FINAL DECISION
Ausgrid
Distribution Determination

2019 to 2024

Attachment 7
Corporate income tax

April 2019

AUSTRALIAN ENERGY REGULATOR

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Note

This attachment forms part of the AER's final decision on the distribution determination that will apply to Ausgrid for the 2019-2024 regulatory control period. It should be read with all other parts of the final decision.

As a number of issues were settled at the draft decision stage or required only minor updates, we have not prepared all attachments. The attachments have been numbered consistently with the equivalent attachments to our longer draft decision. In these circumstances, our draft decision reasons form part of this final decision.

The final decision includes the following attachments:

Overview

Attachment 1 – Annual revenue requirement

Attachment 2 – Regulatory asset base

Attachment 4 – Regulatory depreciation

Attachment 5 – Capital expenditure

Attachment 7 – Corporate income tax

Attachment 9 – Capital expenditure sharing scheme

Attachment 10 – Service target performance incentive scheme

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Attachment 15 – Alternative control services

Attachment 18 – Tariff structure statement

Attachment A – Negotiating framework

Attachment B – Pricing methodology

Contents

Shortened forms

Shortened form	Extended form
AER	Australian Energy Regulator
ATO	Australian Taxation Office
capex	capital expenditure
CESS	capital expenditure sharing scheme
disposals	asset disposals
distributor	distribution network service provider
DMIAM	demand management innovation allowance (mechanism)
DV	diminishing value method for calculating depreciation
EBSS	efficiency benefit sharing scheme
Gamma	value of imputation credits
ITAA	Income Tax Assessment Act 1997
NER	National Electricity Rules
NSW	New South Wales
opex	operating expenditure
PTRM	post-tax revenue model
RAB	regulatory asset base
RFM	roll forward model
RIN	regulatory information notice
SL	straight-line method for calculating depreciation
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 Ausgrid's distribution and transmission (dual function assets)[1] networks for the 2019–24 regulatory control period.[2] Under the post-tax framework, a corporate income tax allowance is calculated as part of the building block assessment using our post-tax revenue model (PTRM). This attachment sets out our final decision on Ausgrid's revised proposed corporate income tax allowance for the 2019–24 regulatory control period. It presents our assessment of the inputs required in the PTRM for the calculation of the cost of corporate income tax.

7.1 Final decision

Our final decision on the estimated cost of corporate income tax is $128.8 million and $4.9 million ($ nominal) for Ausgrid over the 2019–24 regulatory control period for its distribution and transmission networks respectively. This represent reductions of $49.0 million (or 27.6 per cent) and $6.6 million (or 57.1 per cent) on Ausgrid's revised proposed values for its distribution and transmission networks respectively.

The key reasons for these reductions are:

- we amended the PTRM to implement the findings in our final report on the review of the regulatory tax approach (the tax review), which concluded shortly before the submission of Ausgrid's revised proposal (section 7.4.1). Specifically, for this final decision, we have applied the diminishing value (DV) method for tax depreciation to all new depreciable assets except for forecast capex associated with in-house software, equity raising costs and buildings. These changes have reduced the revised proposed corporate income tax allowances by about $19.4 million (or 10.9 per cent) and $2.5 million (or 21.9 per cent) for Ausgrid's distribution and transmission networks respectively.
- we reduced Ausgrid's revised proposed return on equity (section 2.2 of the Overview). Our final decision on the forecast return on equity affects the amount of estimated taxable income. Therefore, it has contributed to the reductions on the revised proposed corporate income tax allowances by about $29.2 million (or 16.4 per cent) and $4.0 million (or 34.9 per cent) for Ausgrid's distribution and transmission networks respectively.

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1 Ausgrid's dual function assets are high voltage assets which support the broader NSW/ACT transmission network owned and operated by TransGrid. We apply transmission pricing to these assets. See: AER, *Framework and approach Ausgrid, Endeavour Energy and Essential Energy Regulatory control period commencing 1 July 2019,* July 2017, p. 13.

2 NER, cl. 6.4.3(a)(4).

Our determination on the regulatory depreciation (attachment 4) affects the calculation of the estimated taxable income, which in turn impacts the corporate income tax allowances.

We reduced the revised proposed opening tax asset base (TAB) values as at 1 July 2019 by $1.7 million and $0.4 million for Ausgrid's distribution and transmission networks respectively. While we accept Ausgrid's approach for establishing the opening TAB, we have updated the revised proposed opening TAB values to reflect amendments to Ausgrid's allocations of movements in capitalised provisions for its 2017–18 actual capex (section 7.4.2). The reductions on the opening TAB values have slightly increased the corporate income tax allowances.

As a consequence of the updated opening TAB values, we have updated Ausgrid's remaining tax asset lives as at 1 July 2019. We accept Ausgrid's revised proposed standard tax asset lives, which are consistent with our draft decision. We also determine standard tax asset lives of 40 years for the new 'Buildings (system)' and 5 years for the new 'In-house software' asset classes that are subject to the straight-line (SL) method of tax depreciation (section 7.4.3).

For this final decision, we accept Ausgrid's revised proposed value of imputation credits (gamma) of 0.585 (section 2.2 of the Overview).

Table 7.1 and Table 7.2 set out our final decision on the estimated cost of corporate income tax allowance for Ausgrid over the 2019–24 regulatory control period for its distribution and transmission networks respectively.

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

	2019–20	2020–21	2021–22	2022–23	2023–24	Total
Tax payable	66.1	54.7	61.9	67.4	60.2	310.4
Less: value of imputation credits	38.7	32.0	36.2	39.4	35.2	181.6
Net corporate income tax allowance	**27.4**	**22.7**	**25.7**	**28.0**	**25.0**	**128.8**

Source: AER analysis.

Table 7.2 AER's final decision on Ausgrid cost of corporate income tax allowance for the 2019–24 regulatory control period ($million, nominal) – transmission

	2019–20	2020–21	2021–22	2022–23	2023–24	Total
Tax payable	2.4	1.7	1.7	3.1	3.0	11.9
Less: value of imputation credits	1.4	1.0	1.0	1.8	1.8	6.9
Net corporate income tax allowance	**1.0**	**0.7**	**0.7**	**1.3**	**1.2**	**4.9**

Source: AER analysis.

7.2 Ausgrid's revised proposal

Ausgrid's revised proposed corporate income tax allowances are $177.9 million and $11.5 million ($nominal) for the 2019–24 regulatory control period for its distribution and transmission networks respectively. Ausgrid's revised proposal is based on the approach in the draft decision to estimate the corporate income tax allowance. In its revised proposal, Ausgrid noted the AER's tax review and its intent to engage further with the AER during the consultation process to give effect to the outcomes of this review.[3]

Table 7.3 and Table 7.4 set out Ausgrid's revised proposed roll forward of its TAB values over the 2014–19 regulatory control period for its distribution and transmission networks respectively.

Table 7.3 Ausgrid's revised proposed TAB roll forward ($million, nominal) – distribution

	2014–15	2015–16	2016–17	2017–18	2018–19[a]
Opening TAB	8559.3	8785.1	8815.2	8932.0	9227.9
Capital expenditure[b]	563.8	386.6	465.1	636.9	848.7
Less: tax depreciation	338.0	356.6	348.3	340.9	364.9
Plus: assets transferred to distribution from transmission					201.8
Closing TAB	8785.1	8815.2	8932.0	9227.9	9913.6

Source: Ausgrid, *Attachment 4.01 - RFM for distribution,* January 2019.

(a) Based on estimated capex.

(b) Net of disposals.

[3] Ausgrid, *Revised regulatory proposal 2019–24*, January 2019, p. 15.

Table 7.4 Ausgrid's revised proposed TAB roll forward ($million, nominal) – transmission

	2014–15	2015–16	2016–17	2017–18	2018–19[a]
Opening TAB	1502.1	1511.7	1453.5	1505.0	1527.0
Capital expenditure[b]	58.3	–7.2	102.6	72.2	54.5
Less: tax depreciation	48.8	51.0	51.0	50.2	53.4
Less: assets transferred to distribution from transmission					201.8
Closing TAB	1511.7	1453.5	1505.0	1527.0	1326.2

Source: Ausgrid, *Attachment 4.04 - RFM for transmission,* January 2019.

(a) Based on estimated capex.

(b) Net of disposals.

Table 7.5 and Table 7.6 set out Ausgrid's revised proposed corporate income tax allowance for the 2019–24 regulatory control period for its distribution and transmission networks respectively.

Table 7.5 Ausgrid's revised proposed cost of corporate income tax allowance for the 2019–24 regulatory control period – distribution ($million, nominal)

	2019–20	2020–21	2021–22	2022–23	2023–24	Total
Tax payable	79.5	76.0	87.4	95.7	89.9	428.6
Less: value of imputation credits	46.5	44.5	51.1	56.0	52.6	250.7
Net corporate income tax allowance	**33.0**	**31.5**	**36.3**	**39.7**	**37.3**	**177.9**

Source: Ausgrid, *Revised proposed PTRM – distribution*, January 2019.

Table 7.6 Ausgrid's revised proposed cost of corporate income tax allowance for the 2019–24 regulatory control period – transmission ($million, nominal)

	2019–20	2020–21	2021–22	2022–23	2023–24	Total
Tax payable	4.2	4.7	5.2	6.7	6.9	27.7
Less: value of imputation credits	2.5	2.7	3.0	3.9	4.0	16.2
Net corporate income tax allowance	**1.8**	**1.9**	**2.2**	**2.8**	**2.8**	**11.5**

Source: Ausgrid, *Revised proposed PTRM – transmission*, January 2019.

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 Ausgrid's 2019–24 regulatory control period.[4] Our estimate is the taxable income a benchmark efficient entity would earn for providing standard control services if it operated Ausgrid's network business.

For this final decision, we have changed some aspects of our approach for calculating the estimated corporate income tax allowance since we made the draft decision in November 2018. In our draft decision, we noted that we had commenced a review into our regulatory tax approach. We also noted that we would apply any changes to our regulatory models arising from the tax review to the final decision for Ausgrid's 2019–24 regulatory control period.

In December 2018, we released the final report of the tax review,[5] which identified some required changes to our approach to estimating tax depreciation expenses in our regulatory models (PTRM and RFM).[6] The changes to our regulatory tax approach require amending our models to:[7]

- recognise immediate tax expensing of some capex forecast for a regulatory control period
- 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 depreciation method under the tax law.

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. This means that only changes to the PTRM are required in the first regulatory control period when transitioning into the new tax approach. As such, the tax depreciation approach in the RFM remains the same as the draft decision for the purposes of this final decision.

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

Our approach for calculating a distributor's estimated cost of corporate income tax allowance is set out in our PTRM[8] and involves the following steps:[9]

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4 NER, cl. 6.5.3.

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

6 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 which is an input to the PTRM for the calculation of the tax building block.

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

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

9 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 assessable income (taxable revenue) that would be earned by a benchmark efficient entity operating the distributor's business. This is the approved forecast revenues for the distribution business that we determined using the building block approach.[10]
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 block.[11]
    - Interest expense is a function of the size of the regulatory asset base (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 existing assets and the DV tax depreciation method[12] for all new assets except for in-house software, buildings and equity raising costs. The expenditure for these assets are to be depreciated using the SL method under the tax law. The new 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 to be depreciated for tax purposes for the year in which it is forecast to be incurred,[13] and is then included in the total tax depreciation amount for that year.

    Revenue increments or decrements resulting from CESS, EBSS and DMIAM may also be included in the benchmark tax expenses if they are also included in the taxable revenue.
3. We estimate the annual taxable income that would be earned by a benchmark efficient entity operating the distributor's business by subtracting the benchmark estimates of tax expenses (step 2) from the approved forecast revenues for the distribution business (step 1).

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[10] 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 revenue increments or decrements resulting from the capital expenditure sharing scheme (CESS), efficiency benefit sharing scheme (EBSS) and demand management innovation allowance mechanism (DMIAM).

[11] Our assessment approach for the opex building block is discussed in attachment 6.

[12] For more explanation of how we calculate depreciation using the DV method, please see: AER, *Distribution PTRM handbook*, April 2019, p. 22.

[13] 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.

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 distributor'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 distributor's proposed cost of corporate tax allowance by analysing the proposed inputs to the PTRM for calculating that allowance. While our assessment approach for most of the tax inputs has not changed since the draft decision, we have updated the value of gamma in this final decision to be consistent with the 2018 *Rate of return instrument*. In addition, 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 inputs are discussed in turn below:

- **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 Ausgrid's actual capex incurred during the 2014–19 regulatory control period, and the final year (2013–14) of the previous regulatory control period.[14] Our assessment approach for this input has not changed since the draft decision.

  The roll forward of the opening TAB for 2014–19 is calculated in our RFM. We have not amended the RFM to implement the tax review. 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 draft decision for the purposes of this final decision. Subsequent to this final decision we will make the relevant amendments to the RFM for changes from the tax review. The amended RFM will then be used for the purposes of the TAB roll forward for 2019–24 at the next reset.

  This opening TAB value is used to estimate forecast tax depreciation for the 2019–24 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 new assets forecast to be added to the TAB in the

[14] 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.

2019–24 regulatory control period (with some exceptions discussed further below), we will apply the DV method of tax depreciation.

- **The remaining tax asset life for each asset class at the commencement of the 2019–24 regulatory control period**: Our standard method in the RFM for determining the remaining tax asset lives is the weighted average method. Our assessment approach for this input has not changed since the draft decision.
- **The standard tax asset life for each asset class:** Our assessment of Ausgrid's proposed standard tax asset lives is 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 Ausgrid's asset classes should be consistent with the ATO taxation ruling 2018/4 regarding the effective life of depreciating assets where possible.[15]

  While our assessment approach for this input has not changed since the draft decision, we also explain how we assess the standard tax asset lives for the in-house software, buildings and equity raising costs asset classes.

  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.[16] We note that the tax effective lives for in-house software, buildings and equity raising costs are not covered under the ATO taxation ruling 2018/4. 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:

  - 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. This is consistent with the rate applied in the draft decision.
- **The value of gamma:** The gamma input for Ausgrid is 0.585 for this final decision. Our draft decision applied a gamma value of 0.5. Since then, we have published the *Rate of return instrument*, which requires us to use a gamma value of 0.585.[17]

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15 ATO, *Taxation Ruling 2018/4– Income tax: effective life of depreciating assets (applicable from 1 July 2018)*.

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

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

Ausgrid's revised proposal adopted this gamma value. 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 control period will be reduced by this amount. Our assessment approach for this input has not changed since the draft decision. Ausgrid does not have any accumulated tax losses as at the start of the 2019–24 regulatory control period.[18]
- **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 2019–24 regulatory control period. For this final decision, our assessment of forecast immediate expensing of capex will be guided by the distributor's actual immediate expensing of capex from the previous regulatory control period. We will collect actual data relating to this expenditure in our annual reporting regulatory information notice (RIN) to further inform our decision on the amount of forecast immediate expensing of capex in future regulatory determinations.
- **Diminishing value multiplier:** The amended PTRM (version 4) applies the following formula to calculate the tax depreciation under the DV method:[19]

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

where:

D_t is the tax depreciation in year t

$D_0 = 0$

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

$i = year\ 0$

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 tax standard asset life inputs are 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

[18] Ausgrid, *Revised proposed PTRM – distribution*, January 2019 and Ausgrid, *Revised proposed PTRM – transmission*, January 2019.

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

depreciable assets except for certain assets. It provides for asset classes 47, 48, 49 and 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 2011/6[20] 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.[21] Further, the distributor 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.[22] We note that this includes new buildings and structural improvements to existing buildings.[23] 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 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.[24] We note that this includes computer software, or the right to use computer software that the distributor acquires, develops or has someone else develop for the distributor's business use.[25] 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.

7.4 Reasons for final decision

We determine costs of corporate income tax allowances of $128.8 million and $4.9 million ($nominal) for Ausgrid over the 2019–24 regulatory control period for its distribution and transmission networks respectively. These represent reductions of

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

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

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

23 ITAA, section 43.20.

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

25 ITAA, section 995.1.

$49.0 million (or 27.6 per cent) and $6.6 million (or 57.1 per cent) from Ausgrid's revised proposal for its distribution and transmission networks respectively.

As discussed above, we applied the new amended PTRM (version 4) for this final 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 about $21.9 million (or 11.6 per cent) for Ausgrid's combined distribution and transmission networks.

We have reduced the revised proposed opening TABs as at 1 July 2019. As a consequence, we have updated Ausgrid's remaining tax asset lives as at 1 July 2019. We accept Ausgrid's revised proposed standard tax asset lives, which are consistent with our draft decision. We also determine standard tax asset lives of 40 years for the new 'Buildings (system)' and 5 years for the new 'In-house software' asset classes that are subject to the SL method of tax depreciation. Our reasons for these amendments are discussed below.

Discussed in other attachments and the Overview, our final decision on Ausgrid's revised proposed return on capital (attachments 2, 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. We have accepted the revised proposed value of imputation credits (gamma) of 0.585 (section 2.2 of the Overview).

7.4.1 Implementation of the tax review

In the draft decision, we applied the existing PTRM (version 3) at the time to calculate the various components required to estimate Ausgrid's cost of corporate income tax for the 2019–24 regulatory control period. We noted that we would apply any amended regulatory models arising from the tax review for the final decision. Ausgrid calculated the corporate income tax allowance using version 3 of our PTRM for its revised proposal, which was submitted prior to the finalisation of the new PTRM version 4.

We published the new amended PTRM (version 4) in April 2019 which implements the changes identified from the final report of the tax review.[26] 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.[27]

[26] We have not yet amended the RFM to implement the new tax depreciation approach. This is because the final report of the tax review recommended that the required changes would apply to new assets only. This means that only changes to the PTRM are required in the first regulatory control period when transitioning into the new tax depreciation approach.

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

Our assessment of the new tax inputs submitted by Ausgrid 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 immediately deductible capex to be provided for each asset class for each regulatory year of the 2019–24 regulatory control period.

Ausgrid submitted that it has not forecast any of its capex as immediately deductible during the 2019–24 regulatory control period.[28] For this final decision, we accept Ausgrid's submission because the proposed approach is consistent with its past tax practice.[29] As discussed above, we will collect actual data relating to this expenditure in our annual reporting RINs to further inform our decision on the amount of forecast immediate expensing of capex in the next regulatory determination for Ausgrid.

Assets exempt from the diminishing value method

In our draft decision, we 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 2019, but applies the DV method as the new regulatory benchmark for tax depreciation to all new capex.[30] 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.[31] 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 Ausgrid's forecast capex, we asked Ausgrid if it wishes to propose any relevant forecast capex to be exempted from the DV tax depreciation method.

In its response to our information request, Ausgrid submitted that $220.7 million[32] of forecast capex associated with buildings (system and non-system) and $119.4 million[33] of forecast capex associated with in-house software are to be exempted from the DV

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

28 Ausgrid, *Response to AER email: Implementation of the tax review - Ausgrid*, dated 13 March 2019.

29 Ausgrid, *Revised regulatory proposal 2019–24*, January 2019, p. 45 and Ausgrid, *Submission: Post-tax revenue models (transmission and distribution) - April* 2019 amendment, 12 March 2019, p. 2.

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

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

32 This includes $185.1 million for the distribution network and $35.6 million for the transmission network.

33 This includes $110.2 million for the distribution network and $9.2 million for the transmission network.

tax depreciation method. It has provided us with the reallocation of the forecast capex related to these assets from the existing asset classes to the prescribed SL tax depreciation asset classes in the PTRM. Specifically, these reallocations are:

- A proportion of forecast capex in the 'Substations' asset class is reallocated to the new 'Buildings (system)' asset class for the distribution PTRM.
- A proportion of forecast capex in the 'Transmission buildings 132/66kV' asset class is reallocated to the new 'Buildings (system)' asset class for the transmission PTRM.
- Forecast capex in the 'Buildings' asset class is fully reallocated to the relabelled 'Buildings (non-system)' asset class for both distribution and transmission PTRMs.
- A proportion of forecast capex in the 'IT systems' asset class is reallocated to the new 'In-house software' asset class for both distribution and transmission PTRMs.

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

- buildings satisfies the definition of a capital work under section 43.20 of the ITAA and in ATO taxation ruling 97/25[34]
- in-house software satisfies the definition under section 995.1 of the ITAA and ATO taxation ruling 2016/3.[35]

Therefore, these assets are not required to be depreciated using the DV method for tax purposes. The overall impact of our final decision to apply the DV tax depreciation method to new assets is to reduce Ausgrid's revised proposed estimated corporate income tax allowances by $19.4 million (or 10.9 per cent) and $2.5 million (or 21.9 per cent) for its distribution and transmission networks respectively ($ nominal), all else being equal.

7.4.2 Opening tax asset base as at 1 July 2019

We determine opening TAB values as at 1 July 2019 of $9911.9 million and $1325.9 million ($ nominal) for Ausgrid's distribution and transmission networks respectively. These amounts are $1.7 million and $0.4 million lower than the respective values proposed by Ausgrid in its revised proposal.

In our draft decision, we accepted Ausgrid's proposed method to establish the opening TABs as at 1 July 2019. However, we amended some of the proposed inputs used for the TAB roll forward—specifically, we made adjustments for capitalised provisions and reclassification of services.[36]

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[34] ATO, *Taxation Ruling 97/25*, July 2017.

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

[36] AER, *Draft Decision Ausgrid 2019–24 Distribution Determination Attachment 5: Corporate income tax*, September 2018, p. 12.

We also noted in the draft decision that the proposed capex for 2017–18 and 2018–19 were estimates and that Ausgrid would provide the actual capex for 2017–18 in its revised proposal, and that it may revise the 2018–19 capex estimate.

While Ausgrid's revised proposal RFMs incorporated our approach for the reclassification of services,[37] it did not adopt our amendments for capitalised provisions in 2015–17 capex. Ausgrid's revised proposal also updated the 2017–18 estimated capex with actuals and revised 2018–19 estimate of capex with the latest figures.[38]

For the reasons discussed in attachment 2, we agree with Ausgrid that we do not need to adjust for capitalised provisions in 2015–17 capex because the capex values in its annual reporting RINs for those years do not include any capitalised provisions. However, we have adjusted the 2017–18 actual gross capex for movements in capitalised provisions to reflect Ausgrid's amended annual RIN for that year. We have accepted the revised estimate of the 2018–19 capex as it reflects more recent data.

In Ausgrid's revised proposal for its transmission network RFM, it adjusted the 2016−17 capex for the capitalisation of a finance lease, which was previously omitted.[39] This had the effect of increasing the opening TAB at 1 July 2019 by $18.4 million. As a consequence of this capex inclusion, Ausgrid's RFM needs to make a TAB adjustment at 30 June 2019 for this amount to reallocate to a new asset class labelled 'Transmission leases (network)' for the purposes of calculating tax depreciation from 1 July 2019. Ausgrid's revised proposed RFM made the TAB adjustment by reallocating $19.5 million to this new asset class, which is equivalent to the amount of the RAB adjustment at 30 June 2019. We consider that this transfer amount is not appropriate as it includes the indexation for inflation and the cost of capital. We therefore have amended the transfer amount to be $18.4 million, which is consistent with tax rule treatment.[40] In its response to our information request, Ausgrid agreed with our approach on the transfer amount.[41]

Table 7.7 and Table 7.8 set out our final decision on the roll forward of Ausgrid's TAB values over the 2014–19 regulatory control period for its distribution and transmission networks respectively.

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37 Ausgrid's revised proposal updated the amount of reallocation of certain assets from its transmission to distribution networks due to a reclassification of services.

38 Ausgrid, *Attachment 4.01 - RFM for distribution,* January 2019; Ausgrid, *Attachment 4.04 - RFM for transmission,* January 2019.

39 As discussed in attachment 2, the capex adjustment is now shown in Ausgrid's amended 2016–17 annual reporting RIN. We have reviewed the information and we consider it is reasonable to include this finance lease amount in the opening TAB.

40 The TAB roll forward in the RFM is in nominal terms and contains no indexation or half-year WACC adjustments to the net capex being added to the TAB.

41 Ausgrid, *Response to IR#59 TX RFM adjustments for finance leases*, emailed 15 February 2019.

Table 7.7 AER's final decision on Ausgrid's TAB roll forward for the 2014–19 regulatory control period – distribution ($ million, nominal)

	2014–15	2015–16	2016–17	2017–18[a]	2018–19[a]
Opening TAB	8559.3	8785.1	8815.2	8932.0	9226.2
Capital expenditure[b]	563.8	386.6	465.1	635.1	848.7
Less: tax depreciation	338.0	356.6	348.3	340.9	364.9
Plus: assets transferred to distribution from transmission					201.8
Closing TAB	8785.1	8815.2	8932.0	9226.2	9911.9

Source: AER analysis.

(a) Based on estimated capex.

(b) Net of disposals.

Table 7.8 AER's final decision on Ausgrid's TAB roll forward for the 2014–19 regulatory control period – transmission ($ million, nominal)

	2014–15	2015–16	2016–17	2017–18[a]	2018–19[a]
Opening TAB	1502.1	1511.7	1453.5	1505.0	1526.6
Capital expenditure[b]	58.3	–7.2	102.6	71.8	54.5
Less: tax depreciation	48.8	51.0	51.0	50.2	53.4
Less: assets transferred to distribution from transmission					201.8
Closing TAB	1511.7	1453.5	1505.0	1526.6	1325.9

Source: AER analysis.

(a) Based on estimated capex.

(b) Net of disposals.

7.4.3 Standard and remaining tax asset lives as at 1 July 2019

For this final decision, we accept Ausgrid's revised proposed standard tax asset lives. In addition, we determine standard tax asset lives of 40 years and 5 years for the new 'Buildings (system)'[42] and 'In-house software' asset classes respectively. We have updated the remaining tax asset lives as at 1 July 2019 to reflect the amendments we made to the opening TAB values as at 1 July 2019.

In the draft decision, we accepted Ausgrid's proposed standard tax asset lives. We also accepted Ausgrid's proposal to use the RFM's weighted average remaining life approach to determine the remaining tax asset lives as at 1 July 2019. However, we

[42] Ausgrid has an existing 'Buildings' asset class which has been relabelled to 'Buildings (non-system)' and retains the same standard tax asset life of 40 years.

updated the remaining tax asset lives as at 1 July 2019 to reflect our draft decision on the opening TAB values.

Ausgrid's revised proposal adopted the draft decision standard tax asset lives and updated the remaining tax asset lives as at 1 July 2019 to reflect the revised opening TAB values.

Discussed in section 7.4.1, as part of the implementation of the new tax depreciation approach, Ausgrid proposed to reallocate forecast capex associated with buildings and in-house software into the prescribed SL tax depreciation asset classes in the amended PTRM. The existing asset class for 'Buildings' has been moved to apply the SL tax depreciation method—relabelled 'Buildings (non-system)—and so we retain a standard tax asset life of 40 years for this asset class that is consistent with our draft decision. We determine a standard tax asset life of 40 years for the new 'Buildings (system)' asset class, as this is consistent with the number of years required to completely depreciate a capital works asset for tax purposes under the ITAA.[43] We also determine a standard tax asset life of 5 years for the new 'In-house software' asset class, as this is consistent with the ITAA.[44] In its response to our information request, Ausgrid agreed that both of these standard tax asset lives are appropriate for the new asset classes for tax depreciation purposes.[45]

For the new 'Transmission leases (network)' asset class, Ausgrid's revised proposal assigned a standard tax asset life of 50 years. We have not retained this standard tax asset life in the PTRM because Ausgrid has not proposed any forecast capex for this asset class during the 2019–24 regulatory control period. As a result, we are not required to assess the proposed standard tax asset life for this asset class for tax depreciation purposes.

We also accept Ausgrid's revised proposed approach to calculate the remaining tax asset lives as at 1 July 2019 for tax depreciation purposes of its existing assets, which were calculated using the weighted average method. This is consistent with the approach accepted in our draft decision. However, we have updated the remaining tax asset lives as at 1 July 2019 to reflect the amendments we made to the opening TAB values as at 1 July 2019 (section 7.4.2).

For the new 'Transmission leases (network)' asset class, Ausgrid proposed to assign a remaining tax asset life of 46 years. Ausgrid has provided clarification around the calculation of this life.[46] Based on the information before us, we consider it is appropriate to use the economic life of the capitalised lease as the remaining tax asset life, which is consistent with the ATO's guidance on determining the effective tax life of

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43 ITAA, sections 43.15, 43.140, 43.210.

44 ITAA, section 40.95(7).

45 Ausgrid, *Response to AER email: Implementation of the tax review - Ausgrid*, dated 5 March 2019.

46 Ausgrid has advised us that the lease was first recognised in the 2014–15 financial statements and that the remaining life of 46 years was therefore calculated as the standard life of 50 years less the 4 years between 2014–15 and 2018–19 (when the lease starts to depreciate), Ausgrid, *Response to IR#59* emailed 21 February 2019.

an asset.[47] We therefore accept the proposed remaining tax asset life for this asset class.

For the new 'In-house software' and 'Buildings (system)' 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 2019–24 regulatory control period. We therefore record 'n/a' in the PTRM for these asset classes.

Table 7.9 and Table 7.10 set out our final decision on the standard and remaining tax asset lives as at 1 July 2019 for Ausgrid for its distribution and transmission networks. We are satisfied that the standard and remaining tax asset lives are appropriate for application over the 2019–24 regulatory control period. We are also 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.[48]

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47 ATO, *Taxation Ruling 2018/4–Income tax: effective life of depreciating assets (applicable from 1 July 2018)*, p. 10; ITAA, section 40.105.

48 NER, cl. 6.5.3.

Table 7.9 AER's final decision on Ausgrid's standard and remaining tax asset lives – distribution (years)

Asset class	Standard tax asset life	Remaining tax asset lives as at 1 July 2019[a]
Sub-transmission lines and cables	47.5[b]	33.5
Cable tunnel (dx)	40.0[b]	33.9
Distribution lines and cables	48.7[b]	37.7
Substations	40.0[b]	28.2
Transformers	42.0[b]	26.8
Low voltage lines and cables	45.8[b]	35.3
Customer metering and load control	25.0[b]	9.5
Customer metering (digital)[d]	n/a	1.0
Communications (digital) - dx	10.0[b]	7.6
Total communications	7.4[b]	5.4
System IT (dx)	7.0[b]	6.3
Ancillary substation equipment (dx)	15.0[b]	11.6
Land and easements	n/a	n/a
Furniture, fittings, plant and equipment	10.6[b]	6.3
Land (non-system)[e]	n/a	5.0
Other non-system assets	10.5[b]	7.5
IT systems	4.0[b]	3.6
Motor vehicles	20.0[b]	10.9
Buildings (system)	40.0[c]	n/a
Buildings (non-system)	40.0[c]	33.1
In-house software	5.0[c]	n/a
Equity raising costs	5.0[c]	38.4

Source: AER analysis.

(a) Used for straight-line method of tax depreciation.

(b) Used for diminishing value method of tax depreciation.

(c) Used for straight-line method of tax depreciation.

(d) There is no forecast capex allocated to the 'Customer metering (digital)' asset class for the 2019–24 regulatory control period. Therefore, no standard tax asset life is assigned to this asset class. Also this asset class has a very small residual value. We have set the remaining tax asset life to 1 year to fully depreciate the amount and remove it remove it from the TAB in the 2019–24 regulatory control period. We do not expect this asset class to be used in subsequent regulatory control periods because metering expenditure is classified as alternative control services.

(e) This asset class has a negative value. The remaining tax asset life is 5 years to remove it from the TAB by the end of the 2019–24 regulatory control period.

n/a not applicable. We have not assigned a standard tax asset life to the 'Land and easements' and 'Land (non-system)' asset classes because the assets allocated to these asset classes are non-depreciating assets. There are no opening TAB values as at 1 July 2019 for the 'Buildings (system)' and 'In-house software' asset classes. Therefore, no remaining tax asset lives are assigned to these asset classes.

Table 7.10 AER's final decision on Ausgrid's standard and remaining tax asset lives – transmission (years)

Asset class	Standard tax asset life	Remaining tax asset lives as at 1 July 2019[a]
Transmission & zone land & easements	n/a	n/a
Transmission buildings 132/66kV	40.0[b]	29.6
Zone buildings 132/66kV	40.0[b]	29.0
Transmission transformers 132/66kV	40.0[b]	26.7
Zone transformers 132/66kV	45.0[b]	29.7
Transmission substation equip 132/66kV	40.0[b]	29.3
Zone substation equip 132/66kV	40.0[b]	29.9
Ancillary substation equipment (tx)	15.0[b]	10.5
132kV tower lines	47.6[b]	35.4
132kV concrete & steel pole lines	47.6[b]	36.7
132kV wood pole lines	47.6[b]	27.9
132kV feeders underground	47.0[b]	35.4
Cable tunnel (tx)	47.6[b]	35.9
Network control & com systems	37.2[b]	12.5
Communications (digital) – tx	10.0[b]	7.1
System IT (tx)	7.0[b]	6.5
IT systems	4.0[b]	3.4
Furniture, fittings, plant and equipment	10.6[b]	5.9
Motor vehicles	20.0[b]	10.5
Land (non-system)[d]	n/a	5.0
Other non-system assets	10.5[b]	7.5
Transmission leases (network)	50.0[b]	46.0
Buildings (system)	40.0[c]	n/a
Buildings (non-system)	40.0[c]	31.9
In-house software	5.0[c]	n/a

Equity raising costs	5.0[c]	36.7

Source: AER analysis.

(a) Used for straight-line method of tax depreciation.

(b) Used for diminishing value method of tax depreciation.

(c) Used for straight-line method of tax depreciation.

(d) This asset class has a negative value. The remaining tax asset life is 5 years to remove it from the TAB by the end of the 2019–24 regulatory control period.

n/a not applicable. We have not assigned a standard tax asset life to the 'Transmission & zone land & easements' and 'Land (non-system)' asset classes because the assets allocated to these asset classes are non-depreciating assets. There are no opening TAB values as at 1 July 2019 for the 'Buildings (system)' and 'In-house software' asset classes. Therefore, no remaining tax asset lives are assigned to these asset classes.