



**PRELIMINARY DECISION**  
**Ergon Energy 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 Ergon Energy'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
ASRR	aggregate service revenue requirement
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 Ergon Energy's 2015–20 regulatory control period.<sup>1</sup> 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 Ergon Energy 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 Ergon Energy'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 Ergon Energy's proposed cost of corporate income tax allowance of \$621.4 million. Our preliminary decision on the estimated cost of corporate income tax is \$204.2 million over the 2015–20 regulatory control period. This represents a reduction of \$417.2 (or 67.1 per cent) compared to its proposal.

The reduction reflects our amendments to some of Ergon Energy'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 affect revenues, which also impact 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 Ergon Energy.

**Table 8.1 AER's preliminary decision on Ergon Energy'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	60.5	64.6	68.6	74.6	71.9	340.3
Less: value of imputation credits	24.2	25.8	27.5	29.9	28.8	136.1
<b>Net corporate income tax allowance</b>	<b>36.3</b>	<b>38.8</b>	<b>41.2</b>	<b>44.8</b>	<b>43.1</b>	<b>204.2</b>

Source: AER analysis.

<sup>1</sup> NER, cl. 6.4.3(a)(4).

## 8.2 Ergon Energy's proposal

Ergon Energy proposed a forecast cost of corporate income tax of \$621.4 million (\$ nominal) using the AER's PTRM and the following inputs:

- an opening TAB as at 1 July 2015 of \$6325.1 million (\$ nominal)
- an expected statutory income tax rate of 30 per cent per year
- a value for gamma of 0.25<sup>2</sup>
- remaining tax asset lives of assets in existence as at 30 June 2015 derived using an average depreciation approach<sup>3,4</sup>
- the same standard tax asset lives for depreciating new assets for the 2015–20 regulatory control period as approved for the 2010 distribution determination. However, for the 'Equity raising costs' asset class Ergon Energy proposed a standard asset life of 'n/a' which results in no tax depreciation.

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

**Table 8.2 Ergon Energy'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	154.3	163.0	175.3	164.8	171.1	828.6
Less: value of imputation credits	38.6	40.8	43.8	41.2	42.8	207.1
<b>Net corporate income tax allowance</b>	<b>115.7</b>	<b>122.3</b>	<b>131.5</b>	<b>123.6</b>	<b>128.3</b>	<b>621.4</b>

Source: Ergon Energy, *Regulatory Proposal*, October 2014, 03.01.01 – Ergon Energy's Building Block Components, p. 31.

## 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 Ergon Energy'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:

<sup>2</sup> Ergon Energy, *Regulatory Proposal*, October 2014, Appendix C.

<sup>3</sup> Ergon Energy, *Regulatory Proposal*, October 2014, 03.01.01 – Ergon Energy's Building Block Components, p. 26.

<sup>4</sup> Ergon Energy's average depreciation approach to deriving the remaining tax asset lives divides each asset class' opening TAB at 1 July 2015 by the forecast 2015–16 tax depreciation for that asset class (from the RFM).



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 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.<sup>5</sup>
- **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.

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<sup>5</sup> 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.

- **The income tax rate:** The statutory income tax rate is 30 per cent per year.
- **The value of gamma:** The gamma input for Ergon Energy is 0.40. Refer to attachment 4 for detailed discussion on this matter.

We received one submission from the CCP on Ergon Energy'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.<sup>6</sup> 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.<sup>7</sup> This estimate must be determined in accordance with the manner set out in the PTRM.<sup>8</sup> 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

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<sup>6</sup> CCP, *CCP Sub-Panel submission on Energex, Ergon and SAPN revenues controls*, pp. 11–12.

<sup>7</sup> NER, cl. 6.5.3.

<sup>8</sup> NER, cls. 6.5.3 and 6.4.2(b)(4).

increase the tax allowance.<sup>9</sup> Depending on the source of the revenue increase, the tax increase may be equal to or less than proportional to the company tax rate.<sup>10</sup>

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 ten per cent increase in the corporate income tax allowance causes revenues to increase by about 0.8 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 1.1 per cent.

## 8.4 Reasons for preliminary decision

We do not accept Ergon Energy's proposed cost of corporate income tax allowance of \$621.4 million (\$ nominal). We have instead determined a cost of corporate income tax allowance of \$204.2 million. This represents a reduction of \$417.2 million (or 67.1 per cent) from Ergon Energy'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)

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<sup>9</sup> 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.

<sup>10</sup> 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.

- 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 Ergon Energy's proposed standard tax asset lives, as they are consistent with those approved for the 2010–15 regulatory control period and the values prescribed by the Commissioner for taxation in tax ruling 2014/4.<sup>11</sup> Further, we have updated the standard tax asset life for the 'Equity raising costs' asset class, consistent with the approach approved for the 2010–15 regulatory control period (section 8.4.3).

### 8.4.1 Opening tax asset base

We accept Ergon Energy'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 Ergon Energy's proposed opening TAB value as at 1 July 2015 of \$6325.1 million (\$ nominal). Instead we determine an opening TAB value as at 1 July 2015 of \$6377.8 million (\$ nominal). This represents an increase of \$52.7 million (\$ nominal) or 0.8 per cent. This increase is due to the adjustments made to the actual capex values in Ergon Energy's proposed RFM as discussed in attachment 2.<sup>12</sup>

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

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

	2010–11	2011–12	2012–13	2013–14	2014–15 <sup>b</sup>
Opening TAB	3932.8	4483.2	4949.6	5478.5	5904.2
Capital expenditure <sup>a</sup>	769.8	717.7	798.6	708.7	846.9
Less: Tax depreciation	219.4	251.3	269.7	282.9	293.4
Closing TAB	4483.2	4949.6	5478.5	5904.2	6457.7
Meters moved to ACS and unregulated assets removed					-79.9
<b>Opening TAB as at 1 July 2015</b>					<b>6377.8</b>

Source: AER analysis.

(a) Net of disposals.

(b) Based on estimated capex.

<sup>11</sup> Australian Taxation Office, *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>.

<sup>12</sup> At the time of this preliminary decision, the roll forward of Ergon Energy's TAB includes estimated capex values for 2014–15. We will update the 2014–15 estimated capex values for the substitute decision.

## 8.4.2 Remaining tax asset lives

We do not accept Ergon Energy's proposed approach to estimating remaining tax asset lives at 1 July 2015. Ergon Energy proposed to use the average depreciation approach to calculate remaining tax asset lives. We have instead determined remaining tax asset lives using our preferred weighted average approach that rolls forward the approved remaining tax asset lives at the start of the 2010–15 regulatory control period having regard to the amount of capex incurred in that period.

To calculate remaining tax asset lives, Ergon Energy used the same approach to calculate the RAB remaining asset lives. For the same reasons as discussed in attachment 5, we have concerns with Ergon Energy's approach as it tends to result in lower lives. In particular, it does not control well for when assets expire. For example, an asset may expire at the end of 2015–16, yet the depreciation associated with that asset for 2015–16 is effectively assumed to continue into the future under Ergon Energy's approach. Accordingly, we do not accept Ergon Energy's proposed remaining tax asset lives for this preliminary decision. Instead we have used the weighted average approach to determine the remaining tax asset lives at 1 July 2015.

For the substitute decision we will recalculate Ergon Energy's remaining tax asset lives as at 1 July 2015 based on updated capex inputs in its RFM. This is because the actual capex values are inputs for calculating the weighted average remaining tax asset lives in the RFM.<sup>13</sup>

We are satisfied the remaining tax asset lives estimated under the weighted average approach provide a better estimate of the tax depreciation amount for a benchmark efficient service provider as required by the NER.<sup>14</sup>

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

## 8.4.3 Standard tax asset lives

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

- broadly consistent with the values prescribed by the Commissioner for taxation in tax ruling 2014/4<sup>15</sup>

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<sup>13</sup> At the time of this preliminary decision, the roll forward of Ergon Energy'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 Ergon Energy's remaining tax asset lives as at 1 July 2015 using the method approved in this preliminary decision.

<sup>14</sup> NER, cl 6.5.3.

<sup>15</sup> 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.

- 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 remain 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.<sup>16</sup> This is also consistent with the standard asset life for this asset class approved at the 2010 distribution determination.

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

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

Asset class	Standard tax asset life	Remaining tax asset life as at 1 July 2015
Overhead Sub-transmission lines	45.0	21.0
Underground Sub-transmission cables	50.0	35.3
Overhead distribution lines	45.0	32.2
Underground distribution cables	50.0	37.3
Distribution equipment	45.0	42.8
Substation bays	40.0	35.7
Substation establishment	40.0	33.0
Distribution substation switchgear	40.0	34.8
Zone transformers	40.0	25.5
Distribution transformers	40.0	25.2
Low voltage services	40.0	23.6
Metering	25.0	21.8
Communications – pilot wires	10.0	6.3
Generation assets	15.0	14.3
Other equipment	40.0	37.6
Control centre - SCADA	10.0	6.1
Land & easements (system)	n/a	n/a

<sup>16</sup> ATO, *Guide to depreciating assets 2001-02: Business related costs—section 40-880 deductions*, ATO reference; NONAT7170, p. 25.

Asset class	Standard tax asset life	Remaining tax asset life as at 1 July 2015
Metering Type 5-6	25.0	n/a
Communications	10.0	7.8
IT systems	4.0	3.1
Office equipment & furniture	10.0	7.1
Motor vehicles	13.5	9.7
Plant & equipment	5.0	3.3
Buildings	40.0	31.5
Land & easements	n/a	n/a
Land improvements	40.0	36.5
Equity raising costs	5.0	1.0

Source: AER analysis.

n/a: not applicable.