



DRAFT DECISION

Energex Distribution Determination 2020 to 2025

Attachment 7 Corporate income tax

October 2019

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Note

This attachment forms part of the AER's draft decision on the distribution determination that will apply to Energex for the 2020–25 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

Attachment 9 – Capital expenditure sharing scheme

Attachment 10 – Service target performance incentive scheme

Attachment 11 – Demand management incentive scheme

Attachment 12 – Classification of services

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Shortened forms

Shortened form	Extended form
AER	Australian Energy Regulator
capex	capital expenditure
disposals	asset disposals
distributor	distribution network service provider
DV	diminishing value
gamma	value of imputation credits
ITAA	Income Tax Assessment Act 1997
NER or the rules	national electricity rules
NSP	network service provider
opex	operating expenditure
PTRM	post-tax revenue model
RAB	regulatory asset base
RFM	roll forward model
RIN	regulatory information notice
SL	straight-line
TAB	tax asset base
tax review	the 2018 review of the regulatory tax approach

7 Corporate income tax

Our determination of the annual revenue requirement includes the estimated cost of corporate income tax for Energex's 2020–25 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 Energex to recover the estimated cost of corporate income tax during the 2020–25 regulatory control period.

This attachment presents our assessment of Energex's proposed corporate income tax allowance for the 2020–25 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 \$21.9 million (\$ nominal) for Energex in the 2020–25 regulatory control period. This represents a decrease of \$131.4 million compared to Energex's proposal of \$153.4 million (\$ nominal).

The key reasons for the reduction are:

- Application of the latest version of the PTRM (version 4) released in April 2019 which implements the findings in our final report on the review of the regulatory tax approach (the tax review).² Specifically, for this draft decision, we have recognised immediate expensing of some forecast capital expenditure (capex) for the calculation of tax depreciation (section 7.4.1). We also applied the diminishing value (DV) method for tax depreciation to all new depreciable assets except for forecast capex associated with buildings (capital works) and in-house software.³ These changes have reduced Energex's proposed corporate income tax allowance by about \$80.5 million (or 52.5 per cent).⁴
- Adjusted the proposed opening TAB as at 1 July 2020 (section 7.4.2), which follows our draft decision to reduce the value of legacy ICT assets to be rolled into the regulatory asset base (RAB) and other input amendments.⁵ We also reduced the tax remaining asset life of the 'Legacy ICT' asset class from 10 years to 3.8 years to better reflect the life of these assets under tax law (section 7.4.3).

¹ NER, cl. 6.4.3(a)(4).

² AER, *Final report, Review of regulatory tax approach*, December 2018.

³ All assets acquired prior to 30 June 2020 will continue to be depreciated using the straight-line depreciation method for regulatory tax purposes, until these assets are fully depreciated.

⁴ The reduction is calculated based on the expenditure and rate of return inputs from Energex's proposed model.

⁵ This is discussed in section 2.4.2, attachment 2 of this draft decision.

We accept Energex's proposed standard tax asset lives for all of its existing asset classes. The proposed standard tax asset lives are broadly consistent with the tax asset lives prescribed by the Commissioner for taxation in ATO taxation ruling 2019/5 and are the same as the approved standard tax asset lives for the 2015–20 regulatory control period. Further, we determine standard tax asset lives of 40 years and 3.8 years respectively for the two new asset classes of 'Buildings - capital works' and 'In-house software' that are subject to the straight-line method of tax depreciation (section 7.4.4).

We also accept the proposed remaining tax asset lives as at 1 July 2020 for all asset classes (with the exception of the 'Legacy ICT' asset class) because they are calculated based on the weighted average method as set out in our roll forward model (RFM).

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 for Energex over the 2020–25 regulatory control period.

Table 7.1 AER's draft decision on Energex's cost of corporate income tax for the 2020–25 regulatory control period (\$ million, nominal)

	2020–21	2021–22	2022–23	2023–24	2024–25	Total
Tax payable	13.4	3.7	4.9	9.6	21.3	52.8
Less: value of imputation credits	7.8	2.1	2.8	5.6	12.5	30.9
Net corporate income tax	5.6	1.5	2.0	4.0	8.8	21.9

Source: AER analysis.

7.2 Energex's proposal

Energex proposed an estimated cost of corporate income tax of \$153.4 million (\$ nominal) using the AER's PTRM (version 3), which adopted the straight-line (SL) tax depreciation approach with the following inputs:⁶

- an opening TAB value as at 1 July 2020 of \$8294.1 million (\$ nominal)⁷
- a new 'Legacy ICT' asset class with an opening tax asset value of \$146.7 million and tax remaining asset life of 10 years⁸

⁶ Energex, 8.003 PTRM - SCS PUBLIC, 31 January 2019.

⁷ This includes an addition of \$146.7 million (\$ nominal) of legacy ICT assets to the opening TAB as at 1 July 2020. The addition of these assets was discussed in attachment 2.

⁸ These asset were previously owned by a third party entity SPARQ (which was part of Energy Queensland) but used to provide ICT services for Energex and Ergon Energy in the 2015–20 regulatory control period. The cost for

- an expected statutory income tax rate of 30 per cent per year
- a value of imputation credits (gamma) of 0.585
- remaining tax asset lives of assets in existence as at 30 June 2020 calculated using a weighted average remaining life approach as set out in the AER's RFM⁹
- the same standard tax asset lives for tax depreciation purposes of new assets for its existing asset classes in the 2020–25 regulatory control period as approved for the 2015–20 distribution determination.

Table 7.2 sets out Energex's proposed TAB roll forward over the 2015–20 regulatory control period.

Table 7.2 Energex's proposed TAB roll forward for the 2015–20 regulatory control period (\$ million, nominal)

	2015–16	2016–17	2017–18	2018–19 ^a	2019–20 ^a
Opening TAB	6674.3	7050.1	7380.9	7665.5	7914.1
Capital expenditure ^b	595.2	563.0	532.4	510.7	505.6
Less: tax depreciation	219.3	232.2	247.8	262.1	272.4
Closing TAB	7050.1	7380.9	7665.5	7914.1	8147.4
Roll-in of legacy ICT assets					146.7 ^c
Opening TAB as at 1 July 2020					8294.1

Source: Energex, *8.007 RFM - SCS PUBLIC*, 31 January 2019.

(a) Based on estimated capex.

(b) Net of disposals.

(c) These asset were previously owned by a third party entity SPARQ (which was part of Energy Queensland) but used to provide ICT services for Energex and Ergon Energy in the 2015–20 regulatory control period. The cost for providing the services was included as part of Energex's regulated opex allowance for this period. With the merger of the two entities to Energy Queensland, Energex proposed to roll the residual value of these assets into the opening TAB as at 1 July 2020.

providing the services was included as part of Energex's regulated opex allowance for this period. With the merger of the two entities to Energy Queensland, Energex proposed to roll the residual value of these assets into the TAB.

⁹ As discussed in attachment 4, Energex proposed year-by-year tracking depreciation for its regulatory asset base going forward. However, it has not proposed to do so for its tax asset base going forward.

Table 7.3 sets out Energex's proposed cost of corporate income tax for the 2020–25 regulatory control period.

Table 7.3 Energex's proposed cost of corporate income tax for the 2020–25 regulatory control period (\$ million, nominal)

	2020–21	2021–22	2022–23	2023–24	2024–25	Total
Tax payable	34.1	78.3	81.6	85.7	89.8	369.6
Less: value of imputation credits	19.9	45.8	47.7	50.2	52.5	216.2
Net corporate income tax	14.1	32.5	33.9	35.6	37.3	153.4

Source: Energex, *8.003 PTRM - SCS PUBLIC*, 31 January 2019.

At the time of the submission of Energex's regulatory proposal, we had not finalised our version 4 PTRM amendments to implement the tax review findings. Therefore, Energex's proposal did not account for the changes to the regulatory tax approach from our tax review. Energex submitted that it would work with the AER as part of its regulatory determination process to give effect to these changes.¹⁰

7.3 Assessment approach

We make an estimate of taxable income for each regulatory year as part of our determination of the annual revenue requirement for Energex's 2020–25 regulatory control period.¹¹ Our estimate is the taxable income a benchmark efficient entity would earn for providing standard control services if it operated Energex's business, which is determined in accordance with the PTRM.¹²

In May 2018, we commenced a review of our regulatory tax approach. We released the final report of the tax review in December 2018, which identified some required changes to our approach to estimating tax depreciation expenses in our regulatory models (PTRM and RFM).¹³ The changes to our regulatory tax approach require amending our models to:¹⁴

- recognise immediate tax expensing of some capex forecast for a regulatory control period

¹⁰ Energex, *1.003 2020–25 Regulatory proposal*, 31 January 2019, p. 102.

¹¹ NER, cl. 6.5.3.

¹² NER, cl. 6.5.3

¹³ AER, *Final report, Review of regulatory tax approach*, December 2018, pp. 6–20; The PTRM specifies the manner in which the estimated cost of corporate income tax is to be calculated. The RFM calculates the distributor's tax asset base at the start of the next regulatory control period, which is an input to the PTRM for the calculation of the tax building block.

¹⁴ Capping of gas asset tax lives was also a finding from the final report, but does not require a model change.

- adopt the DV method for tax depreciation to all future capex except for a limited number of assets which must be depreciated using the SL tax depreciation method, under the tax law.¹⁵

In April 2019, we published a new version of the PTRM (version 4) which implements the changes to the tax depreciation approach. We have not yet amended the RFM because the tax review final report stated that the required changes to the tax depreciation approach would apply to new assets only. Therefore, only changes to the PTRM were required in the first regulatory control period when adopting the new tax approach. As such, no immediate change to the RFM would be required until the subsequent regulatory control period—in this case, the current RFM remains appropriate for Energex's 2020–25 distribution determination. An amended RFM will be required at the next reset to roll forward the TAB during the 2020–25 regulatory control period with capex being depreciated using the DV method.

How the estimated cost of corporate income tax is calculated in the PTRM

Our approach for calculating a DNSP's estimated cost of corporate income tax is set out in our PTRM¹⁶ and involves the following steps:¹⁷

1. We estimate the annual assessable income (taxable revenue) that would be earned by a benchmark efficient entity operating the DNSP's business. This is the approved forecast revenues for the DNSP that we determined using the building block approach.¹⁸ It includes capital contributions where these are subject to taxation.
2. We then estimate the benchmark tax expenses such as operating expenditure (opex), interest expense, tax depreciation in the following ways:
 - operating expense is set equal to the opex building block¹⁹
 - interest expense is a function of the size of the RAB, the benchmark gearing assumption (60 per cent) and the regulated cost of debt
 - tax depreciation expense is calculated using a separate value for the TAB, and standard and remaining tax asset lives for taxation purposes. Previously, the PTRM applied the SL method for calculating tax depreciation for all assets. Consistent with the findings of the tax review, the new amended PTRM (version 4) applies the SL tax depreciation method for

¹⁵ We will continue to apply SL tax depreciation for assets acquired prior to 1 July 2020 for the 2020–25 regulatory control period until they are fully depreciated.

¹⁶ AER, *Distribution PTRM (version 4)*, April 2019.

¹⁷ 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).

¹⁸ The total revenue for tax purposes is the sum of the building blocks including return on capital, return of capital, operating expenditure and cost of corporate taxation, and any capital contributions. It may also include other revenue adjustments, but the assessment of whether they should give rise to a tax allowance will occur on a case by case basis.

¹⁹ Our assessment approach for the opex building block is discussed in attachment 6 of the draft decision.

existing assets and the DV tax depreciation method²⁰ for all assets acquired after 30 June 2020 except for in-house software, buildings and equity raising costs. The expenditure for these assets are to be depreciated using the SL method under Australian tax law. The amended PTRM (version 4) also accounts for the value of certain forecast capex to be immediately expensed when estimating the benchmark tax expense. The value of immediately expensed capex is deducted from the net capex being depreciated for tax purposes for the year in which it is forecast to be incurred.²¹ The immediately expensed amount is then included in the total tax depreciation amount for the relevant year.

There may be other revenue adjustments, but the assessment of whether they should give rise to a tax allowance occurs on a case by case basis.

3. We estimate the annual taxable income that would be earned by a benchmark efficient entity operating the DNSP's business by subtracting the benchmark estimates of tax expenses (step 2) from the approved forecast revenues for the distribution network business (step 1).
4. We apply the statutory income tax rate to the estimated annual taxable income (after adjustment for any tax loss carried forward) to arrive at a notional amount of tax payable.
5. We deduct the expected value for the utilisation of imputation credits (gamma) by investors from the notional amount of tax payable. The tax payable net of the expected value of imputation credits represents the corporate income tax allowance and is included as a separate building block in determining the DNSP's annual revenue requirement.

How we assess the tax inputs to the PTRM

The estimated cost of corporate income tax allowance is an output of our PTRM. We therefore assess the DNSP's proposed cost of corporate tax by analysing the proposed inputs to the PTRM for calculating that cost. While our assessment approach for most of the tax inputs remain largely the same as the determination for the current 2015–20 regulatory control period, our amended PTRM (version 4) requires two new sets of inputs for the calculation of tax depreciation—the forecast immediate expensing of certain capex and the assets to be exempted from the DV method of tax depreciation. Our assessment approach for each of the tax inputs required in the PTRM including the two new sets of inputs are discussed in turn below:

- **the opening TAB as at the commencement of the 2020–25 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 2015 and Energex's actual capex incurred

²⁰ For more explanation of how we calculate depreciation using the DV method, please see: AER, *Distribution PTRM handbook*, April 2019, pp. 22–23.

²¹ That is, the net capex to be added to the TAB for tax depreciation purposes is the amount of gross capex, less disposals, less the immediately deductible capex.

during the 2015–20 regulatory control period, and the final year (2014–15) of the previous regulatory control period.²² We do not adjust the TAB value for immediate expensing of past capex in the roll forward process. This is consistent with our 2015–20 regulatory determination which applied SL tax depreciation to capex incurred during that period as prescribed in the PTRM.

The roll forward of the opening TAB for 2015–20 is calculated in our RFM. We have not amended the RFM to implement the tax review at this time. This is because the tax review final report set out that the required changes to the tax depreciation approach would apply to new assets only. As such, the approach for determining the opening TAB value remains the same as the previous determination for the purposes of this draft decision. We have commenced our review of the RFM to implement the findings of the tax review and plan to release draft amendments in December 2019 for public consultation.²³ We expect that the final amended RFM will then be used for the purposes of the TAB roll forward for 2020–25 at the next reset.

This opening TAB value is used to estimate forecast tax depreciation for the 2020–25 regulatory control period, including new assets to be added to the TAB over this period. We will continue to apply the SL method of tax depreciation for the opening TAB value. However, for all assets forecast to be added to the TAB in the 2020–25 regulatory control period (with some exceptions discussed further below), we will apply the DV method of tax depreciation.

- **the standard tax asset life for each asset class:** Our assessment of a DNSP's proposed standard tax asset lives is generally guided by the effective life of depreciating assets determined by the Commissioner for Taxation. We consider that the standard tax asset lives for the majority of Energex's asset classes should be consistent with the ATO taxation ruling 2019/5 regarding the effective life of depreciating assets where possible.²⁴

As discussed above, the new amended PTRM (version 4) applies the DV tax depreciation method for all new assets except for in-house software, buildings and equity raising costs. It provides designated asset classes for these assets to be depreciated using the SL method for tax purposes.²⁵ We note that the tax effective lives for in-house software, buildings and equity raising costs are not covered under the ATO taxation ruling 2019/5. Therefore, our assessment of the standard tax asset lives for these asset classes are guided by the *Income Tax Assessment Act 1997* (ITAA). Specifically, we consider that the standard tax asset life should be:

²² 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.

²³ See <https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/roll-forward-models-transmission-and-distribution-2020-amendment>.

²⁴ ATO, *Taxation Ruling TR2019/5– Income tax: effective life of depreciating assets (applicable from 1 July 2019)*.

²⁵ Our assessment approach on new assets to be exempted from the DV method is discussed in detail below.

- 40 years for buildings – This is consistent with the number of years required to completely depreciate a capital works asset such as buildings for tax purposes when applying sections 43.15, 43.140 and 43.210 of the ITAA
- 5 years for in-house software – This is consistent with section 40.95(7) of the ITAA
- 5 years for equity raising costs – This is consistent with section 40.880 of the ITAA.
- **the income tax rate:** The statutory income tax rate is 30 per cent per year for businesses of the size we regulate, which was adopted in Energex's proposal.
- **the value of gamma:** The gamma input for Energex is 0.585 for this draft decision. This is consistent with the 2018 *Rate of return instrument*, which requires us to use a gamma value of 0.585, and adopted in Energex's proposal.²⁶ 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 2020:** Where a business has tax losses under our benchmark approach, 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 control period will be reduced by this amount. Energex does not have any accumulated tax losses as at the start of the 2020–25 regulatory control period.²⁷
- **forecast immediate expensing of capex:** The amended PTRM (version 4) requires a forecast for immediately deductible capex to be provided for each regulatory year of the 2020–25 regulatory control period. Our assessment of forecast immediate expensing of capex will be guided by the DNSP's actual immediate expensing of capex from the previous regulatory control period.²⁸ We will collect actual data relating to this expenditure in our annual reporting regulatory information notices to further inform our decision on the amount of forecast immediate expensing of capex in future regulatory determinations. Benchmarking may also be considered going forward.²⁹
- **diminishing value multiplier:** The amended PTRM (version 4) applies the following formula to calculate the tax depreciation under the DV method:³⁰

$$D_t = \left(\text{Nominal net capex}_i - \sum_{n=0}^{t-1} D_n \right) \times \text{DV multiplier} \div \text{standard tax asset life}$$

²⁶ AER, *Rate of return instrument*, December 2018, p. 19.

²⁷ Energex, *8.003 PTRM - SCS PUBLIC*, 31 January 2019.

²⁸ In the tax review final report we labelled our approach to determining the amount of capex that is to be immediately expensed as an 'actuals informed approach'. AER, *Final report, Review of regulatory tax approach*, December 2018, p. 66.

²⁹ AER, *Final report, Review of regulatory tax approach*, December 2018, pp. 66–67.

³⁰ This formula shows how the tax depreciation for capex in a particular year is calculated under the DV method in the PTRM.

where:

D_t is the tax depreciation in year t

$D_0 = 0$

$t = 1, 2, 3, \dots$

$i = \text{year } 0$

The PTRM provides an input section for the 'DV multiplier' in the above formula to be recorded for each year of the regulatory control period. This is labelled as the 'diminishing value multiplier' in the PTRM. We note that currently the DV multiplier is set at 200 per cent by the ATO. Our assessment approach for the standard tax asset life inputs is discussed above. The assessment approach for capex is discussed in attachment 5.

- **new assets to be exempted from the diminishing value method:** The amended PTRM (version 4) applies the DV method for tax depreciation purposes to all new depreciable assets except for certain assets. It provides for asset classes 47 to 50 to be depreciated using the SL method for tax purposes rather than the DV method. These asset classes are to contain new assets associated with in-house software, buildings and equity raising costs.

We consider that the benchmark allowance for equity raising costs should not be depreciated using the DV method. We note that section 40.880 of the ITAA and the ATO's taxation ruling 2011/6³¹ require that businesses claim deductions on equity raising costs in equal proportions over a five-year period. Therefore, in the PTRM, we apply the SL method for calculating the tax depreciation for equity raising costs, consistent with the ITAA and ATO's requirements.³² Further, the DNSP may propose capex associated with buildings and in-house software to be exempted from the DV method of tax depreciation in the PTRM if the proposal satisfies the following requirements:

- **buildings:** We consider that capex for buildings may be exempted from the DV method in the PTRM, consistent with sections 43.15, 43.140 and 43.210 of the ITAA. However, such capex must be consistent with the definition of a capital work under section 43.20 of the ITAA and in ATO taxation ruling 97/25.³³ We note that this includes new buildings and structural improvements to existing buildings.³⁴ However, capex on separate assets within a building such as air-conditioning units, transformers and converters are not consistent with the definition of a capital work, and therefore are required to be depreciated using the DV method in the PTRM.
- **in-house software:** We consider that capex for in-house software may be exempted from the DV method in the PTRM, consistent with section 40.72 of

³¹ ATO, *Taxation Ruling 2011/6*, July 2016.

³² The benchmark allowance for equity raising costs is determined within the PTRM.

³³ ATO, *Taxation Ruling 97/25*, July 2017.

³⁴ ITAA, section 43.20.

the ITAA. However, such capex must be consistent with the definition of in-house software under section 995.1 of the ITAA and in ATO taxation ruling 2016/3.³⁵ We note that this includes computer software, or the right to use computer software that the DNSP acquires, develops or has someone else develop for the DNSP's business use.³⁶ However, capex associated with other IT assets such as computer hardware is not consistent with the definition of in-house software, and therefore is required to be depreciated using the DV method in the PTRM.

7.3.1 Interrelationships

The cost of corporate income tax building block feeds directly into the annual revenue requirement. This allowance is determined by five factors:

- pre-tax revenues
- tax expenses (including tax depreciation)
- the corporate tax rate
- any tax losses carried forward
- 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 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.³⁷ Depending on the source of the revenue increase, the tax increase may be equal to or less than proportional to the company tax rate.³⁸

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:

³⁵ ATO, *Taxation Ruling 2016/3*, October 2018.

³⁶ ITAA, section 995.1.

³⁷ 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.

³⁸ 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.

- 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 – These expenses generally will match the opex allowance including any revenue adjustments, but the assessment of whether they should be treated as a tax expense occurs on a case by case basis.
- 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/method and asset lives assigned for tax depreciation purposes.

A business that has tax expenses which are greater than its taxable revenue in a period would not be subject to pay tax and generate a tax loss. A tax loss from previous period(s) can be carried forward to offset against tax payable in the current period.

For Energex, our draft decision cost of corporate income tax makes up only 0.4 per cent of the total building block revenue for the 2020–25 regulatory control period. Therefore, a 10 per cent increase in the corporate income tax allowance will only have a marginal impact on total revenue.

7.4 Reasons for draft decision

We determine a cost of corporate income tax of \$21.9 million (\$ nominal) for Energex over the 2020–25 regulatory control period. This represents a reduction of \$131.4 million (or 85.7 per cent) from Energex's regulatory proposal.

As discussed above, we applied the new amended PTRM (version 4) for this draft decision to implement the changes to our regulatory tax approach identified in the tax review final report. These changes have reduced the revised proposed cost of corporate income tax allowance by \$80.5 million (or 52.5 per cent).

We accept Energex's proposed method to establish the opening TAB as at 1 July 2020. However, we reduced Energex's proposed opening TAB value as at 1 July 2020 to \$8283.1million (\$ nominal)—a reduction of \$11.0 million (or 0.1 per cent).

This is because we:

- reduced the value of the legacy ICT assets proposed to be included in the opening TAB at 1 July 2020³⁹
- corrected the proposed adjustments for movements in capitalised provisions over the 2015–20 period

³⁹ Our final decision will update the value of the 'Legacy ICT' asset class by replacing the 2018–19 estimated capex with actuals, and updating the 2019–20 estimated capex.

- removed the 'Communications', 'Research and development' and 'Easements' asset classes since they have an immaterial opening tax asset value and no new capex allocated to them for the 2015–20 and 2020–25 regulatory control periods.

We accept Energex's proposed standard tax asset lives for all of its existing asset classes. Further, we determine standard tax asset lives of 40 years and 3.8 years respectively for the two new asset classes of 'Buildings - capital works' and 'In-house software' that are subject to the SL method of tax depreciation.

We also accept the proposed remaining tax asset lives as at 1 July 2020 for all asset classes (with the exception of 'Legacy ICT' asset class) because they are calculated based on the weighted average method as set out in our RFM.

Discussed in other attachments and the overview, our draft decision on Energex's proposed return on capital (attachments 2, 3, 5 and section 2.2 of the overview) and the regulatory depreciation (attachment 4) building blocks affect total revenues, and therefore also impact the forecast corporate income tax allowance.

7.4.1 Implementation of the tax review

Energex prepared its proposed estimate of corporate income tax using version 3 of our PTRM, and was submitted prior to the amended PTRM (version 4) being published.

We published the new amended PTRM (version 4) in April 2019, which implements the changes identified from the final report of the tax review. Specifically, we made the following two changes which affect the calculation of tax depreciation in the PTRM:

- **immediate expensing of capex** – we allow for certain capex to be immediately expensed when estimating the benchmark tax expense
- **diminishing value depreciation method** – we apply the DV method for tax depreciation purposes to all new depreciable assets except for capex associated with in-house software, equity raising costs and buildings.⁴⁰

We consulted with Energex on the PTRM changes and new inputs for implementing the new tax depreciation approach resulting from the tax review. While Energex was not required to provide these inputs as part of its regulatory proposal, it has actively engaged with us in the lead up to this draft decision to provide the relevant tax input requirements for the amended PTRM.⁴¹

Our assessment of the new tax inputs submitted by Energex are discussed below.

Forecast immediate expensing of capex

Certain capex (such as refurbishment capex) is able to be 'immediately expensed' under tax legislation. The amended PTRM (version 4) requires a forecast for

⁴⁰ The buildings asset class may be classified as system or non-system assets in the PTRM.

⁴¹ Energex, *Information request 007*, 22 March 2019.

immediately deductible capex to be provided for each asset class for each regulatory year of the 2020–25 regulatory control period.

In response to our request for additional tax input requirements, Energex provided actual/estimated immediately deductible capex data for the 2015–20 regulatory control period and a forecast capex of \$471.8 million (\$2019–20, or 20.3 per cent)⁴² that will be immediately expensed for tax purposes in the 2020–25 regulatory control period.⁴³

We accept Energex's proposed approach for determining the forecast immediate expensing of capex for the 2020–25 regulatory control period.⁴⁴ This approach is consistent with the findings of the tax review. The proposed capex to be immediately expensed reflects the proportion of immediately expensed capex claimed by Energex historically. We consider it reasonable to expect that the same proportion of capex will also be deducted immediately by Energex for its annual tax returns during the 2020–25 regulatory control period. We note that although the proportion of immediately expensed capex is broadly in line with the current 2015–20 regulatory control period, Energex's proposed value of the forecast immediate expensing capex for the 2020–25 regulatory period is significantly lower compared to the actuals for the 2015–20 regulatory control period. We understand this is mainly driven by the forecast decrease in overheads (eligible for immediate expensing) proposed by Energex.⁴⁵

As discussed in attachment 5, we have reduced Energex's proposed forecast capex by 10.8 per cent. However, this net reduction to forecast capex is the result of a decrease to the proposed direct capex which has been partially offset by an increase to the proposed capitalised overhead.⁴⁶ Since the capitalised overheads form a large part of the forecast capex eligible for immediate expensing, our draft decision is to increase the proposed forecast immediate expensing capex by \$16.6 million (\$ nominal) to reflect our decision on Energex's forecast capex. We will collect actual data relating to the immediately expensing of capex in our annual reporting RINs to further inform our decision for this type of expenditure in the next regulatory determination for Energex.

⁴² Compared with the proposed gross capex of \$2326.9 million (\$2019–20).

⁴³ Energex, *Information request 007*, 22 March 2019, pp. 2–5.

⁴⁴ Energex, *Information request 007*, 22 March 2019, p. 4.

For the 2015–20 regulatory control period, Energex's immediately expensed capex for tax purposes includes all expenditure items not directly allocated with the exception of fleet operating expenditure that is capitalised. Energex proposed to continue to apply the same approach to calculate its forecast immediate expensing capex for the 2020–25 regulatory control period.

⁴⁵ Energex's proposed immediately expensed capex for the 2020–25 regulatory control period represents a 43 per cent decrease from actual/estimated amount for the 2015–20 regulatory control period, while the proposed forecast capitalised overheads, a major component of the indirect costs, represents 38 per cent reduction from the 2015–20 regulatory control period.

⁴⁶ The increase to the proposed capitalised overhead is due to correcting for errors we identified in Energex's modelling. Please refer to section A.8 of attachment 5 of this draft decision for details.

Our draft decision to recognise immediately deductible capex has reduced Energex's proposed estimated cost of corporate income tax by \$64.5 million (\$ nominal, or 42.1 per cent), all else being equal.⁴⁷

Assets exempt from the diminishing value method

Energex's proposal used version 3 of the PTRM, which applies the SL method to calculate tax depreciation for all asset classes. The amended PTRM (version 4) continues to apply the SL tax depreciation method to the opening TAB at 1 July 2020, but applies the DV method as the new regulatory benchmark for tax depreciation to all new capex.⁴⁸ However, as discussed above, there are some exceptions to this approach under the tax law such as assets relating to in-house software, buildings and equity raising costs.⁴⁹ In the PTRM, the benchmark allowance for equity raising costs is determined within the model and depreciated using the SL tax depreciation method as default. As part of our consultation on the new inputs for Energex's forecast capex, we asked Energex to propose any relevant forecast capex to be exempted from the DV tax depreciation method.

In its response to our information request, Energex submitted that \$165.7 million (\$2019–20) of forecast capex associated with in-house software and \$33.4 million (\$2019–20) of forecast capex associated with buildings are to be exempted from the DV tax depreciation method. It provided us with the reallocation of the forecast capex related to these assets from the existing asset classes of 'IT system' and 'Buildings' to the prescribed SL tax depreciation asset classes for 'In-house software' and 'Buildings - capital works' respectively in the PTRM.

We accept Energex's proposed allocation of forecast capex for in-house software and buildings (capital works) to be depreciated using the SL method for tax depreciation purposes. This is because the proposed forecast capex for:

- in-house software satisfies the definition under section 995.1 of the ITAA and in ATO taxation ruling 2016/3⁵⁰
- buildings satisfies the definition of a capital work under section 43.20 of the ITAA and in ATO taxation ruling 97/25.⁵¹

Therefore, these assets are not required to be depreciated using the DV method for tax purposes.

The overall impact of our draft decision to apply the DV tax depreciation method to new assets is to reduce Energex's proposed estimated cost of corporate income tax by \$15.9 million (\$ nominal, or 10.4 per cent), all else being equal.⁵²

⁴⁷ The calculated decrease due to the change is based on the expenditure and the rate of return input data provided in Energex's proposal PTRM.

⁴⁸ AER, *Final report, Review of regulatory tax approach*, December 2018, p. 76.

⁴⁹ Asset classes 47, 48, 49 and 50 in the PTRM (version 4) provide for this.

⁵⁰ ATO, *Taxation Ruling 2016/3*, October 2018.

⁵¹ ATO, *Taxation Ruling 97/25*, July 2017.

7.4.2 Opening tax asset base as at 1 July 2020

We accept Energex's proposed method to establish the opening TAB as at 1 July 2020. Based on the proposed approach, we have determined Energex's opening TAB value as at 1 July 2020 of \$8283.1 million (\$ nominal). This represents a reduction of \$11.0 million (or 0.1 per cent) compared to its proposal.

We have reviewed the inputs to the TAB roll forward and found that they were mostly correct and reconcile with relevant data sources such as annual reporting RINs and the 2015–20 decision models. However, we made the following amendments to Energex's proposed inputs to the RFM which explains the difference in our draft decision opening TAB value and the value proposed by Energex:

- reduction to the proposed opening TAB value as at 1 July 2020 for the 'Legacy ICT' asset class
- correction to the adjustments for movements in capitalised provisions over the 2015–20 regulatory control period⁵³
- removal of the 'Communications', 'Research and development' and 'Easements' asset classes because they have an immaterial opening tax asset value and no new capex allocated to them for the 2015–20 and 2020–25 regulatory control periods.⁵⁴

The 'Legacy ICT' asset class is new and proposed by Energex to be included in its opening TAB as at 1 July 2020. The assets included in this asset class were previously owned by a third party entity SPARQ to provide IT services for Energex in the 2015–20 regulatory control period and therefore not included as part of the TAB prior to 1 July 2020. With the merger of the two entities to Energy Queensland in 2017 and for the reasons discussed in attachment 2, we accept that the residual value of these assets is to be rolled into the TAB. However, for this draft decision we amend a number of proposed inputs used to calculate the residual value of these assets as at 1 July 2020. As a result, we reduce the proposed opening tax asset value for these asset as at 1 July 2020 to \$124.8 million (\$ nominal) from \$146.7 million. For our final decision, we will update the value of the 'Legacy ICT' asset class by replacing the 2018–19 estimated capex with actuals, and updating the 2019–20 estimated capex.

We note that the opening TAB as at 1 July 2020 may be updated to reflect actual capex for 2018–19 and any revised 2019–20 capex estimates as part of the final decision.

⁵² The calculated decrease due to the change is based on the expenditure and the rate of return input data provided in Energex's proposal PTRM.

⁵³ Energex supported this amendment in response to our information request. Energex, *Information request 028*, 17 May 2019.

⁵⁴ The opening tax asset value for these asset classes ranged from \$5 to –\$770. We consider removing these asset classes will simplify the modelling. In its response to our information request, Energex supported this amendment in response to our information request. Energex, *Information request 028*, 17 May 2019.

Table 7.4 sets out our draft decision on the roll forward of Energex's TAB values over the 2015–20 regulatory control period.

Table 7.4 AER's draft decision on Energex's TAB roll forward for the 2015–20 regulatory control period (\$ million, nominal)

	2015–16	2016–17	2017–18	2018–19 ^a	2019–20 ^a
Opening TAB	6672.9	7050.6	7388.2	7677.1	7925.4
Capital expenditure ^b	597.0	569.8	537.0	510.7	505.6
Less: tax depreciation	219.3	232.2	248.1	262.4	272.8
Closing TAB	7050.6	7388.2	7677.1	7925.4	8158.2
Roll-in of legacy ICT assets					124.8 ^c
Opening TAB as at 1 July 2020					8283.1

Source: AER analysis.

(a) Based on estimated capex.

(b) Net of disposals.

(c) These asset were previously owned by a third party entity SPARQ (which was part of Energy Queensland) but used to provide ICT services for Energex and Ergon Energy in the 2015–20 regulatory control period. The cost for providing the services was included as part of Energex's regulated opex allowance for this period. With the merger of the two entities to Energy Queensland, the residual value of these assets is rolled into the opening TAB as at 1 July 2020.

7.4.3 Remaining tax asset lives

We accept Energex's proposed weighted average method to calculate the remaining tax asset lives as at 1 July 2020. The proposed method is a continuation of the approved approach used in the 2015–20 regulatory control period and applies the approach as set out in our RFM.

In accepting the weighted average method, we have updated Energex's proposed remaining tax asset lives to reflect our adjustments to Energex's opening TAB value as at 1 July 2020 (section 7.4.2). We will update the remaining tax asset lives for the final decision for any changes to the estimated capex values in the RFM because they are used as inputs for calculating the remaining tax asset lives.⁵⁵

Energex's proposal did not include a remaining tax asset life for the 'Legacy ICT' asset class.⁵⁶ Our draft decision is to assign a remaining tax asset life of 3.8 years for these

⁵⁵ At the time of this draft decision, the roll forward of Energex's TAB includes estimated capex values for 2018–19 and 2019–20. We will update the 2018–19 estimated capex values with the actual values for the final decision, and may further update the estimate of 2019–20 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 Energex's remaining tax asset lives as at 1 July 2020 using the method approved in this draft decision.

⁵⁶ Energex, 8.003 PTRM - SCS PUBLIC, 31 January 2019.

new assets, consistent with the standard tax asset life of the 'IT systems' asset class. We are satisfied that this approach meets the requirements of tax law. We consulted with Energex on this amendment and it agreed with our position.⁵⁷

For the new 'In-house software' and 'Buildings - capital works' asset classes we have not assigned remaining tax asset lives as there are no opening tax values for these asset classes, only forecast capex are being allocated to these asset classes over the 2020–25 regulatory control period. We therefore record 'n/a' in the PTRM for these asset classes.

Table 7.5 sets out our draft decision on the remaining tax asset lives at 1 July 2020 for Energex. We are satisfied that the remaining tax asset lives are appropriate for application over the 2020–25 regulatory control period. We are also satisfied that the remaining tax asset lives provide an 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.⁵⁸

7.4.4 Standard tax asset lives

We accept Energex's proposed standard tax asset lives for its existing asset classes because they are:

- broadly consistent with the tax asset lives prescribed by the Commissioner for taxation in ATO taxation ruling 2019/5⁵⁹
- the same as the approved standard tax asset lives for the 2015–20 regulatory control period.

Discussed in section 7.4.1, as part of the implementation of the new tax depreciation approach, Energex proposed to reallocate forecast capex associated with buildings (capital works) and in-house software to the prescribed SL tax depreciation asset classes in the amended PTRM. We determine a standard tax asset life of 40 years for the 'Buildings - capital works' asset class, as this is consistent with the number of years required to completely depreciate a capital works asset such as buildings under the ITAA.⁶⁰ We also determine a standard tax asset life of 3.8 years for the 'In-house software' asset class, as this is consistent with the ITAA.⁶¹ In its response to our information request, Energex agreed that both of these standard tax asset lives are appropriate for tax depreciation purposes.⁶²

Table 7.5 sets out our draft decision on the standard tax asset lives for Energex. We are satisfied that the standard tax asset lives are appropriate for application over the

⁵⁷ Energex, *Information request 035*, 10 June 2019.

⁵⁸ NER, cl 6.5.3.

⁵⁹ ATO, *Taxation Ruling TR2019/5– Income tax: effective life of depreciating assets* (applicable from 1 July 2019).

⁶⁰ ITAA, sections 43.15, 43.140, 43.210.

⁶¹ ITAA, section 40.95(7).

⁶² Energex, *Information request 007*, 22 March 2019.

2020–25 regulatory control period. We are also satisfied that the standard tax asset lives provide an 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.⁶³

Table 7.5 AER's draft decision on Energex's standard and remaining tax asset lives (years)

Asset class	Standard tax asset life	Remaining tax asset lives as at 1 July 2020 ^d
OH sub-transmission lines	45.0 ^b	31.9
UG sub-transmission cables	50.0 ^b	35.0
OH distribution lines	45.0 ^b	35.9
UG distribution cables	50.0 ^b	35.0
Distribution equipment	45.0 ^b	36.6
Substation bays	40.0 ^b	29.6
Substation establishment	40.0 ^b	32.5
Distribution substation switchgear	40.0 ^b	31.1
Zone transformers	40.0 ^b	28.7
Distribution transformers	45.0 ^b	34.0
Low voltage services	40.0 ^b	30.2
Load control & network metering devices ^a	25.0 ^b	21.4
Communications - pilot wires	10.0 ^b	7.6
Street lighting (residual rate 2 assets)	15.0 ^b	1.3
Systems buildings	40.0 ^b	33.6
Systems easements	n/a	n/a
System land	n/a	n/a
Control centre - SCADA	10.0 ^b	9.5
IT systems	3.8 ^b	3.0
Office equipment & furniture	13.1 ^b	5.4
Motor vehicles	12.9 ^b	8.3
Plant & equipment	5.2 ^b	3.3
Buildings	40.0 ^b	30.6
Land	n/a	n/a

⁶³ NER, cl. 6.5.3.

Asset class	Standard tax asset life	Remaining tax asset lives as at 1 July 2020 ^d
Legacy ICT	n/a ^e	3.8
Buildings - capital works	40.0 ^c	n/a
In-house software	3.8 ^c	n/a
Equity raising costs	5.0 ^c	n/a ^f

Source: AER analysis.

- (a) This asset class was renamed 'Load control & network metering devices' in the 2015–20 distribution determination to better reflect the assets that make up this asset class. Energex referred to it as 'Metering' asset class in its proposal.
 - (b) Used for diminishing value method of tax depreciation.
 - (c) Used for straight-line method of tax depreciation.
 - (d) Used for straight-line method of tax depreciation.
 - (e) There is no forecast capex allocated to the 'Legacy ICT' asset class, therefore no standard tax asset life is assigned to this asset class.
 - (f) There is no opening tax value for the 'Equity raising costs' asset class, therefore no remaining tax asset life is assigned to this asset class.
- n/a not applicable. We have not assigned a standard tax asset life and remaining tax asset life to the 'System land', 'System easements' and 'Land' asset classes because the assets allocated to these asset classes are non-depreciating assets. We also have not assigned a remaining tax asset life to the 'Buildings - capital works' and 'In-house software' asset classes prescribed for SL tax depreciation because they have no opening TAB values as at 1 July 2020.