DRAFT DECISION
Endeavour Energy
Distribution determination

2019–24

Attachment 7 – Corporate income tax

November 2018

AUSTRALIAN ENERGY REGULATOR

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Note

This attachment forms part of the AER's draft decision on the distribution determination that will apply to Endeavour Energy for the 2019–24 regulatory control period. It should be read with all other parts of the draft decision.

The draft decision includes the following attachments:

Overview

Attachment 1 – Annual revenue requirement

Attachment 2 – Regulatory asset base

Attachment 3 – Rate of return

Attachment 4 – Regulatory depreciation

Attachment 5 – Capital expenditure

Attachment 6 – Operating expenditure

Attachment 7 – Corporate income tax

Attachment 8 – Efficiency benefit sharing scheme

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Attachment 10 – Service target performance incentive scheme

Attachment 11 – Demand management incentive scheme

Attachment 12 – Classification of services

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Attachment 14 – Pass through events

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Attachment 17 – Connection policy

Attachment 18 - Tariff structure statement

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Shortened forms

Shortened form	Extended form
AER	Australian Energy Regulator
ATO	Australian Taxation Office
capex	capital expenditure
CESS	capital expenditure sharing scheme
distributor	distribution network service provider
NER	National Electricity Rules
opex	operating expenditure
PTRM	post-tax revenue model
RAB	regulatory asset base
RFM	roll forward model
RIN	regulatory information notice
TAB	tax asset base

7 Corporate income tax

Our determination of the annual revenue requirement includes the estimated cost of corporate income tax for Endeavour Energy's (Endeavour) 2019–24 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 Endeavour to recover the costs associated with the estimated corporate income tax payable during the 2019–24 regulatory control period.

This attachment presents our assessment of Endeavour's proposed corporate income tax allowance for the 2019–24 regulatory control period. It also presents our assessment of its 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.

7.1 Draft decision

We determine an estimated cost of corporate income tax of $197.8 million ($ nominal) for Endeavour in the 2019–24 regulatory control period. This represents a reduction of $32.8 million (or 14.2 per cent) from Endeavour's proposal of $230.6 million ($ nominal).

The reduction to the tax allowance made in this decision reflects our amendment to Endeavour's proposed inputs for forecasting the cost of corporate income tax, specifically:

- the value of imputation credits—gamma (section 2.2 of the overview), which is the main driver of the reduced allowance.
- our adjustments to the return on capital (attachments 2, 3 and 5) and the regulatory depreciation (attachment 4) building blocks affect revenues, which in turn impacts the tax calculation. The changes affecting revenues are discussed in attachment 1.

Table 7.1 sets out our draft decision on the estimated cost of corporate income tax allowance for Endeavour over the 2019–24 regulatory control period.

[1] NER, cl. 6.4.3(a)(4).

Table 7.1 AER's draft decision on Endeavour's cost of corporate income tax allowance for the 2019–24 regulatory control period ($ million, nominal)

	2019–20	2020–21	2021–22	2022–23	2023–24	Total
Tax payable	72.0	70.0	81.1	87.2	85.4	395.7
Less: value of imputation credits	36.0	35.0	40.5	43.6	42.7	197.8
Net corporate income tax allowance	**36.0**	**35.0**	**40.5**	**43.6**	**42.7**	**197.8**

Source: AER analysis.

Application of the tax review in the final decision

For this draft decision, we have used our current regulatory models (PTRM and RFM) to calculate the various components required to estimate Endeavour's cost of corporate income tax for the 2019–24 regulatory control period. Our assessment approach for this draft decision is discussed in section 7.3 below. We are currently undertaking a review of our regulatory tax approach (the tax review). As discussed in the initial report to the tax review published on 28 June 2018, we intend to apply any changes to our regulatory models arising from the tax review to the final decision for Endeavour's 2019–24 regulatory control period in April 2019.[2]

As indicated in the initial report, in is intended that any required changes to our regulatory models will be proposed in December 2018 as part of the final position of the tax review. After consultation on the proposed amended models, final model amendments will be released by April 2019. Endeavour is due to submit its revised regulatory proposal in January 2019. This means that any proposed changes to our regulatory models will be published shortly before the submission of the revised regulatory proposal.

We will provide further consultation on possible changes in our upcoming discussion paper for the tax review. We will also consult with Endeavour directly on specific implementation issues and possible interactions with other aspects of the revenue determination as soon as the likely direction of the tax review and any model changes are evident. We consider that early and extensive consultation on any proposed changes to the regulatory models will ensure that Endeavour and other stakeholders have sufficient opportunity to comment on the changes to the regulatory models before the final decision is made.

[2] AER, *Initial Report–Review of regulatory tax approach*, June 2018, pp. 4–5.

7.2 Endeavour Energy's proposal

Endeavour proposed a forecast cost of corporate income tax of $230.6 million ($ nominal) for the 2019–24 regulatory control period using the AER's PTRM, which adopted a straight-line tax depreciation approach and the following inputs:[3]

- an opening TAB value as at 1 July 2019 of $5855.6 million ($ nominal)
- an expected statutory income tax rate of 30 per cent per year
- a value for gamma of 0.40
- remaining tax asset lives of assets in existence as at 30 June 2019 calculated using a weighted average approach as set out in the AER's RFM
- the same standard tax asset lives for tax depreciation purposes of new assets for the 2019–24 regulatory control period as approved for the 2014–19 distribution determination, with the exception of two asset classes.[4] Endeavour has proposed some minor changes to the standard tax asset lives for its 'Furniture, fitting, plant and equipment' and 'Information and communication technology' asset classes.[5]

Table 7.2 sets out Endeavour's proposed corporate income tax allowance for the 2019–24 regulatory control period.

Table 7.2 Endeavour's proposed cost of corporate income tax allowance for the 2019–24 regulatory control period ($ million, nominal)

	2019–20	2020–21	2021–22	2022–23	2023–24	Total
Tax payable	67.7	67.1	79.2	86.1	84.3	384.4
Less: value of imputation credits	27.1	26.9	31.7	34.4	33.7	153.7
Net corporate income tax allowance	**40.6**	**40.3**	**47.5**	**51.6**	**50.6**	**230.6**

Source: Endeavour, *Proposed PTRM*, April 2018.

7.3 AER's assessment approach

We make an estimate of taxable income for each regulatory year as part of our determination of the annual revenue requirement for Endeavour's 2019–24 regulatory control period.[6] Our estimate is the taxable income a benchmark efficient entity would

3 Endeavour, *Proposed PTRM*, April 2018.

4 Endeavour creates separate asset classes for each regulatory control period. The asset classes and the standard tax asset lives for the 2019–24 regulatory control period are consistent with those approved in the 2014–19 distribution determination.

5 Endeavour proposed to reduce the standard tax asset life for the 'Furniture, fitting, plant and equipment' asset classes to 7.2 years from 8.6 years and to increase the standard tax asset life for the 'Information and communication technology' asset class to 4.9 years from 2.9 years.

6 NER, cl. 6.5.3.

earn for providing standard control services if it operated Endeavour's business. Our approach for calculating a distributor's cost of corporate income tax allowance is set out in our PTRM and involves the following steps:[7]

1. We estimate the annual taxable income that would be earned by a benchmark efficient entity operating the distributor's business. A distributor's taxable income is calculated by subtracting from the approved forecast revenues the benchmark estimates of tax expenses. Using the PTRM, we model the distributor'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 used for the rate of return calculation. Tax depreciation is calculated using a separate value for the TAB, and standard and remaining tax asset lives for taxation purposes. The PTRM (and RFM) uses the straight-line method for tax depreciation. All tax expenses (including other expenses such as opex) are offset against the distributor'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 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 distributor's annual revenue requirement.

The cost of corporate income tax allowance is an output of our PTRM. We therefore assess the distributor's proposed cost of corporate 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 2019–24 regulatory control period:** We consider that the roll forward of the opening TAB should be based on the approved opening TAB as at 1 July 2014 and Endeavour's actual capex incurred during the 2014–19 regulatory control period, and the final year (2013–14) of the previous regulatory control period.[8]
- **The remaining tax asset life for each asset class at the commencement of the 2019–24 regulatory control period:** Our standard method for determining the remaining tax asset lives is the weighted average method. The weighted average method rolls forward the remaining tax asset life as at 1 July 2014 for an asset class in order to take into account the actual capex for the 2014–19 regulatory control period. This approach reflects the mix of assets within that tax asset class,

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7 The PTRM must specify the manner in which the estimated cost of corporate income tax is to be calculated: NER, cl. 6.4.2(b)(4).

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.

when they were acquired over that period and the remaining tax asset lives of existing assets at the end of that period. The residual asset values of all assets are used as weights at the end of the period.

- **The standard tax asset life for each asset class:** We assess Endeavour's proposed standard tax asset lives against those prescribed by the Commissioner for Taxation in tax ruling 2018/4 and the approved standard tax asset lives in the distributor's distribution determination for the 2014–19 regulatory control period.[9]
- **The income tax rate:** The statutory income tax rate is 30 per cent per year.
- **The value of gamma:** The gamma input for Endeavour is 0.50. Refer to section 2.2 of the overview for further discussion on this matter.
- **The size and treatment of any tax losses as at 1 July 2019:** Where a business has tax losses, we require the provision of this value to determine the appropriate estimated taxable income for a regulatory control period. If there is an amount of tax losses accumulated, the forecast taxable income for the regulatory period will be reduced by this amount.

7.3.1 Interrelationships

The cost of corporate income tax building block feeds directly into the annual revenue requirement. This 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.

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.[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]

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9 ATO, *TR 2018/4—Income tax: effective life of depreciating assets (applicable from 1 July 2018)*, July 2018.

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 PTRM is therefore 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 (or deductions) 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 cost of corporate income tax allowance (all things being equal). Tax expenses include:

- Interest on debt – Interest is a tax offset. The size of this offset 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 businesses 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.

For Endeavour, a 10 per cent increase in the corporate income tax allowance causes revenues to increase by about 0.5 per cent. An increase in the gamma from 0.40 to 0.50 would decrease the corporate income tax allowance by 19.6 per cent and total revenues by about 1.0 per cent.[12]

7.4 Reasons for draft decision

We determine an estimated cost of corporate income tax allowance of $197.8 million ($ nominal) for Endeavour in the 2019–24 regulatory control period. This represents a reduction of $32.8 million (or 14.2 per cent) from Endeavour's proposal. This is largely because we amended the value of imputation credits—gamma (section 2.2 of the overview).

Our adjustments to the return on capital (attachments 2, 3 and 5)[13] and the return of capital (attachment 4) building blocks affect revenues, and therefore also impact the forecast corporate income tax allowance.

We accept Endeavour's proposed opening tax asset base and tax asset lives for new and existing assets.

7.4.1 Opening tax asset base as at 1 July 2019

We accept Endeavour's proposed method to establish the opening TAB as at 1 July 2019 as it is based on the approach set out in our RFM. Based on the proposed approach, we accept Endeavour's proposed opening TAB value as at 1 July 2019 of

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12 We have analysed the sensitivity of the corporate income tax allowance relative to total revenue, and compared the effects of the two gamma values based on input data from Endeavour's proposed PTRM.

13 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 Endeavour's forecast capex.

$5855.6 million ($ nominal) for this draft decision. We have reviewed the inputs to the TAB roll forward and found that they were correct and reconcile with relevant data sources such as annual reporting RIN and the 2014–19 decision models. We note that this opening TAB as at 1 July 2019 may be updated to reflect actual capex for 2017–18 and any updated 2018–19 capex estimates as part of the final decision.[14]

Table 7.3 set out our draft decision on the roll forward of Endeavour's TAB values over the 2014–19 regulatory control period.

Table 7.3 AER's daft decision on Endeavour's TAB roll forward for the 2014–19 regulatory control period ($ million, nominal)

	2014–15	2015–16	2016–17	2017–18[a]	2018–19[a]
Opening TAB	4572.9	4895.0	5058.4	5243.7	5541.1
Capital expenditure	477.1	334.2	354.3	476.5	514.3
Less: tax depreciation	155.0	170.8	169.0	179.1	199.8
Closing TAB	4895.0	5058.4	5243.7	5541.1	5855.6

Source: AER analysis.

(a) Based on estimated capex.

7.4.2 Standard tax asset lives

Endeavour proposed that most of the standard tax asset lives approved for use in the most recent distribution determination remain appropriate under the ATO rules. We agree with this assessment and consider that they are broadly consistent with the values prescribed by the Commissioner for taxation in tax ruling 2018/4.[15]

We also agree with the proposed changes Endeavour made to the standard tax asset lives for the 'Furniture, fitting, plant and equipment (reducing the life to 7.2 years from 8.6 years) and the 'Information and communication technology' (increasing the life to 4.9 years from 2.9 years) asset classes. Endeavour explained these changes as being a result of both changing the weighting of assets within the asset class and the latest ATO rules on these assets. The impact from these changes is not significant in revenue terms.[16]

Table 7.4 sets out our draft decision on the standard tax asset lives for Endeavour. We are satisfied the standard tax asset lives are appropriate for application over the 2019–24 regulatory control period. We are also satisfied the standard tax asset lives provide

[14] At the time of this draft decision, the roll forward of Endeavour's TAB includes estimated capex values for 2017–18 and 2018–19. We expect Endeavour will provide actual capex for 2017–18 and the 2018–19 capex estimates may be revised based on more up to date information in its revised proposal. We will update these values in the final decision accordingly.

[15] ATO, *TR 2018/4—Income tax: effective life of depreciating assets (applicable from 1 July 2018)*, July 2018.

[16] Endeavour Energy, *Email, RE: RFM & CESS Model*, 13 February 2018.

an appropriate estimate of the tax depreciation amount that would be consistent with the tax expenses used to estimate the annual taxable income for a benchmark efficient service provider as required by the NER.[17]

Table 7.4 AER's draft decision on Endeavour's standard tax asset lives (years)

Asset class	Standard tax asset life
2019-20 to 2023-24 Sub-transmission lines and cables	46.8
2019-20 to 2023-24 Distribution lines and cables	47.9
2019-20 to 2023-24 Substations	40.0
2019-20 to 2023-24 Transformers	40.0
2019-20 to 2023-24 Low voltage lines and cables	47.8
2019-20 to 2023-24 Customer metering and load control	25.0
2019-20 to 2023-24 Communication	10.0
2019-20 to 2023-24 Land	n/a
2019-20 to 2023-24 Easements	n/a
2019-20 to 2023-24 Equity raising costs	5.0
2019-20 to 2023-24 Emergency spares (major plant, excludes inventory)	40.0
2019-20 to 2023-24 Information & communication technology	4.9
2019-20 to 2023-24 Furniture, fittings, plant and equipment	7.2
2019-20 to 2023-24 Motor vehicles	12.1
2019-20 to 2023-24 Buildings	40.0
2019-20 to 2023-24 Land (non-system)	n/a

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.

7.4.3 Remaining tax asset lives

We accept Endeavour's proposed weighted average method to calculate the remaining tax asset lives as at 1 July 2019 for its existing asset classes. We note we will update the remaining tax asset lives for the final decision for any changes to any estimated

[17] NER, cl. 6.5.3.

capex values in the RFM because they are used as inputs for calculating the remaining tax asset lives.[18]

Endeavour proposed to create separate asset classes for each regulatory control period (period-by-period tracking approach) to provide more accurate treatment of depreciation associated with capex forecast for that period. This means that Endeavour's proposal adopts the weighted average method to calculate remaining tax asset lives as at 1 July 2019 for existing asset classes. A new set of asset classes is then applied for depreciating new capex over the 2019–24 regulatory control period. In attachment 4 we explained our reasons to accept Endeavour's proposed use of period-by-period tracking to determine its remaining asset lives for the RAB. For the same reasons, we accept Endeavour's proposal to use this approach to calculate the remaining tax asset lives as at 1 July 2019.

Table 7.5 sets out our draft decision on the remaining tax asset lives at 1 July 2019 for Endeavour. We consider the remaining tax asset lives are appropriate for application over the 2019–24 regulatory control period. We are satisfied the remaining tax asset lives provide an appropriate estimate of the tax depreciation amount that would be consistent with the tax expenses used to estimate the annual taxable income for a benchmark efficient service provider as required by the NER.[19]

Table 7.5 AER's draft decision on Endeavour's remaining tax asset lives at 1 July 2019 (years)

Asset class	Remaining tax asset life
2013-14 ORAB Sub-transmission lines and cables	33.0
2013-14 ORAB Distribution lines and cables	34.0
2013-14 ORAB Substations	28.8
2013-14 ORAB Transformers	22.5
2013-14 ORAB Low voltage lines and cables	29.5
2013-14 ORAB Customer metering and load control	13.0
2013-14 ORAB Communication	3.3
2013-14 ORAB Land	n/a
2013-14 ORAB Easements	n/a
2013-14 ORAB Equity raising costs	32.0

[18] At the time of this draft decision, the roll forward of Endeavour's TAB includes estimated capex values for 2017–18 and 2018–19. We will update the 2017–18 estimated capex values with the actual values for the final decision, and may further update the estimate of 2018–19 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 Endeavour's remaining tax asset lives as at 1 July 2019 using the method approved in this draft decision.

[19] NER, cl. 6.5.3.

Asset class	Remaining tax asset life
2013-14 ORAB Emergency spares (major plant, excludes inventory)	21.9
2013-14 ORAB Information & communication technology	0.0
2013-14 ORAB Furniture, fittings, plant and equipment	5.0
2013-14 ORAB Motor vehicles	2.1
2013-14 ORAB Buildings	28.3
2013-14 ORAB Land (non-system)	n/a
2013-14 ORAB Other non-system assets	n/a
2014-15 to 2018-19 Sub-transmission lines and cables	44.6
2014-15 to 2018-19 Distribution lines and cables	46.2
2014-15 to 2018-19 Substations	38.1
2014-15 to 2018-19 Transformers	37.6
2014-15 to 2018-19 Low voltage lines and cables	45.6
2014-15 to 2018-19 Customer metering and load control	23.1
2014-15 to 2018-19 Communication	8.9
2014-15 to 2018-19 Land	n/a
2014-15 to 2018-19 Easements	n/a
2014-15 to 2018-19 Equity raising costs	1.0
2014-15 to 2018-19 Emergency spares (major plant, excludes inventory)	39.1
2014-15 to 2018-19 Information & communication technology	2.4
2014-15 to 2018-19 Furniture, fittings, plant and equipment	7.2
2014-15 to 2018-19 Motor vehicles	11.3
2014-15 to 2018-19 Buildings	37.1
2014-15 to 2018-19 Land (non-system)	n/a

Source: AER analysis.

n/a: not applicable. We have not assigned a remaining asset life to some asset classes because the assets allocated to those asset classes are not subject to depreciation.