



DRAFT DECISION
TransGrid transmission
determination
2018 to 2023

Attachment 8 – Corporate
income tax

September 2017

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Note

This attachment forms part of the AER's draft decision on TransGrid's transmission determination for 2018–23. It should be read with all 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	annual service revenue requirement
augex	augmentation expenditure
capex	capital expenditure
CCP	Consumer Challenge Panel
CESS	capital expenditure sharing scheme
CPI	consumer price index
DMIA	demand management innovation allowance
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
NSCAS	network support and control ancillary services
NSP	network service provider
NTSC	negotiated transmission service criteria
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

Shortened form	Extended form
RIN	regulatory information notice
RPP	revenue and 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

Our revenue determination includes the estimated cost of corporate income tax for TransGrid's 2018–23 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 amount allows TransGrid to recover the costs associated with the estimated corporate income tax payable during the 2018–23 regulatory control period.

This attachment sets out our draft decision on TransGrid's proposed corporate income tax allowance for the 2018–23 regulatory control period. 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 cost of corporate income tax allowance of \$247.9 million (\$nominal). Our draft decision on the estimated cost of corporate income tax is \$168.5 million (\$nominal) over the 2018–23 regulatory control period. This represents a reduction of \$79.4 million (or 32.0 per cent) from TransGrid's proposal.

The reduction reflects our amendments to TransGrid's proposed inputs for forecasting the cost of corporate income tax including the standard tax asset lives (section 8.4.2) and the value of imputation credits—gamma (attachment 4). Our adjustments to the return on capital (attachments 2, 3 and 6)² and the return of capital (attachment 5) building blocks affect revenues, which in turn impact the tax calculation. The changes affecting revenues are discussed in attachment 1.

Table 8.1 sets out our draft decision on the estimated cost of corporate income tax allowance for TransGrid over the 2018–23 regulatory control period.

¹ NER, cl. 6A.5.4(a)(4).

² The forecast capex amount is a key input for calculating the return of and return on capital building blocks. Attachment 6 sets out our draft decision on TransGrid's forecast capex.

Table 8.1 AER's draft decision on TransGrid's cost of corporate income tax allowance for the 2018–23 regulatory control period (\$million, nominal)

	2018–19	2019–20	2020–21	2021–22	2022–23	Total
Tax payable	50.3	53.5	56.0	59.2	61.9	280.8
Less: value of imputation credits	20.1	21.4	22.4	23.7	24.8	112.3
Net corporate income tax allowance	30.2	32.1	33.6	35.5	37.2	168.5

Source: AER analysis.

8.2 TransGrid's proposal

TransGrid proposed a forecast cost of corporate income tax of \$247.9 million (\$nominal) using the AER's PTRM, which adopts a straight-line tax depreciation approach and the following inputs:³

- an opening TAB as at 1 July 2018 of \$4025.0 million (\$nominal)
- an expected statutory income tax rate of 30 per cent per year
- a value for gamma of 0.25
- remaining tax asset lives for each asset class in existence as at 1 July 2018 calculated using a weighted average approach as set out in the AER's RFM
- asset classes and standard tax asset lives as approved at the 2014–18 transmission determination.⁴

Table 8.2 sets out TransGrid's proposed corporate income tax allowance for the 2018–23 regulatory control period.

³ TransGrid - *Post Tax Revenue Model* - 0117 - PUBLIC.

⁴ TransGrid creates separate asset classes for each regulatory control period. The asset classes and the standard tax asset lives for the 2018–23 regulatory control period are consistent with those approved in the 2014–18 transmission determination. In addition, TransGrid has proposed a standard tax asset life of 36 years for a new asset class for assets relating to the provision of network support and control ancillary services (NSCAS).

Table 8.2 TransGrid's proposed corporate income tax allowance for the 2018–23 regulatory control period (\$million, nominal)

	2018–19	2019–20	2020–21	2021–22	2022–23	Total
Tax payable	59.4	62.9	65.8	69.6	73.0	330.6
Less: value of imputation credits	14.8	15.7	16.4	17.4	18.3	82.6
Net corporate income tax allowance	44.5	47.1	49.3	52.2	54.8	247.9

Source: TransGrid, *Revenue proposal*, 31 January 2017, p. 199.

8.3 Assessment approach

We make an estimate of taxable income for each regulatory year as part of our revenue determination.⁵ Our estimate is for the taxable income a benchmark efficient entity would earn for providing prescribed transmission services if it operated TransGrid's business. Our approach for calculating a TNSP's cost of corporate income tax is set out in our PTRM and involves the following steps:⁶

1. We estimate the annual taxable income that would be earned by a benchmark efficient entity operating the TNSP's business.⁷ A TNSP's taxable income is calculated by reducing 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 the TAB (which may have a different value from the RAB), 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.
2. The statutory income tax rate is then applied to the estimated annual taxable income (after adjustment for any tax loss carried forward) to arrive at a notional amount of tax payable.
3. We apply a discount to that notional amount of tax payable to account for the assumed utilisation of imputation credits (gamma) by investors.
4. The tax payable net of assumed utilised imputation credits represents the corporate income tax allowance and is included as a separate building block in determining the TNSP's annual building block revenue requirement.

⁵ NER, cl. 6A.6.4.

⁶ 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).

⁷ NER, cl. 6A.6.4.

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

- **The opening TAB as at the commencement of the 2018–23 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 2014–18 regulatory control period and TransGrid's actual capex incurred during that period and the final year (2013–14) of the previous regulatory control period.⁸
- **The standard tax asset life for each asset class:** We assess TransGrid's proposed standard tax asset lives, where necessary, against those prescribed by the Commissioner for taxation in tax ruling 2017/2⁹ and the approved standard tax asset lives in TransGrid's transmission determination for the 2014–18 regulatory control period.
- **The remaining tax asset life for each asset class at the commencement of the 2018–23 regulatory control period:** Our roll forward model (RFM) determines the remaining tax asset lives using the weighted average method.¹⁰ 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:** We determine the value of gamma value to be 0.40. Refer to attachment 4 for detailed discussion on this matter.

We received one submission from the CCP on TransGrid's proposed corporate income tax. The CCP submitted that the AER's current approach may overestimate the tax expense of the benchmark efficient entity. It provided evidence from the Commonwealth Treasury, Credit Suisse and National Audit Office in the UK to support its concerns that the reported actual tax paid and effective tax rate for infrastructure owners may be much less than the forecast of 30 per cent per year, due to their specific organisational structure. The CCP also submitted that the AER should review its approach to the estimation of tax expense of the benchmark efficient entity as part of its next review of the *Rate of return guideline*.¹¹

⁸ The tax depreciation is therefore recalculated based on actual capex. The same tax depreciation approach of using actual capex applies to the roll forward of the TAB at the next reset.

⁹ ATO, *Taxation Ruling Income tax: effective life of depreciating assets (applicable from 1 July 2017)*, June 2017, <http://law.ato.gov.au/atolaw/view.htm?docid=%22TXR%2FTR20172%2FNAT%2FATO%2F00001%22>, accessed on 17 July 2017.

¹⁰ 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.

¹¹ Consumer Challenge Panel Sub-Panel 9, *Submission to the AER; Response to proposals from TransGrid for a revenue reset for 2018-19 to 2022-23*, 12 May 2017, pp. 80–83.

As noted above, we are required to estimate the cost of corporate income tax based on a benchmark efficient entity operating the TNSP's business.¹² This estimate must be determined in accordance with the manner set out in the PTRM.¹³ The PTRM models benchmark cash flows and applies the statutory income tax rate of 30 per cent per year for estimating the forecast tax payment, in accordance with the requirements of the NER.¹⁴ We have consistently applied this approach to all regulated gas and electricity network businesses to date. The CCP acknowledged that the current approach is embedded within the PTRM and should not be changed for this TransGrid transmission determination. We agree with the CCP that the current approach should remain unchanged for this reset. Any amendment to the current approach may require a broader review of the current framework.

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 is offset 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.¹⁵

Depending on the source of the revenue increase, the tax increase may be equal to or less than proportional to the company tax rate.¹⁶

The tax expenses (or deductions) depend on various building block components and their size. Some components give rise to tax expenses, such as opex, interest

¹² NER, cl. 6A.6.4.

¹³ NER, cll. 6A.6.4 and 6A.5.3(b)(4).

¹⁴ NER, cl. 6A.6.4.

¹⁵ 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.

¹⁶ 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.

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 cost of corporate income 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 – These expenses will match the opex allowance including any revenue increments or decrements generated from the EBSS and CESS.
- 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 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 0.6 per cent.

The CCP noted that if we accepted TransGrid's proposal, its benchmark allowance for corporate tax for the 2018–23 regulatory control period would increase by an average of \$20.3 million (\$nominal) per annum compared to the 2014–18 regulatory control period. It further noted that of this increase, almost \$10 million is due to TransGrid's use of a lower value of imputation credits, but the remainder is due to an expected increase in the benchmark tax calculation.¹⁷

As noted above, the estimated corporate income tax amount is impacted by our decision on various building block components as well as the value of gamma. In our draft decision, we determine the value of gamma to be 0.40, instead of 0.25 proposed by TransGrid (attachment 4). We have also made amendments to other building blocks such as return on capital and return of capital which affect the benchmark corporate tax allowance. Accordingly, the estimated corporate income tax for TransGrid for the 2018–23 regulatory control period has increased by 5.7 million (\$nominal) per annum compared to the 2014–18 period.

The majority of the increase in TransGrid's estimated corporate income tax is due to lower tax depreciation in the 2018–23 regulatory control period compared to the 2014–18 period. The 'Transmission lines (pre 2004-05)' asset class was fully depreciated for tax purposes in 2016–17. This asset class has historically contributed to more than 30 per cent of the total tax depreciation in the current and previous regulatory control periods. Hence, its removal has significantly reduced the tax depreciation going forward. This has resulted in lower tax depreciation to offset revenues which gives rise

¹⁷ Consumer Challenge Panel Sub-Panel 9, *Submission to the AER; Response to proposals from TransGrid for a revenue reset for 2018-19 to 2022-23*, 12 May 2017, p. 36.

to higher taxable income, all things being equal, and therefore also to a higher corporate income tax allowance for TransGrid in the 2018–23 regulatory control period.

8.4 Reasons for draft decision

We do not accept TransGrid's proposed cost of corporate income tax of \$247.9 million (\$nominal). We have instead determined a cost of corporate income tax of \$168.5 million. This represents a reduction of \$79.4 million (or 32.0 per cent) from TransGrid's proposal.

This is because we adjusted the following proposed inputs to the PTRM for tax purposes:

- the standard tax asset lives for some asset classes (section 8.4.2).
- the value for gamma (attachment 4).

We have accepted the following proposed inputs to the PTRM for tax purposes:

- the opening TAB value at 1 July 2017 (section 8.4.1)
- the remaining tax asset lives (section 8.4.3).

Our adjustments to the return on capital (attachments 2, 3 and 6)¹⁸ and the return of capital (attachment 5) building blocks affect revenues, and therefore also impact the forecast corporate income tax allowance.

8.4.1 Opening tax asset base at 1 July 2018

We accept TransGrid's proposed method to establish the opening TAB at 1 July 2018 as it is based on the approach set out in our RFM. Based on the proposed approach and our review of the relevant inputs, we accept TransGrid's opening TAB value as at 1 July 2018 of \$4025.0 million. We note that this opening TAB as at 1 July 2018 will be updated for the final decision.¹⁹

Table 8.3 sets out our draft decision on the roll forward of TransGrid's TAB values.

¹⁸ The forecast capex amount is a key input for calculating the return of and return on capital building blocks. Attachment 6 sets out our draft decision on TransGrid's forecast capex.

¹⁹ At the time of this draft decision, the roll forward of TransGrid's TAB includes estimated capex values for 2016–17 and 2017–18. We will update the 2016–17 estimated capex values with the actual values for the final decision, and may further update the estimate of 2017–18 capex.

Table 8.3 AER's draft decision on TransGrid's TAB roll forward for the 2014–18 regulatory control period (\$million, nominal)

	2014–15	2015–16	2016–17 ^b	2017–18 ^b
Opening TAB	3702.9	3797.2	3847.1	3845.4
Capital expenditure ^a	285.6	252.1	152.4	318.5
Less: tax depreciation	191.3	202.2	154.1	138.9
Closing TAB	3797.2	3847.1	3845.4	4025.0

Source: AER analysis.

(a) As commissioned, net of disposals.

(b) Based on estimated capex.

8.4.2 Standard tax asset lives

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

- broadly consistent with the values prescribed by the Commissioner for taxation in tax ruling 2017/2²⁰
- the same as those approved standard tax asset lives for the 2014–18 regulatory control period.

However, we did not accept the standard tax asset life of 36 years for the proposed new asset class for 'NSCAS assets'. We are not required to make a decision on TransGrid's proposed standard tax asset lives for NSCAS assets as we have not approved the proposed roll-in amount of NSCAS assets to the TAB. The reasons for our decision on the proposed roll-in of the NSCAS assets are discussed in attachment 6.

Further, we do not accept TransGrid's proposed standard tax asset life of 25 years for its 'Transmission line life extension (2018–23)' asset class. We have changed the standard tax asset life for this asset class to 35 years to be consistent with our draft decision on the standard asset life for this asset class for regulatory depreciation purposes (attachment 5). We consider a standard tax asset life of 35 years provides a better estimate of the tax depreciation amount for a benchmark efficient TNSP.²¹

Table 8.4 sets out our draft decision on TransGrid's standard tax asset lives for the 2018–23 regulatory control period. We are satisfied that the standard tax asset lives are appropriate for application over the 2018–23 regulatory control period. We are also

²⁰ ATO, *Taxation Ruling Income tax: effective life of depreciating assets (applicable from 1 July 2017)*, June 2017, <http://law.ato.gov.au/atolaw/view.htm?docid=%22TXR%2FTR20172%2FNAT%2FATO%2F0001%22>, accessed on 17 July 2017.

²¹ NER, cl. 6A.6.4(a)(2).

satisfied the standard tax asset lives provide an appropriate estimate of the tax depreciation for a benchmark efficient TNSP as required by the NER.²²

8.4.3 Remaining tax asset lives as at 1 July 2018

We accept TransGrid's proposed weighted average method to calculate the remaining tax asset lives as at 1 July 2018 for existing asset classes. As discussed in attachment 5, TransGrid creates separate asset classes for each regulatory control period to ensure accurate treatment of depreciation associated with capex and asset disposals forecast for that period.²³ This means that TransGrid's proposal adopts the weighted average method to calculate remaining tax asset lives as at 1 July 2018 for existing asset classes. A new set of asset classes is then applied for depreciating new capex over the 2018–23 regulatory control period. We consider this approach to be reasonable as it achieves a similar outcome as the 'year-by-year tracking' approach for tax depreciation that we approved in recent decisions for other network service providers.²⁴ Further, we note that this approach is a continuation of that approved in TransGrid's previous determinations.

We note we will update the proposed remaining tax asset lives for the final decision for any changes to any estimated capex values in the RFM because they are used as inputs for calculating the remaining tax asset lives.²⁵ Table 8.4 sets out our draft decision on the remaining tax asset lives as at 1 July 2018 for TransGrid.

Table 8.4 AER's draft decision on TransGrid's standard and remaining tax asset lives as at 1 July 2018 (years)

Asset class	Standard tax asset life	Remaining tax asset life as at 1 July 2018
Transmission lines (pre 2004–05)	n/a	0.0
Underground cables (pre 2004–05)	n/a	30.6
Substations including buildings (pre 2004–05)	n/a	8.2
Transmission lines (2004–09)	n/a	40.1

²² NER, cl. 6A.6.4.

²³ TransGrid, *Revenue proposal*, 31 January 2017, p. 195. The asset classes and the standard tax asset lives for the 2018–23 regulatory control period are consistent with those approved in the 2014–18 transmission determination.

²⁴ AER, *Draft decision: TasNetworks distribution determination - Attachment 8 - Corporate income tax*, September 2015, pp.16-17; AER, *Final decision: SA Power Networks distribution determination - Attachment 8 - Corporate income tax*, October 2015, p. 8; AER, *Final decision: Ergon Energy distribution determination - Attachment 8 - Corporate income tax*, October 2015, p. 9.

²⁵ At the time of this draft decision, the roll forward of TransGrid's TAB includes estimated capex values for 2016–17 and 2017–18. We will update the 2016–17 estimated capex values with the actual values for the final decision, and may further update the estimate of 2017–18 capex. The 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 2018 using the method approved in this draft decision.

Asset class	Standard tax asset life	Remaining tax asset life as at 1 July 2018
Underground cables (2004–09)	n/a	32.4
Substations including buildings (2004–09)	n/a	29.8
SCADA and communications (2004–09)	n/a	4.8
Transmission lines & cables (2009–14)	n/a	44.7
Substations (2009–14)	n/a	34.2
Secondary systems (2009–14)	n/a	29.5
Communications (2009–14)	n/a	29.4
Minor plant, motor vehicles & mobile plant (2009–14)	n/a	2.2
Transmission lines (2014–18)	n/a	49.5
Underground cables (2014–18)	n/a	43.6
Substations (2014–18)	n/a	38.2
Secondary systems (2014–18)	n/a	13.6
Communications (short life) (2014–18)	n/a	9.0
Business IT (2014–18)	n/a	3.1
Minor plant, motor vehicles & mobile plant (2014–18)	n/a	6.9
Transmission line life extension (2014–18)	n/a	24.1
Residual - other	n/a	1.0
Transmission lines (2018–23)	50.0	n/a
Underground cables (2018–23)	45.0	n/a
Substations (2018–23)	40.0	n/a
Secondary systems (2018–23)	15.0	n/a
Communications (short life) (2018–23)	10.0	n/a
Business IT (2018–23)	4.0	n/a
Minor plant, motor vehicles & mobile plant (2018–23)	8.0	n/a
Transmission line life extension (2018–23)	35.0	n/a
Land and easements	n/a	n/a
NSCAS assets	n/a	n/a
Equity raising costs ^a	n/a	32.6

Source: AER analysis.

- n/a: not applicable. We have not assigned a standard tax asset life to some asset classes because the assets allocated to those asset classes are not subject to tax depreciation. The asset classes ending with '(pre 2004–05)'; '(2004–09)'; '(2009–14)' and '(2014–18)' also do not have assigned standard tax asset lives because forecast capex is no longer allocated to them.
- (a) For this draft decision, TransGrid does not satisfy the requirements to incur benchmark equity raising costs associated with its forecast capex for the 2018–23 regulatory control period. Therefore, a standard tax asset life for equity raising costs is not required.