DRAFT DECISION

SA Power Networks Distribution Determination 2020 to 2025

Attachment 7 Corporate income tax

October 2019

AUSTRALIAN ENERGY REGULATOR

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Note

This attachment forms part of the AER's draft decision on the distribution determination that will apply to SA Power Networks for the 2020–2025 regulatory control period. It should be read with all other parts of the draft decision.

The draft decision includes the following attachments:

Overview

Attachment 1 – Annual revenue requirement

Attachment 2 – Regulatory asset base

Attachment 3 – Rate of return

Attachment 4 – Regulatory depreciation

Attachment 5 – Capital expenditure

Attachment 6 – Operating expenditure

Attachment 7 – Corporate income tax

Attachment 8 – Efficiency benefit sharing scheme

Attachment 9 – Capital expenditure sharing scheme

Attachment 10 – Service target performance incentive scheme

Attachment 11 – Demand management incentive scheme

Attachment 12 – Classification of services

Attachment 13 – Control mechanisms

Attachment 14 – Pass through events

Attachment 15 – Alternative control services

Attachment 16 – Negotiated services framework and criteria

Attachment 17 – Connection policy

Attachment 18 – Tariff structure statement

Contents

Shortened forms

Shortened form	Extended form
AER	Australian Energy Regulator
capex	capital expenditure
CCP 14	Consumer Challenge Panel, sub-panel 14
CESS	capital expenditure sharing scheme
CPI	consumer price index
disposals	asset disposals
distributor	distribution network service provider
DV	diminishing value
gamma	value of imputation credits
ITAA	Income Tax Assessment Act 1997
NEL	national electricity law
NEM	national electricity market
NER or the rules	national electricity rules
NSP	network service provider
opex	operating expenditure
PTRM	post-tax revenue model
RAB	regulatory asset base
RFM	roll forward model
RIN	regulatory information notice
SL	straight-line
tax review	the 2018 review of the regulatory tax approach
WACC	weighted average cost of capital

7 Corporate income tax

Our determination of the annual revenue requirement includes the estimated cost of corporate income tax for SA Power Networks' 2020–25 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 allows SA Power Networks to recover the estimated cost of corporate income tax during the 2020–25 regulatory control period.

This attachment presents our assessment of SA Power Networks' proposed corporate income tax allowance for the 2020–25 regulatory control period. It also presents our assessment of its proposed opening tax asset base (TAB), its proposed standard tax asset lives, and the year-by-year depreciation tracking approach that it has used to estimate tax depreciation for the purpose of calculating tax expenses.

7.1 Draft decision

We recently completed a review of the regulatory tax approach (the tax review) and decided to make some changes to apply going forward.[2] Given the timing of our final report on the tax review, SA Power Networks proposed a placeholder corporate income tax allowance of $1 for 2020–25.[3] Our draft decision has implemented the tax review changes and we determine a corporate income tax allowance of $37.6 million ($ nominal) for SA Power Networks in the 2020–25 regulatory control period.

In our draft decision, we applied the latest version of the PTRM (version 4) released in April 2019 to implement the findings of the tax review. We have recognised immediate expensing of some forecast 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 buildings (capital works) and in-house software.[4] These changes have reduced the corporate income tax allowance by about $116.3 million (or 80.9 per cent) compared to if it was estimated under the previous tax approach (section 7.4.1).[5] Our draft decision corporate income tax allowance is higher than SA Power Networks' proposed $1

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

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

3 SA Power Networks' proposal included a placeholder estimated tax expense adjustment of around $220 million per year. The placeholder adjustment reduced the taxable income for the 2020–25 regulatory control period to zero. SA Power Networks' proposal stated that the inclusion of the placeholder adjustment will better reflect the estimated cost of corporate income tax under the new tax approach as the amended PTRM (version 4) was not yet finalised at the time of the submission of its regulatory proposal.
SA Power Networks, *2020–25 Regulatory proposal – Attachment 7 – Corporate income tax,* 31 January 2019, pp. 7–8.

4 All assets acquired prior to 30 June 2020 will continue to be depreciated using the straight-line depreciation method for tax purposes, until these assets are fully depreciated.

5 The reduction is calculated based on the expenditure and rate of return inputs from SA Power Networks' proposed model.

placeholder due to the impact of immediate expensing of capex being somewhat smaller than SA Power Networks had anticipated.

We have revised the opening tax asset base (TAB) as at 1 July 2020. As discussed in relation to the RAB (attachment 2), we made a correction for movements in capitalised provisions over the 2015–20 regulatory control period. This impacted the TAB too, although it has a minor impact on the corporate income tax allowance. Our draft decision does not accept SA Power Networks' proposal to adjust the TAB as at 1 July 2020 to reflect the immediately expensed capex incurred in the 2015–20 regulatory control period (section7.4.2). We consider the estimated cost of corporate income tax calculated using SA Power Networks' proposed approach would be higher than the benchmark efficient amount and therefore not in the long term interest of customers.

We accept SA Power Networks' proposed standard tax asset lives for all of its asset classes. The proposed standard tax asset lives are broadly consistent with the tax asset lives prescribed by the Commissioner for taxation in ATO taxation ruling 2019/5 and/or are the same as the approved standard tax asset lives for the 2015–20 regulatory control period. Further, we determine standard tax asset lives of 40 years and 4 years respectively for the two new asset classes of 'Buildings - capital works' and 'In-house software' that are subject to the straight-line method of tax depreciation (section 7.4.4).

We also accept SA Power Networks' proposal to continue using the year-by-year tracking approach for tax depreciation of its existing assets. Under this approach, the capex for each year of a regulatory control period is depreciated individually for tax purposes (section 7.4.3).

Our adjustments to the return on capital (attachments 2, 3 and 5) and the regulatory depreciation (attachment 4) building blocks affect revenues, which in turn impacts the tax calculation. The changes affecting revenues are discussed in attachment 1.

Table 7.1 set out our draft decision on the cost of corporate income tax for SA Power Networks over the 2020–25 regulatory control period.

Table 7.1 AER's draft decision on SA Power Networks' cost of corporate income tax for the 2020–25 regulatory control period ($ million, nominal)

	2020–21	2021–22	2022–23	2023–24	2024–25	Total
Tax payable	15.6	15.1	17.4	21.4	21.0	90.5
Less: value of imputation credits	9.1	8.9	10.2	12.5	12.3	53.0
Net corporate income tax	**6.5**	**6.3**	**7.2**	**8.9**	**8.7**	**37.6**

Source: AER analysis.

7.2 SA Power Networks' proposal

SA Power Networks proposed an estimated cost of corporate income tax of $1 ($ nominal) using the AER's PTRM (version 3), which adopted the straight-line (SL) tax depreciation approach with the following inputs:[6]

- opening TAB value as at 1 July 2020 of $3479.8 million ($ nominal)
- an expected statutory income tax rate of 30 per cent per year
- a value of imputation credits (gamma) of 0.585
- depreciation of the opening TAB at 1 July 2020 for each asset class applying the year-by-year tracking approach calculated in the depreciation model, consistent with the approach approved for the 2015–20 distribution determination
- the same standard tax asset lives for tax depreciation purposes of new assets for all existing asset classes in the 2020–25 regulatory control period as approved for the 2015–20 distribution determination. In addition, SA Power Networks proposed three new asset classes—'Sub-transmission and distribution lines - short life', Substations and transformers - short life' and 'Electronic network assets' with standard tax asset lives of 25 years, 20 years and 15 years respectively.
- a placeholder estimated tax expense adjustment for the 2020–25 regulatory control period to account for the new tax approach for immediate expensing of certain capex and DV method of tax depreciation for new assets.[7]
- Table 7.2 sets out SA Power Networks' proposed TAB roll forward over the 2015–20 regulatory control period.

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6 SA Power Networks, *2020–25 Regulatory proposal – Attachment 1.1 - Distribution PTRM,* 31 January 2019

7 SA Power Networks proposed a placeholder estimated tax expense adjustment of around $220 million per year. The placeholder adjustment reduced the taxable income for the 2020–25 regulatory control period to zero. SA Power Networks stated that the inclusion of the placeholder adjustment will better reflect the estimated cost of corporate income tax under the new tax approach as the amended PTRM (version 4) was not yet finalised at the time of the submission of its regulatory proposal.
SA Power Networks, *Regulatory proposal 2020-25 – Attachment 7 – Corporate income tax,* 31 January 2019, pp. 7–8.

Table 7.2 SA Power Networks' proposed TAB roll forward for the 2015–20 regulatory control period ($ million, nominal)

	2015–16	2016–17	2017–18	2018–19[a]	2019–20[a]
Opening TAB	2466.3	2607.0	2759.1	2994.2	3233.1
Capital expenditure[b]	302.0	324.7	420.5	438.5	446.4
Less: tax depreciation	161.3	172.6	185.4	199.6	199.7
Closing TAB	**2607.0**	**2759.1**	**2994.2**	**3233.1**	**3479.8**

Source: SA Power Networks, *2020–25 Regulatory proposal – Support document – SAPN - 1.1 - PTRM Model - Public,* 31 January 2019

(a) Based on estimated capex.

(b) Net of disposals.

Table 7.3 sets out SA Power Networks' proposed cost of corporate income tax for the 2020–25 regulatory control period.

Table 7.3 SA Power Networks' proposed cost of corporate income tax for the 2020–25 regulatory control period ($ million, nominal)

	2020–21	2021–22	2022–23	2023–24	2024–25	Total
Tax payable	0.0	0.0	0.0	0.0	0.0	0.0
Less: value of imputation credits	0.0	0.0	0.0	0.0	0.0	0.0
Net corporate income tax	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**

Source: SA Power Networks, *2020–25 Regulatory proposal – Support document – SAPN - 1.1 - PTRM Model - Public,* January 2019

At the time of the submission of SA Power Network's regulatory proposal, we had not finalised our version 4 PTRM amendments to implement the tax review findings. Therefore, SA Power Networks provided a placeholder estimate of $1 for the corporate income tax allowance for the 2020–25 regulatory control period. SA Power Networks noted that the proposal does not contain detailed workings for the tax building block and that it is based on its estimate of how immediate expensing of capex and the adoption of the DV method of tax depreciation for new assets would impact the tax calculation. SA Power Networks stated that it will incorporate the outcome from the amended PTRM in its revised regulatory proposal.[8]

Subsequent to its proposal, SA Power Networks submitted that the value of the opening TAB in its proposed RFM should be adjusted down to reflect the immediate

[8] SA Power Networks, *2020–25 Regulatory proposal – Attachment 7 – Corporate income tax*, 31 January 2019, p. 8.

expensing of capex incurred in previous regulatory control periods.[9] SA Power Networks estimated that this adjustment would add around $15 million ($ nominal) to the cost of corporate income tax for the 2020–25 regulatory control period.[10]

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 SA Power Networks' 2020–25 regulatory control period.[11] Our estimate is the taxable income a benchmark efficient entity would earn for providing standard control services if it operated SA Power Networks' business, which is determined in accordance with the PTRM.[12]

In May 2018, we commenced a review of our regulatory tax approach. We released the final report of the tax review in December 2018, which identified some required changes to our approach to estimating tax depreciation expenses in our regulatory models (PTRM and RFM).[13] The changes to our regulatory tax approach require amending our model to:[14]

- 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 SL tax depreciation method, under the tax law.[15]

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. Therefore, only changes to the PTRM were required in the first regulatory control period when adopting the new tax approach. As such, no immediate change to the RFM would be required until the subsequent regulatory control period—in this case, the current RFM remains appropriate for SA Power Networks' 2020–25 distribution determination. An amended RFM will be required at the next reset to roll forward the TAB during the 2020–25 regulatory control period with capex being depreciated using the DV method.

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9 SA Power Networks, *Information request 007*, 3 June 2019.

10 Other than the impact on the 2020–25 regulatory control period, it should be noted that SA Power Networks' proposal will also increase the cost of corporate income tax for regulatory control period(s) beyond 2020–25 if accepted.

11 NER, cl. 6.5.3.

12 NER, cl. 6.5.3

13 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 at the start of the next regulatory control period, which is an input to the PTRM for the calculation of the tax building block.

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

15 We will continue to apply SL tax depreciation for assets acquired prior to 1 July 2020 for the 2020–25 regulatory control period until they are fully depreciated.

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

Our approach for calculating a DNSP's estimated cost of corporate income tax is set out in our PTRM[16] and involves the following steps:[17]

1. We estimate the annual assessable income (taxable revenue) that would be earned by a benchmark efficient entity operating the DNSP's business. This is the approved forecast revenues for the DNSP that we determined using the building block approach.[18] It includes capital contributions where these are subject to taxation.
2. We then estimate the benchmark tax expenses such as operating expenditure (opex), interest expense, tax depreciation in the following ways:
    - operating expense is set equal to the opex building block[19]
    - 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[20] for all assets acquired after 30 June 2020 except for in-house software, buildings and equity raising costs. The expenditure for these assets are to be depreciated using the SL method under Australian tax law. The 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 being depreciated for tax purposes for the year in which it is forecast to be incurred.[21] The immediately expensed amount is then included in the total tax depreciation amount for the relevant year.

   There may be other revenue adjustments, but the assessment of whether they should give rise to a tax allowance occurs on a case by case basis.

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16 AER, *Distribution PTRM (version 4)*, April 2019.

17 The PTRM must specify the manner in which the estimated cost of corporate income tax is to be calculated: NER, cl. 6.4.2 b (4).

18 The total revenue for tax purposes is the sum of the building blocks including return on capital, return of capital, operating expenditure and cost of corporate taxation, and any capital contributions. It may also include other revenue adjustments, but the assessment of whether they should give rise to a tax allowance will occur on a case by case basis.

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

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

21 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.

3. We estimate the annual taxable income that would be earned by a benchmark efficient entity operating the DNSP's business by subtracting the benchmark estimates of tax expenses (step 2) from the approved forecast revenues for the distribution network business (step 1).
4. We apply the statutory income tax rate to the estimated annual taxable income (after adjustment for any tax loss carried forward) to arrive at a notional amount of tax payable.
5. We deduct the expected value for the utilisation of imputation credits (gamma) by investors from the notional amount of tax payable. The tax payable net of the expected value of imputation credits represents the corporate income tax allowance and is included as a separate building block in determining the DNSP'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 DNSP's proposed cost of corporate tax by analysing the proposed inputs to the PTRM for calculating that cost. While our assessment approach for most of the tax inputs remain largely the same as the determination for the current 2015–20 regulatory control period, 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 sets of inputs) are discussed in turn below:

- **the opening TAB as at the commencement of the 2020–25 regulatory control period:** We consider that the roll forward of the opening TAB should be based on the approved opening TAB as at 1 July 2015 and SA Power Networks' actual capex incurred during the 2015–20 regulatory control period, and the final year (2014–15) of the previous regulatory control period.[22] We do not adjust the TAB value for immediate expensing of past capex in the roll forward process. This is consistent with our 2015–20 regulatory determination which applied SL tax depreciation to capex incurred during that period as prescribed in the PTRM.

  The roll forward of the opening TAB for 2015–20 is calculated in our RFM. We have not amended the RFM to implement the tax review at this time. This is because the tax review final report set out that the required changes to the tax depreciation approach would apply to new assets only. As such, the approach for determining the opening TAB value remains the same as the previous determination for the purposes of this draft decision. We have commenced our review of the RFM to implement the findings of the tax review and plan to release draft amendments in

[22] 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.

December 2019 for public consultation.[23] We expect that the final amended RFM will then be used for the purposes of the TAB roll forward for 2020–25 at the next reset.

This opening TAB value is used to estimate forecast tax depreciation for the 2020–25 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 assets forecast to be added to the TAB in the 2020–25 regulatory control period (with some exceptions discussed further below), we will apply the DV method of tax depreciation.

- **the standard tax asset life for each asset class:** Our assessment of a DNSP's proposed standard tax asset lives is generally 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 SA Power Networks' asset classes should be consistent with the ATO taxation ruling 2019/5 regarding the effective life of depreciating assets where possible.[24]
- 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.[25] We note that the tax effective lives for in-house software, buildings and equity raising costs are not covered under the ATO taxation ruling 2019/5. Therefore, our assessment of the standard tax asset lives for these asset classes are guided by the *Income Tax Assessment Act 1997* (ITAA). Specifically, we consider that the standard tax asset life should be:
    - 40 years for buildings – 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 for businesses of the size we regulate, which was adopted in SA Power Networks' proposal.
- **the value of gamma:** The gamma input for SA Power Networks is 0.585 for this draft decision. This is consistent with the 2018 *Rate of return instrument*, which requires us to use a gamma value of 0.585, and adopted in SA Power Networks'

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[23] See https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/roll-forward-models-transmission-and-distribution-2020-amendment.

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

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

proposal.[26] 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 2020:** Where a business has tax losses under our benchmark approach, we require the provision of this value to determine the appropriate estimated taxable income for 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. SA Power Networks does not have any accumulated tax losses as at the start of the 2020–25 regulatory control period.[27]
- **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 2020–25 regulatory control period. Our assessment of forecast immediate expensing of capex will be guided by the DNSP's actual immediate expensing of capex from the previous regulatory control period.[28] We will collect actual data relating to this expenditure in our annual reporting regulatory information notices to further inform our decision on the amount of forecast immediate expensing of capex in future regulatory determinations. Benchmarking may also be considered going forward.[29]
- **diminishing value multiplier:** The amended PTRM (version 4) applies the following formula to calculate the tax depreciation under the DV method:[30]
- $D_t = (Nominal\ net\ capex_i - \sum_{n=0}^{t-1} D_n) \times DV\ multiplier \div standard\ tax\ asset\ life$

  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 is discussed above. The assessment approach for capex is discussed in attachment 5.

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

[27] SA Power Networks, *2020–25 Regulatory proposal – Support document – SAPN - 1.1 - PTRM Model - Public*, 31 January 2019.

[28] In the tax review final report we labelled our approach to determining the amount of capex that is to be immediately expensed as an 'actuals informed approach'. AER, *Final report, Review of regulatory tax approach*, December 2018, p. 66.

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

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

- **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 to 50 to be depreciated using the SL method for tax purposes rather than the DV method. These asset classes are to contain new assets associated with in-house software, buildings and equity raising costs.
- We consider that the benchmark allowance for equity raising costs should not be depreciated using the DV method. We note that section 40.880 of the ITAA and the ATO's taxation ruling 2011/6[31] 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.[32] Further, the DNSP may propose capex associated with buildings and in-house software to be exempted from the DV method of tax depreciation in the PTRM if the proposal satisfies the following requirements:
    - **buildings**: We consider that capex for buildings may be exempted from the DV method in the PTRM, consistent with sections 43.15, 43.140 and 43.210 of the ITAA. However, such capex must be consistent with the definition of a capital work under section 43.20 of the ITAA and in ATO taxation ruling 97/25.[33] We note that this includes new buildings and structural improvements to existing buildings.[34] 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.[35] We note that this includes computer software, or the right to use computer software that the DNSP acquires, develops or has someone else develop for the DNSP's business use.[36] 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.

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31 ATO, *Taxation Ruling 2011/6*, July 2016.

32 The benchmark allowance for equity raising costs is determined within the PTRM.

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

34 ITAA, section 43.20.

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

36 ITAA, section 995.1.

7.3.1 Interrelationships

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

- pre-tax revenues
- tax expenses (including tax depreciation)
- the corporate tax rate
- any tax losses carried forward
- gamma—the expected proportion of company tax that is returned to investors through the utilisation of imputation credits—which is offset against the corporate income tax allowance.

Of these 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.[37] Depending on the source of the revenue increase, the tax increase may be equal to or less than proportional to the company tax rate.[38]

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 – These expenses generally will match the opex allowance including any revenue adjustments, but the assessment of whether they should be treated as a tax expense occurs on a case by case basis.
- Tax depreciation – A separate TAB is maintained for the 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

[37] 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.

[38] 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.

indexation. The TAB is also affected by the depreciation rate/method and asset lives assigned for tax depreciation purposes.

- A business that has tax expenses which are greater than its taxable revenue in a period would not be subject to pay tax and generate a tax loss. A tax loss from previous period(s) can be carried forward to offset against tax payable in the current period.

For SA Power Networks, our draft decision cost of corporate income tax makes up 1.0 per cent of the total building block revenue for the 2020–25 regulatory control period. Therefore, a 10 per cent increase in the corporate income tax allowance will have a minimal impact on total revenue.

7.4 Reasons for draft decision

We determine a cost of corporate income tax of $37.6 million ($ nominal) for SA Power Networks over the 2020–25 regulatory control period.

As discussed above, we applied the amended PTRM (version 4) for this draft decision to implement the changes to our regulatory tax approach identified in the tax review final report. These model changes and our draft decisions on the other building block components have reduced the cost of corporate income tax allowance by $154.2 million (or 84.9 per cent) if it was estimated under the previous tax approach.

We do not accept SA Power Networks' proposed opening TAB as at 1 July 2020 of $3479.8 million ($ nominal). Our draft decision instead determines an opening TAB value of $3476.1 million ($ nominal) as at 1 July 2020—a reduction of $3.7 million (or 0.1 per cent). This is because we corrected a number of minor input errors in the proposed RFM.

We accept SA Power Networks' proposed standard tax asset lives for all of its asset classes. We also accept SA Power Networks' proposal to continue using the year-by-year tracking approach for tax depreciation of its existing assets. Further, we determine standard tax asset lives of 40 years and 4 years respectively for the two new asset classes of 'Buildings - capital works' and 'In-house software' that are subject to the SL method of tax depreciation.

Discussed in other attachments and the overview, our draft decision on SA Power Networks' proposed return on capital (attachments 2, 3, 5 and section 2.2 of the overview) and the regulatory depreciation (attachment 4) building blocks affect total revenues, and therefore also impact the forecast corporate income tax allowance.

7.4.1 Implementation of the tax review

SA Power Networks prepared its proposed estimate of corporate income tax using version 3 of our PTRM, and was submitted prior to the amended PTRM (version 4) being published. In doing so, SA Power Networks noted that its proposal does not contain detailed workings for the tax building block and that it is based on its estimate of how the new tax approach would impact the tax calculation.

We published the new amended PTRM (version 4) in April 2019 which implements the changes identified from the final report of the tax review. 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.[39]

We consulted with SA Power Networks on the PTRM changes and new inputs for implementing the new tax depreciation approach resulting from the tax review. While SA Power Networks was not required to provide these inputs as part of its regulatory proposal, it has actively engaged with us in the lead up to this draft decision to provide the relevant tax input requirements for the amended PTRM.[40]

Our assessment of the new tax inputs submitted by SA Power Networks 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 2020–25 regulatory control period.

In response to our request for additional tax input requirements, SA Power Networks provided actual/estimated immediately deductible capex data for the 2015–20 regulatory control period and a forecast capex of $731.6 million ($2019–20, or 35.0 per cent)[41] that will be immediately expensed for tax purposes in the 2020–25 regulatory control period.[42]

We accept SA Power Networks' proposed approach for determining the forecast immediate expensing of capex for the 2020–25 regulatory control period.[43] 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 SA Power Networks historically. We consider it reasonable to expect that a similar proportion of capex will also be deducted immediately by SA Power Networks for its

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

40 SA Power Networks, *Information request 007,* 21 March 2019

41 Compared with the proposed gross capex of $2091.1 million ($2019–20).

42 SA Power Networks, *Information request 007*, 21 March 2019, p. 2.

43 SA Power Networks, *Information request 007*, 21 March 2019, pp. 1–2.
SA Power Networks' most recent actual capex that were expensed immediately includes: asset replacement capex, labour overheads and network overheads. SA Power Networks proposed to calculate the forecast immediately expensed capex based on the proposed asset replacement capex. SA Power Networks also proposed to forecast network and labour overheads at the same average overhead rates as 2017–18. It noted that the forecasts may be revised using the overhead rates for 2018–19 when it becomes available.

annual tax returns during the 2020–25 regulatory control period. We note that SA Power Networks' proposed value of the forecast immediate expensing of capex for the 2020–25 regulatory period is broadly in line with its actuals from the most recent years.[44]

As discussed in attachment 5, we have reduced SA Power Networks' proposed forecast capex by 23.0 per cent.[45] For this reason our draft decision is to reduce the proposed forecast immediate expensing capex by 153.6 million to reflect our decision on SA Power Networks' forecast capex. We will collect actual data relating to the immediately expensing of capex in our annual reporting RINs to further inform our decision for this type of expenditure in the next regulatory determination for SA Power Networks.

Our draft decision to recognise immediately deductible capex has reduced SA Power Networks' estimated cost of corporate income tax by $97.2 ($ nominal, or 67.6 per cent) had it been estimated under the previous tax approach, all else being equal.[46]

Assets exempt from the diminishing value method

SA Power Networks' proposal used version 3 of the PTRM, which applies the SL method to calculate tax depreciation for all asset classes. However, it included a high-level estimated impact of the change to applying the DV method of tax depreciation to new assets. The amended PTRM (version 4) continues to apply the SL tax depreciation method to the opening TAB at 1 July 2020, but applies the DV method as the new regulatory benchmark for tax depreciation to all new capex.[47] 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.[48] 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 SA Power Networks' forecast capex, we asked SA Power Networks to propose any relevant forecast capex to be exempted from the DV tax depreciation method.

In its response to our information request, SA Power Networks submitted that $231.5 million ($2019–20) of forecast capex associated with in-house software and $55.3 million ($2019–20) associated with buildings are to be exempted from the DV tax depreciation method. It provided us with the reallocation of the forecast capex related to these assets from the existing asset classes of 'IT' and 'Buildings' to the prescribed

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44 The forecast immediately expensed capex for the 2020–25 regulatory control period averaged around $146 million ($2019–20) per year, while actual immediately expensed capex from 2015–16 to 2017–18 averaged around $140 million ($2019–20) per year.
SA Power Networks, *Information request 007*, 22 March 2019, pp. 2–3.

45 Calculated based on the gross forecast capex in real $2019–20 terms.

46 The calculated decrease due to the change is based on expenditure and rate of return input data provided in SA Power Networks' proposal PTRM.

47 AER, *Final report, Review of regulatory tax approach*, December 2018, p. 76.

48 Asset classes 47, 48, 49 and 50 in the PTRM (version 4) provide for this.

SL tax depreciation asset classes for 'In-house software' and 'Buildings - capital works' respectively in the PTRM.

We accept SA Power Networks' proposed allocation of some forecast capex for in-house software and buildings (capital works) to be depreciated using the SL method for tax depreciation purposes. This is because the proposed forecast capex for:

- in-house software satisfies the definition under section 995.1 of the ITAA and in ATO taxation ruling 2016/3[49]
- buildings satisfies the definition of a capital work under section 43.20 of the ITAA and in ATO taxation ruling 97/25.[50]
- Therefore, these assets are not required to be depreciated using the DV method for tax purposes.
- The overall impact of our draft decision to apply the DV tax depreciation method to new assets is to reduce SA Power Networks' estimated cost of corporate income tax by $19.1 million ($ nominal, or 13.3 per cent) had it been estimated under the previous tax approach, all else being equal.

7.4.2 Opening tax asset base as at 1 July 2020

For this draft decision, we do not accept SA Power Networks' proposed opening TAB value as at 1 July 2020 of $3479.8 million ($ nominal). Our draft decision instead determines an opening TAB value of $3476.1 million ($ nominal) as at 1 July 2020.

In our review of the inputs to SA Power Networks' TAB roll forward we found that they were mostly correct and reconcile with relevant data sources such as annual reporting RINs and the 2015–20 decision models. However, for this draft decision we made the following amendments to SA Power Networks' proposed inputs to the RFM:

- corrected an error in reported adjustments for movements in capitalised provisions over the 2015–20 regulatory control period.
- reversed the reported actual capex for the 2017–18 'Fixed land' and 'Easements' asset classes.

SA Power Networks supported these amendment in its response to our information request.[51]

We do not accept a late proposal by SA Power Networks to adjust down the opening TAB as at 1 July 2020 to reflect the immediate expensing of capex incurred in previous regulatory control periods.[52] SA Power Networks calculated that its corporate income

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

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

51 SA Power Networks, *Information request 029,* 15 May 2019.
SA Power Networks, *Information request 061,* 4 July 2019.

52 SA Power Networks, *Additional response to AER information request 007*, 3 June 2019.

tax allowance would be $15 million ($ nominal) higher over the 2020–25 regulatory control period due to this proposed adjustment.[53] Its TAB would be hundreds of millions lower under its proposal.[54] SA Power Networks had not consulted with customers on this adjustment but wanted the AER to consider it in the draft decision.[55] We have carefully done so, but find it is inconsistent with the PTRM, inconsistent with our benchmark tax approach (creating a windfall gain for SA Power Networks) and not in the long term interest of customers. We provide detailed reasoning in the section below.

We note that the opening TAB as at 1 July 2020 may be updated to reflect actual capex for 2018–19 and any revised 2019–20 capex estimates as part of the final decision.

Table 7.4 sets out the roll forward of SA Power Networks' TAB values over the 2015–20 regulatory control period.

Table 7.4 AER's draft decision on SA Power Networks' TAB roll forward for the 2015–20 regulatory control period ($ million, nominal)

	2015–16	2016–17	2017–18	2018–19a	2019–20a
Opening TAB	2466.3	2609.9	2757.6	2989.8	3229.0
Capital expenditure[b]	304.9	320.4	417.5	438.5	446.4
Less: tax depreciation	161.3	172.7	185.3	199.3	199.4
Closing TAB	2609.9	2757.6	2989.8	3229.0	3476.1

Source: AER analysis.
(a) Based on estimated capex.
(b) Net of disposals.

Changing the benchmark tax approach

As a result of the 2018 tax review, we recently revised the PTRM to implement the findings from the tax review. We decided that for new assets (forecast capex) incurred in future regulatory control periods a benchmark efficient entity (BEE) would try to immediately expense capex for tax purposes where the ATO allows it to do so.[56] We decided not to revisit past capex treatment as this would be retrospective, creating windfall gains or losses which do not arise from efficiency improvements made by the

[53] The impact would extend beyond that period, but SA Power Networks did not quantify these additional impacts. It also did not provide any detail on the affected asset classes, relevant years, and the quantum of adjustment required to each of the past capex amounts impacted going back to 2010.

[54] On the basis of the high level figures provided by SA Power Networks to the tax review and recognising that immediate expensing of capex occurred since SA Power Networks was first regulated in 2010.

[55] SA Power Networks, *Further response to AER information request 007*, 25 June 2019.
AER staff meeting with SA Power Networks staff, 23 July 2019.

[56] The review also considered that the DV method of tax depreciation should be used for new assets going forward.

business and to which the business would be unable to respond.[57] Given the previous benchmark did not account for immediate expensing of capex, some businesses gained timing benefits on past capex by claiming immediately expensing in practice. Our previous benchmark did not recognised immediate expensing, so no immediate expensing was applied in respect of past capex to any businesses in determining the value of their TABs.

SA Power Networks submitted that the value of its opening TAB as at 1 July 2020 should be adjusted down to reflect the immediate expensing of capex incurred in previous regulatory control periods.[58] It stated that because SA Power Networks immediately expensed capex in the past, there should be no residual tax value still included in the opening TAB at 1 July 2020 associated with this capex going forward. It submitted that removing the residual tax value of previous immediately expensed capex in practice would provide the best estimate of tax under clause 6.5.3 of the NER. SA Power Networks further submitted that failing to remove the residual tax value would under compensate it on its tax allowance going forward.

We consider SA Power Networks' proposal is inconsistent with the direction provided in the PTRM and accompanying handbook that the opening TAB is to be as determined in the RFM. It is also inconsistent with our benchmark tax approach (creating windfall losses for customers) and is against customers' long term interests. In particular:

- Our approach provides businesses with incentives to respond to our new benchmark and customers receive the benefit of the change in benchmark tax approach.
- Under our approach SA Power Networks keeps its timing benefits made in the past.
- Under SA Power Network's proposal customers face wind fall losses.

These findings are discussed in detail now.

Providing businesses with incentives and sharing benefits with customers

The prospective adjustment of the benchmark tax approach is consistent with the principles of incentive regulation. Incentive regulation means that we make a benchmark assessment of efficient costs to operate a network, and set regulated revenues for a number of years in advance so that regulated networks can recover these costs. Where regulated networks outperform the benchmark—that is, they become more efficient and keep costs below the regulatory estimate—they retain this benefit for a period of time. However, we then observe these efficiency gains and prospectively adjust our benchmark in future years, so that consumers benefit in the long term. In SA Power Networks' case, it benefited from immediate expensing in the past. However, it will harder to gain further timing benefit by immediately expensing

[57] AER, *Final report, Review of regulatory tax approach*, December 2018, pp. 56–57.

[58] SA Power Networks, *Further response to AER information request 007*, 25 June 2019.

future capex as SA Power Networks is already doing this consistent with the BEE.[59] As a result of this tax review change, customers receive the timing benefit of future immediate expensing of capex.[60]

In general terms, our position and the approach set out in the PTRM is that the BEE made its past tax decisions one way (that is, it did not try to immediately expense capex), but will now adopt a more efficient way to operate for tax purposes (that is, it does immediately expense capex where it can).

SA Power Networks' proposal suggests a revisiting of past practice by the BEE. It is clearly inconsistent with incentive regulation to expect that the BEE would attempt to go back and request amendments from the ATO to immediately expense past capex in previous tax returns, now that the BEE has recognised that it would achieve a timing benefit if it had done so. If it were allowed to do so, thereby gaining a refund, or creating tax losses carried forward,[61] customers would be expected to benefit from such an outcome under our new benchmark and SA Power Networks would not gain any net increase in tax allowance.[62] We expect that the ATO would allow the BEE to commence immediate expensing of relevant capex in a prospective manner, consistent with the change in benchmark approach.

The past practice of the BEE was that set out as the benchmark approach in previous decisions, and implemented in the PTRM and RFMs applying across the 2010–15 and 2015–20 regulatory control periods. The new practice of the BEE is set out in the final report of the tax review,[63] as implemented in the latest version of the PTRM,[64] and when required, the corresponding version of the RFM.[65]

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59 Going forward, SA Power Networks will only gain a timing benefit if it immediately expenses in practice a greater amount of capex than the forecast for the 2020–25 regulatory control period.

60 It should be noted that ultimately the nominal amount of tax paid both with and without immediate expensing should be the same over the life of an asset, other things being equal. However, immediate expensing brings forward tax offsets and therefore creates a timing benefit in NPV terms.

61 The BEE would not simply seek to have its TAB written down, as it would be worse off. It would only do so if it could get a refund, or to create tax losses carried forward, as a quid pro quo. It would then gain a timing benefit.

62 SA Power Networks' tax allowance may actually be reduced in the short run as the tax losses created will need to be used up before an allowance was given. We would expect a refund would be passed through to customers as a separate revenue adjustment.

63 AER, *Final report, Review of regulatory tax approach, Section 2.2*, December 2018.

64 Clause 6.5.3 of the NER requires the AER to estimate the benchmark cost of corporate income tax in accordance with the PTRM. We released version 4 of the PTRM in April 2019 to implement the findings of the tax review including the modelling for the new practice of the BEE. This version of the PTRM applies two tax depreciation methods for different assets. The SL tax depreciation method applies for existing assets (assets created prior to the implementation of the new practice of the BEE and contained in the opening TAB value at the start of the upcoming regulatory control period), and the DV tax depreciation method for new assets forecast to enter the TAB in the upcoming regulatory control period (2020–25) for SA Power Networks.
AER, *Distribution PTRM (version 4)*, April 2019; see also AER, *Final decision, Amendment, Electricity transmission and distribution network service providers, Post-tax revenue models (version 4), Section 2*, April 2019 and AER, *Final decision, Amendment, Electricity transmission and distribution network service providers, Post-tax revenue model handbook section 2.3.3, section 2.5.1 and section 2.6.2*, April 2019.

65 As noted above the RFM to implement the tax review final report is not yet required but will be published in 2020.

Although SA Power Network may have preferred the AER had not changed its benchmark tax approach in relation to immediate expensing, it does not appear to question our application to new capex. Its concern is the treatment of past capex.

SA Power Networks keeps the timing benefits related to past capex

The NER does not provide for us to adjust for under/over recovery of actual tax compared to the benchmark in past regulatory control periods. So no adjustment should be made in setting the forecast benchmark tax allowance to account for the fact that SA Power Networks received a benefit from the tax allowance in the 2010–15 and 2015–20 regulatory control periods as a result of its decision to immediately expense its capex.

SA Power Networks has claimed immediate expensing on a material amount of capex since it was first regulated by us in 2010. This means SA Power Networks' actual tax depreciation was higher than estimated by the regulatory benchmark, which led to a higher tax expense and a lower actual tax paid (all things being equal). This allowed SA Power Networks to obtain a revenue benefit in the past because its actual tax costs were lower than the regulatory benchmark tax allowance. The revenue benefit associated with any given item of immediately expensed capex was not evenly spread across time. [66] These effects can be seen in the following simplified example.

Suppose a business spends $100 of refurbishment capex for a pole in year 1. The pole has a standard tax asset life of 20 years. The regulatory benchmark applies SL tax depreciation over 20 years for the asset, while the business claims immediate expensing in 1 year for the asset. We apply a 7 per cent nominal rate of return, 2.5 per cent inflation and 30 per cent tax rate to generate the first chart which compares the regulatory tax allowance and the actual tax paid for the business over the life of the asset.

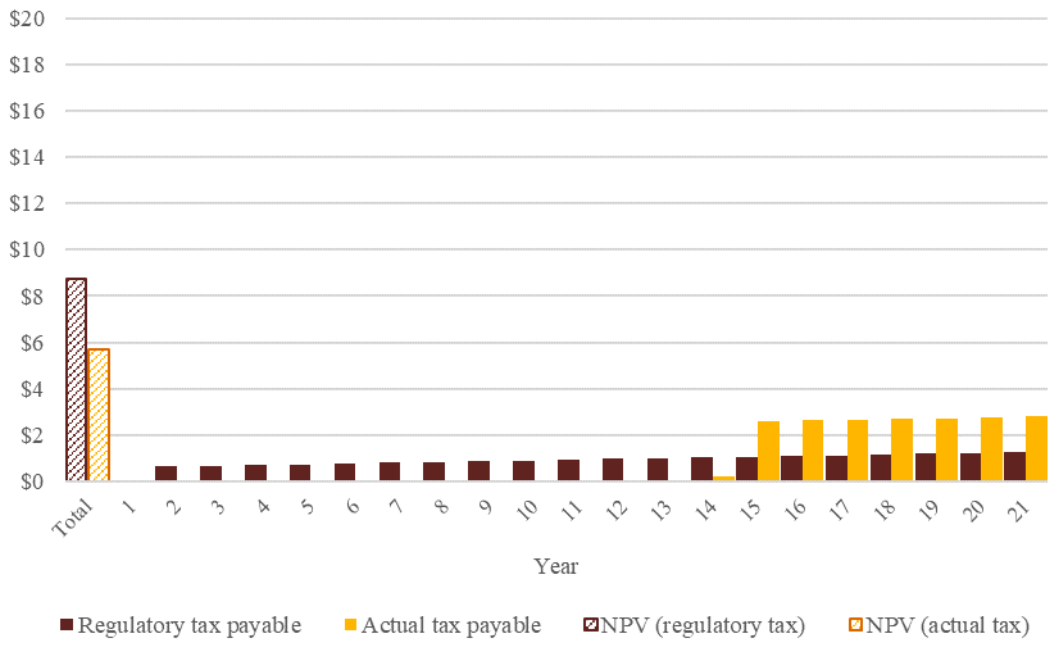
Figure 7.1 shows that in the regulatory modelling of benchmark tax the expenditure is capitalised and deducted from taxable income over the 20 year life of the asset. Therefore, there is a small relatively stable tax payable (allowance) for the life of the asset (brown bars). However, where that expenditure is expensed in the year in which it occurred for tax purposes (year 1), the business pays no tax for the first 13 years (therefore no yellow bars shown in the early years). This is because the immediate expensing of the capex produced a tax loss in year 2, and that tax loss is used to offset its taxable income from year 2 to year 13. It starts to pay tax from year 14 (yellow bars) after it fully exhausted the tax loss credits. This figure also shows that when the tax costs are discounted to net present value (NPV) terms using the assumed rate of return, the regulatory benchmark tax payable is larger than the actual tax payable. This means the business receives a revenue benefit in the first 14 years compared to the benchmark because it pays lower tax, but in the next 7 years it pays higher tax than

[66] This is a time value of money effect—the gains (in early years) and losses (in later years) are equal in nominal terms, but the earlier cash flows outweigh the later cash flows.

the benchmark. The NPV total is presented as the cross-hatched bars on the left hand side of the figure.

In nominal terms, the total actual tax paid and the benchmark regulatory tax allowance over the life of the asset is the same at $19.2.[67] However, once we take account of the time value of money, the NPV of the actual tax paid ($5.7) is lower than the benchmark regulatory tax allowance ($8.7), a gain of around 50 per cent. We refer to this revenue impact as the timing benefit.

Figure 7.1 Regulatory tax payable (SL tax depreciation) compared to actual tax payable (immediate expensing of capex)



Source: AER analysis; AER, *Final decision, Review of regulatory tax approach*, December 2018, p. 62.

Windfall losses faced by customers under SA Power Networks' proposal

Businesses can only respond to incentives on a prospective basis. Any change that is made retrospectively is therefore going to create wind fall gains or losses. As noted above, the BEE did not immediately expense capex in the past. This means that the TAB of the BEE will contain the residual value of past capex consistent with the benchmark approach applied in the past. SA Power Networks' proposal to remove the residual value of immediately expensed capex in practice, therefore creates windfall gains for SA Power Networks (windfall losses for customers) over a number of regulatory control periods. These windfall gains are significantly larger than the timing benefit (illustrated in Figure 7.1) already received by SA Power Networks.

[67] The total tax depreciation (tax offset) in nominal terms is also the same both in calculating actual tax and the regulatory tax, and is equal to the initial cost of the asset of $100.

The impact of SA Power Networks' proposed adjustment to the opening TAB can be illustrated by further extending the same example as set out in Figure 7.2.

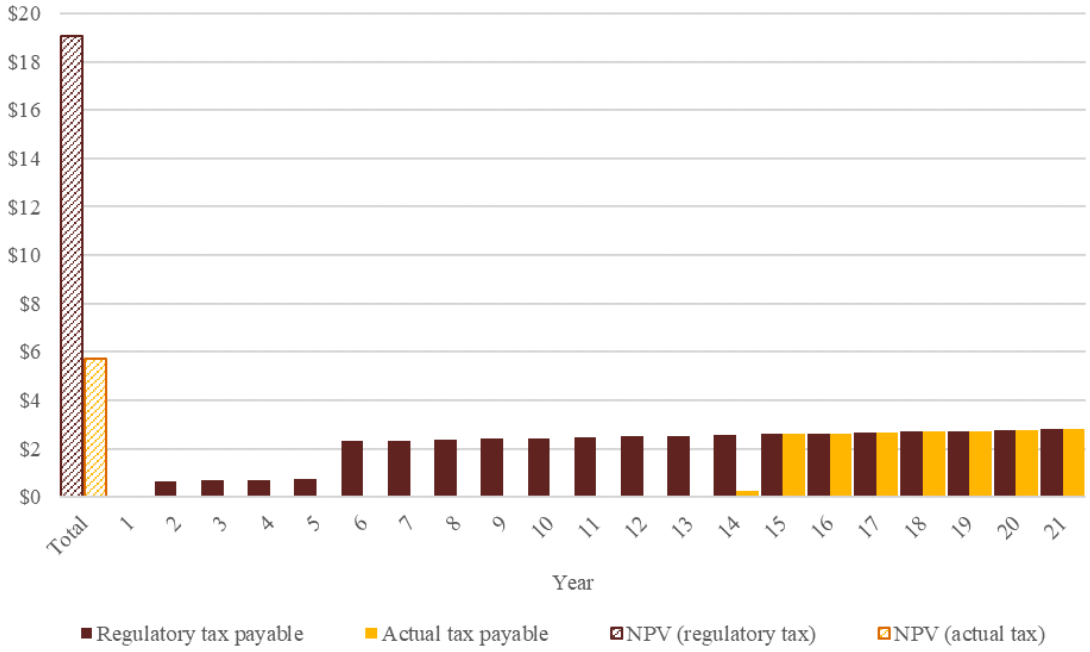
Figure 7.2 shows the actual tax paid and the regulatory tax allowance calculated using SA Power Networks' proposed approach for a $100 capex that was immediately expensed. It shows the regulatory tax allowance increases in year 6 compared to the AER's approach set out in Figure 7.1, as the TAB is adjusted downward to reflect the residual tax value of the previous immediately expensed capex. The outcome under this approach is:[68]

- In nominal terms, the total actual tax paid is $19.2 compared to the regulatory tax allowance of $43.7 over 20 years, a difference of 128 per cent.[69] Whereas under the AER's approach the two amounts are equal ($19.2) in nominal terms. The difference of $24.5 ($43.7–$19.2) is the windfall benefit to SA Power Networks if the residual tax value of past immediately expensed capex is removed from the TAB in nominal terms.
- In NPV terms, the actual tax paid ($5.7) is significantly lower than the benchmark regulatory tax allowance ($19.1), a difference of 233 per cent. Whereas under the AER's approach the regulatory allowance would be $8.7 in NPV terms, with a timing benefit of around 50 per cent received by SA Power Networks. The difference of $10.4 ($19.1–$8.7) is the windfall benefit to SA Power Networks if the residual tax value of past immediately expensed capex was removed in NPV terms.

[68] Had the tax review been implemented in a different year the figures in this example would differ, which illustrates the arbitrary nature of SA Power Networks' proposed approach. Note that even if the tax review had been implemented in year 16, where the regulatory tax payable and actual tax payable match, customers still face windfall loss under SA Power Networks proposal. These windfall losses can be seen by comparing the regulatory tax payable in Figures 7.1 and 7.2, with those in Figure 7.2 being significantly higher.

[69] The total tax depreciation (tax offset) in nominal terms is only $20 under SA Power Networks' proposal, compared to the initial cost of the asset of $100. That is, customers would forgo $80 in tax offsets if SA Power Networks' proposed adjustment to the TAB was accepted in this case.

Figure 7.2 Regulatory tax payable (adjustment to reflect immediate expensing of past capex in year 6) compared to actual tax payable (immediate expensing of capex)



Source: AER analysis.

Other issues

In further discussions with us on 22 July 2019, SA Power Networks expressed concerns that the ATO could disallow immediate expensing of capex claimed in the past. If that is the case, SA Power Networks will need to give back the timing benefit (as discussed in relation to Figure 7.1) to the ATO, but SA Power Networks will neither gain nor lose compared to the AER's previous benchmark, as SA Power Networks would then merely conform to the previous tax depreciation profile.

In our tax review final report we decided to recognise immediate expensing after careful consideration of the available evidence on ATO acceptance of this practice. This included the draft ATO ruling TR 2017/D1, the specific worked examples in that document referring to electricity assets, and the ATO determination it superseded.[70] We also had regard to the substantial number of businesses that were recording material levels of immediate expensing and had been doing so for a number of years without any adverse ATO action.[71] Our application of the 'actuals informed' approach to SA Power Networks has set the forecast level of immediate expensing in line with its past practice, so there would not appear to be additional risk from this cause. For the

[70] See AER, *Final report, Review of regulatory tax approach*, December 2018, pp. 59–61.
[71] See AER, *Final report, Review of regulatory tax approach*, December 2018, pp. 63, 67–68.

AER to ignore the tax residual value on immediately expensed capex would not only afford SA Power Networks windfall gains (Figure 7.2, but customers would effectively face the risk of any adverse ATO outcome. That is not in customers' long term interests.

SA Power Networks also stated it would be under compensated in practice against the benchmark tax allowance under our approach. The fact that SA Power Networks will pay higher tax in the future because it paid lower tax in the past through immediate expensing does not mean it is undercompensated going forward. As shown in Figure 7.1 it actually received a timing benefit from doing so. We consider that to determine in practice if a business was undercompensated would require an actual tax approach. The best estimate for the BEE does not equate to an actual tax approach.

If an actual tax approach was adopted there would be many factors (besides immediate expensing) determining the tax estimate that would see the actual tax differ from the estimate we determine. There may, for example, be revaluation gains on the TAB or tax losses carried forward that were generated by, among other things, immediate expensing. These other factors may reduce SA Power Networks' actual tax. During the tax review, businesses (including SA Power Networks) were not supportive of the AER applying an actual tax approach.[72]

A final implication of SA Power Networks' proposal is that it would appear to require the AER to look back on all other regulated networks' past capex and reassess whether they had made efficient decisions in either immediately expensing or not in practice. The tax review final report noted that while a substantial number of networks were immediately expensing capex at material levels, a substantial number were not doing so (although they may suggest they would have under an alternative benchmark).[73] If SA Power Networks' view was accepted, it is therefore possible that all businesses would have their TABs written down to varying degrees and customers would face windfall losses, paying higher tax allowances, across all businesses. This would be inconsistent with the aims of incentive regulation and customers' long term interests.

Conclusion

We consider that the residual tax value of past capex should continue to be used to provide tax offsets for taxable income when calculating the benchmark cost of corporate income tax, consistent with the benchmark applied to that past capex.[74] SA

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[72] SA Power Networks, *Submission to the AER Initial Report – Review of regulatory tax approach*, 26 July 2018, p. 2. The majority of the regulated network service providers also expressed a similar view in their submissions to the tax review. See AER, *Final report, Review of regulatory tax approach, Appendix A*, December 2018.

[73] AER, *Final report, Review of regulatory tax approach*, December 2018, p. 63.

[74] AER, *Final report, Review of regulatory tax approach*, December 2018, p. 63.
This is also reflected in the operation of the PTRM (version 4), which requires the opening TAB value for the forthcoming regulatory control period (2020–25) for SA Power Networks is to be sourced from the closing TAB value which has been determined in the RFM. The RFM applicable in the 2015–20 regulatory control period determines the TAB by using SL tax depreciation. It does not allow for immediate expensing.

Power Networks did not challenge the estimates of tax in the past. The outcome of those past estimates is that a residual tax value remains for the assets in question. To ignore these residual values would see customers face significant windfall losses that would be inconsistent with their long term interests.[75] The long term interests of customers represents the key objective of the NER.

7.4.3 Year-by-year tracking approach

We accept SA Power Networks' continued use of the year-by-year tracking approach for calculating tax depreciation of its existing assets. This is consistent with our draft decision to accept SA Power Networks' continued use of year-by year tracking for regulatory depreciation purposes (attachment 4). It is also consistent with the approved approach in our 2015–20 distribution determination for SA Power Networks. Under this approach, the capex for each year of a regulatory control period is depreciated individually for tax purposes. It will result in each tax asset class having an expanding list of sub-assets to reflect the regulatory year in which capex on those assets occurred. This extra data helps track remaining tax asset values and associated tax depreciation, and is therefore consistent with the NER.

We are satisfied the continued application of the year-by-year tracking method to calculate SA Power Networks' tax depreciation of existing assets provides an estimate of the tax depreciation amount for a benchmark efficient distributor as required by the NER.[76]

7.4.4 Standard tax asset lives

We accept SA Power Networks' proposed standard tax asset lives for its asset classes because they are:

- broadly consistent with the values prescribed by the Commissioner for taxation in ATO taxation ruling 2019/5,[77] and/or
- the same as the approved standard tax asset lives for the 2015–20 regulatory control period.
- Discussed in section 0, as part of the implementation of the new tax depreciation approach, SA Power Networks proposed to reallocate forecast capex associated with buildings (capital works) and in-house software to the prescribed SL tax depreciation asset classes in the amended PTRM. We determine a standard tax asset life of 40 years for the 'Buildings - capital works' asset class, as this is

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[75] Options to reduce the TAB while avoiding windfall losses to customers could include: accelerating tax depreciation of the residual values in the TAB; making an offsetting revenue adjustment to reflect the amount the TAB is reduced by; or creating a tax loss carried forward equivalent to the amount the TAB is reduced by. These options while avoiding a windfall gain or loss would result in a short run cash flow that would disadvantage to SA Power Networks. We have not considered these options further at this time.

[76] NER, cl. 6.5.3.

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

consistent with the number of years required to completely depreciate a capital works asset such as buildings under the ITAA.[78] We also determine a standard tax asset life of 4 years for the 'In-house software' asset class, as this is consistent with the ITAA.[79] In its response to our information request, SA Power Networks agreed that both of these standard tax asset lives are appropriate for tax depreciation purposes.[80]

Table 7.5 sets out our draft decision on the standard tax asset lives for SA Power Networks. We are satisfied that the standard tax asset lives are appropriate for application over the 2020–25 regulatory control period. We are also satisfied that the standard tax asset lives provide an estimate of the tax depreciation amount that would be consistent with the tax expenses used to estimate the annual taxable income for a benchmark efficient service provider.[81]

Table 7.5 AER's draft decision on SA Power Networks' standard tax asset lives (years)

Asset class	Standard tax asset life
Sub-transmission lines[a]	47.5
Distribution lines[a]	47.5
Substations[a]	40.0
Distribution transformers[a]	40.0
LVS[a]	47.5
Communications[a]	10.0
Contributions	n/a
Land	n/a
Substation land	n/a
Easements	n/a
Buildings[a]	40.0
Heavy vehicles - 15 year[a]	15.0
Heavy vehicles - 10 year[a]	15.0
Light vehicles[a]	6.7
IT assets[a]	4.0
Plant & tools/office furniture[a]	10.0

78 ITAA, sections 43.15, 43.140, 43.210.
79 ITAA, section 40.95(7).
80 SA Power Networks, *Information request 007,* 21 March 2019.
81 NER, cl. 6.5.3.

Asset class	Standard tax asset life
Sub-transmission and distribution lines - short life[a]	25.0
Substations and transformers - short life[a]	20.0
Electronic network assets[a]	15.0
Buildings - capital works[b]	40.0
In-house software[b]	4.0
Equity raising costs[b]	5.0

Source: AER analysis.

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

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

n/a not applicable. We have not assigned a standard tax asset life to the 'Contributions', 'Land', 'Substation land' and 'Easements' asset classes because the assets allocated to these asset classes are non-depreciating assets.