DRAFT DECISION
Amadeus Gas Pipeline Access Arrangement 2016 to 2021

Attachment 8 – Corporate income tax

November 2015

AUSTRALIAN ENERGY REGULATOR

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Note

This attachment forms part of the AER's draft decision on the access arrangement for the Amadeus Gas Pipeline for 2016–21. 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 12 - Non-tariff components

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Contents

Shortened forms

Shortened form	Extended form
AA	Access Arrangement
AAI	Access Arrangement Information
AER	Australian Energy Regulator
AGP	Amadeus Gas Pipeline
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
EBSS	Efficiency Benefit Sharing Scheme
ERP	equity risk premium
Expenditure Guideline	Expenditure Forecast Assessment Guideline
gamma	Value of Imputation Credits
GSL	Guaranteed Service Level
MRP	market risk premium
NEGI	north eastern gas interconnector
NGL	national gas law
NGO	national gas objective
NGR	national gas rules
NPV	net present value
opex	operating expenditure
PFP	partial factor productivity
PPI	partial performance indicators
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
TAB	Tax asset base

Shortened form	Extended form
UAFG	Unaccounted for gas
WACC	weighted average cost of capital
WPI	Wage Price Index

8 Corporate income tax

When determining the total revenue for APTNT, we must estimate APTNT's cost of corporate income tax.[1] APTNT has adopted the post-tax framework to derive its revenue requirement for the 2016–21 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 approve APTNT's proposed approach to calculate its forecast corporate income tax allowance. APTNT'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 approve APTNT's proposed corporate income tax allowance of $5.2 million ($nominal) for the 2016–21 access arrangement period. This is mainly a consequence of our adjustments to APTNT's value of imputation credits—gamma—(attachment 4) and other building block costs that affect revenues, such as the rate of return on capital (attachment 3), forecast capex (attachment 6) and forecast opex (attachment 7).[3]

We approve APTNT's proposed method to roll forward the tax asset base (TAB) because it is consistent with the AER's roll forward model (RFM) for electricity service providers and the approach previously approved in gas access arrangement decisions. However, we do not approve the proposed opening TAB of $37.2 million ($nominal) as at 1 July 2016. We instead determined an opening TAB of $35.5 million ($nominal). This amendment is due to input changes we made to APTNT's proposed RFM and updating the estimate of conforming capex for 2015–16.

We approve APTNT's proposed standard tax asset lives for the 2016–21 access arrangement period. This is because they are consistent with the provisions of the *Income Tax Assessment Act* (ITAA) 1997 and the standard tax asset lives prescribed in the Tax Ruling 2015/2. Also, these proposed standard tax asset lives are consistent with the approved standard tax asset lives in the 2011–16 access arrangement period. As discussed in attachment 5, we created a 'Land and easement' asset class for APTNT's forecast land capex in the 2016–21 access arrangement period. Consistent with tax law requirements, we have not applied a standard tax asset life to this new asset class. This is because land and easement are non-depreciating assets.

We accept APTNT's proposed weighted average method to calculate the remaining tax asset lives as at 1 July 2016. In accepting the weighted average method, we have updated APTNT's proposed remaining tax asset lives as at 1 July 2016. This is due to corrections we have made to some input errors in the remaining tax asset lives

1 NGR, r. 76(c).

2 APTNT, *Amadeus Gas Pipeline access arrangement revision proposal submission,* August 2015, p.168.

3 Changes to other building block costs affect revenues, which also impact the tax calculation.

calculation in APTNT's proposed roll forward model (RFM).[4] These errors are discussed in detail in sections 8.4.1 and 8.4.2.2.

In assessing APTNT's proposal, we have had regard to the requirement of the NGO and the revenue and pricing principles.[5] Our draft decision on APTNT's corporate income tax allowance over the 2016–21 access arrangement period is $1.6 million ($nominal), as set out in Table 8.1. This represents a reduction of $3.6 million ($nominal) or 69.0 per cent of APTNT's proposed forecast corporate income tax allowance.

Table 8.1 AER's draft decision on corporate income tax allowance for APTNT ($million, nominal)

	2016–17	2017–18	2018–19	2019–20	2020–21	Total
Tax payable	0.5	0.5	0.5	0.5	0.5	2.7
Less: value of imputation credits	0.2	0.2	0.2	0.2	0.2	1.1
Net corporate income tax allowance	**0.3**	**0.3**	**0.3**	**0.3**	**0.3**	**1.6**

Source: AER analysis.

8.2 APTNT's proposal

APTNT proposed a corporate income tax allowance of $5.2 million ($nominal) for the 2016–21 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 2016–21 access arrangement period. In estimating its corporate income tax allowance, APTNT used:

- an opening TAB of $37.2 million ($nominal) as at 1 July 2016 (as shown in Table 8.3)
- an expected statutory income tax rate of 30 per cent per year
- a value for the assumed utilisation of imputation credits (gamma) of 0.25
- the standard tax asset lives as approved for the 2011–16 access arrangement period
- the remaining tax asset lives which are calculated using a weighted average remaining life approach as contained in its proposed RFM.

[4] APTNT, *Response to AER information request: AER Amadeus 05 – RFM,* 16 September 2015.

[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 8.2 APTNT's proposed corporate income tax allowance for the 2016–21 access arrangement period ($million, nominal)

	2016–17	2017–18	2018–19	2019–20	2020–21	Total
Tax payable	1.5	1.4	1.4	1.5	1.1	6.9
Less: Value of imputation credits	0.4	0.3	0.4	0.4	0.3	1.7
Net corporate income tax allowance	**1.1**	**1.0**	**1.1**	**1.1**	**0.8**	**5.2**

Source: APTNT, *Proposed PTRM*, August 2015.

Note: Numbers may not add due to rounding.

APTNT's proposed roll forward of its TAB over the 2011–16 access arrangement period is set out in Table 8.3.

Table 8.3 APTNT's proposed tax asset base roll forward over the current 2011–16 access arrangement period ($million, nominal)

	2011–12	2012–13	2013–14	2014–15	2015–16
Opening tax asset base	3.9	6.4	20.7	22.6	24.7
Capex	4.1	15.8	3.8	4.0	14.9
Tax depreciation	–1.6	–1.5	–1.9	–2.0	–2.3
Closing tax asset base	6.4	20.7	22.6	24.7	37.2

Source: APTNT, *Proposed RFM*, August 2015.

8.3 AER's assessment approach

Our approach to calculate APTNT's cost of corporate income tax begins with an estimate of taxable income that would be earned by a benchmark efficient company operating APTNT'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 APTNT'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 APTNT's total revenue.[6]

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

- the opening TAB as at 1 July 2016
- the standard tax asset life for each asset class
- the remaining tax asset life for each asset class as at 1 July 2016
- the income tax rate
- the value of imputation credits (gamma).

In assessing APTNT's proposal, we have had regard to the NGO and the revenue and pricing principles.[7]

We consider that the roll forward of the opening TAB to 1 July 2016 should be based on the approved opening TAB as at 1 July 2011 and APTNT's actual capex in the 2011–16 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 APTNT's proposed standard tax asset lives, where appropriate, by comparing them against the values approved in the 2011–16 access arrangement period as well as those prescribed by the Commissioner for taxation in tax ruling 2015/2.[8]

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 a tax asset class from the last year of the earlier access arrangement period (in APTNT's case 2010–11) 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 (or if they were existing assets at the beginning), and the remaining value of those assets (used as a weight) at the end of the period. We will assess the outcomes of other approaches against the outcomes of this standard approach.

6 NGR, r. 76(c).

7 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.

8 Australian Taxation Office, *Taxation Ruling Income tax: effective life of depreciating assets (applicable from 1 August 2015)*: http://law.ato.gov.au/atolaw/view.htm?docid=%22TXR%2FTR20152%2FNAT%2FATO%2F00001%22.

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.[9] Depending on the source of the revenue increase, the tax increase may be equal to or less than proportional to the company tax rate.[10]

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

9 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.

10 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.

A ten per cent increase in the corporate income tax allowance would cause revenues to increase by about 0.4 per cent. The proposed gamma of 0.25 compared to the AER's decision of 0.4, would increase the corporate income tax allowance by 32 per cent and total revenues by about 1 per cent.

8.4 Reasons for draft decision

Our draft decision on APTNT's corporate income tax allowance is $1.6 million ($nominal), which is a reduction of $3.6 million ($nominal) or 69.2 per cent of APTNT's proposal.

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

- changes to the opening TAB as at 1 July 2016 (section 8.4.1)
- updates to the remaining tax asset lives as at 1 July 2016 and the addition of the new asset class for 'Land and easement' (section 8.4.2)
- changes made to the estimate of conforming capex for 2015–16 (attachment 6)
- changing the value of gamma to 0.4 from 0.25 (attachment 4)
- changes to other building block components including forecast rate of return (attachment 3), forecast capex (attachment 6) and forecast opex (attachment 7).[11]

8.4.1 Opening tax asset base as at 1 July 2016

We accept APTNT's approach to determine the opening TAB. This is because APTNT's proposed approach is consistent with the AER's RFM for electricity service providers and the approach previously approved in other gas access arrangement decisions. However, we do not approve APTNT's proposed total opening TAB of $37.2 million ($nominal) as at 1 July 2016. We determine an opening TAB value of $35.5 million ($nominal) as at 1 July 2016. This is mainly because of our amendments to the estimate of conforming capex for 2015–16 and the remaining tax asset lives inputs in the proposed RFM.

We assessed the inputs APTNT used to roll forward the TAB over the 2011–16 access arrangement. This includes the opening TAB and remaining tax asset life values as at 1 July 2011, and actual capex for 2010–11 and 2011–16 access arrangement period.

We do not accept APTNT's proposed opening TAB inputs as at 1 July 2011 because they are not consistent with the approved values in the opening TAB in the 2011–16 access arrangement.[12] APTNT's use of different opening TAB inputs as at 1 July 2011 appears to adjust for actual capex in the final year of the previous access arrangement

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[11] NGR, r. 87A.

[12] AER, *Final decision, N.T. Gas Access arrangement proposal for the Amadeus Gas Pipeline, 1 August 2011–30 June 2016*, July 2011, p. 87.

period (2010–11).[13] However, the RFM requires the use of approved opening TAB inputs as at 1 July 2011 and accounts for the reconciliation of actual capex for 2010–11 in the TAB roll forward process. We have therefore changed the 1 July 2011 opening TAB inputs in the RFM to reflect the approved values.

Further, we are not satisfied that the actual (conforming) capex included in the TAB reflects the requirements of rule 79 of the NGR. In particular, we have updated the 2015–16 estimate of capex for this draft decision in the RFM to reflect our decision on conforming capex in 2015–16.[14] Our detailed assessment of the conforming capex is set out in attachment 6.

We have also amended the remaining tax asset lives inputs as at 1 July 2011 in the RFM. This is because the proposed remaining tax asset lives inputs as at 1 July 2011 were not consistent with the approved values in the 2011–16 access arrangement period.[15]

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

Table 8.4 AER's draft decision on APTNT's tax asset base roll forward for the 2011–16 access arrangement period ($million, nominal)

	2011–12	2012–13	2013–14	2014–15	2015–16
Opening tax asset base	9.3	11.8	26.0	27.9	30.0
Capex	4.1	15.8	3.8	4.0	7.8
Tax depreciation	–1.6	–1.5	–1.9	–2.0	–2.3
Closing tax asset base	11.8	26.0	27.9	30.0	35.5

Source: AER analysis.

8.4.2 Tax asset lives

8.4.2.1 Standard tax asset lives

We approve APTNT's proposed standard tax asset lives assigned to each of its asset classes for the 2016–21 access arrangement period. This is because they are consistent with the statutory cap on the effective life of gas transmission assets under the *Income Tax Assessment Act (ITAA)* 1997, and with the standard tax asset lives

13 APTNT, *Response to AER information request: AER Amadeus 05 – RFM*, 16 September 2015.

14 We note that the capex determined in this draft decision for 2015–16 is an estimate. As part of the final decision, we expect the estimate of capex for 2015–16 to be revised based on more up to date information and that APTNT may provide this revision in its revised proposal.

15 AER, *Final decision, N.T. Gas Access arrangement proposal for the Amadeus Gas Pipeline, 1 August 2011–30 June 2016*, July 2011, p. 87.

prescribed in the Tax Ruling 2015/2.[16] The proposed standard tax asset lives are also consistent with the approved standard tax asset lives in the 2011–16 access arrangement.[17]

As discussed in attachment 5, we decided to create a 'Land and easement' asset class for APTNT's forecast land capex in the 2016–21 access arrangement period. Consistent with our approach for regulatory depreciation, we have not applied a standard tax asset life to this new asset class for tax depreciation purposes ("n/a" is assigned for tax depreciation modelling purposes in the PTRM). This is because land and easement are non-depreciating assets, and therefore should not have a standard tax asset life for tax depreciation purposes. This approach is consistent with Australian accounting standards and ATO's treatment for such assets.[18] We have also consistently treated land and easement as non-depreciating assets for other regulated businesses.

8.4.2.2 Remaining tax asset lives as at 1 July 2016

We accept APTNT's proposed weighted average method to calculate the remaining tax asset lives as at 1 July 2016. In accepting the weighted average method, we have updated APTNT's remaining tax asset lives[19] as at 1 July 2016 to reflect our amendments to the remaining tax asset lives inputs as at 1 July 2011 as discussed in section 8.4.1. We also corrected some input errors in the tax asset lives roll forward calculation in the RFM which also affected the value of the remaining tax asset lives as at 1 July 2016.[20]

Our draft decision on APTNT's standard tax asset lives and remaining tax asset lives for each of its asset classes for the 2016–21 access arrangement period is set out in Table 8.5.

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16 *ITAA 1997*, s. 40.102(5); Australian Taxation Office, *Taxation Ruling Income tax: effective life of depreciating assets (applicable from 1 August 2015)*: http://law.ato.gov.au/atolaw/view.htm?docid=%22TXR%2FTR20152%2FNAT%2FATO%2F00001%22.

17 AER, *Amadeus final decision PTRM*, July 2011.

18 Australian accounting standard board, *Accounting standard AASB1021: Depreciation, August 1997*, pp. 10–11; ATO, *Guide to depreciating assets 2011*, 2011, p. 3.

19 We note that the capex determined in this draft decision for 2015–16 are estimates. As part of the final decision, we expect the estimate of capex for 2015–16 to be revised based on more up to date information and that APTNT may provide this revision in its revised proposal. The capex figures are used to calculate the weighted average remaining tax asset lives. Therefore, we may recalculate APTNT's remaining tax asset lives using the method approved in this draft decision to reflect revisions to 2015–16 capex values for the final decision.

20 APTNT, *Response to AER information request: AER Amadeus 05 – RFM,* 16 September 2015.

Table 8.5 AER's draft decision on APTNT's standard tax asset lives and remaining tax asset lives as at 1 July 2016 for the 2016–21 access arrangement period (year)

Tax asset class	Standard tax asset life	Remaining tax asset life as at 1 July 2016
Pipelines	20	16.2
Compression	20	n/a
Meter station	20	16.7
SCADA	15	14.9
O&M facilities	10	8.8
Buildings	40	n/a
Return tariff payment[a]	n/a	n/a
Corporate assets (IT software)[a]	n/a	n/a
Land and easement	n/a	n/a

Source: AER analysis.

n/a Not applicable.

(a) The 'Return tariff payment' and 'Corporate assets (IT software)' asset classes are no longer used for tax depreciation purposes because there is no residual TAB values and no forecast capex allocated to these asset classes for the 2016–21 access arrangement period.

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 2016–21 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 base as at 1 July 2016, as set out in Table 8.4.

Revision 8.3 Make all necessary amendments to reflect this draft decision on the standard and remaining tax asset lives for the 2016–21 access arrangement period as set out in Table 8.5.