draft decision, the roll forward of Powerlink's TAB includes estimated capex values for 2015–16 and 2016–17. We will update the 2015–16 estimated capex values with the actual values for the final decision, and may further the estimate of 2016–17 capex.

¹⁴ ATO, *Taxation Ruling Income tax: effective life of depreciating assets (applicable from 1 July 2016)*, July 2016, <http://law.ato.gov.au/atolaw/view.htm?docid=%22TXR%2FTR20161%2FNAT%2FATO%2F00001%22>, accessed on 24 August 2016.

for a benchmark efficient TNSP as required by the NER.¹⁵ Table 8.4 sets out our draft decision on Powerlink's standard tax asset lives for the 2017–22 regulatory control period.

8.4.3 Remaining tax asset lives

We accept Powerlink's proposed weighted average method to calculate the remaining tax asset lives as at 1 July 2017. The proposed method applies the approach as set out in the RFM.

In accepting the weighted average method, we have updated the proposed remaining tax asset lives to reflect our adjustments to Powerlink's capex inputs for 2012–13 and 2014–15 in its proposed RFM, as discussed in attachment 2. This is because the capex values are inputs for calculating the weighted average remaining tax asset lives in the RFM. We note we will also update the proposed remaining tax asset lives for the final decision for any changes to estimated capex.¹⁶ Table 8.4 sets out our draft decision on the remaining tax asset lives as at 1 July 2017 for Powerlink.

Table 8.4 AER's draft decision on Powerlink's standard and remaining tax asset lives as at 1 July 2017 (years)

Asset class	Standard tax asset life	Remaining tax asset life as at 1 July 2017
Transmission lines - overhead	47.5	28.6
Transmission lines - underground	45.0	17.5
Transmission lines - refit	30.0	28.0
Substations primary plant	40.0	26.9
Substations secondary systems	12.5	8.1
Communications other assets	12.5	9.6
Comms - civil works	40.0	19.6
Network switching centres	12.0	7.8
Land	n/a	n/a
Easements	n/a	n/a
Commercial buildings	40.0	32.4

¹⁵ NER, cl. 6A.6.4.

¹⁶ At the time of this draft decision, the roll forward of Powerlink's TAB includes estimated capex values for 2015–16 and 2016–17. We will update the 2015–16 estimated capex values with the actual values for the final decision, and may further update the estimate of 2016–17 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 Powerlink's remaining tax asset lives as at 1 July 2017 using the method approved in this draft decision.

Asset class	Standard tax asset life	Remaining tax asset life as at 1 July 2017
Computer equipment	2.5	2.1
Office furniture & miscellaneous	15.0	5.4
Office machines	10.0	5.1
Vehicles	7.0	5.0
Moveable plant	5.0	3.7
Insurance spares	n/a	n/a
Equity raising costs	5	0.0

Source: AER analysis.

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