DRAFT DECISION
Essential 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 Essential 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

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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
DMIAM	demand management innovation allowance mechanism
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 Essential Energy's (Essential) 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 Essential 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 Essential'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 $138.1 million ($ nominal) for Essential in the 2019–24 regulatory control period. This represents a reduction of $81.6 million (or 37.1 per cent) from Essential's proposal of $219.7 million ($ nominal).

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

- standard tax asset lives for buildings and capitalised property leases (section 7.4.2)
- proposed tax treatment of revenue adjustments associated with the capital expenditure sharing scheme (CESS) and the demand management innovation allowance mechanism (section 7.4.3)
- 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 Essential over the 2019–24 regulatory control period.

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

Table 7.1 AER's draft decision on Essential'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	48.0	50.0	52.9	63.4	61.8	276.2
Less: value of imputation credits	24.0	25.0	26.4	31.7	30.9	138.1
Net corporate income tax allowance	**24.0**	**25.0**	**26.4**	**31.7**	**30.9**	**138.1**

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 Essential'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 Essential's 2019–24 regulatory control period in April 2019.[2]

As indicated in the initial report, it 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. Essential 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 Essential 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 Essential 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 Essential Energy's proposal

Essential proposed a forecast cost of corporate income tax of $219.7 million ($ 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 $6881.0 million ($ 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.[4]

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

Table 7.2 Essential'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	63.3	67.0	71.2	82.7	81.9	366.1
Less: value of imputation credits	25.3	26.8	28.5	33.1	32.8	146.4
Net corporate income tax allowance	**38.0**	**40.2**	**42.7**	**49.6**	**49.1**	**219.7**

Source: Essential, *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 Essential's 2019–24 regulatory control period.[5] Our estimate is the taxable income a benchmark efficient entity would earn for providing standard control services if it operated Essential'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:[6]

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3 Essential, *Proposed PTRM*, April 2018.

4 Essential has also proposed a new asset class for 'Capitalised property leases' but has not assigned a standard tax asset life.

5 NER, cl. 6.5.3.

6 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).

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 Essential's actual capex incurred during the 2014–19 regulatory control period, and the final year (2013–14) of the previous regulatory control period.[7]
- **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, 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 Essential's proposed standard tax asset lives against those prescribed by the Commissioner

[7] 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.

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.[8]

- **The income tax rate:** The statutory income tax rate is 30 per cent per year.
- **The value of gamma:** The gamma input for Essential 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.[9] Depending on the source of the revenue increase, the tax increase may be equal to or less than proportional to the company tax rate.[10]

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

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

9 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.

10 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.

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 Essential, a 10 per cent increase in the corporate income tax allowance causes revenues to increase by about 0.4 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 0.8 per cent.[11]

7.4 Reasons for draft decision

We determine an estimated cost of corporate income tax allowance of $138.1 million ($ nominal) for Essential in the 2019–24 regulatory control period. This represents a reduction of $81.6 million (or 37.1 per cent) from Essential's proposal. This is because we amended the following proposed inputs to the PTRM for tax purposes:

- the standard asset lives for buildings and capitalised property leases (section 7.4.2)
- proposed tax treatment of revenue adjustments associated with the capital expenditure sharing scheme (CESS) and the demand management innovation allowance mechanism (DMIAM) (section 7.4.3)
- 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 and 3) and the return of capital (attachment 4) building blocks affect revenues, and therefore also impact the forecast corporate income tax allowance.

7.4.1 Opening tax asset base as at 1 July 2019

We accept Essential'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 Essential's opening TAB value as at 1 July 2019 of $6881.0 million ($ 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

[11] 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 Essential's proposed PTRM.

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.[12]

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

Table 7.3 AER's daft decision on Essential'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	5340.8	5738.9	6031.4	6284.8	6568.1
Capital expenditure	623.1	510.7	477.0	524.9	566.5
Less: tax depreciation	225.1	218.2	223.5	241.7	253.5
Closing TAB	5738.9	6031.4	6284.8	6568.1	6881.0

Source: AER analysis.

(a) Based on estimated capex.

7.4.2 Standard and remaining tax asset lives

We accept the majority of Essential's proposed standard tax asset lives for its asset classes, with two exceptions, because they are:

- broadly consistent with the values prescribed by the Commissioner for taxation in tax ruling 2018/4[13]
- the same as the approved standard tax asset lives over the 2014–19 regulatory control period.

Essential proposed a standard tax asset life for its 'Buildings' asset class of 100 years, consistent with its previous determinations. We have reviewed the tax rules and compared Essential to its peers, and consider that a shorter standard tax asset life of 40 years would be more appropriate. We raised this issue with Essential and it has agreed with the change going forward.[14] We are satisfied that this standard tax asset life provides a better estimate of the tax depreciation amount for a benchmark efficient distributor.[15] We have therefore adjusted the PTRM input for this standard tax asset life.

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[12] At the time of this draft decision, the roll forward of Essential's TAB includes estimated capex values for 2017–18 and 2018–19. We expect Essential 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.

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

[14] Essential, *Email: RE: Essential - AER information request #025 - Tax asset lives for Buildings*, 23 July 2018. No adjustment was made to the remaining tax asset life of Buildings which is 88.8 years as at 1 July 2019.

[15] NER, cl. 6.5.3.

Essential did not propose any standard tax asset life for its new asset class for 'Capitalised property leases'. This means the expenditure incurred for this asset class would not be depreciated for tax purposes. We consider that a benchmark efficient distributor would use depreciation to achieve a tax offset to minimise its tax expense in respect of capitalised leases. It appears that the ATO has not provided a specific ruling on the effective life for capitalised leases. Given this, we consider it appropriate to use the economic life of the capitalised leases as the standard tax asset life, which is consistent with the ATO's guidance on determining the effective life of an asset.[16] In response to an information request, Essential agreed to set the standard tax asset life for the 'Capitalised property leases' asset class equal to the standard asset life of 8 years used for RAB depreciation purposes (discussed in attachment 4). We consider that this approach provides a reasonable estimate of the tax depreciation amount for a benchmark efficient distributor.[17] We have therefore adjusted the PTRM input for this standard tax asset life.

We accept Essential's proposed weighted average method to calculate the remaining tax asset lives as at 1 July 2019. The proposed method applies the approach as set out in our RFM. We note we will update the 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.[18]

Table 7.4 sets out our draft decision on the standard and remaining tax asset lives for Essential. We consider the standard and remaining tax asset lives are appropriate for application over the 2019–24 regulatory control period. We are satisfied the standard and 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 as required by the NER.[19]

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16 ATO, *Taxation Ruling TR2018/4– Income tax: effective life of depreciating assets (applicable from 1 July 2018)*, p. 10; Income tax assessment ACT 1997, Section 40.105.

17 NER, cl. 6.5.3.

18 At the time of this draft decision, the roll forward of Essential'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 Essential's remaining tax asset lives as at 1 July 2019 using the method approved in this draft decision.

19 NER, cl. 6.5.3.

Table 7.4 AER's draft decision on Essential's standard and remaining tax asset lives (years)

Asset class	Standard tax asset life	Remaining tax asset life as at 1 July 2019
Sub-transmission lines and cables	47.5	36.4
Distribution lines and cables	45.0	32.7
Substations	40.0	28.5
Transformers	40.0	32.4
Low voltage lines and cables	45.0	36.6
Customer metering and load control	25.0	19.1
Communications	10.0	7.4
Land	n/a	n/a
Easements	n/a	n/a
IT systems	4.0	3.4
Furniture, fittings, plant and equipment	6.7	5.1
Motor vehicles	15.0	8.3
Buildings	40.0	88.8
Land (non-system)	n/a	n/a
Other non-system assets	43.8	32.7
Capitalised property leases	8.0	n/a
Equity raising costs	5.0	33.1

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. There are no capitalised property leases as at 1 July 2019.

7.4.3 Tax treatment of other revenue adjustments

We queried Essential's tax treatment of the CESS and DMIAM revenue adjustments in its proposed PTRM. In response, Essential said its tax treatment of those revenue adjustments were an oversight and agreed with changes we suggested.[20]

Accordingly, we changed the setting of the switches in the PTRM so the revenue adjustments are recognised as both income and expenses for tax purposes. As a

20 Essential, *Email: RE: AER - Essential IR#034 - CESS and DMIA tax treatment*, 31 August 2018.

result no additional tax penalty or reward is calculated in relation to these revenue adjustments.[21]

[21] This can be done in the PTRM by setting both the tax income and tax expense switches to ‘yes’. Whether the switches for tax income and tax expenses are set ‘yes, yes' or ‘no, no’ for these revenue adjustments brings the same tax outcome.