DRAFT DECISION
Jemena Gas Networks (NSW) Ltd
Access Arrangement

2020 to 2025

Attachment 7
Corporate income tax

November 2019

AUSTRALIAN ENERGY REGULATOR

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Note

This attachment forms part of the AER's draft decision on the access arrangement that will apply to Jemena Gas Networks (NSW) Ltd ('JGN') for the 2020–2025 access arrangement period. It should be read with all other parts of the draft decision.

The draft decision includes the following documents:

Overview

Attachment 1 – Services covered by the access arrangement

Attachment 2 – Capital base

Attachment 3 – Rate of return

Attachment 4 – Regulatory depreciation

Attachment 5 – Capital expenditure

Attachment 6 – Operating expenditure

Attachment 7 – Corporate income tax

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Attachment 11 – Non-tariff components

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Attachment 13 – Capital expenditure sharing scheme

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Shortened forms

Shortened form	Extended form
AER	Australian Energy Regulator
ATO	Australian Tax Office
Capex	Capital expenditure
CPI	Consumer price index
DV	Diminishing value
Gamma	Value of Imputation Credits
ITAA	Income Tax Assessment Act 1997
JGN	Jemena Gas Networks (NSW) Ltd
NGL	National Gas Law
NGO	National Gas Objective
NGR	National Gas Rules
Opex	Operating expenditure
PTRM	Post-tax revenue model
RFM	Roll forward model
RIN	Regulatory Information Notice
SL	Straight-line
TAB	Tax asset base

7 Corporate income tax

Our determination of the total revenue for JGN includes the estimated cost of corporate income tax for JGN's 2020–25 access arrangement period.[1] JGN has adopted the post-tax framework to derive its revenue requirement for the 2020–25 period.[2] Under the post-tax framework, a corporate income tax allowance is calculated as part of the building blocks assessment. This amount allows JGN to recover the estimated cost of corporate income tax during the 2020–25 period.

This attachment presents our assessment of JGN's proposed corporate income tax allowance for the 2020–25 access arrangement period. It also presents our assessment of its proposed opening tax asset base (TAB), and the standard tax asset lives used to estimate tax depreciation for the purpose of calculating tax expenses.

7.1 Draft decision

We accept JGN's proposed approach to calculate its forecast corporate income tax allowance. JGN's proposed approach is based on our post-tax revenue model (PTRM) for electricity service providers and is consistent with the findings from our recent review of the regulatory tax approach (tax review).[3]

We determine an estimated cost of corporate income tax of $6.1 million ($ nominal) for JGN in the 2020–25 period. This represents a reduction of $11.1 million (or 64.4 per cent) from JGN's proposed cost of corporate income tax of $17.3 million ($ nominal). The majority of this reduction is due to our amendments to JGN's proposed return on capital (Attachments 2, 3 and 5) and regulatory depreciation (Attachment 4). These building blocks affect total revenues which, in turn, impact the tax calculation.

We accept JGN's implementation of the findings in our final report on the tax review. Specifically, we accept JGN's proposal to apply the diminishing value (DV) method for tax depreciation to all new depreciable assets except for forecast capital expenditure (capex) associated with buildings, leasehold improvements and in-house software (section 7.4.1).

We also accept JGN's proposed standard tax asset lives for all of its existing asset classes as they are broadly consistent with the tax asset lives prescribed by the Australian Tax Office's (ATO) taxation ruling 2019/5 (section 7.4.4).[4]

Further, we accept JGN's proposed standard tax asset lives of 40 years for the 'Buildings' and 'Leasehold improvements' asset classes, and 5 years for the 'Software – Inhouse' asset class, as they are consistent with the tax law (section 7.4.4).[5]

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1 National Gas Rules (NGR), r. 76(c).

2 JGN, *2020–25 Access Arrangement Proposal – Attachment 7.2 – PTRM*, June 2019.

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

4 ATO, *Taxation Ruling TR2019/5 – Income tax: effective life of depreciating assets (applicable from 1 July 2019),* p.180.

We reduced JGN's proposed opening TAB value as at 1 July 2020 by $0.4 million. While we accept JGN's approach for establishing the opening TAB, we have corrected some consumer price index (CPI) adjustment errors in the TAB roll-forward (section 7.4.2). The reduction to the opening TAB value has slightly increased the corporate income tax allowance.

Table 7.1 sets out our draft decision on the estimated cost of corporate income tax for JGN over the 2020–25 period.

Table 7.1 AER's draft decision on JGN's cost of corporate income tax for the 2020–25 access arrangement period ($million, nominal)

	2020–21	2021–22	2022–23	2023–24	2024–25	Total
Tax payable	0.9	2.7	4.6	6.0	0.6	14.8
Less: value of imputation credits	0.5	1.6	2.7	3.5	0.3	8.7
Net corporate income tax	**0.4**	**1.1**	**1.9**	**2.5**	**0.2**	**6.1**

Source: AER analysis.

7.2 JGN's proposal

JGN proposed an estimated cost of corporate income tax of $17.3 million ($ nominal) for the 2020–25 access arrangement period. It used our PTRM (version 4) for electricity service providers to calculate the corporate income tax allowance for each year of the 2020–25 period.[6] In estimating its corporate income tax allowance, JGN used the following inputs:

- an opening TAB as at 1 July 2020 of $1242.4 million ($ nominal)
- depreciation of the opening TAB at 1 July 2019 for each asset class applying the DV method. JGN has made amendments to the PTRM template to allow for this:
    - JGN's use of the DV method continues the approach applied in its previous access arrangements and provides for better alignment between the regulatory tax allowance and actual tax practice
- an expected statutory income tax rate of 30 per cent per year
- a value of imputation credits (gamma) of 0.585.

JGN proposed standard tax asset lives that are different from the implied standard tax lives from the 2015–20 access arrangement as set out in Table 7.2. These proposed standard asset lives are broadly consistent with those prescribed by the Commissioner

[5] ITAA, sections 43.15, 43.140, 43.210; ITAA, section 40.95(7).

[6] JGN, *2020–25 Access Arrangement Proposal – Attachment 7.2 – PTRM*, June 2019.

for Taxation in ATO taxation ruling 2019/5.[7] The proposed standard tax asset lives for other asset classes are unchanged and reflect the lives approved for the 2015–20period.

Table 7.2 JGN's proposed standard tax asset lives for the 2020–25 access arrangement period compared to implied standard tax asset lives approved for the 2015–20 access arrangement period

Asset class	Approved diminishing value depreciation rate for 2015–20	Implied approved tax asset lives for 2015–20 (years)[a]	Proposed standard tax asset lives for 2020–25 (years)
Contract meters	10%	20	15
Meter reading devices	10%	20	15
Tariff meters	10%	20	15
Computers – IT infrastructure	40%	5	4
Fixed plant	20%	10	10.8
Furniture	20%	10	10.8
Low value assets	60%	3.3	6.5
Mobile plant	20%	10	6.5
Vehicles	25%	8	7.5
Software – Inhouse	50%	4	5
Equity raising costs	11%	n/a[b]	5

Source: JGN, *2020–25 Access Arrangement Proposal – Attachment 7.3 – RFM*, June 2019; AER, *Final decision JGN – PTRM*, February 2019; JGN, *Response to information request 017*, 22 August 2019, p. 3.

a) The implied approved tax asset lives are calculated by using the following formula: 1 / approved diminishing value (DV) depreciation rate × 200%.

b) We did not calculate the implied approved standard tax asset life for the 'Equity raising costs' asset class. The tax depreciation rate for this asset class was calculated based on the weighted average standard life of the opening tax asset base in the approved PTRM.

JGN also proposed to reallocate its capitalised pigging costs from the existing asset classes to a new asset class labelled 'Existing pigging and inspection costs', applying from 1 July 2020.[8] JGN proposed a remaining tax asset life of 5 years for this asset class to fully depreciate the residual tax value for pigging and inspection costs over the 2020–25 period (section 7.4.3).

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7 ATO, *Taxation Ruling TR2019/5 – Income tax: effective life of depreciating assets (applicable from 1 July 2019),* p.180.

8 JGN, *2020–25 Access Arrangement Proposal – Attachment 6.3 – RFM – Pigging Costs*, 30 June 2019.

Table 7.3 sets out JGN's proposed TAB roll forward over the 2015–20 period.

Table 7.3 JGN's proposed tax asset base roll forward over the 2015–20 access arrangement period ($million, nominal)

	2015–16	2016–17	2017–18	2018–19 [a]	2019–20 [a]
Opening tax asset base	944.8	1023.5	1073.9	1130.3	1180.6
Capital expenditure[b]	204.6	181.5	189.5	186.6	201.3
Less: tax depreciation	125.9	131.1	133.1	136.3	139.6
Closing tax asset base	**1023.5**	**1073.9**	**1130.3**	**1180.6**	**1242.4**

Source: JGN, *2020–25 Access Arrangement Proposal – Attachment 7.2 – PTRM*, June 2019.

(a) Based on estimated capex.

(b) Net of disposals.

Table 7.4 sets out JGN's proposed cost of corporate income tax for the 2020–25 period.

Table 7.4 JGN's proposed cost of corporate income tax for the 2020–25 access arrangement period ($million, nominal)

	2020–21	2021–22	2022–23	2023–24	2024–25	Total
Tax payable	6.6	7.9	9.3	10.8	7.0	41.6
Less: value of imputation credits	3.8	4.6	5.5	6.3	4.1	24.3
Net corporate income tax	**2.7**	**3.3**	**3.9**	**4.5**	**2.9**	**17.3**

Source: JGN, *2020–25 Access Arrangement Proposal – Attachment 7.2 – PTRM*, June 2019.

7.3 Assessment approach

We make an estimate of taxable income for each regulatory year of the access arrangement period as part of our determination of the total revenue requirement for JGN's 2020–25 access arrangement period.[9] Our estimate is the taxable income a benchmark efficient entity would earn for providing reference services if it operated JGN's business.

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

[9] NGR, r. 87A(1).

models (PTRM and RFM).[10] The changes to our regulatory tax approach require amending our models to:[11]

- recognise immediate tax expensing of some capex forecast for a access arrangement 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 straight-line (SL) tax depreciation method under the tax law.

JGN's proposal is based on our PTRM (version 4), which incorporates our new regulatory tax approach to calculate the corporate income tax allowance for each year of the 2020–25 period.[12] JGN has made further modifications to the PTRM to allow for the DV method of tax depreciation to continue applying to its opening TAB at 1 July 2020. This reflects JGN's approved previous access arrangements where it applied the DV method to the majority of its existing assets for tax purposes.

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

Our approach for calculating a gas pipeline service provider's estimated cost of corporate income tax allowance involves the following steps:

1. We estimate the annual assessable income (taxable revenue) that would be earned by a benchmark efficient entity operating the gas pipeline service provider's business. This is the approved forecast revenues for the gas pipeline service provider that we determined using the building block approach.[13] 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 block[14]
    - interest expense is a function of the size of the capital base, 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/or remaining tax asset lives for taxation purposes. Previously, JGN's access arrangements applied the DV method for calculating tax depreciation for most of its assets. JGN's proposed PTRM

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10 AER, *Final report: Review of regulatory tax approach*, December 2018, p. 76. The PTRM specifies the manner in which the estimated cost of corporate income tax is to be calculated. The RFM calculates the gas pipeline service provider's tax asset base which is an input to the PTRM for the calculation of the tax building block.

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

12 JGN, *2020–25 Access Arrangement Proposal – Attachment 7.2 – PTRM*, June 2019.

13 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.

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

continues with this approach and is consistent with the findings of the tax review, where it applies the DV tax depreciation method[15] 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 tax review also found that the PTRM should account 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.[16] 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 gas pipeline service provider's business by subtracting the benchmark estimates of tax expenses (step 2) from the approved forecast revenues for the service provider (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 gas pipeline service provider's total revenue requirement.

How we assess the tax inputs to the PTRM

The estimated cost of corporate income tax allowance is an output of the PTRM. We therefore assess the gas pipeline service provider's proposed cost of corporate income 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) access arrangement period, our PTRM, giving effect to the changes from the tax review, 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:

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

[16] 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.

- **opening TAB as at the commencement of the 2020–25 access arrangement 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 JGN's actual capex incurred during the 2015–20 access arrangement period, and the final year (2014–15) of the previous access arrangement period.[17] 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 access arrangement that the benchmark efficient entity at the time will not immediately expense any capex during that period.

  The roll forward of the opening TAB for the 2015–20 period is calculated in JGN's RFM. JGN has historically applied the DV method of tax depreciation to roll forward its TAB.

  This opening TAB value is used to estimate forecast tax depreciation for the 2020–25 period, including new assets to be added to the TAB over this period. Consistent with JGN's proposal, we will continue to apply the DV method of tax depreciation for the opening TAB value and all new assets forecast to be added to the TAB in the 2020–25 period (with some exceptions discussed further below).

- **standard tax asset life for each asset class:** Our assessment of a gas pipeline service provider's proposed standard tax asset lives is generally guided by the effective life for depreciating assets determined by the Commissioner for Taxation. The ATO sets a statutory life cap of 20 years on certain classes of gas transmission and distribution assets.[18] We consider that the standard tax asset lives for JGN's asset classes should be consistent with the ATO taxation ruling 2019/5 regarding the effective life of depreciating assets where possible.[19]

  As discussed above, the PTRM applies the DV tax depreciation method for all new assets except for in-house software, buildings and capital works, and equity raising costs. It provides designated asset classes for these assets to be depreciated using the SL method for tax purposes.[20] The tax effective lives for in-house software, buildings and capital works, 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:

  - 40 years for buildings and capital works – This is consistent with the number of years required to completely depreciate a capital works asset such as

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17 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.

18 ATO, *Taxation Ruling TR2019/5 – Income tax: effective life of depreciating assets (applicable from 1 July 2019)*, p. 180. For transmission assets: compressor station assets, gas pipeline LNG station assets, pipelines–transmission, spur or lateral, regulators and underground gas storage asset. For distribution assets: low pressure gas storage holders, pipelines (high, medium and low pressure trunks, primary or secondary mains or services) and regulators.

19 ATO, *Taxation Ruling TR2019/5 – Income tax: effective life of depreciating assets (applicable from 1 July 2019*), p. 180.

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

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.

- **income tax rate:** The statutory income tax rate is 30 per cent per year for the businesses of the size we regulate, which was adopted in JGN's proposal.
- **value of gamma:** The gamma input for JGN 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 was adopted in JGN's proposal.[21] Refer to section 4.2 of the Overview for this draft decision for further discussion on this matter.
- **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 an access arrangement period. If there is an amount of tax losses accumulated, the forecast taxable income for the period will be reduced by this amount. JGN does not have any accumulated tax losses as at the start of the 2020–25 period.[22]
- **forecast immediate expensing of capex:** The PTRM requires a forecast for immediately deductible capex to be provided for each regulatory year of the 2020–25 access arrangement period. Our assessment of forecast immediate expensing of capex is guided by the gas pipeline service provider's actual immediate expensing of capex from the previous access arrangement period.[23] We will collect actual data relating to this expenditure in our annual reporting Regulatory Information Notices (RIN) to further inform our decision on the amount of forecast immediate expensing of capex in future access arrangements. Benchmarking may also be considered going forward.[24]
- **diminishing value multiplier:** The PTRM applies the following formula to calculate the tax depreciation under the DV method:[25]

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

where:

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

22 JGN, *2020–25 Access Arrangement Proposal – Attachment 7.2 – PTRM*, June 2019.

23 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.

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

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

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 access arrangement period. This is labelled as the 'diminishing value multiplier' in the PTRM. 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 PTRM applies the DV method for tax depreciation purposes to all new depreciable assets except for certain assets. It provides for the PTRM 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. Section 40.880 of the ITAA and the ATO's taxation ruling 2011/6[26] 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.[27] Further, the gas pipeline service provider 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.[28] This includes new buildings and structural improvements to existing buildings.[29] We further note, 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-

[26] ATO, *Taxation Ruling 2011/6*, July 2016.

[27] The benchmark allowance for equity raising costs is determined within the PTRM.

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

[29] ITAA, section 43.20.

house software under section 995.1 of the ITAA and in ATO taxation ruling 2016/3.[30] This includes computer software, or the right to use computer software that the gas pipeline service provider acquires, develops or has someone else develop for the gas pipeline service provider's business use.[31] We further note, 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.

In assessing JGN's proposal, we have had regard to the National Gas Objective (NGO) and the revenue and pricing principles.[32] The NGR also require that any forecast must be arrived at on a reasonable basis and must represent the best forecast or estimate possible in the circumstances.[33]

7.3.1 Interrelationships

The cost of corporate income tax building block feeds directly into the total 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 five 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.[34] Depending on the source of the revenue increase, the tax increase may be equal to or less than proportional to the company tax rate.[35]

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

31 ITAA, section 995.1.

32 National Gas Law (NGL), s. 28; NGR, r. 100(1). The NGO is set out in NGL, s. 23. The revenue and pricing principles are set out in NGL, s. 24.

33 NGR, r. 74(2).

34 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.

35 For example, although increased opex adds to revenue requirement, these expenses are also offset against the revenues as deductions in determining tax, so there is no net impact in this case. A higher return on equity, in contrast, gives rise to no offsetting tax expenses and therefore increases the tax allowance in proportion to the company tax rate.

The tax expenses (or deductions) depend on various building block components and their size. Some components give rise to tax expenses, such as opex, interest payments and tax depreciation of assets. However, others do not, such as increases in return on equity. Higher tax expenses offset revenues as deductions in the tax calculation and therefore reduce the cost of corporate income tax allowance (all things being equal). Tax expenses include:

- interest on debt – Interest is a tax offset. The size of this offset depends on the ratio of debt to equity and therefore the proportion of the capital base funded through debt. It also depends on the allowed return on debt and the size of the capital base.
- 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 service provider reflecting tax rules. This TAB is affected by many of the same factors as the capital base, such as capex, although unlike the capital base 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 the previous period(s) can be carried forward to offset against tax payable in the current period.

For JGN, the cost of corporate income tax makes up around 0.7 per cent of the total building block revenue for the 2020–25 period. Therefore, a 10 per cent increase in the corporate income tax allowance causes revenues to increase by about 0.1 per cent.

7.4 Reasons for draft decision

We determine a cost of corporate income tax of $6.1 million ($ nominal) for JGN over the 2020–25 access arrangement period. This represents a reduction of $11.1 million (or 64.4 per cent) from JGN's proposal.

We accept JGN's proposal to establish the opening TAB as at 1 July 2020, including the application of the DV method of tax depreciation for the 2015–20 period. However, we reduced JGN's proposed opening TAB value as at 1 July 2020 to $1241.9 million ($ nominal)—a reduction of $0.4 million—due to correcting for some errors.

We accept JGN's proposed standard tax asset lives for all of its existing asset classes. We also accept JGN’s proposal in relation to the implementation of the tax review.

Discussed in other attachments and the Overview, our draft decision on JGN’s proposed return on capital (Attachments 2, 3 and 5) and the regulatory depreciation

(Attachment 4) building blocks affect total revenues, and therefore also impact the forecast corporate income tax allowance.[36]

7.4.1 Implementation of the tax review

JGN's proposal calculated the corporate income tax and is based on the new amended PTRM (version 4) for electricity service providers which implemented the changes identified from the final report of the tax review. [37] Our assessment of the tax inputs associated with the tax review are discussed below.

Forecast immediate expensing of capex

Certain capex (such as refurbishment capex) is able to be 'immediately expensed' under tax legislation. The PTRM provides that a forecast of immediately deductible capex be recorded for each asset class for each regulatory year of the access arrangement period.

JGN did not forecast any of its capex as immediately deductible during the 2020–25 period.[38] JGN submitted that it does not expect to immediately expense any capex during the 2020–25 period as all the relevant costs that could be expensed for tax purposes are treated as opex for regulatory purposes during this period.[39]

For this draft decision, we accept JGN's submission that it has no forecast for immediately expensing of capex for the 2020–25 period. 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 access arrangement for JGN.

Assets exempt from the diminishing value 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, buildings and capital works.

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. JGN has proposed forecast capex for leasehold improvements, buildings and in-house software to be depreciated using the SL method for tax depreciation purposes. We accept the proposal on the basis of the information before us.

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36 NGR, r. 87A.

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

38 JGN, *2020–25 Access Arrangement Proposal – Attachment 7.2 – PTRM*, June 2019.

39 JGN, *Response to AER – JGN – IR030 – Further PTRM and Depreciation model questions*, 15 October 2019.

In response to an information request, JGN confirmed that the proposed forecast capex for:[40]

- in-house software satisfies the definition under section 995.1 of the ITAA and ATO taxation ruling 2016/3[41]
- buildings and leasehold improvements satisfies the definition of a capital work under section 43.20 of the ITAA and in ATO taxation ruling 97/25[42]

Gas asset life caps

Our new regulatory tax approach applies a 20 year cap on the tax asset lives for certain new gas assets. This is consistent with ATO's tax ruling which sets a statutory life cap of 20 years on certain classes of gas transmission and distribution assets.[43]

JGN's proposed standard tax asset lives for its gas pipeline assets are capped at 20 years, reflecting our new regulatory tax approach.

7.4.2 Opening tax asset base as at 1 July 2020

We accept JGN's proposed method to establish the opening TAB as at 1 July 2020. This is because JGN's proposed approach is consistent with the approach previously approved for the 2015–20 access arrangement.

We determine an opening TAB value as at 1 July 2020 of $1241.9 million ($ nominal) for JGN. This represents a reduction of $0.4 million compared to JGN's proposed value of $1242.4 million. This is because we made some CPI adjustments to the actual capex added to the TAB to bring it to correct dollar terms. JGN has confirmed that it does not have any concerns with this amendment.[44]

We have reviewed the inputs to the TAB roll forward and found they were correct and reconcile with relevant data sources, such as historical data RINs and the 2015–20 decision models. However, 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.

Table 7.5 sets out our draft decision on the roll forward of JGN's TAB values over the 2015–20 period.

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40 JGN, *Response to information request 017*, 22 August 2019, pp. 6–7.

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

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

43 ATO, *Taxation Ruling TR2019/5 – Income tax: effective life of depreciating assets (applicable from 1 July 2019)*, p. 180. For transmission assets–compressor station assets, Gas pipeline LNG station assets, pipelines–transmission, spur or lateral, regulators and underground gas storage asset. For distribution assets low pressure gas storage holders, pipelines (high, medium and low pressure trunks, primary or secondary mains or services) and regulators.

44 JGN, *Response to information request 017*, 22 August 2019, pp. 4–5.

Table 7.5 AER's draft decision on JGN's TAB roll forward for the 2015–20 access arrangement period ($ million, nominal)

	2015–16	2016–17	2017–18	2018–19 [a]	2019–20 [a]
Opening TAB	944.8	1023.5	1074.1	1130.1	1180.6
Capital expenditure[b]	204.6	181.7	189.1	186.7	200.9
Less: tax depreciation	125.9	131.1	133.1	136.3	139.5
Closing TAB	**1023.5**	**1074.1**	**1130.1**	**1180.6**	**1241.9**

Source: AER analysis.

(a) Based on estimated capex.

(b) Net of disposals.

7.4.3 Tax depreciation on opening TAB as at 1 July 2020

We accept JGN's proposal to depreciate its opening TAB as at 1 July 2020 by continuing the use of the DV method. JGN has historically applied the DV method to depreciate its assets for tax purposes. Therefore, JGN has amended the PTRM to allow its opening TAB as at 1 July 2020 to continue depreciating under the DV method. JGN has applied the DV rates for tax depreciation of each asset class that were approved for the 2015–20 period to depreciate its opening TAB as at 1 July 2020. We consider this is appropriate because it provides for tax depreciation schedules for the existing assets that are consistent with the depreciation method approved in the 2015–20 access arrangement.[45]

Accelerated tax depreciation of existing pigging and inspection costs

We accept JGN's proposal to apply accelerated depreciation to the residual value of existing pigging and inspection costs for tax purposes over the 2020–25 access arrangement period.

JGN proposed to reallocate some of its capitalised pigging costs from its existing asset classes to a new asset class labelled 'Existing pigging and inspection costs', applying from 1 July 2020.[46] JGN proposed a remaining tax asset life of 5 years apply to this asset class to fully depreciate the residual tax value for pigging and inspection costs over the 2020–25 period.[47] We consider this approach is reasonable as JGN has

45 AER, *Final decision – PTRM*, February 2019.

46 JGN, *2020–25 Access Arrangement Proposal – Attachment 6.3 – RFM – Pigging Costs*, June 2019.

47 JGN proposed to apply the SL method to depreciate these assets over 5 years. However, in our draft decision we have applied the DV method to be consistent with the approach approved at the last access arrangement review for depreciating these assets. This approach achieves the same outcome as the approach proposed by JGN because we write-off the residual value of these assets in the last year of the 2020–25 access arrangement period. JGN agreed with this change. JGN, *Response to information request 017,* 22 August 2019, p. 8.

proposed to expense these costs for both regulatory and tax purposes over the 2020–25 period.[48]

Further, as discussed in Attachment 6, we accept JGN's proposal to change the classification of these costs to opex from capex in the 2020–25 period.

7.4.4 Standard tax asset lives

We accept JGN's proposed standard tax asset lives assigned to its existing asset classes for the 2020–25 access arrangement period because they are broadly consistent with the tax asset lives prescribed by the Commissioner for Taxation in ATO taxation ruling 2019/5[49]. They are also consistent with the statutory cap on the effective life of 20 years for gas pipeline assets under the ITAA.

JGN established its proposed standard tax asset lives for the 2020–25 period by mapping its proposed forecast capex projects for this period to ATO asset classes.[50] In instances where asset classes are an aggregate of smaller asset categories (such as property and tools and equipment), JGN used the weighted average approach to calculate the standard tax asset lives using the forecast capex for each asset type as weights. This explains some of the differences between the implied tax asset lives based on DV depreciation rate used for the 2015–20 period and the proposed standard tax asset lives for 2020–25 period.[51]

JGN also has proposed standard tax asset lives of 15 years for 'Contract meters', 'Meter reading devices', 'Tariff meters' and 4 years for the 'Computers – IT infrastructure' asset classes, which are shorter than the implied tax asset lives used for the 2015–20 access arrangement. We accept these proposed shorter standard tax asset lives as they are consistent with the effective tax lives determined by the ATO.[52]

Discussed in section 7.4.1, as part of the implementation of the new tax depreciation approach, JGN proposed to reallocate forecast capex associated with buildings, leasehold improvements and in-house software to the prescribed SL tax depreciation asset classes in the PTRM.

We accept JGN's proposed standard tax asset life of 40 years for the 'Buildings' and 'Leasehold improvements' asset classes, as this is consistent with the number of years required to completely depreciate a capital works asset under the ITAA.[53] We also accept JGN's proposed standard tax asset life of 5 years for the 'Software – Inhouse' asset class, as this is consistent with the ITAA.[54]

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48 JGN, *Response to AER – JGN – IR030 – Further PTRM and Depreciation model questions*, 15 October 2019.

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

50 JGN, *Response to information request 017*, 22 August 2019, p. 8.

51 This applies to 'Fixed Plant', 'Furniture', 'Low value assets', 'Mobile plant' and 'Vehicles' asset classes.

52 ATO, *Taxation Ruling TR2019/5 – Income tax: effective life of depreciating assets (applicable from 1 July 2019)*, p. 180; ITAA, section 40.95(7).

53 ITAA, sections 43.15, 43.140, 43.210.

54 ITAA, section 40.95(7).

Our draft decision on JGN's standard tax asset lives for each of its asset classes is set out in Table 7.6. We are satisfied that the standard tax asset lives are appropriate for application over the 2020–25 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.[55]

Table 7.6 AER's draft decision on JGN's standard tax asset lives as at 1 July 2020 for the 2020–25 access arrangement period (years)

Asset class	Standard tax asset life
Trunk Wilton-Sydney[a]	20.0
Trunk Sydney-Newcastle[a]	20.0
Trunk Wilton-Wollongong[a]	20.0
Contract meters[a]	15.0
Fixed plant - distribution[a]	20.0
HP mains[a]	20.0
HP services[a]	20.0
MP mains[a]	20.0
MP services[a]	20.0
Meter reading devices[a]	15.0
Country POTS[a]	20.0
Tariff meters[a]	15.0
Computers – IT infrastructure[a]	4.0
Fixed plant[a]	10.8
Furniture[a]	10.8
Land[a]	n/a
Low value assets[a]	6.5
Mobile plant[a]	6.5
Vehicles[a]	7.5
Existing pigging and inspection costs[a]	n/a
Leasehold improvements[b]	40.0
Buildings[b]	40.0

55 NGR, r. 87A(1).

Software – Inhouse[b]	5.0
Equity raising costs[b]	5.0

Source: AER analysis.

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

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

n/a Not applicable. We have not assigned a standard tax asset life to the 'Land' asset class because it is a non-depreciating asset for tax purposes. We have not assigned a standard tax asset life to the 'Existing pigging and inspection costs' asset class as we do not expect any forecast capex to be allocated to it for the 2020–25 access arrangement period. This is because the pigging and inspection costs will be expensed going forward from the start of the 2020–25 period. Instead, the residual tax value for this asset class will be fully depreciated over the 2020–25 period.

7.5 Revisions

We require the following revisions to make the access arrangement proposal acceptable:

Revision 7.1	Make all necessary amendments to reflect this draft decision on the proposed corporate income tax allowance for the 2020–25 access arrangement period, as set out in Table 7.1.
Revision 7.2	Make all necessary amendments to reflect this draft decision on the opening tax asset base as at 1 July 2020, as set out in Table 7.5.