Draft decision

TasNetworks transmission determination

2015-16 to 2018-19

Attachment 8: Corporate income tax

November 2014

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Note

This attachment forms part of the AER's draft decision on the transmission determination for TasNetworks' 2015–19 regulatory control period. It should be read in conjunction 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

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Attachment 12 – pricing methodology

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Shortened forms

Shortened form	Extended form
AARR	aggregate annual revenue requirement
AASB	Australian Accounting Standards Board
ABS	Australian Bureau of Statistics
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
ARPC	Australian Reinsurance Pool Corporation
ASRR	aggregate service revenue requirement
ASX	Australian Stock Exchange
ATO	Australian Tax Office
augex	augmentation expenditure
Benchmarking report	AER, *Electricity transmission network service providers annual benchmarking report*, November 2014
capex	capital expenditure
capex incentive guideline	AER, *Capital Expenditure Incentive Guideline for Electricity Network Service Providers*, November 2013
CCP	Consumer Challenge Panel
CEG	Competition Economics Group
CESS	capital expenditure sharing scheme
CPI	consumer price index
DAE	Deloitte Access Economic
DRP	debt risk premium
EBA	enterprise bargaining agreement

Shortened form	Extended form
EBSS	efficiency benefit sharing scheme
EGWWS	electricity, gas, water and waste services
EMCa	Energy Market Consulting associates
ERA	Economic Regulation Authority of Western Australia
ERP	equity risk premium
EUAA	Energy Users Association of Australia
Guideline	AER, *Expenditure forecast assessment guideline for electricity transmission*, November 2013
JGN	Jemena Gas Networks
MAR	maximum allowed revenue
MEU	Major Energy Users
MJA	Marsden Jacob Associates
MRP	market risk premium
MTFP	multilateral total factor productivity
MW	megawatts
NEL	national electricity law
NEM	national electricity market
NEO	national electricity objective
NER	national electricity rules
NERA	NERA Economic Consulting
NSP	network service provider
NTNDP	National Transmission Network Development Plan
NTSC	negotiated transmission service criteria
NSW	New South Wales

Attachment 8 | Corporate income tax

Shortened form	Extended form
opex	operating expenditure
PFP	partial factor productivity
PPI	partial performance indicators
PPI	producer price index
PTRM	post-tax revenue model
QCA	Queensland Competition Authority
RAB	regulatory asset base
RBA	Reserve Bank of Australia
repex	replacement expenditure
RFM	roll forward model
RIN	regulatory information notice
RPP	revenue and pricing principles
SFG	SFG Consulting
SLCAPM	Sharpe-Lintner capital asset pricing model
STPIS	service target performance incentive scheme
TAB	tax asset base
TFP	total factor productivity
TNSP	transmission network service provider
TSBC	Tasmanian Small Business Council
TUoS	transmission use of system
version one of the EBSS	AER, *Electricity transmission network service providers: Efficiency benefit sharing scheme*, September 2007
version two of the EBSS	AER, *Efficiency benefit sharing scheme for electricity network service providers*, November 2013

Shortened form	Extended form
WACC	weighted average cost of capital
WPI	wage price index

Attachment 8 | Corporate income tax

8 Corporate income tax

The AER is required to make a decision on the estimated cost of corporate income tax for TasNetworks' 2014–19 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 TasNetworks' 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 TasNetworks' proposed estimated cost of corporate income tax allowance of $23.3 million ($ nominal) over the 2014–19 period. Our draft decision on the estimated cost of corporate income tax is $25.3 million ($ nominal) for TasNetworks over the 2014–19 period, an increase of $2.0 million (or 8.6 per cent) from its proposal.

We made this adjustment because we amended some of TasNetworks' proposed inputs for estimating the forecast corporate income tax allowance such as the opening TAB (section 8.4.1) and the remaining tax asset lives (section 8.4.3). It also reflects our draft decision on the value of imputation credits—gamma—(attachment 4). Our determinations on other building block components including forecast capex (attachment 6) and forecast opex (attachment 7) affect revenues, 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 20.5 per cent for TasNetworks. Table 8-1 sets out our draft decision on the estimated cost of corporate income tax allowance for TasNetworks.

Table 8-1   AER's draft decision on TasNetworks' cost of corporate income tax allowance for the 2014–19 period ($ million, nominal)

	2014–15	2015–16	2016–17	2017–18	2018–19	Total
Tax payable	7.4	8.0	8.7	8.7	9.4	42.2
Less: value of imputation credits	3.0	3.2	3.5	3.5	3.7	16.9
Net corporate income tax allowance	**4.5**	**4.8**	**5.2**	**5.2**	**5.6**	**25.3**

Source: AER analysis.

8.2 TasNetworks' proposal

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

- an opening TAB as at 1 July 2014 of $1144.3 million ($ nominal)

- an expected statutory income tax rate of 30 per cent per year

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[1]   NER, clause 6A.5.4(a)(4).
[2]   Transend, *Revenue proposal*, p. 109; Transend, *Proposed PTRM*, May 2014.

- a value for gamma of 0.50

- the proposed standard and remaining tax asset lives for calculating its tax depreciation as contained in its proposed PTRM. TasNetworks proposed to increase the remaining tax asset lives of the 'Transmission lines and cables' and 'Transmission substations' to 34 years and 32 years from the roll forward model (RFM) derived lives of 16 years and 24 years, respectively. TasNetworks did not propose any changes to its standard tax asset lives approved in its 2009 transmission determination. However, it proposed three new 'Communications assets' asset classes with standard tax asset lives of 45 years (medium life), 10 years (short life) and 5 years (very short life).

Table 8-2 sets out TasNetworks' proposed corporate income tax allowance for the 2014–19 period.

Table 8-2 **TasNetworks' proposed corporate income tax allowance for the 2014–19 period ($ million, nominal)**

	2014–15	2015–16	2016–17	2017–18	2018–19	Total
Tax payable	8.3	8.9	9.5	9.6	10.4	46.7
Less: value of imputation credits	4.1	4.4	4.8	4.8	5.2	23.3
Net corporate income tax allowance	**4.1**	**4.4**	**4.8**	**4.8**	**5.2**	**23.3**

Source: Transend, *Regulatory proposal*, p. 109.

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 TasNetworks' 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 PTRM[3] 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.

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[3] The PTRM must set specify the manner in which the estimated cost of corporate income tax is to be calculated: NER, clause 6A.5.3(b)(4).
[4] NER, clause 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 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 proposed by TasNetworks is 0.5, which is consistent with the value determined in our *Rate of return* guideline. 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]

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[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 0.2 per cent. The proposed gamma of 0.5 compared to the AER's decision of 0.4, would decrease total revenues by about 0.6 per cent.

8.4   Reasons for draft decision

We do not accept TasNetworks' proposed estimated cost of corporate income tax allowance. This is because we adjusted the following proposed inputs to the PTRM for tax purposes:

- the opening TAB value at the commencement of the 2014–19 period (section 8.4.1)

- the remaining tax asset lives (section 8.4.3)

- the value for gamma (attachment 4)

- our determinations on other building block components, including forecast opex (attachment 7) and forecast capex (attachment 5), also impact the estimated corporate income tax allowance.[8]

We determine an estimated cost of corporate income tax of $25.3 million ($ nominal) for TasNetworks, which represents an increase of $2.0 million (or 8.6 per cent) from its proposal.

8.4.1   Opening tax asset base at 1 July 2014

We accept TasNetworks' proposed method to establish the opening TAB as at 1 July 2014. However, we reduced TasNetworks' proposed opening TAB value as at 1 July 2014 to $1143.8 million ($ nominal). This reduction is due to adjustments we made to the actual capex values in TasNetworks' proposed asset base roll forward model (RFM) as discussed in attachment 2. This relates to our

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[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]   NER, clause 6A.6.4.

adjustment to actual capex inputs over the 2009–14 regulatory control period for movements in capitalised provisions.[9]

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

Table 8-3   AER's draft decision on TasNetworks' TAB roll forward for the 2009–14 regulatory control period ($ million, nominal)

	2009–10	2010–11	2011–12	2012–13	2013–14
Opening TAB	777.5	783.8	958.8	1 022.9	1 064.0
Capital expenditure[a]	50.1	221.5	105.1	87.2	131.4[b]
Tax depreciation	−43.7	−46.6	−40.9	−46.2	−50.5
Closing TAB	783.8	958.8	1 022.9	1 064.0	1 144.8
Assets removed from prescribed services					−1.1
Opening TAB as at 1 July 2014					**1 143.8**

Source: AER analysis.
(a)   As commissioned, net of disposals.
(b)   Based on estimated capex.

8.4.2   Standard tax asset lives

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

▪ broadly consistent with the values prescribed by the Commissioner for taxation in tax ruling 2014/4[10]

▪ the same as those approved standard tax asset lives for the 2009–14 regulatory control period.

We also accept TasNetworks' proposed standard tax asset lives for the new 'Communication assets' asset classes with standard asset lives of 45 years (medium life), 10 years (short life) and 5 years (very short life). As discussed in attachment 5, we accepted Transend's proposed standard asset lives for these asset classes for regulatory depreciation purposes. We consider the standard tax asset life for these asset classes should reflect the same asset life for regulatory depreciation purposes. Therefore, we accept TasNetworks' proposed standard tax asset lives for these asset classes. We are satisfied that the proposed standard tax asset lives are appropriate for applying over the 2014–19 period. We are satisfied the proposed standard tax asset lives are likely to provide an appropriate estimate of the tax depreciation amount for a benchmark efficient TNSP as required by the NER.[11]

Table 8-4 sets out our draft decision on TasNetworks' standard tax asset lives for the 2014–19 period.

8.4.3   Remaining tax asset lives

We accept TasNetworks' proposed weighted average method to calculate the remaining tax asset lives as at 1 July 2014. 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

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[9]   At the time of this draft decision, the roll forward of TasNetworks' TAB includes estimated capex values for 2013–14. We will update the 2013–14 estimated capex values with the actual values for the final decision.

[10]   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, accessed on 25 September 2014.

[11]   NER, clause 6A.6.4.

reflect our adjustments to TasNetworks' actual capex in its proposed RFM, as discussed in attachment 2.[12] This is because the actual capex values are inputs for calculating the weighted average remaining tax asset lives in the RFM.

We also accept TasNetworks' proposal to increase the remaining tax asset life of the 'Transmission lines and cables' and 'Transmission substations' asset classes. As discussed in attachment 5, we approved TasNetworks' proposal to increase the remaining asset lives for these asset classes. Therefore, we consider that similar increases should also apply to the remaining tax asset life to be consistent with the remaining asset life for regulatory depreciation purposes.

We note TasNetworks has not assigned a remaining tax asset for its 'Equity raising' asset class, reflecting that such a life was not established for this class in the 2009 determination. However, for this draft decision, we consider it appropriate to assign a remaining tax asset life of 5 years for the 'Equity raising' asset class for tax depreciation purposes. This is because the Australian Taxation Office (ATO) requires equity raising costs to be amortised over a five-year period on a straight-line basis.[13] In recent determinations, we adopted a standard tax asset life of 5 years for amortising equity raising costs for tax depreciation purposes.[14] We consider applying this remaining tax asset life provides a better estimate of the tax depreciation amount for a benchmark efficient TNSP as required by the NER.[15]

Table 8-4 sets out our draft decision on the remaining tax asset lives as at 1 July 2014 for TasNetworks.

Table 8-4   AER's draft decision on TasNetworks' standard and remaining tax asset lives as at 1 July 2014 (years)

Asset class	Standard tax asset life	Remaining tax asset life as at 1 July 2014
Transmission lines and cables*	n/a	33.9
Transmission substations*	n/a	32.1
Protection and control*	n/a	3.8
Refurbishment*	n/a	5.0
Other*	n/a	0.3
Other - IT*	n/a	5.0
Other - general*	n/a	5.0
Other - buildings*	n/a	31.3
Land and easements	n/a	n/a
Transmission line assets - long life (60)	60.0	57.9

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[12]   At the time of this draft decision, the roll forward of TasNetworks' TAB includes estimated capex values for 2013–14. We will update the 2013–14 estimated capex values with the actual values for the final decision. The 2013–14 capex values are used to calculate the weighted average remaining tax asset lives in the RFM. Therefore, for the final decision we will recalculate TasNetworks' remaining tax asset lives as at 1 July 2014 using the method approved in this draft decision.

[13]   ATO, *Guide to depreciating assets 2001-02: Business related costs—section 40-880 deductions*, ATO reference; NO NAT7170, p. 25.

[14]   AER, *Draft decision: Powerlink transmission determination 2012–13 to 2016–17*, 2011, p. 265–266; AER, *Draft decision: ElectraNet transmission determination 2013–14 to 2017–18*, 2013, p. 193–194.

[15]   NER, clause 6A.6.4.

Asset class	Standard tax asset life	Remaining tax asset life as at 1 July 2014
Transmission line assets - medium life (45)	45.0	43.7
Transmission line assets - short life (10)	10.0	9.4
Substation assets - long life (60)	60.0	58.2
Substation assets - medium life (45)	45.0	43.2
Substation assets - short life (15)	15.0	12.8
Protection and control - short life (15)	15.0	13.5
Protection and control - short life (4)	4.0	2.2
Transmission operations - short life (10)	10.0	8.3
Transmission operations - short life (4)	4.0	2.8
Other - medium life (40)	40.0	37.1
Other - short life (9)	9.0	6.9
Other - short life (4)	4.0	2.8
Land and easements	n/a	n/a
Equity raising costs[a]	n/a	5.0
Communication assets - long life (45)	45.0	n/a
Communication assets - medium life (10)	10.0	n/a
Communication assets - short life (5)	5.0	n/a

Source: AER analysis.
n/a: not applicable.
* We have changed the standard tax asset lives to 'n/a' for these asset classes because they do not need to have standard tax asset lives assigned as a result of forecast capex no longer being allocated to them.
(a) For this draft decision, TasNetworks do not satisfy the requirements to incur benchmark equity raising costs associated with its forecast capex for the 2014–19 regulatory control period. Therefore, a standard tax asset life for equity raising costs is not required.