



Draft decision
TransGrid transmission determination
2015–16 to 2017–18
Attachment 8: Corporate income tax

November 2014

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Note

This attachment forms part of the AER's draft decision on TransGrid's revenue proposal 2015–18. 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

Attachment 13 – pass through events

Attachment 14 – negotiated services

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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 TransGrid's 2014–18 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 TransGrid'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 TransGrid's proposed estimated cost of corporate income tax allowance of \$230.4 million (\$ nominal) over the 2014–18 period. Our draft decision on the estimated cost of corporate income tax is \$118.4 million (\$ nominal) for TransGrid over the 2014–18 period, a reduction of \$112 (or 48.6 per cent) from its proposal. This reduction is mainly driven by our determination on TransGrid'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 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 27.7 per cent for TransGrid. Table 8-1 sets out our draft decision on the estimated cost of corporate income tax allowance for TransGrid.

Table 8-1 AER's draft decision on TransGrid's cost of corporate income tax allowance for the 2014–18 period (\$ million, nominal)

	2014–15	2015–16	2016–17	2017–18	Total
Tax payable	35.2	38.2	61.5	62.4	197.3
Less: value of imputation credits	14.1	15.3	24.6	24.9	78.9
Net corporate income tax allowance	21.1	22.9	36.9	37.4	118.4

Source: AER analysis.

8.2 TransGrid's proposal

TransGrid 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 \$3792.8 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 TransGrid, *Revenue proposal*, pp.204–205; TransGrid, *Proposed PTRM*, May 2014.

- the proposed standard and remaining tax asset lives for calculating its tax depreciation as contained in its proposed PTRM. TransGrid proposed to reduce the standard tax asset lives for its 'Underground cables' (to 45 years from 50 years), 'Secondary systems' (to 15 years from 35 years) and 'Communications' (to 10 years from 35 years) asset classes. It also proposed a new 'Transmission line life extension' asset class with a standard tax asset life of 25 years.

Table 8-2 sets out TransGrid's proposed corporate income tax allowance for the 2014–18 period.

Table 8-2 TransGrid's proposed corporate income tax allowance for the 2014–18 period (\$ million, nominal)

	2014–15	2015–16	2016–17	2017–18	Total
Tax payable	59.5	64.2	90.7	92.8	307.2
Less: value of imputation credits	14.9	16.0	22.7	23.2	76.8
Net corporate income tax allowance	44.6	48.1	68.0	69.6	230.4

Source: TransGrid, *Regulatory proposal*, p. 205.

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 TransGrid'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. We will assess the outcomes of other approaches against the outcomes of this standard method in the RFM.
- 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 TransGrid 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 0.6 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 1.5 per cent.

8.4 Reasons for draft decision

We do not accept TransGrid's proposed estimated cost of corporate income tax allowance. We have accepted the following proposed inputs to the PTRM for tax purposes:

- the opening TAB value at the commencement of the 2014–18 period (section 8.4.1)
- the remaining tax asset lives (section 8.4.3).

However, we have adjusted other proposed inputs to the PTRM which affect the calculation of the taxable income, and therefore the estimated corporate income tax allowance:⁸

- the value for gamma (attachment 4)
- our determinations on other building block components, including forecast opex (attachment 7) and forecast capex (attachment 6).

We determine an estimated cost of corporate income tax of \$118.4 million (\$ nominal) for TransGrid, which represents a reduction of \$112 million (or 48.6 per cent) from its proposal.

8.4.1 Opening tax asset base at 1 July 2014

We accept TransGrid's proposed opening TAB values as at 1 July 2014 of \$3792.8 million (\$ nominal). TransGrid has applied the approach set out in our RFM to establish its proposed opening

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, cl. 6A.6.4.

TAB. Also, as discussed in attachment 2, we accept the actual capex values in TransGrid's proposed RFM.⁹

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

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

	2009–10	2010–11	2011–12	2012–13	2013–14
Opening TAB	2718.0	2800.8	3001.4	3189.2	3382.8
Capital expenditure ^a	221.0	345.1	345.5	362.6	595.9 ^b
Tax depreciation	–138.3	–144.4	–157.7	–169.0	–185.9
Closing TAB	2800.8	3001.4	3189.2	3382.8	3792.8

Source: AER analysis.

(a) As commissioned, net of disposals.

(b) Based on estimated capex.

8.4.2 Standard tax asset lives

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

- broadly consistent with the values prescribed by the Commissioner for taxation in tax ruling 2014/4¹⁰
- the same as those approved standard tax asset lives for the 2009–14 regulatory control period.

We also accept TransGrid's proposed changes to the standard tax asset lives for the 'Underground cables 2014–18' (to 45 years from 50 years), 'Secondary systems 2014–18' (to 15 years from 35 years) asset classes and 'Communications 2014–18' (to 10 years from 35 years). In addition, we accept TransGrid's proposed standard tax asset life of 25 years for the new 'Transmission line life extension' asset class. As discussed in attachment 5, we accepted TransGrid's proposed standard asset lives for these four 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 TransGrid's 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 2014–18 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 TransGrid's standard tax asset lives for the 2014–18 period.

8.4.3 Remaining tax asset lives

We accept TransGrid's 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

⁹ At the time of this draft decision, the roll forward of TransGrid's 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.atolaw.gov.au/atolaw/view.htm?docid=%22TXR%2FTR20144%2FNAT%2FATO%2F00001%22>, accessed on 25 September 2014.

¹¹ NER, cl. 6A.6.4.

weighted average method, we note we will have to update the proposed remaining tax asset lives for the final decision.¹² This is because of required updates to the actual capex values in the RFM, which are inputs for calculating the weighted average remaining tax asset lives.

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

Table 8-4 AER's draft decision on TransGrid's 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 (pre 2004-05)	n/a	2.1
Underground cables (pre 2004-05)	n/a	34.6
Substations including buildings (pre 2004-05)	n/a	12.2
SCADA and communications (pre 2004-05)	n/a	0.4
Non-network assets (pre 2004-05)	n/a	n/a
SMHEA assets (pre 2004-05)	n/a	n/a
Transmission lines (2004-09)	n/a	44.1
Underground cables (2004-09)	n/a	36.4
Substations including buildings (2004-09)	n/a	33.8
SCADA and communications (2004-09)	n/a	8.8
Non-network assets (2004-09)	n/a	3.5
Transmission lines & cables (2009-14)	n/a	48.7
Substations (2009-14)	n/a	38.2
Secondary systems (2009-14)	n/a	33.5
Communications (2009-14)	n/a	33.5
Business IT (2009-14)	n/a	3.2
Minor plant, motor vehicles & mobile plant (2009-14)	n/a	6.5
Equity raising costs (2009-14)	n/a	36.6
Transmission lines (2014-18)*	50.0	n/a
Underground cables (2014-18)*	45.0	n/a
Substations (2014-18)*	40.0	n/a
Secondary systems (2014-18)*	15.0	n/a

¹² At the time of this draft decision, the roll forward of TransGrid's 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 TransGrid's remaining tax asset lives as at 1 July 2014 using the method approved in this draft decision.

Asset class	Standard tax asset life	Remaining tax asset life as at 1 July 2014
Communications (short life) (2014-18) ^a	10.0	n/a
Business IT (2014-18)*	4.0	n/a
Minor plant, motor vehicles & mobile plant (2014-18)*	8.0	n/a
Transmission line life extension (2014-18)*	25.0	n/a
Equity raising costs (2014-18) ^b	n/a	n/a
Land and easements	n/a	n/a

Source: AER analysis.

n/a: not applicable. The asset classes ending with '(pre 2004-05)'; '(2004-09)'; and '(2009-14)' do not have assigned standard tax asset lives because forecast capex is no longer allocated to them.

* We changed the regulatory control period label from '2014-19' to '2014-18' in the PTRM.

(a) As discussed in attachment 5, we have changed the name of this asset class to 'Communications (short life) 2014-18' to better reflect the nature of the assets allocated to this asset class.

(b) For this draft decision, TransGrid does not satisfy the requirements to incur benchmark equity raising costs associated with its forecast capex for the 2014-18 regulatory control period. Therefore, a standard tax asset life for equity raising costs (2014-18) is not required.