



Draft decision

Jemena Gas Networks (NSW) Ltd

Access arrangement 2015–20

Attachment 8 – Corporate income tax

November 2014

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Note

This attachment forms part of the AER's draft decision on Jemena Gas Networks' 2015–20 access arrangement. It should be read with 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

Attachment 9 – efficiency carryover mechanism

Attachment 10 – reference tariff setting

Attachment 11 – reference tariff variation mechanism

Attachment 12 – non-tariff components

Attachment 13 – demand

Contents

Contents	8-4
Shortened forms	8-5
8 Corporate income tax	8-7
8.1 Draft decision	8-7
8.2 JGN proposal.....	8-7
8.3 AER assessment approach	8-8
8.3.1 Interrelationships	8-9
8.4 Reasons for the draft decision	8-10
8.4.1 Opening tax asset base as at 1 July 2015	8-10
8.4.2 Tax depreciation method.....	8-11
8.4.3 Revisions	8-13

Shortened forms

Shortened form	Extended form
2010–15 access arrangement	Access arrangement for JGN effective from 1 July 2010 to 30 June 2015 inclusive
2010–15 access arrangement period	1 July 2010 to 30 June 2015 inclusive
2015–20 access arrangement	Access arrangement for JGN effective from 1 July 2015 to 30 June 2020 inclusive
2015–20 access arrangement period	1 July 2015 to 30 June 2020 inclusive
Access arrangement information	Jemena Gas Networks (NSW) Ltd, <i>Access Arrangement Information 2015–20</i> , 30 June 2014
Access arrangement proposal	Jemena Gas Networks (NSW) Ltd, <i>Access arrangement, JGN's NSW gas distribution networks, 1 July 2015 – 30 June 2020</i> , 30 June 2014
AER	Australian Energy Regulator
capex	capital expenditure
CAPM	capital asset pricing model
CCP	Consumer Challenge Panel
Code	National Third Party Access Code for Natural Gas Pipeline Systems
CPI	consumer price index
DRP	debt risk premium
ERP	equity risk premium
JGN	Jemena Gas Networks (NSW) Ltd (CAN 003 004 322)
MRP	market risk premium
NGL	national gas law
NGO	national gas objective
NGR	national gas rules

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
Reference service agreement proposal	Jemena Gas Networks (NSW) Ltd, <i>Reference Service Agreement, JGN's NSW gas distribution networks</i> , 30 June 2014
RFM	roll forward model
RIN	regulatory information notice
RPP	revenue and pricing principles
SLCAPM	Sharpe-Lintner capital asset pricing model
WACC	weighted average cost of capital

8 Corporate income tax

When determining the total revenue for JGN, we must estimate JGN's cost of corporate income tax.¹ JGN has adopted the post-tax framework to derive its revenue requirement for the 2015–20 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 do not approve JGN's proposed corporate income tax allowance of \$126.3 million (\$nominal) for the 2015–20 access arrangement period. This is mainly a consequence of our adjustments to JGN's value of imputation credits—gamma—(attachment 4) and the rate of return on capital (attachment 3).³

Our adjustments result in an estimated corporate income tax allowance of \$60.5 million (\$nominal) for JGN as shown in table 8-1.

Table 8-1 AER's draft decision on corporate income tax allowance for JGN (\$million, nominal)

	2015-16	2016-17	2017-18	2018-19	2019-20	Total
Tax payable	15.0	17.5	21.1	25.1	22.0	100.8
Less: value of imputation credits	6.0	7.0	8.5	10.0	8.8	40.3
Net corporate income tax allowance	9.0	10.5	12.7	15.1	13.2	60.5

Source: AER analysis.

8.2 JGN proposal

JGN's proposed roll forward of its tax asset base (TAB) over the 2010–15 access arrangement period is set out in table 8-2.

Table 8-2 JGN's proposed tax asset base roll forward over the current 2010–15 access arrangement period (\$million, nominal)

Details	2010-11	2011-12	2012-13	2013-14	2014-15
Opening tax asset base	600.1	679.3	753.5	786.7	867.6
Capex	159.9	169.3	132.2	182.7	245.3
Less: tax depreciation	–80.6	–95.1	–99.1	–101.8	–116.2
Closing tax asset base	679.3	753.5	786.7	867.6	996.7

Source: JGN, *Access arrangement information*, June 2014, Table 10-1, p. 101.

¹ NGR, r. 76(c).

² JGN, *Access arrangement information*, June 2014, p. 99.

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

For the 2015–20 access arrangement period, JGN proposed a total corporate income tax allowance of \$126.3 million (\$nominal) as set out in table 8-3.

Table 8-3 JGN's proposed corporate income tax allowance for the 2015–20 access arrangement period (\$million, nominal)

	2015-16	2016-17	2017-18	2018-19	2019-20	Total
Tax payable	28.2	30.9	34.8	38.6	35.7	168.4
Less: Value of imputation credits	7.1	7.7	8.7	9.7	8.9	42.1
Net cost of corporate tax	21.2	23.2	26.1	29.0	26.8	126.3

Source: JGN, *Access arrangement information*, June 2014, Table 10–2, p. 101.

JGN proposed to use the diminishing value method for tax depreciation to estimate the value of its TAB as at the beginning of the 2015–16 regulatory year and to roll that value forward through the 2015–20 access arrangement period. JGN stated that the reasons for this are that:⁴

- it elects using diminishing value tax depreciation for the bulk of its assets when determining its tax liability with the Australian Tax Office
- a rational benchmark efficient entity could be expected to use the diminishing value method because it minimises near term tax liability
- the AER approved JGN's use of the diminishing value method for the 2010–15 access arrangement period, so continued use of this method maintains consistency between periods.

JGN has adopted the legislated income tax rate of 30 per cent and a gamma value of 0.25.

8.3 AER assessment approach

We consider the cost of corporate income tax for JGN should be calculated based on the estimated taxable income that would be earned by a benchmark efficient company operating JGN'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 JGN'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 JGN's total revenue.⁵

JGN calculated the corporate income tax allowance using its revenue model.⁶ We have therefore assessed JGN's proposed corporate income tax allowance by analysing its proposed inputs to the revenue model for calculating the tax allowance. These inputs include:

- the opening TAB as at 1 July 2015

⁴ JGN, *Access arrangement information*, June 2014, p. 100.

⁵ NGR, r. 76(c).

⁶ JGN, *Access arrangement proposal Appendix 12.1 Revenue model*, June 2014.

- the tax depreciation approach for each asset class
- the diminishing value rate for tax depreciation for each asset class
- the income tax rate
- the value of gamma.

In assessing JGN'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 2015 should be based on the approved opening TAB as at 1 July 2010 and JGN's actual capex in the 2010–15 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 6.⁸

We have assessed JGN's proposed diminishing rates, where appropriate, by comparing them against the rates approved in the 2010–15 access arrangement period as well as those prescribed by the Commissioner for taxation in tax ruling 2014/4.⁹

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
- 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.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

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 The asset classes differ between the capital base roll forward and the tax asset base roll forward. However, the total values of annual capex in the 2008–12 access arrangement period will be consistent.

⁹ Australian Taxation Office, *Taxation Ruling Income tax: effective life of depreciating assets (applicable from 1 July 2014)*, August 2014, <http://law.ato.gov.au/atolaw/view.htm?docid=%22TXR%2FTR20144%2FNAT%2FATO%2F00001%22>

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 revenue model should therefore be set up to run an iterative process until the revenue and tax allowances become stable.

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.

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.

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 0.9 per cent.

8.4 Reasons for the draft decision

Our draft decision on JGN's corporate income tax allowance is \$60.5 million (\$nominal), which is a reduction of \$65.8 million (\$nominal) or 52 per cent of JGN's proposal.

We accept JGN's proposed method for calculating the corporate income tax allowance, including the proposed opening TAB as at 1 July 2015 and tax depreciation rates. However, we adjusted several inputs proposed by JGN for calculating the corporate income tax allowance. These relate to:

- changing the value of gamma to 0.4 from 0.25 (attachment 4)
- changes to other building block components including forecast rate of return on capital (attachment 3) and forecast capex (attachment 6) that impact total revenues, and therefore also impact the forecast corporate income tax allowance.¹²

8.4.1 Opening tax asset base as at 1 July 2015

We accept JGN's approach to determine the opening TAB, and after minor updates to the inputs, determine a TAB value of \$996.5 million (\$nominal) as at 1 July 2015.

¹² NGR, r. 87A.

Table 8-4 sets out our draft decision on the roll forward of JGN's TAB values.

Table 8-4 AER's draft decision on JGN's tax asset base roll forward for the 2010–15 access arrangement period (\$million, nominal)

Details	2010-11	2011-12	2012-13	2013-14	2014-15
Opening tax asset base	600.1	679.3	753.5	786.7	867.6
Capex	159.9	169.3	132.2	182.7	245.1
Tax depreciation	-80.6	-95.1	-99.1	-101.8	-116.2
Closing tax asset base	679.3	753.5	786.7	867.6	996.5

Source: JGN, *Access arrangement information*, June 2014, Table 10-1, p. 101. AER analysis.

We assessed the inputs JGN used to roll forward the TAB over the 2010–15 access arrangement. This includes actual capex and depreciation data for 2010–11 to 2012–13, and forecast data for 2013–14 and 2014–15. Subsequent to lodging its proposal, JGN provided a minor update which reduced forecast 2014–15 capex by \$0.2 million.¹³

After incorporating this minor update, we are satisfied the capex over the 2010–15 access arrangement period reflects the requirements of rule 79 of the NGR. Our detailed assessment of this conforming capex is set out in attachment 6. We note that the capex determined in this draft decision for 2013–14 and 2014–15 are estimates. As part of the final decision, we expect the estimate of capex for 2013–14 to be replaced by actuals. We also expect the estimate of capex for 2014–15 to be revised based on more up to date information and that JGN would provide this revision in its revised proposal.

We are satisfied the tax depreciation values we have determined over the 2010–15 access arrangement period are appropriate for the purposes of the TAB roll forward over that period. This is because the tax depreciation values were calculated using the same approach and tax depreciation rates as approved for the 2010–15 access arrangement.¹⁴ We are also satisfied with the inputs for calculating the tax depreciation, such as gross capex (as updated) and disposals. Our detailed assessment of these inputs is set out in attachment 6.

8.4.2 Tax depreciation method

We accept JGN's proposal to use the diminishing value method for estimating tax depreciation. This method is consistent with that approved for the 2010–15 access arrangement period.¹⁵

We assessed JGN's proposed diminishing value rates for tax depreciation for each asset class, which are the same as those approved for the 2010–15 access arrangement period. We have also compared the rates, where appropriate, against those prescribed by the Commissioner for taxation in tax ruling 2014/4.¹⁶ We are satisfied that the proposed tax depreciation rates remain appropriate for applying over the 2015–20 access arrangement period.

¹³ JGN, *Email response to information request AER JGN 025a, Submissions on JGN proposal (pricing issues) - follow up*, 25 September 2014.

¹⁴ AER, *Final decision: JGN access arrangement 2010–15*, June 2010, pp. 205–207.

¹⁵ AER, *Final decision: JGN access arrangement 2010–15*, June 2010, p. 14.

¹⁶ Australian Taxation Office, *Taxation Ruling Income tax: effective life of depreciating assets (applicable from 1 July 2014)*, August 2014, <http://law.ato.gov.au/atolaw/view.htm?docid=%22TXR%2FTR20144%2FNAT%2FATO%2F00001%22>

We note that JGN did not propose any forecast equity raising costs in the 2015–20 access arrangement period. For this reason, the diminishing value rate for this asset class is only used to calculate tax depreciation on equity raising costs as at 1 July 2015, which was added to the TAB in the 2010–15 access arrangement period.

Table 8-5 sets out our draft decision on JGN's diminishing value rates for tax depreciation over the 2015–20 access arrangement period.

Table 8-5 AER's draft decision on JGN's diminishing value rates for tax depreciation calculation (per cent)

Asset class	Diminishing value rate for tax depreciation
Trunk Wilton-Sydney	10%
Trunk Sydney-Newcastle	10%
Transmission pipeline (Wilton-Wollongong)	10%
Contract meters	10%
Fixed Plant - distribution	10%
HP mains	10%
HP services	10%
MP mains	10%
MP services	10%
Meter reading devices	10%
Country POTS	10%
Tariff meters	10%
Building	3%
Computers	40%
Software	50%
Fixed plant	20%
Furniture	20%
Land	n/a
Leasehold improvements	3%
Low value assets	60%
Mobile plant	20%
Vehicles	25%
Equity raising costs	11%

Source: JGN, *Access arrangement proposal Appendix 12.1 Revenue model*, June 2014. AER analysis.

8.4.3 Revisions

The AER requires the following revisions to make the access arrangement proposal acceptable:

Revision 8.1 Make all necessary amendments to reflect the AER's draft decision on the proposed corporate income tax allowance for the 2015–20 access arrangement period, as set out in table 8-1.