



**PRELIMINARY DECISION**  
**United Energy distribution**  
**determination**  
**2016 to 2020**

**Attachment 8 – Corporate**  
**income tax**

October 2015

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## Note

This attachment forms part of the AER's preliminary decision on United Energy's revenue proposal 2016–20. 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

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## Shortened forms

Shortened form	Extended form
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
AMI	Advanced metering infrastructure
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
PPI	partial performance indicators
PTRM	post-tax revenue model
RAB	regulatory asset base
RBA	Reserve Bank of Australia
repex	replacement expenditure

Shortened form	Extended form
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 United Energy's 2016–20 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 United Energy to recover the costs associated with the estimated corporate income tax payable during the 2016–20 regulatory control period.

This attachment presents our assessment of United Energy's proposed corporate income tax allowance for the 2016–20 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 United Energy's proposed cost of corporate income tax allowance of \$149.1 million (\$ nominal). Our preliminary decision on the estimated cost of corporate income tax is \$84.6 million over the 2016–20 regulatory control period. This represents a reduction of \$64.6 million (or 43.3 per cent) compared to United Energy's proposal.

The reduction reflects our amendments to some of United Energy's proposed inputs for forecasting the cost of corporate income tax such as the opening TAB (section 8.4.2), and the standard and remaining tax asset lives (sections 8.4.3 and 8.4.4 respectively). 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 United Energy over the 2016–20 regulatory control period.

**Table 8-1 AER's preliminary decision on United Energy's cost of corporate income tax allowance for the 2016–20 regulatory control period (\$ million, nominal)**

	2016	2017	2018	2019	2020	Total
Tax payable	26.1	27.0	28.9	31.9	27.2	140.9
Less: value of imputation credits	10.4	10.8	11.5	12.8	10.9	56.4
<b>Net corporate income tax allowance</b>	<b>15.6</b>	<b>16.2</b>	<b>17.3</b>	<b>19.1</b>	<b>16.3</b>	<b>84.6</b>

Source: AER analysis.

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

## 8.2 United Energy's proposal

United Energy proposed a forecast cost of corporate income tax of \$149.1 million (\$ nominal) using the AER's PTRM, which adopts a straight-line tax depreciation approach and the following inputs:<sup>2</sup>

- an opening TAB as at 1 January 2016 of \$1307.4 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 31 December 2015 calculated based on the standard tax asset life for an asset class multiplied by the ratio of the RAB remaining asset life to the RAB standard asset life
- standard tax asset lives calculated using a weighted average of relevant tax categories from the July 2014 ATO tax ruling (TR 2014/4).

Table 8-2 sets out United Energy's proposed corporate income tax allowance for the 2016–20 regulatory control period.

**Table 8-2 United Energy's proposed cost of corporate income tax allowance for the 2016–20 regulatory control period (\$ million, nominal)**

	2016	2017	2018	2019	2020	Total
Tax payable	42.5	43.7	42.6	33.2	36.9	198.8
Less: value of imputation credits	10.6	10.9	10.6	8.3	9.2	49.7
<b>Net corporate income tax allowance</b>	<b>31.9</b>	<b>32.8</b>	<b>31.9</b>	<b>24.9</b>	<b>27.6</b>	<b>149.1</b>

Source: United Energy, *Regulatory proposal*, April 2015, Attachment 6 - PTRM - standard control.

Note Totals may not add up due to rounding.

## 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 United 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:

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

<sup>2</sup> United Energy, *Regulatory proposal*, April 2015, pp 127–134 and Attachment 6 - PTRM - standard control.



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 2016–20 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 2011–15 regulatory control period and the service provider's actual capex incurred during the 2011–15 regulatory control period.<sup>3</sup>
- **The remaining tax asset life for each asset class at the commencement of the 2016–20 regulatory control period:** For the 2016–20 regulatory control period, United Energy proposed to transition to the straight-line tax depreciation approach from the diminishing value approach.<sup>4</sup> This requires the establishment of remaining tax asset lives at 1 January 2016. We have recently approved a method in our determination for Ausgrid to establish remaining tax asset lives for existing assets.<sup>5</sup> United Energy's proposal is based on this method to calculate the remaining tax asset life for an asset class. This involves using the standard tax asset life for the asset class multiplied by the ratio of the RAB remaining asset life to the RAB standard asset life. We will assess United Energy's proposed approach against that approved method.

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<sup>3</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.

<sup>4</sup> Our 2011–15 determination for United Energy did not contain remaining tax asset lives for depreciating its opening TAB at 1 January 2011 as they are not required under the diminishing value approach.

<sup>5</sup> AER, *Draft decision, Ausgrid distribution determination 2015–16 to 2018–19, Attachment 8: Corporate income tax*, November 2014, pp. 8–17 to 8–19.

- **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 2015/2 and the approved standard tax asset lives in the service provider's distribution determination for the 2011–15 regulatory control period.
- **The income tax rate:** The statutory income tax rate is 30 per cent per year.
- **The value of gamma:** We have determined the gamma input for United Energy is 0.40. Refer to attachment 4 for detailed discussion on this matter.

We are required to estimate the cost of corporate income tax based on a benchmark efficient entity.<sup>6</sup> This estimate must be determined in accordance with the manner set out in the PTRM.<sup>7</sup>

### 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.<sup>8</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>9</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

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<sup>6</sup> NER, cl. 6.5.3.

<sup>7</sup> NER, cls. 6.5.3 and 6.4.2(b)(4).

<sup>8</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>9</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.

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.

For United Energy, a 10 per cent increase in the corporate income tax allowance causes revenues to increase by about 0.5 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 per cent and total revenues by about 1.5 per cent.

## 8.4 Reasons for preliminary decision

We do not accept United Energy's proposed estimated cost of corporate income tax. We have instead determined a cost of corporate income tax allowance of \$84.6 million (\$ nominal). This represents a reduction of \$64.6 million (or 43.3 per cent) from United Energy's proposal.

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

- the opening TAB value at 1 January 2016 (section 8.4.2)
- the standard and remaining tax asset lives (sections 8.4.3 and 8.4.4 respectively)
- the value of gamma (attachment 4)
- other building block components including forecast opex (attachment 7) and forecast capex (attachment 6) that impact revenues, and therefore also impact the forecast corporate income tax allowance.

### 8.4.1 Transition to straight-line tax depreciation

We accept United Energy's proposal to use the straight-line depreciation approach to calculate the corporate income tax allowance for the 2016–20 regulatory control period. This is consistent with the approach set out in the PTRM.

United Energy's corporate income tax allowance for the 2011–15 regulatory control period was calculated based on the diminishing value method. This method was established by the previous regulator, the Essential Services Commission of Victoria (ESCV), and adopted by the AER for the 2011–15 regulatory control period in accordance with clause 11.17.2 (Transitional provisions of specific application to

Victoria) of the NER.<sup>10</sup> This transitional rule does not apply for the 2016–20 regulatory control period. Therefore, we accept United Energy's proposal to transition to our preferred straight-line tax depreciation approach for the 2016–20 regulatory control period.

### 8.4.2 Opening tax asset base

We accept United Energy's proposed method to establish the opening TAB as at 1 January 2016 as it is based on the approach approved at the 2010 determination. However, we do not accept United Energy's proposed opening TAB value as at 1 January 2016 of \$1307.4 million (\$ nominal). Instead we determine an opening TAB as at 1 January 2016 of \$1358.1 million (\$ nominal).<sup>11</sup> This represents an increase of \$50.8 million (\$ nominal) or 3.9 per cent. This increase is due to the adjustments made to United Energy's proposed capex values as discussed in attachment 2.<sup>12</sup> The same adjustments are required to be made to the tax additions used in the TAB calculations. This includes the removal of capitalised provisions in 2014 and the correction for asset class allocation of 2011–14 capex.

Table 8-3 sets out our preliminary decision on the roll forward of United Energy's TAB values over the 2011–15 regulatory control period.

**Table 8-3 AER's preliminary decision on United Energy's TAB roll forward (\$ million, nominal)**

	2011	2012	2013	2014	2015 <sup>a</sup>
Opening TAB	861.4	972.9	1097.2	1197.7	1313.5
Capital expenditure	185.9	204.9	192.1	210.1	203.6
Less: Tax depreciation	74.3	80.7	91.5	94.2	159.0
<b>Closing TAB</b>	<b>972.9</b>	<b>1097.2</b>	<b>1197.7</b>	<b>1313.5</b>	<b>1358.1</b>

Source: AER analysis.

(a) Based on estimated capex.

<sup>10</sup> AER, *Final decision, Victorian electricity distribution network service providers Distribution determination 2011–2015*, October 2010, pp. 520–521.

<sup>11</sup> At the time of this preliminary decision, the roll forward of United Energy's TAB includes estimated capex values for 2015. We will update the 2015 estimated capex values for the substitute (final) decision.

<sup>12</sup> The proposed capex was incorrectly allocated to a shorter lived asset class. United Energy's proposal therefore included too much tax depreciation of capex than if the capex had been correctly allocated.

### 8.4.3 Standard tax asset lives

We accept the majority of United Energy's proposed standard tax asset lives because they are broadly consistent with the values prescribed by the Commissioner for taxation in tax ruling 2015/2.<sup>13</sup>

We are satisfied that the proposed standard tax asset lives are appropriate for applying over the 2016–20 regulatory control period.

However, we have changed the standard tax asset lives for the 'SCADA (5-year asset)' and 'SCADA (10-year asset)' asset classes. United Energy proposed a standard tax asset life of 10 years to apply to the 'SCADA (5-year asset)' asset class, and 5 years to apply to the 'SCADA (10-year asset)' asset class. We consider this to be an error in the proposal which we have corrected. Our preliminary decision is to apply a standard tax asset life of 5 years to the 'SCADA (5-year asset)' asset class and 10 years to the 'SCADA (10-year asset)' asset class.

We also consider that a standard tax asset life of 'n/a' should be assigned to the proposed 'Land' asset class instead of zero for tax modelling purposes in the PTRM reflecting the non-depreciating nature of land capex.<sup>14</sup>

Table 8-4 sets out our preliminary decision on the standard tax asset lives for United Energy.

### 8.4.4 Remaining tax asset lives

Our 2010 determination for United Energy did not contain remaining tax asset lives for depreciating its opening TAB as at 1 January 2011. Instead, the transitional rules at the time required us to adopt for the 2011–15 regulatory control period the same tax depreciation methodology as used by the ESCV for the 2006–10 regulatory control period.<sup>15</sup> As discussed in section 8.4.1, we accept United Energy's proposal to use the straight-line depreciation approach to calculate the corporate income tax allowance for the 2016–20 regulatory control period. This requires us to determine remaining tax asset lives for depreciating the opening TAB as at 1 January 2016.

We consider United Energy's approach to determine remaining tax asset lives as at 1 January 2016 is reasonable. This approach is based on the standard tax asset life of an asset class multiplied by the ratio of the RAB remaining asset life to the RAB standard asset life.<sup>16</sup> However, we consider an adjustment is required with the proposed use of RAB remaining asset lives as at 1 January 2011 in the calculation.

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<sup>13</sup> ATO, *Taxation Ruling Income tax: effective life of depreciating assets (applicable from 1 July 2015)*, July 2015, <http://law.ato.gov.au/atolaw/view.htm?docid=%22TXR%2FTR20152%2FNAT%2FATO%2F00001%22>, accessed on 29 July 2015.

<sup>14</sup> We note that United Energy did propose any land capex over the 2016–20 regulatory control period, therefore this change has no impact over that period.

<sup>15</sup> AER, *Victorian distribution draft decision 2011–15*, June 2010, p. 552.

<sup>16</sup> United Energy, *Regulatory proposal*, April 2015, p. 133.

The adjustment requires the RAB remaining asset lives as at 1 January 2016 to instead be used in the calculation because the establishment of the remaining tax asset lives relate to assets existing at 1 January 2016. With this adjustment, we are satisfied that the approach results in an estimate of tax depreciation consistent with the tax expenses used to estimate the annual taxable income of a benchmark efficient entity over the 2016–20 regulatory control period. The approach is consistent with the method approved in our recent determination for Ausgrid.<sup>17</sup>

In adjusting United Energy’s approach to establish the remaining tax asset lives as at 1 January 2016, we have updated the proposed remaining tax asset lives consistent with the adjustments to the RAB remaining asset lives as at 1 July 2014, discussed in attachment 5.<sup>18</sup> This is because the approach to calculate the remaining tax asset life uses the ratio of the RAB remaining asset life to the RAB standard asset life.

At the time of this preliminary decision, the RAB remaining asset lives used in this calculation include estimated capex values for 2015. We expect to update the 2015 estimated capex values for the final decision. Therefore, for the final decision, we will update United Energy’s remaining tax asset lives at 1 January 2016 using the method approved in this preliminary decision for any revisions to the RAB remaining asset lives.

We note United Energy’s proposal assigns a remaining tax asset life of ‘n/a’ for its ‘Metering’ asset class. Applying ‘n/a’ in the PTRM means that the small residual opening TAB value of \$0.1 million (\$ nominal) as at 1 January 2016 will not be depreciated. We instead determine a remaining tax asset life of 1 year to fully depreciate (by way of writing off) this residual value.

Table 8-4 sets out our preliminary decision on the remaining tax asset lives at 1 January 2016 for United Energy. 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.<sup>19</sup>

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<sup>17</sup> AER, *Ausgrid distribution determination 2015–16 to 2018–19 draft decision*, attachment 8, November 2014, pp. 25–26.

<sup>18</sup> Having established the remaining tax asset lives as at 1 January 2016 for this determination process, we consider that when rolling forward these remaining tax asset lives to 1 January 2020 at the next reset our preferred weighted average method should be used.

<sup>19</sup> NER, cl. 6.5.3.

**Table 8-4 AER's preliminary decision on United Energy's standard and remaining tax asset lives (years)**

Asset class	Standard tax asset life	Remaining tax asset life as at 1 January 2016
Subtransmission	45.0	25.2
Distribution system assets	46.0	32.7
Metering	25.0	1.0
Public lighting	15.0	n/a
SCADA (5-year asset)	5.0	2.3
Non network - IT	4.0	2.9
Non network - other	12.0	8.4
Neutral screen services	n/a	n/a
Distribution transformers upgrades	n/a	n/a
SCADA (10-year asset)	10.0	n/a
Land	n/a	n/a
Equity raising costs	5.0	n/a

Source: AER analysis.

n/a: not applicable.