FINAL DECISION

Power and Water Corporation Distribution Determination 2019 to 2024

Attachment 7 Corporate income tax

April 2019

AUSTRALIAN ENERGY REGULATOR

Inquiries about this publication should be addressed to:

Australian Energy Regulator
GPO Box 520
Melbourne Vic 3001

Tel: 1300 585 165
Email: AERInquiry@aer.gov.au

AER reference: 60610

Note

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

The final decision includes the following attachments:

Overview

Attachment 1 – Annual revenue requirement

Attachment 2 – Regulatory asset base

Attachment 3 – Return on debt transition

Attachment 4 – Regulatory depreciation

Attachment 5 – Capital expenditure

Attachment 6 – Operating expenditure

Attachment 7 – Corporate income tax

Attachment 13 – Control mechanisms

Attachment 15 – Alternative control services

Attachment 18 – Tariff structure statement

Attachment A – Negotiating framework

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
EBSS	efficiency benefit sharing scheme
gamma	value of imputation credits
ITAA	Income Tax Assessment Act 1997
NER	National Electricity Rules As in force in the Northern Territory
opex	operating expenditure
PTRM	post-tax revenue model
RAB	regulatory asset base
RFM	roll forward model
RIN	regulatory information notice
SL	straight-line
TAB	tax asset base
Tax review	The 2018 review of the regulatory tax approach

7 Corporate income tax

Our determination of the annual revenue requirement includes the estimated cost of corporate income tax for Power and Water's 2019–24 regulatory control period.[1] Under the post-tax framework, a corporate income tax allowance is calculated as part of the building block assessment using our post-tax revenue model (PTRM). This attachment sets out our final decision on Power and Water'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 $5.9 million ($nominal) for Power and Water over the 2019–24 regulatory control period. This represents a reduction of $14.6 million (or 71.1 per cent) from Power and Water's revised proposed cost of corporate income tax allowance ($nominal).

One of the key reasons for this reduction is because 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 after the submission of Power and Water's revised proposal (section 7.4.1). Specifically, for this final decision, we have recognised immediately expensed capital expenditure (capex) for the calculation of tax depreciation. We also 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 allowance by $11.8 million (or 57.5 per cent).

Our final decision to increase the value of imputation credits (gamma) to 0.585 from Power and Water's revised proposal of 0.5 also contributes to the reduction to the corporate income tax allowance (section 2.2 of the overview).

We determine an opening tax asset base (TAB) value of $923.7 million ($nominal) as at 1 July 2019 for Power and Water.[2] This is $0.7 million (or 0.1 per cent) higher than the value of $922.9 million proposed by Power and Water in its revised proposal. While we accept Power and Water's approach for establishing the TAB, we have updated the revised proposed opening TAB value to reflect Power and Water's revised actual capex for 2017–18 (section 7.4.2). This higher opening TAB value has slightly reduced the corporate income tax allowance.

As a consequence of the updated opening TAB value, we have updated Power and Water's remaining tax asset lives as at 1 July 2019. We accept Power and Water's

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1 NT NER, cl. 6.4.3(a)(4).

2 This opening TAB value is for Power and Water's assets providing standard control services (SCS). We determined an opening TAB value of $12.6 million for Power and Water's assets providing alternative control service (ACS), which is further discussed at attachment 15.

revised proposed standard tax asset lives, which are consistent with our draft decision. We also determine standard tax asset lives of 40 years and 5 years for the new 'Buildings' and 'In-house software' asset classes that are subject to the straight-line (SL) method of tax depreciation (section 7.4.3).

Our determinations on other components of Power and Water's revised proposal also affect the corporate income tax allowance. Specifically, they relate to Power and Water's revised proposed return on capital (attachments 2, 3, 5, and section 2.2 of the Overview) and the regulatory depreciation (attachment 4) building blocks. These building blocks affect total revenues, which in turn impacts the tax calculation.

Table 7-1 sets out our final decision on the estimated cost of corporate income tax allowance for Power and Water over the 2019–24 regulatory control period.

Table 7-1 AER's final decision on Power and Water's cost of corporate income tax allowance for the 2019–24 regulatory control period ($million, nominal)

	2019–20	2020–21	2021–22	2022–23	2023–24	Total
Tax payable	4.2	2.5	2.7	2.1	2.9	14.3
Less: value of imputation credits	2.4	1.5	1.6	1.2	1.7	8.4
Net corporate income tax allowance	**1.7**	**1.0**	**1.1**	**0.9**	**1.2**	**5.9**

Source: AER analysis.

7.2 Power and Water's revised proposal

Power and Water's revised proposed corporate income tax allowance is $20.6 million for the 2019–24 regulatory control period. Power and Water noted that the revised proposal is based on the approaches and inputs used in the draft decision to estimate the corporate income tax allowance. Power and Water also noted the AER's tax review and its intent to engage further with the AER on the outcomes of this review, which may affect how the corporate income tax allowance is determined for the 2019–24 regulatory control period.[3]

As part of its transition to the NT NER and the AER's PTRM which operates under a post-tax framework, Power and Water has to establish an opening TAB value for the first time for regulatory purposes. This is because the determination for the 2014–19 regulatory control period was set by the Utilities Commission using a pre-tax framework. Power and Water's revised proposal has adopted our draft decision on the establishment of an opening TAB as at 1 July 2019. However, it has proposed to

[3] Power and Water, *Revised regulatory proposal*, November 2018, p. 53.

exclude capital contributions incurred in the 2014–19 regulatory control period in its revised proposed opening TAB value.[4]

Table 7-2 sets out Power and Water's revised proposed roll forward of its TAB values over the 2014–19 regulatory control period.

Table 7-2 Power and Water's revised proposed TAB roll forward ($million, nominal)

	2014–15	2015–16	2016–17	2017–18	2018–19[a]
Opening TAB	769.2	825.6	869.2	891.7	905.1
Capital expenditure[b]	78.8	68.4	49.5	42.4	42.2
Less: tax depreciation	22.5	24.8	27.0	29.0	31.0
Interim closing TAB	825.6	869.2	891.7	905.1	916.3
Roll-in of corporate assets					19.6
Closing TAB as at 30 June 2019 (SCS and ACS)					935.9
Closing TAB as at 30 June 2019 (ACS only)					12.9
Closing TAB as at 30 June 2019 (SCS only)					922.9

Source: Power and Water, *PWC04.10 - SCS and ACS Metering Roll Forward Model - 29 Nov 18 - Public,* November 2018.

(a) Based on estimated capex.

(b) Net of disposals and capital contributions.

Table 7-3 sets out Power and Water's revised proposed corporate income tax allowance for the 2019–24 regulatory control period.

Table 7-3 Power and Water's revised proposed cost of corporate income tax allowance for the 2019–24 regulatory control period ($million, nominal)

	2019–20	2020–21	2021–22	2022–23	2023–24	Total
Tax payable	7.9	8.1	8.4	8.3	8.4	41.1
Less: value of imputation credits	3.9	4.0	4.2	4.2	4.2	20.6
Net corporate income tax allowance	**3.9**	**4.0**	**4.2**	**4.2**	**4.2**	**20.6**

Source: Power and Water, *PWC04.01 - SCS Post-tax Revenue Model - 29 Nov 18 - Public*, November 2018.

[4] Power and Water, *Revised regulatory proposal 1 July 2019 to 30 June 2024*, November 2018, pp. 55 and 56.

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 Power and Water's 2019–24 regulatory control period. Our estimate is the taxable income a benchmark efficient entity would earn for providing standard control services if it operated Power and Water's energy network business.[5]

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 September 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 Power and Water's 2019–24 regulatory control period.

In December 2018, we released the final report of the tax review, 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 straight-line 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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5 NT NER, cl. 6.5.3.

6 AER, *Final report: Review of regulatory tax approach*, December 2018, pp. 6–20; The PTRM specifies the manner in which the estimated cost of corporate income tax is to be calculated. The RFM calculates the distributor's tax asset base 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: NT 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:** Power and Water is required to establish an opening TAB value at the commencement of the 2019–24 regulatory control period. This is because Power and Water was previously regulated under a pre-tax framework by the Utilities Commission. Therefore, an opening TAB value at 1 July 2019 needs to be established in this distribution determination for the transition from a pre-tax to a post-tax framework. Consistent with our assessment approach in the draft decision, we consider that the establishment of the opening TAB value should reflect Power and Water's tax asset value as assessed by the ATO for its annual tax returns.

  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 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 Power and Water'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 Power and Water's asset

classes should be consistent with the ATO taxation ruling 2018/4 regarding the effective life of depreciating assets where possible.[14]

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.[15] 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 Power and Water 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.[16] 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. Power and Water does not have any accumulated tax losses as at the start of the 2019–24 regulatory control period.[17]
- **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

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

[15] Our assessment approach on new assets to be exempted from the DV method is discussed further below.

[16] AER, *Rate of return instrument*, December 2018, p. 19.

[17] Power and Water, *Regulatory Proposal*, March 2018, pp. 111 and 112.

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:[18]

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

  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 standard tax 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 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[19] 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.[20] Further, the distributor may propose capex associated with buildings and in-house software to be exempted

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

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

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

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.[21] We note that this includes new buildings and structural improvements to existing buildings. 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.[22] 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.[23] 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 a cost of corporate income tax allowance of $5.9 million ($nominal) for Power and Water over the 2019–24 regulatory control period. This represents a reduction of $14.6 million (or 71.1 per cent) from Power and Water's revised proposal.

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 $11.8 million (or 57.5 per cent).

We increased the revised proposed opening TAB value as at 1 July 2019 by $0.7 million (or 0.1 per cent). While we accept Power and Water's approach for establishing the TAB, we have updated the revised proposed opening TAB value to reflect Power and Water's revised actual capex for 2017–18.

We accept Power and Water'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' and 'In-house software' asset classes that are subject to the SL method for tax

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

22 ATO, *Taxation Ruling 2*016/3, October 2018.

23 ITAA, section 995.1.

depreciation. We have updated the remaining tax asset lives as at 1 July 2019 to reflect the amendments we made to the opening TAB value as at 1 July 2019.

Our reasons for these amendments are discussed below.

Discussed in other attachments and the overview, our final decision on Power and Water's revised proposed return on capital (attachments 2, 3 and 5, and section 2.2 of the Overview) and regulatory depreciation (attachment 4) building blocks affect total revenues, and therefore also impact the forecast corporate income tax allowance. Our final decision to increase the value of imputation credits (gamma) to 0.585 from the revised proposed value of 0.50 further reduced the estimated corporate income tax allowance for the 2019–24 regulatory control period (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 Power and Water'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. Power and Water calculated the corporate income tax allowance using version 3 of our PTRM for its revised proposal, which was submitted prior to the final report of the tax review.

We published the new amended PTRM (version 4) in April 2019 which implements the changes identified from the final report of the tax review.[24] 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.[25]

We consulted with Power and Water on the PTRM changes and the required new inputs for implementing the new tax depreciation approach following the completion of the tax review. While Power and Water 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.

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[24] 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.

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

Our assessment of the new tax inputs submitted by Power and Water 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.

Power and Water submitted that $43.5 million ($2018–19, or 11.3 per cent)[26] of its forecast capex will be immediately expensed for tax purposes in the 2019–24 regulatory control period. Its historical immediate expensing of capex relates to capitalised overheads. It has calculated the proportion of immediate expensed capitalised overheads in 2017–18.[27] It then applied the same proportion on the forecast capex to determine the forecast immediate expensed capex for each asset class over the 2019–24 regulatory control period.

For this final decision, we accept Power and Water's proposed approach for determining the forecast immediate expensing of capex for the 2019–24 regulatory control period. This approach is consistent with the findings of the tax review. The proposed capex to be immediately expensed reflects the proportion of immediately expensed capex claimed by Power and Water historically. We consider it reasonable to expect that the same proportion of capex will also be deducted immediately by Power and Water for its annual tax returns during the 2019–24 regulatory control period. 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 Power and Water. We also accept the proposed $43.5 million ($2018–19) to be immediately expensed for tax purposes in the 2019–24 regulatory control period. As discussed in attachment 5, we have accepted Power and Water's revised proposed capex.[28] Therefore, we have not made any further adjustments to the proposed forecast amount.

Our final decision to recognise immediately deductible capex has reduced Power and Water's revised proposed estimated corporate income tax allowance by $6.8 million ($nominal, or 32.9 per cent), all else being equal.[29]

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,

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[26] Compared with the revised proposed gross capex of $385.8 million ($2018–19).

[27] Power and Water, *Email to AER: PWC - updated 2019-24 capex forecast model*, dated 26 February 2019.

[28] Excluding forecast ERC.

[29] This is based on Power and Water's revised proposal inputs in the PTRM.

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 Power and Water's forecast capex, we asked Power and Water 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, Power and Water submitted that $1.0 million ($2018–19) of forecast capex associated with buildings and $3.3 million ($2018–19) of forecast capex associated with in-house software are to be exempted from the DV tax depreciation method. It provided us with the reallocation of the forecast capex related these assets from the existing asset classes of 'Property' and 'IT and Communications' to the prescribed SL tax depreciation asset classes for 'Buildings' and 'In-house software' respectively in the PTRM.

We accept Power and Water'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[32]
- in-house software satisfies the definition under section 995.1 of the ITAA and in ATO taxation ruling 2016/3.[33]

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 Power and Water's revised proposed estimated corporate income tax allowance by $5.1 million ($nominal, or 24.6 per cent), all else being equal.

7.4.2 Opening tax asset base as at 1 July 2019

We determine an opening TAB value as at 1 July 2019 of $923.7 million ($nominal) for Power and Water.[34] This is $0.7 million (or 0.1 per cent) higher than the value of $922.9 million proposed by Power and Water in its revised proposal.

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

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

34 This opening TAB value is for Power and Water's assets providing standard control services (SCS). We determined an opening TAB value of $12.6 million for Power and Water's assets providing alternative control service (ACS), which is further discussed at attachment 15.

In our draft decision, we accepted Power and Water's proposed method to establish the opening TAB as at 1 July 2019. However, we made changes to some of the proposed input values, including the starting point opening TAB as at 1 July 2014, the standard tax asset lives and remaining tax asset lives as at 1 July 2014.

In its revised proposal, Power and Water has largely adopted the same approach from the draft decision on the establishment of an opening TAB as at 1 July 2019. However, it proposed to exclude capital contributions incurred in the 2014–19 regulatory control period in rolling forward the TAB to 1 July 2019. Power and Water's revised proposed opening TAB value is $922.9 million ($nominal) which is $49.5 million (or 5.1 per cent) lower than the value we determined in the draft decision.

We accept Power and Water's revised proposal to exclude the capital contributions received prior to the start of the 2019–24 regulatory control period for the purposes of establishing the opening TAB value at 1 July 2019. Power and Water was regulated under a pre-tax framework by the Utilities Commission in the 2014–19 regulatory control period. The pre-tax framework does not involve making an explicit allowance for corporate income tax, and instead provides a return on the capital invested that is sufficient for the tax to be paid by the investor. Since capital contributions are not included in the RAB, the tax liability on the capital contributions were not accounted for in the return on capital allowance provided in the 2014–19 distribution determination. Therefore, we consider that past customer contributions should be excluded from the TAB when the distributor transitions from a pre-tax to a post-tax frameworks. We note that capital contributions incurred after the transition (from 1 July 2019) will be included in the TAB for the purposes of tax depreciation.[35]

While we accept the proposal to exclude capital contributions from the opening TAB value, we note that Power and Water has inadvertently removed the capital contribution value for 2017–18 twice in the revised proposed RFM (see attachment 2). Further, Power and Water has revised the actual capex for 2017–18 after the submission of the revised proposal. The revision is required to correct an error in its 2017–18 annual reporting RIN. Consequently, we have updated the 2017–18 actual capex in the RFM to reflect the corrected value. The net impact of these corrections has resulted in a slightly higher opening TAB value at 1 July 2019 than the revised proposed value.

Table 7-4 sets out our final decision on the roll forward of Power and Water's TAB values over the 2014–19 regulatory control period.

[35] Under the post-tax framework, capital contributions are recognised as taxable revenue and therefore results in a cost of corporate income tax allowance.

Table 7-4 AER's final decision on Power and Water's TAB roll forward ($million, nominal)

	2014–15	2015–16	2016–17	2017–18	2018–19[a]
Opening TAB	769.2	825.6	869.2	891.7	905.4
Capital expenditure[b]	78.8	68.4	49.5	42.6	42.2
Less: tax depreciation	22.5	24.8	27.0	29.0	30.8
Interim closing TAB	825.6	869.2	891.7	905.4	916.8
Roll-in of corporate assets					19.6
Closing TAB as at 30 June 2019 (ACS and SCS)					936.3
Closing TAB as at 30 June 2019 (ACS only)					12.6
Closing TAB as at 30 June 2019 (SCS only)					923.7

Source: AER analysis.

(a) Based on estimated capex.

(b) Net of disposals and customer contributions.

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

For this final decision, we accept Power and Water'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' 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 value as at 1 July 2019.

In the draft decision, we amended Power and Water's proposed standard tax asset lives.[36] We accepted Power and Water'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 updated the remaining tax asset lives as at 1 July 2019 to reflect our draft decision on the opening TAB values and remaining tax asset lives as at 1 July 2014.

Power and Water has adopted the draft decision standard tax asset lives in its revised proposal. It has updated the remaining tax asset lives as at 1 July 2019 to reflect the revised proposed opening TAB value as at 1 July 2019.

Discussed in section 7.4.1, as part of the implementation of the new tax depreciation approach, Power and Water proposed to reallocate forecast capex associated with buildings and in-house software into the prescribed SL tax depreciation asset classes in the amended PTRM. We determine a standard tax asset life of 40 years for the Buildings' asset class, as this is consistent with the number of years required to

[36] AER, *Power & Water Corporation 2019-24 - Draft decision - Attachment 7 - Corporate income tax*, September 2018, p.19

completely depreciate a capital works asset for tax purposes under the ITAA.[37] We also determine a standard tax asset life of 5 years for the 'In-house software' asset class, as this is consistent with the ITAA.[38] In its response to our information request, Power and Water agreed that both these standard tax asset lives are appropriate for the new asset classes for tax depreciation purposes.[39]

We also accept Power and Water'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 in the RFM. 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 value as at 1 July 2019 (section 7.4.2).

For the new 'In-house software' and 'Buildings' 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 7-5 sets out our final decision on the standard and remaining tax asset lives as at 1 July 2019 for Power and Water. 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.[40]

Table 7-5 AER's final decision on Power and Water's standard and remaining tax asset lives as at 1 July 2019 (years)

Asset class	Standard tax asset life	Remaining tax asset lives as at 1 July 2019[a]
Substations	44.5[b]	34.7
Distribution lines	57.3[b]	39.5
Transmission lines	50.6[b]	43.6
LV services	18.3[b]	14.8
Distribution substations	43.9[b]	32.6
Distribution switchgear	37.1[b]	31.7
Protection	36.2[b]	28.9

37 ITAA, sections 43.15, 43.140, 43.210.

38 ITAA, section 40.95(7).

39 Power and Water, *Email to AER: PWC - updated 2019–24 capex forecast model*, dated 14 March 2019.

40 NT NER, cl. 6.5.3.

SCADA	12.0[b]	8.2
Communications	22.6[b]	17.2
Land and easements	n/a	n/a
Property	40.0[b]	17.4
IT and communications	5.7[b]	4.9
Motor vehicles	5.0[b]	1.8
Plant and equipment	14.0[b]	8.8
Property leases	15.8[b]	n/a
Fleet leases	5.7[b]	n/a
Buildings	40.0[c]	n/a
In-house software	5.0[c]	n/a
Equity raising costs	5.0[c]	n/a

Source: AER analysis.

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

(b) Used for diminishing method of tax depreciation.

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

n/a Not applicable. We have not assigned a standard tax asset life to the 'Land and easements' asset class because the assets allocated to this asset class are non-depreciating assets. There are no opening TAB values as at 1 July 2019 for the 'Property leases', 'Fleet leases', 'Buildings', 'In-house software' and 'Equity raising costs' asset classes. Therefore, no remaining tax asset lives are assigned to these asset classes.