



PRELIMINARY DECISION
Energex determination 2015–16
to 2019–20

Attachment 8 – Corporate
income tax

April 2015

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Note

This attachment forms part of the AER's preliminary decision on Energex's 2015–20 distribution determination. It should be read with all other parts of the preliminary decision.

The preliminary decision includes the following documents:

Overview

Attachment 1 – Annual revenue requirement

Attachment 2 – Regulatory asset base

Attachment 3 – Rate of return

Attachment 4 – Value of imputation credits

Attachment 5 – Regulatory depreciation

Attachment 6 – Capital expenditure

Attachment 7 – Operating expenditure

Attachment 8 – Corporate income tax

Attachment 9 – Efficiency benefit sharing scheme

Attachment 10 – Capital expenditure sharing scheme

Attachment 11 – Service target performance incentive scheme

Attachment 12 – Demand management incentive scheme

Attachment 13 – Classification of services

Attachment 14 – Control mechanism

Attachment 15 – Pass through events

Attachment 16 – Alternative control services

Attachment 17 – Negotiated services framework and criteria

Attachment 18 – Connection policy

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Shortened forms

Shortened form	Extended form
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
augex	augmentation expenditure
capex	capital expenditure
CCP	Consumer Challenge Panel
CESS	capital expenditure sharing scheme
CPI	consumer price index
DRP	debt risk premium
DMIA	demand management innovation allowance
DMIS	demand management incentive scheme
distributor	distribution network service provider
DUoS	distribution use of system
EBSS	efficiency benefit sharing scheme
ERP	equity risk premium
Expenditure Assessment Guideline	Expenditure Forecast Assessment Guideline for electricity distribution
F&A	framework and approach
MRP	market risk premium
NEL	national electricity law
NEM	national electricity market
NEO	national electricity objective
NER	national electricity rules
NSP	network service provider
opex	operating expenditure

Shortened form	Extended form
PPI	partial performance indicators
PTRM	post-tax revenue model
RAB	regulatory asset base
RBA	Reserve Bank of Australia
repex	replacement expenditure
RFM	roll forward model
RIN	regulatory information notice
RPP	Revenue and pricing principles
SAIDI	system average interruption duration index
SAIFI	system average interruption frequency index
SLCAPM	Sharpe-Lintner capital asset pricing model
STPIS	service target performance incentive scheme
WACC	weighted average cost of capital

8 Corporate income tax

We are required to make a decision on the estimated cost of corporate income tax for Energex's 2015–20 regulatory control period.¹ Under the post-tax framework, a corporate income tax allowance is calculated as part of the building block assessment using our post-tax revenue model (PTRM). This amount enables Energex to recover the costs associated with the estimated corporate income tax payable during the 2015–20 regulatory control period.

This attachment presents our assessment of Energex's proposed corporate income tax allowance for the 2015–20 regulatory control period. It also presents our assessment of its proposed opening tax asset base (TAB), and the standard and remaining tax asset lives used to estimate tax depreciation for the purpose of calculating tax expenses.

8.1 Preliminary decision

We do not accept Energex's proposed cost of corporate income tax allowance of \$602.3 million. Our preliminary decision on the estimated cost of corporate income tax is \$242.4 million over the 2015–20 regulatory control period. This represents a reduction of \$360.0 (or 59.8 per cent) compared to its proposal.

The reduction reflects our amendments to some of Energex's proposed inputs for forecasting the cost of corporate income tax such as the opening TAB (section 8.4.1), and the remaining tax asset lives (section 8.4.2). It also reflects our preliminary decision on the value of imputation credits—gamma—(attachment 4). Changes to building block costs also affect revenues, which in turn impacts the tax calculation. The changes affecting revenues are discussed in attachment 1.

Table 8.1 sets out our preliminary decision on the estimated cost of corporate income tax allowance for Energex.

Table 8.1 AER's preliminary decision on Energex's cost of corporate income tax allowance for the 2015–20 regulatory control period (\$ million, nominal)

	2015–16	2016–17	2017–18	2018–19	2019–20	Total
Tax payable	69.3	76.0	81.0	85.6	91.9	403.9
Less: value of imputation credits	27.7	30.4	32.4	34.2	36.8	161.6
Net corporate income tax allowance	41.6	45.6	48.6	51.4	55.2	242.4

Source: AER analysis.

¹ NER, cl. 6.4.3(a)(4).

8.2 Energex's proposal

Energex proposed a forecast cost of corporate income tax of \$602.3 million (\$ nominal) using the AER's PTRM and the following inputs:²

- an opening TAB as at 1 July 2015 of \$6632.4 million (\$ nominal)
- an expected statutory income tax rate of 30 per cent per year
- a value for gamma of 0.25
- remaining tax asset lives of assets in existence as at 30 June 2015 derived from the AER's roll forward model (RFM) using a weighted average approach
- tax standard lives consistent with those provided in Energex's 2013–14 annual reporting RIN. This includes some changes to tax standard lives from the 2010 distribution determination.

Table 8.2 sets out Energex's proposed corporate income tax allowance for the 2015–20 regulatory control period.

Table 8.2 Energex's proposed cost of corporate income tax allowance for the 2015–20 regulatory control period (\$ million, nominal)

	2015–16	2016–17	2017–18	2018–19	2019–20	Total
Tax payable	142.6	151.5	160.7	169.6	178.6	803.1
Less: value of imputation credits	35.7	37.9	40.2	42.4	44.7	200.8
Net corporate income tax allowance	107.0	113.6	120.5	127.2	134.0	602.3

Source: Energex, *Regulatory proposal*, October 2014, p 181.

8.3 AER's assessment approach

Under clause 6.5.3 of the National Electricity Rules (NER), we must make an estimate of taxable income for each regulatory year. Our estimate must be for the taxable income a benchmark efficient entity would earn for providing standard control services if it operated Energex's business. The estimate is required to be determined in accordance with the PTRM. Our approach for calculating a service provider's cost of corporate income tax allowance is set out in our PTRM and involves the following steps:

1. We estimate the annual taxable income that would be earned by a benchmark efficient entity operating the service provider's business. A service provider's taxable income is calculated by subtracting from the approved forecast revenues the benchmark estimates of tax expenses. Using the PTRM, we model the service provider's benchmark tax expenses, including interest tax expense and tax

² Energex, *Regulatory proposal*, October 2014, pp 178–184 and Attachment 6 - PTRM - standard control.

depreciation, over the regulatory control period. The interest tax expense is estimated using the benchmark 60 per cent gearing used for the rate of return calculation. Tax depreciation is calculated using a separate value for the TAB, and standard and remaining tax asset lives for taxation purposes. All tax expenses (including other expenses such as opex) are offset against the service provider's forecast revenue to estimate the taxable income.

2. The statutory income tax rate is then applied to the estimated annual taxable income (after adjustment for any tax loss carried forward) to arrive at a notional amount of tax payable.
3. We apply a discount to that notional amount of tax payable to account for the utilisation of imputation credits (gamma) by investors.
4. The tax payable net of assumed utilised imputation credits represents the corporate income tax allowance and is included as a separate building block in determining the service provider's annual revenue requirement.

The cost of corporate income tax allowance is an output of our PTRM. We therefore assess the service provider's proposed cost of corporate tax allowance by analysing the proposed inputs to the PTRM for calculating that allowance. These inputs include:

- **The opening TAB as at the commencement of the 2015–20 regulatory control period:** We consider that the roll forward of the opening TAB should be based on the approved opening TAB as at commencement of the 2010–15 regulatory control period and the service provider's actual capex incurred during the 2010–15 regulatory control period.³
- **The remaining tax asset life for each asset class at the commencement of the 2015–20 regulatory control period:** Our preferred method to determine the remaining tax asset lives is the weighted average method. We consider the weighted average method provides a better reflection of the mix of assets within an asset class. We will assess the outcomes of other approaches against the outcomes of this preferred method.
- **The standard tax asset life for each asset class:** We assess the service provider's proposed standard tax asset lives, where necessary, against those prescribed by the Commissioner for taxation in tax ruling 2014/4 and the approved standard tax asset lives in the service provider's distribution determination for the 2010–15 regulatory control period.
- **The income tax rate:** The statutory income tax rate is 30 per cent per year.
- **The value of gamma:** The gamma input for Energex is 0.40. Refer to attachment 4 for detailed discussion on this matter.

³ 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.

We received one submission from the CCP on Energex's proposed corporate income tax. The CCP submitted that the AER should account for the actual tax situation in its estimate of the tax paid by a benchmark efficient network service provider.⁴ It noted that the reported actual tax paid by one service provider is much less than forecast and may relate to its specific organisational structure.

We are required to estimate the cost of corporate income tax based on a benchmark efficient entity.⁵ This estimate must be determined in accordance with the manner set out in the PTRM.⁶ As noted above, the PTRM uses benchmark cash flows and any carried tax losses to estimate the forecast tax payments, and does take into account the actual tax situation of a given network service provider in the way suggested by the CCP. Further, we note that the CCP has not provided detailed analysis to show the reported actual taxes and drivers for all service providers or why the established approach to estimate tax in the PTRM is not appropriate. Accordingly, we cannot apply the alternative approach in the CCP's submission.

8.3.1 Interrelationships

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

- pre-tax revenues
- tax expenses (including tax depreciation)
- the corporate tax rate
- gamma—the expected proportion of company tax that is returned to investors through the utilisation of imputation credits—which is offset against the corporate income tax allowance. This is discussed further at attachment 4.

Of these four factors, the corporate tax rate is set externally by the Government. The higher the tax rate the higher the required tax allowance.

The pre-tax revenues depend on all the building block components. Any factor that affects revenue will therefore affect pre-tax revenues. Higher pre-tax revenues can increase the tax allowance.⁷ Depending on the source of the revenue increase, the tax increase may be equal to or less than proportional to the company tax rate.⁸

⁴ CCP, *CCP Sub-Panel submission on Energex, Ergon and SAPN revenues controls*, pp. 11–12

⁵ NER, cl. 6.5.3.

⁶ NER, cls. 6.5.3 and 6.4.2(b)(4).

⁷ 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.

⁸ 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 RAB funded through debt. It also depends on the allowed return on debt and the size of the RAB.
- General expenses – In the main these expenses will match the opex allowance.
- Tax depreciation – A separate TAB is maintained for the businesses reflecting tax rules. This TAB is affected by many of the same factors as the RAB, such as capex, although unlike the RAB value it is maintained at its historical cost with no indexation. The TAB is also affected by the depreciation rate and asset lives assigned for tax depreciation purposes.

A 10 per cent increase in the corporate income tax allowance causes revenues to increase by about 0.7 per cent. The proposed gamma of 0.25, compared to the value in our preliminary decision of 0.40, would increase the corporate income tax allowance by 32.3 per cent and total revenues by about 1.2 per cent.

8.4 Reasons for preliminary decision

We do not accept Energex's proposed cost of corporate income tax allowance of \$602.3 million (\$ nominal). We have instead determined a cost of corporate income tax allowance of \$242.4 million. This represents a reduction of \$360.0 million (or 59.8 per cent) from Energex's proposal.

This is because we adjusted the following proposed inputs to the PTRM for tax purposes:

- the opening TAB value as at 1 July 2015 (section 8.4.1)
- the remaining tax asset lives (section 8.4.2)
- the value of gamma (attachment 4)
- other building block components including forecast opex (attachment 7) and forecast capex (attachment 6) that affect revenues, and therefore also impact the forecast corporate income tax allowance.

We accept Energex's proposed standard tax asset lives, as they are consistent with Energex's 2013–14 annual reporting RIN and the values prescribed by the

Commissioner for Taxation in tax ruling 2014/4.⁹ However, we have changed the standard tax asset life for the 'Equity raising costs' asset class from 'n/a' to 5 years.

8.4.1 Opening tax asset base

We accept Energex's proposed method to establish the opening TAB as at 1 July 2015 as it is based on the approach set out in our roll forward model (RFM). However, we do not accept Energex's proposed opening TAB value as at 1 July 2015 of \$6632.4 million (\$ nominal). Instead we determine an opening TAB value as at 1 July 2015 of \$6729.9 million (\$ nominal). This represents an increase of \$97.5 million (\$ nominal) or 1.5 per cent. This increase is due to the adjustments made to the actual capex values in Energex's proposed RFM as discussed in attachment 2.¹⁰

Table 8.3 sets out our preliminary decision on the roll forward of Energex's TAB values over the 2010–15 regulatory control period.

Table 8.3 AER's preliminary decision on Energex's TAB roll forward (\$ million, nominal)

	2010–11	2011–12	2012–13	2013–14	2014–15 ^b
Opening TAB	3759.0	4578.7	5337.7	6024.7	6562.4
Capital expenditure ^a	955.6	926.2	880.2	751.7	811.1
Less: Tax depreciation	135.9	167.2	193.3	214.0	232.9
Closing TAB	4578.7	5337.7	6024.7	6562.4	7140.5
Meters moved to alternative control services and unregulated assets removed					-410.6
Opening TAB as at 1 July 2015					6729.9

Source: AER analysis.

(a) Net of disposals.

(b) Based on estimated capex.

8.4.2 Remaining tax asset lives

We accept Energex's proposed weighted average method to calculate the remaining tax asset lives as at 1 July 2015. The proposed method is consistent with our preferred approach.

⁹ ATO, Taxation Ruling Income tax: effective life of depreciating assets (applicable from 1 July 2014), August 2014, <http://law.ato.gov.au/atoLaw/view.htm?docid=%22TXR%2FTR20144%2FNAT%2FATO%2F00001%22>, accessed on 06 January 2015.

¹⁰ At the time of this preliminary decision, the roll forward of Energex's TAB includes estimated capex values for 2014–15. We will update the 2014–15 estimated capex values for the substitute decision.

In accepting the weighted average method, we have updated the proposed remaining tax asset lives to reflect our adjustments to Energex's actual capex in its proposed RFM, as discussed in attachment 2.¹¹ This is because the actual capex values are inputs for calculating the weighted average remaining tax asset lives in the RFM. This includes updating the remaining tax asset life for the 'Equity raising costs' asset class to 1 year from Energex's proposed 'n/a' for tax depreciation purposes.

We are satisfied the remaining tax asset lives provide an appropriate estimate of the tax depreciation amount for a benchmark efficient service provider as required by the NER.¹²

Table 8.4 sets out our preliminary decision on the remaining tax asset lives at 1 July 2015 for Energex.

8.4.3 Standard tax asset lives

We accept Energex's proposed standard tax asset lives because they are:

- broadly consistent with the values prescribed by the Commissioner for taxation in tax ruling 2014/4¹³
- the same as the approved standard tax asset lives for the 2010–15 regulatory control period.

We are satisfied that the proposed standard tax asset lives are appropriate for applying over the 2015–20 regulatory control period. However, we have changed the standard tax asset life for the 'Equity raising costs' asset class from 'n/a' to 5 years. This is because the Australian Taxation Office (ATO) requires equity raising costs to be amortised over a five-year period on a straight-line basis.¹⁴ This is also consistent with the standard asset life for the 'Equity raising costs' asset class approved at the 2010 distribution determination.

Table 8.4 sets out our preliminary decision on the standard tax asset lives for Energex.

¹¹ At the time of this preliminary decision, the roll forward of Energex's TAB includes estimated capex values for 2014–15. We will update the 2014–15 estimated capex values for the substitute decision. The 2014–15 capex values are used to calculate the weighted average remaining tax asset lives in the RFM. Therefore, for the substitute decision we will recalculate Energex's remaining tax asset lives as at 1 July 2015 using the method approved in this preliminary decision.

¹² NER, cl 6.5.3.

¹³ ATO, *Taxation Ruling Income tax: effective life of depreciating assets (applicable from 1 July 2014)*, August 2014, <http://law.ato.gov.au/atolaw/view.htm?docid=%22TXR%2FTR20144%2FNAT%2FATO%2F00001%22>, accessed on 06 January 2015.

¹⁴ ATO, *Guide to depreciating assets 2001-02: Business related costs—section 40-880 deductions*, ATO reference; NONAT7170, p. 25.

Table 8.4 AER's preliminary decision on Energex's standard and remaining tax asset lives (years)

Asset class	Standard tax asset life	Remaining tax asset life as at 1 July 2015
OH Sub-transmission lines	45.0	33.2
UG Sub-transmission cables	50.0	39.3
OH Distribution lines	45.0	36.1
UG Distribution cables	50.0	35.8
Distribution equipment	45.0	39.5
Substation bays	40.0	32.2
Substation establishment	40.0	33.7
Distribution substation switchgear	40.0	35.1
Zone transformers	40.0	32.3
Distribution transformers	45.0	31.4
Low voltage services	40.0	4.8
Load control & network metering devices	25.0	23.6
Communications - pilot wires	10.0	11.5
Street lighting	15.0	6.3
Systems buildings	40.0	37.2
Systems easements	n/a	n/a
System land	n/a	n/a
Communications	10.0	n/a
Control centre - SCADA	10.0	7.0
IT systems	3.8	2.7
Office equipment & furniture	13.1	8.0
Motor vehicles	12.9	9.2
Plant & equipment	5.2	3.6
Research & development	n/a	n/a
Buildings	40.0	33.3
Easements	n/a	n/a
Land	n/a	n/a
Equity raising costs	5.0	1.0

Source: AER analysis.