



Draft decision
Directlink transmission determination
2015-16 to 2019-20
Attachment 8: Corporate income tax

November 2014

© Commonwealth of Australia 2014

This work is copyright. In addition to any use permitted under the Copyright Act 1968, all material contained within this work is provided under a Creative Commons Attribution 3.0 Australia licence, with the exception of:

- the Commonwealth Coat of Arms
- the ACCC and AER logos

any illustration, diagram, photograph or graphic over which the Australian Competition and Consumer Commission does not hold copyright, but which may be part of or contained within this publication.

The details of the relevant licence conditions are available on the Creative Commons website, as is the full legal code for the CC BY 3.0 AU licence.

Requests and inquiries concerning reproduction and rights should be addressed to the Director, Corporate Communications, ACCC, GPO Box 3131, Canberra ACT 2601, or

publishing.unit@acc.gov.au .

Inquiries about this document should be addressed to:

Australian Energy Regulator
GPO Box 520
Melbourne Vic 3001
Tel: (03) 9290 1444
Fax: (03) 9290 1457
Email: AERInquiry@ aer.gov.au

AER reference: 53446

Note

This attachment forms part of the AER's draft decision on Directlink's revenue proposal 2015–20. It should be read with 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 and negotiated services

Attachment 13 – pass through events

Contents

Contents	8-4
Shortened forms	8-5
8 Corporate income tax	8-7
8.1 Draft decision	8-7
8.2 Directlink's proposal.....	8-7
8.3 AER's assessment approach.....	8-8
8.3.1 Interrelationships	8-9
8.4 Reasons for draft decision	8-10
8.4.1 Opening tax asset base at 1 July 2015	8-10
8.4.2 Remaining tax asset lives.....	8-11
8.4.3 Standard tax asset lives	8-11

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	aggregate service revenue requirement
augex	augmentation expenditure
capex	capital expenditure
CCP	Consumer Challenge Panel
CESS	capital expenditure sharing scheme
CPI	consumer price index
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

Shortened form	Extended form
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
RPP	revenue 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

The AER is required to make a decision on the estimated cost of corporate income tax for Directlink's 2015–20 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 attachment sets out our draft decision on Directlink's proposed corporate income tax allowance. 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 Directlink's proposed estimated cost of corporate income tax allowance of \$4.4 million (\$ nominal) over the 2015–20 regulatory control period. Our draft decision on the estimated cost of corporate income tax is \$2.7 million (\$ nominal) for Directlink over the 2015–20 regulatory control period, a reduction of \$1.7 (or 38.6 per cent) from its proposal. This reduction is mainly driven by our determination on Directlink's proposed value of imputation credits (gamma) as discussed in attachment 4. Our determinations on other building block components including forecast capex (attachment 6) and forecast opex (attachment 7) affect revenue, which also impact the tax calculation.

Based on the approach to modelling the cash flows in the PTRM, we have derived an effective tax rate of 27.7 per cent for Directlink. Table 8-1 sets out our draft decision on the estimated cost of corporate income tax allowance for Directlink.

Table 8-1 AER's draft decision on Directlink's cost of corporate income tax allowance for the 2015–20 regulatory control period (\$ million, nominal)

	2015–16	2016–17	2017–18	2018–19	2019–20	Total
Tax payable	0.8	0.8	0.9	0.9	1.0	4.5
Less: value of imputation credits	0.3	0.3	0.4	0.4	0.4	1.8
Net corporate income tax allowance	0.5	0.5	0.5	0.6	0.6	2.7

Source: AER analysis.

8.2 Directlink's proposal

Directlink estimated its corporate income tax allowance using the AER's PTRM and the following inputs:²

- an opening TAB as at 1 July 2015 of \$97.6 million (\$ nominal)
- an expected statutory income tax rate of 30 per cent per year
- a value for gamma of 0.25

¹ NER, cl. 6A.5.4(a)(4).

² Directlink, *Revenue proposal*, pp.40–42; Directlink, *Proposed PTRM*, May 2014.

- the proposed standard and remaining tax asset lives for calculating its tax depreciation as contained in its proposed PTRM. Directlink proposed to align the remaining tax asset life of the 'Transmission lines' asset class (36 years) with that of the 'Substations' asset class (26 years). It also proposed to use the remaining tax asset life of 26 years to depreciate any new capex proposed for the 2015–20 regulatory control period.

Table 8-2 sets out Directlink's proposed corporate income tax allowance for the 2015–20 regulatory control period.

Table 8-2 Directlink's proposed corporate income tax allowance for the 2015–20 regulatory control period (\$ million, nominal)

	2015–16	2016–17	2017–18	2018–19	2019–20	Total
Tax payable	1.0	1.1	1.2	1.2	1.3	5.8
Less: value of imputation credits	0.3	0.3	0.3	0.3	0.3	1.5
Net corporate income tax allowance	0.8	0.8	0.9	0.9	1.0	4.4

Source: Directlink, *Regulatory proposal*, p. 42; Directlink, *Proposed PTRM*, May 2014.

8.3 AER's assessment approach

Under clause 6A.6.4 of the NER, we must make an estimate of taxable income for each regulatory year. Our estimate must be for the taxable income a benchmark efficient entity would earn for providing prescribed transmission services if it operated Directlink's business. The estimate is required to be determined in accordance with the PTRM. Our approach for calculating a TNSP's cost of corporate income tax is set out in our PTRM³ and involves the following steps:

- First, we estimate the annual taxable income that would be earned by a benchmark efficient entity operating the TNSP's business.⁴ 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.
- The statutory income tax rate is then applied to the estimated annual 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 assumed utilisation of imputation credits (gamma).
- The final estimate of tax payable net of assumed utilised imputation credits is then included as a separate building block in determining the TNSP's annual building block revenue requirement.

³ 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).

⁴ NER, cl. 6A.6.4.

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

- The opening TAB as at the commencement of the TNSP's next 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 TNSP's current regulatory control period and the TNSP's actual capex incurred during its current regulatory control period.
- 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 the Commissioner for taxation in tax ruling 2014/4 and the approved standard tax asset lives in the TNSP's transmission determination for its current regulatory control period.
- The remaining tax asset life for each asset class at the commencement of the TNSP's next regulatory control period: Our roll forward model (RFM) determines the remaining tax asset lives using the weighted average method.⁵ We consider the weighted average method provides a better reflection of the mix of assets within an asset class.
- The income tax rate: The statutory income tax rate is 30 per cent per year.
- The value of gamma: The gamma input that we have decided to apply for Directlink is 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 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 tax allowance.⁶

⁵ 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.

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.

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 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 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 0.4 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 25 per cent and total revenues by about 1 per cent.

8.4 Reasons for draft decision

We do not accept Directlink's proposed estimated cost of corporate income tax allowance. This is because we adjusted several of its proposed inputs to the PTRM for tax purposes, which relate to our determinations on other building block components. These include the value for gamma (attachment 4), forecast opex (attachment 7) and forecast capex (attachment 6) that impact the estimated corporate income tax allowance.

We determine an estimated cost of corporate income tax of \$2.7 million (\$ nominal) for Directlink, which represents a reduction of \$1.7 million (or 38.6 per cent) from its proposal.

8.4.1 Opening tax asset base at 1 July 2015

We accept Directlink's proposed opening TAB as at 1 July 2015 of \$97.5 million (\$ nominal). Directlink has applied the approach set out in our roll forward model (RFM) to establish its proposed opening TAB. Also, as discussed in attachment 2, we accept the actual capex values in Directlink's proposed RFM.⁸

Table 8-3 sets out our draft decision on the roll forward of Directlink's TAB values.

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.

⁸ At the time of this draft decision, the roll forward of Directlink's TAB includes estimated capex values for 2013–14 and 2014–15. We will update the 2013–14 estimated capex values with the actual values for the final decision. We may also update the 2014–15 capex values with revised estimates at the time of the final decision. However, we will update for 2014–15 actual capex at the next reset.

Table 8-3 AER's draft decision on Directlink's TAB roll forward for the 2015–20 regulatory control period (\$ million, nominal)

	2005–06	2006–07	2007–08	2008–09	2009–10	2010–11	2011–12	2012–13	2013–14 ^b	2014–15 ^b
Opening TAB	116.7	115.7	113.4	110.3	107.2	104.2	103.0	101.4	99.2	97.7
Capital expenditure ^a	2.0	0.8	–	–	–	2.0	1.5	0.9	1.7	3.0
Tax depreciation	–3.0	–3.1	–3.1	–3.1	–3.1	–3.1	–3.1	–3.2	–3.2	–3.2
Closing TAB	115.7	113.4	110.3	107.2	104.2	103.0	101.4	99.2	97.7	97.5

Source: AER analysis.

(a) As commissioned, net of disposals.

(b) Based on estimated capex.

8.4.2 Remaining tax asset lives

We accept Directlink's proposal to align the remaining tax asset life of the 'Transmission line' asset class with that of the 'Substations' asset class. As discussed in attachment 5, unlike other TNSPs, Directlink's transmission line assets will have no useful life when the substation assets reach the end of their useful life. Therefore, we consider this proposed alignment is appropriate for tax depreciation purposes. Table 8-4 sets out our draft decision on Directlink's remaining tax asset lives as at 1 July 2015.

8.4.3 Standard tax asset lives

We accept Directlink's proposed standard tax asset lives for tax depreciation purposes of new capex over the 2015–20 regulatory control period. As discussed in attachment 5, we consider the proposed forecast capex are for stay in business and ancillary equipment purposes and should have the same remaining tax life as the substation assets. Therefore, we agree that it is reasonable to change the standard tax asset life of the 'Transmission line' asset class and 'Substations' asset class to 26 years. We are satisfied that the proposed standard tax asset lives are likely to provide an estimate of the tax depreciation amount for a benchmark efficient TNSP as required by the NER.⁹

Table 8-4 sets out our draft decision on Directlink's standard tax asset lives for the 2015–20 regulatory control period.

Table 8-4 AER's draft decision on Directlink's standard and remaining tax asset lives as at 1 July 2015 (years)

Asset class	Standard tax asset life	Remaining tax asset life as at 1 July 2015
Substations	26.2	26.2
Transmission lines	26.2	26.2
Easements	n/a	n/a

Source: AER analysis.

n/a: not applicable.

⁹ NER, cl. 6A.6.4.