DRAFT DECISION
TasNetworks distribution determination 2017–18 to 2018–19

Attachment 8 – Corporate income tax

September 2016

AUSTRALIAN ENERGY REGULATOR

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Note

This attachment forms part of the AER's draft decision on TasNetworks' distribution determination for 2017–19. It should be read with all other parts of the draft decision.

The draft decision includes the following documents:

Overview

Attachment 1 – Annual revenue requirement

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 – Demand management incentive scheme

Attachment 13 – Classification of services

Attachment 14 – Control mechanisms

Attachment 15 – Pass through events

Attachment 16 – Alternative control services

Attachment 17 – Negotiated services framework and criteria

Attachment 18 – Connection policy

Attachment 19 – Tariff structure statement

Contents

Shortened forms

Shortened form	Extended form
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
augex	augmentation expenditure
capex	capital expenditure
CCP	Consumer Challenge Panel
CESS	capital expenditure sharing scheme
CPI	consumer price index
DRP	debt risk premium
DMIA	demand management innovation allowance
DMIS	demand management incentive scheme
distributor	distribution network service provider
DUoS	distribution use of system
EBSS	efficiency benefit sharing scheme
ERP	equity risk premium
Expenditure Assessment Guideline	Expenditure Forecast Assessment Guideline for Electricity Distribution
F&A	framework and approach
MRP	market risk premium
NEL	national electricity law
NEM	national electricity market
NEO	national electricity objective
NER	national electricity rules
NSP	network service provider
opex	operating expenditure
PPI	partial performance indicators
PTRM	post-tax revenue model
RAB	regulatory asset base
RBA	Reserve Bank of Australia
repex	replacement expenditure

Shortened form	Extended form
RFM	roll forward model
RIN	regulatory information notice
RPP	revenue and pricing principles
SAIDI	system average interruption duration index
SAIFI	system average interruption frequency index
SLCAPM	Sharpe-Lintner capital asset pricing model
STPIS	service target performance incentive scheme
WACC	weighted average cost of capital

8 Corporate income tax

Our determination of the annual revenue requirement includes the estimated cost of corporate income tax for TasNetworks' 2017–19 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 enables TasNetworks to recover the costs associated with the estimated corporate income tax payable during the 2017–19 regulatory control period.

This attachment presents our assessment of TasNetworks' proposed corporate income tax allowance for the 2017–19 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.

8.1 Draft decision

We do not accept TasNetworks' proposed cost of corporate income tax allowance of $30.9 million ($ nominal). Our draft decision on the estimated cost of corporate income tax is $18.7 million over the 2017–19 regulatory control period. This represents a reduction of $12.1 million (or 39.3 per cent) from TasNetworks' proposal.

The reduction reflects our amendments to TasNetworks' proposed inputs for forecasting the cost of corporate income tax, including:

- the opening TAB (section 8.4.1)
- standard tax asset lives (section 8.4.2)
- remaining tax asset lives (section 8.4.3)
- the value of imputation credits (gamma) (attachment 4).

Our adjustments to the EBSS carryover amounts (attachment 9), the return on capital (attachments 2 and 3) and the regulatory depreciation (attachment 5) building blocks affect revenues, which in turn impacts the tax calculation. The changes affecting revenues are discussed in attachment 1.

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

Table 8.1 sets out our draft decision on the estimated cost of corporate income tax allowance for TasNetworks over the 2017–19 regulatory control period.

Table 8.1 AER's draft decision on TasNetworks' cost of corporate income tax allowance for the 2017–19 regulatory control period ($ million, nominal)

	2017–18	2018–19	Total
Tax payable	13.0	18.3	31.2
Less: value of imputation credits	5.2	7.3	12.5
Net corporate income tax allowance	**7.8**	**11.0**	**18.7**

Source: AER analysis.

8.2 TasNetworks' proposal

TasNetworks proposed a forecast cost of corporate income tax of $30.9 million ($ nominal) using the AER's PTRM, which adopts a straight-line tax depreciation approach and the following inputs:[2]

- an opening TAB as at 1 July 2017 of $1225.6 million ($ nominal)
- an expected statutory income tax rate of 30 per cent per year
- a value for gamma of 0.25
- remaining tax asset lives of assets in existence as at 30 June 2017 derived using an 'average depreciation' method. This approach involves dividing each asset class' opening TAB at 1 July 2017 by the average forecast 2017–19 tax depreciation for that asset class from the roll forward model (RFM).
- the same standard tax asset lives for tax depreciation purposes of new assets for the 2017–19 regulatory control period as approved for the 2012–17 distribution determination. In addition, TasNetworks proposed a standard tax asset life of 10 years for the new 'Business management systems' asset class.

Table 8.2 sets out TasNetworks' proposed corporate income tax allowance for the 2017–19 regulatory control period.

Table 8.2 TasNetworks' proposed cost of corporate income tax allowance for the 2017–19 regulatory control period ($ million, nominal)

	2017–18	2018–19	Total
Tax payable	20.0	21.2	41.2
Less: value of imputation credits	5.0	5.3	10.3
Net corporate income tax allowance	**15.0**	**15.9**	**30.9**

[2] TasNetworks, *Regulatory proposal 2017–22*, January 2016, pp. 120–122.

Source: TasNetworks, *Regulatory proposal*, January 2016, pp. 120–122.

8.3 Assessment approach

We make an estimate of taxable income for each regulatory year as part of our determination of the annual revenue requirement for TasNetworks' 2017–19 regulatory control period.[3] Our estimate is the taxable income a benchmark efficient entity would earn for providing standard control services if it operated TasNetworks' business. Our approach for calculating a distribution network service provider's (distributor) cost of corporate income tax allowance is set out in our PTRM and involves the following steps:[4]

1. We estimate the annual taxable income that would be earned by a benchmark efficient entity operating the distributor's business. A distributor's taxable income is calculated by subtracting from the approved forecast revenues the benchmark estimates of tax expenses. Using the PTRM, we model the distributor'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 used for the rate of return calculation. 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 distributor'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 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 distributor's annual revenue requirement.

The cost of corporate income tax allowance is an output of our PTRM. We therefore assess the distributor's proposed cost of corporate 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 2017–19 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 distributor's actual capex incurred during the 2012–17 regulatory

[3] NER, cl. 6.5.3.

[4] 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).

control period, and the final year (2011–12) of the previous regulatory control period.[5]

- **The remaining tax asset life for each asset class at the commencement of the 2012–17 regulatory control period:** Our standard method for determining the remaining tax asset lives is the weighted average method. The weighted average method rolls forward the remaining tax asset life for an asset class from the last year of the previous regulatory control period (in TasNetworks' case 2011–12) in order to take into account the actual capex for that year. This approach reflects the mix of assets within that tax asset class, when they were acquired over that period and the remaining tax asset lives of existing assets at the end of that period. The remaining values of all assets are used as weights at the end of the period. We will assess the outcomes of other approaches against the outcomes of this preferred approach.
- **The standard tax asset life for each asset class:** We assess the distributor's proposed standard tax asset lives, where necessary, against those prescribed by the Commissioner for taxation in tax ruling 2016/1 and the approved standard tax asset lives in the distributor's distribution determination for the 2012–17 regulatory control period.
- **The income tax rate:** The statutory income tax rate is 30 per cent per year.
- **The value of gamma:** We have determined the gamma input for TasNetworks is 0.40. 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 revenue requirement. This 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

[5] 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.

increase the tax allowance.[6] Depending on the source of the revenue increase, the tax increase may be equal to or less than proportional to the company tax rate.[7]

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 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 – In the main these expenses will match the opex allowance.
- Tax depreciation – A separate TAB is maintained for the businesses reflecting tax rules. This TAB is affected by many of the same factors as the RAB, such as capex, although unlike the RAB value it is maintained at its historical cost with no indexation. The TAB is also affected by the depreciation rate and asset lives assigned for tax depreciation purposes.

For TasNetworks, a 10 per cent increase in the corporate income tax allowance causes revenues to increase by about 0.4 per cent. The proposed gamma of 0.25, compared to the value in our draft decision of 0.40, would increase the corporate income tax allowance by 32.3 per cent and total revenues by about 1.4 per cent.

8.4 Reasons for draft decision

We do not accept TasNetworks' proposed cost of corporate income tax allowance of $30.9 million ($ nominal). We have instead determined a cost of corporate income tax allowance of $18.7 million. This represents a reduction of $12.1 million (or 39.3 per cent) from TasNetworks' 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)
- standard tax asset lives (section 8.4.2)
- the remaining tax asset lives (sections 8.4.3)

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6 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.

7 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.

- the value of imputation credits (gamma) (attachment 4).

Our adjustments to the EBSS carryover amounts (attachment 9), the return on capital (attachments 2 and 3) and the return of capital (attachment 5) building blocks affect revenues, and therefore also impact the forecast corporate income tax allowance.

We accept TasNetworks' proposed standard tax asset lives for existing asset classes. However, we do not accept TasNetworks' proposed standard tax asset life of 10 years for the new 'Business management systems' asset class (section 8.4.2). We have instead determined a standard tax asset life of 5 years for this asset class, which is consistent with the ATO's guide to depreciating such assets for tax purposes.[8]

8.4.1 Opening tax asset base

We accept TasNetworks' proposed method to establish the opening TAB as 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 $1222.0 million ($ nominal) for TasNetworks.[9] This is $3.7 million or 0.3 per cent ($ nominal) less than TasNetworks' proposed opening TAB value as at 1 July 2017 of $1225.6 million ($ nominal).

We have reviewed the inputs to the TAB roll forward and found that they were largely correct and reconcile with relevant data sources such as annual reporting RIN and the 2012–17 decision models. However, we found the shared assets adjustment to the 2011–12 net capex for the TAB roll forward were inconsistent with the 2012 final decision RFM for TasNetworks. The amount of shared assets adjustment approved for RAB and TAB were different in the 2012 final decision RFM. However, TasNetworks has incorrectly applied the shared assets adjustment amount for the RAB in the 2012 final decision RFM to the TAB in its proposed RFM. We have therefore amended the proposed TAB roll forward to correct this error so that the amount reconciles with the 2012 final decision RFM.

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8 ATO, *Guide to depreciating assets 2016*, June 2016, p. 12.

9 At the time of this draft decision, the roll forward of TasNetworks' TAB includes estimated capex values for 2015–16 and 2016–17. We expect TasNetworks will provide actual capex for 2015–16 and the 2016–17 capex estimates may be revised based on more up to date information in its revised proposal. We will update these values in the final decision accordingly.

Table 8.3 sets out our draft decision on the roll forward of TasNetworks' TAB values over the 2012–17 regulatory control period.

Table 8.3 AER's daft decision on TasNetworks' TAB roll forward ($ million, nominal)

	2012–13	2013–14	2014–15	2015–16	2016–17[a]
Opening TAB	956.9	999.5	1049.9	1087.6	1149.5
Capital expenditure	93.3	105.6	98.4	120.4	130.9
Less: tax depreciation	50.6	55.2	60.7	58.5	58.4
Closing TAB	999.5	1049.9	1087.6	1149.5	1222.0

Source: AER analysis.

(a) Based on estimated capex.

8.4.2 Standard tax asset lives

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

- broadly consistent with the values prescribed by the Commissioner for taxation in tax ruling 2016/1[10]
- the same as the approved standard tax asset lives for existing asset classes over the 2012–17 regulatory control period.

However, we do not accept TasNetworks' proposed standard tax asset life of 10 years for the new 'Business management systems' asset class. TasNetworks proposed this new asset class for use in relation to allocating capex associated with its proposed asset management and IT solution (Ajilis) project. The assets to be included are for asset management, financial, human resources and IT systems. We note that the ATO requires 'in-house software' related assets to be depreciated over a 5 years period for tax purposes. It also recommends that computer hardware to be depreciated over a 4 to 5 years period for tax purposes. Therefore, we have changed the proposed standard tax asset life for the 'Business management systems' asset class to 5 years from 10 years, consistent with ATO's guide on depreciating these types of assets for tax purposes.

Table 8.4 sets out our draft decision on the standard tax asset lives for TasNetworks. We are satisfied the approved 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 as required by the NER.[11]

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10 ATO, *TR 2016/1—Income tax: effective life of depreciating assets (applicable from 1 July 2016)*, July 2016.

11 NER, cl. 6.5.3.

Table 8.4 AER's draft decision on TasNetworks' standard tax asset lives (years)

Asset class	Standard tax asset life
Overhead subtransmission Lines (urban)	44.5
Underground subtransmission Lines (urban)	50.0
Urban zone substations	32.8
Rural zone substations	32.8
SCADA	32.8
Distribution switching stations (ground)	36.3
Overhead high voltage lines urban	34.9
Overhead high voltage lines rural	33.4
Voltage regulators on distribution feeders	45.5
Underground high Voltage lines	31.4
Underground high voltage lines SWER	31.4
Distribution substations HV (pole)	37.6
Distribution substations HV (ground)	33.2
Distribution substations LV (pole)	36.6
Distribution substations LV (ground)	34.1
Overhead low voltage lines underbuilt urban	37.4
Overhead low voltage lines underbuilt rural	38.7
Overhead low voltage lines urban	35.3
Overhead low voltage lines rural	36.7
Underground low voltage lines	42.5
Underground low voltage common trench	43.1
HVST service connections	36.4
HV service connections	36.4
HV metering CA service connections	36.4
HV/LV service connections	36.4
Business LV service connections	36.3
Business LV metering CA service connections	36.4
Domestic LV service connections	36.4
Domestic LV metering CA service connections	36.4

Emergency network spares	n/a
Motor vehicles	9.2
Minor assets	5.2
Non-system property	34.5
Spare parts	n/a
NEM assets	3.0
Business management systems	5.0
Land	n/a
Easements	n/a
Equity raising costs	5.0

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.

8.4.3 Remaining tax asset lives

We do not accept TasNetworks' proposed approach to estimating its remaining tax asset lives as at 1 July 2017. In its regulatory proposal, TasNetworks proposed to adopt an alternative depreciation approach to the 'weighted average remaining life' method for calculating its tax (and regulatory) depreciation for the 2017–19 regulatory control period. It noted that in the recent decisions for the Victorian distributors, the AER has approved a depreciation method which would recognise the specific timing of new capex compared to the weighted average remaining life method.[12] In the recent decisions for the Victorian distributors and SA Power Networks, we referred to this approach described by TasNetworks as the 'year-by-year tracking' method.[13]

However, as discussed in attachment 5, although TasNetworks proposed to use the year-by-year tracking method, it has not implemented this method correctly. We note that it has instead employed the 'average depreciation' method in its proposed RFM. We have previously rejected the average depreciation method in our decisions for the Victorian distributors and SA Power Networks.[14] Consistent with our decision for TasNetworks' regulatory depreciation approach, we accept its proposal to use the

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12 TasNetworks, *Regulatory proposal 2017–19*, January 2016, p. 111.

13 AER, *Preliminary decision CitiPower distribution determination, Attachment 5—Regulatory depreciation*, October 2015, p. 14.

14 AER, *Final decision SA Power Networks distribution determination - Attachment 5 - Regulatory depreciation*, October 2015, pp. 10–17; AER, *Final decision Ergon Energy distribution determination - Attachment 5 - Regulatory depreciation*, October 2015, pp. 10–17; AER, *Preliminary decision CitiPower distribution determination - Attachment 5 - Regulatory depreciation*, October 2015, pp. 14–22; AER, *Preliminary decision Powercor distribution determination - Attachment 5 - Regulatory depreciation*, October 2015, pp. 15–22; AER, *Preliminary decision Jemena distribution determination - Attachment 5 - Regulatory depreciation*, October 2015, pp. 12–19.

year-by-year tracking method for tax depreciation purposes. However, we have established a separate depreciation model for TasNetworks to implement the year-by-year tracking method. We have therefore applied the same year-by-year tracking method as described in attachment 5 for tax depreciation purposes for TasNetworks.

The year-by-year tracking method will result in each tax asset class having an expanding list of sub-assets to reflect the regulatory year in which capital expenditures on those assets occurred. This extra data helps track remaining tax asset values, lives and associated tax depreciation, and is therefore consistent with the NER. Section 5.4.2 of attachment 5 explains the year-by-year tracking method and implementation of this method in greater detail.

We are satisfied the application of the year-by-year tracking method to calculate TasNetworks' tax depreciation of existing assets provides an estimate of the tax depreciation amount for a benchmark efficient service provider as required by the NER.[15] The use of year-by-year tracking means it is no longer necessary to explicitly calculate remaining tax asset lives as at 1 July 2017.[16]

[15] NER, cl. 6.5.3.

[16] Remaining tax asset lives as at 1 July 2012 and standard tax asset lives are used in the year-by-year tracking method, and these are consistent with our 2012 distribution determination.