



Draft Decision

ActewAGL distribution determination

2015–16 to 2018–19

Attachment 8: Corporate income tax

November 2014

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Note

This attachment forms part of the AER's draft decision on ActewAGL's 2015–19 distribution determination. It should be read with other parts of the draft decision.

The draft decision includes the following documents:

Overview

Attachment 1 – Annual revenue requirement

Attachment 2 – Regulatory asset base

Attachment 3 – Rate of return

Attachment 4 – Value of imputation credits

Attachment 5 – Regulatory depreciation

Attachment 6 – Capital expenditure

Attachment 7 – Operating expenditure

Attachment 8 – Corporate income tax

Attachment 9 – Efficiency benefit sharing scheme

Attachment 10 – Capital expenditure sharing scheme

Attachment 11 – Service target performance incentive scheme

Attachment 12 – Demand management incentive scheme

Attachment 13 – Classification of services

Attachment 14 – Control mechanism

Attachment 15 – Pass through events

Attachment 16 – Alternative control services

Attachment 17 – Negotiated services framework and criteria

Attachment 18 – Connection methodology

Attachment 19 – Pricing methodology

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Shortened forms

Shortened form	Extended form
AARR	aggregate annual revenue requirement
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
ASRR	aggregate service revenue requirement
augex	augmentation expenditure
capex	capital expenditure
CCP	Consumer Challenge Panel
CESS	capital expenditure sharing scheme
CPI	consumer price index
CPI-X	consumer price index minus X
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

Shortened form	Extended form
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
RFM	roll forward model
RIN	regulatory information notice
RPP	revenue 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 ActewAGL's 2014–19 period.¹ Under the post-tax framework, a corporate income tax allowance is calculated as part of the building block assessment using our post-tax revenue model (PTRM). This amount enables ActewAGL to recover the costs associated with the estimated corporate income tax payable during the 2014–19 period.

This attachment presents our assessment of ActewAGL's proposed corporate income tax allowances for the 2014–19 period in respect of its distribution and transmission networks. It also presents our assessment of its proposed opening tax asset bases (TABs), and the standard and remaining tax asset lives used to estimate tax depreciation for the purpose of calculating tax expenses.

8.1 Draft decision

We do not accept ActewAGL's proposed estimated cost of corporate income tax allowances of \$53.7 million and \$9.0 million (\$ nominal) for its distribution and transmission networks respectively. Our draft decision on the estimated cost of corporate income tax is \$31.4 million and \$4.4 million (\$ nominal) for ActewAGL's distribution and transmission networks respectively over the 2014–19 period. This represents a reduction of \$22.3 million (or 41.5 per cent) for its distribution network and a reduction of \$4.5 million (or 50.3 per cent) for its transmission network compared to its proposal.

These reductions reflect our amendments to some of ActewAGL's proposed inputs to forecasting the cost of corporate tax such as the standard tax asset lives (section 8.4.2). It also reflects our draft decision on the value of imputation credits—gamma—(attachment 4). Changes to building block costs affect revenues, which also impact the tax calculation. The changes affecting revenues are discussed in attachment 1.

¹ NER, cl 6.4.3(a)(4).

Table 8.1 and Table 8.2 set out our draft decision on the estimated cost of corporate income tax allowances for ActewAGL's distribution and transmission networks respectively. Based on the approach to modelling the cash flows in the PTRM, we have derived effective tax rates of 31.6 per cent for ActewAGL's distribution network and 27.2 per cent for ActewAGL's transmission network.

Table 8.1 AER's draft decision on ActewAGL's cost of corporate income tax allowance for the 2014–19 period – distribution (\$ million, nominal)

	2014–15	2015–16	2016–17	2017–18	2018–19	Total
Tax payable	9.6	10.2	9.6	11.2	11.8	52.4
Less: value of imputation credits	3.8	4.1	3.8	4.5	4.7	20.9
Corporate income tax allowance	5.8	6.1	5.8	6.7	7.1	31.4

Source: AER analysis.

Table 8.2 AER's draft decision on ActewAGL's cost of corporate income tax allowance for the 2014–19 period – transmission (\$ million, nominal)

	2014–15	2015–16	2016–17	2017–18	2018–19	Total
Tax payable	1.3	1.4	1.4	1.7	1.7	7.4
Less: value of imputation credits	0.5	0.6	0.6	0.7	0.7	3.0
Corporate income tax allowance	0.8	0.8	0.8	1.0	1.0	4.4

Source: AER analysis.

8.2 ActewAGL's proposal

ActewAGL proposed a forecast cost of corporate income tax of \$53.7 million and \$9.0 million (\$ nominal) for its distribution and transmission networks respectively, calculated using the AER's PTRM and the following inputs:²

- opening TABs as at 1 July 2014 of \$609.1 million and \$137.1 million (\$ nominal) for its distribution and transmission networks respectively
- an expected statutory income tax rate of 30 per cent per year
- a value for gamma of 0.25
- remaining tax asset lives for the TAB as at 1 July 2014 using the depreciation approach similar to that applied to the regulatory asset base (RAB) remaining asset lives³
- the same standard tax asset lives for depreciating new assets for the 2014–19 period as approved at the 2009–14 regulatory control period, except for the 'Opening distribution assets' asset class.

Table 8.3 and Table 8.4 set out ActewAGL's proposed corporate income tax allowances for its distribution and transmission networks respectively over the 2014–19 period.

² ActewAGL, *Regulatory proposal*, June 2014, Attachment B2 and Attachment B5.

³ ActewAGL, *Regulatory proposal*, June 2014, p. 300.

Table 8.3 ActewAGL's proposed cost of corporate income tax allowance for the 2014–19 period – distribution (\$ million, nominal)

	2014–15	2015–16	2016–17	2017–18	2018–19	Total
Tax payable	13.0	13.8	13.4	15.3	16.1	71.7
Less: value of imputation credits	-3.3	-3.5	-3.4	-3.8	-4.0	-17.9
Corporate income tax allowance	9.8	10.4	10.1	11.5	12.1	53.7

Source: ActewAGL, *Regulatory proposal*, June 2014, Attachment B2.

Table 8.4 ActewAGL's proposed cost of corporate income tax allowance for the 2014–19 period – transmission (\$ million, nominal)

	2014–15	2015–16	2016–17	2017–18	2018–19	Total
Tax payable	2.0	2.1	2.2	2.7	2.9	11.9
Less: value of imputation credits	-0.5	-0.5	-0.6	-0.7	-0.7	-3.0
Corporate income tax allowance	1.5	1.6	1.7	2.0	2.2	9.0

Source: ActewAGL, *Regulatory proposal*, June 2014, Attachment B5.

8.3 AER's assessment approach

Under clause 6.5.3 of the 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 ActewAGL'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 the benchmark estimates of tax expenses from the approved forecast revenues. 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 TAB, and standard and remaining tax asset lives for tax 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 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 income 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 2014–19 period:** We consider that the roll forward of the opening TAB should be based on the approved opening TAB as at commencement of the 2009–14 regulatory control period and the service provider's actual capex incurred during the 2009–14 regulatory control period.⁴
- **The remaining tax asset life for each asset class at the commencement of the 2014–19 period:** Our preferred method to determine the remaining tax asset lives is the weighted average method. We consider the weighted average method provides a better reflection of the mix of asset lives within an asset class. We will assess the outcomes of other approaches against the outcomes of this preferred method.
- **The standard tax asset life for each asset class:** We assess the service provider's proposed standard tax asset lives, where necessary, against those prescribed by the Commissioner for taxation in tax ruling 2014/4 and the approved standard tax asset lives in the service provider's distribution determination for the 2009–14 regulatory control period.
- **The income tax rate:** The statutory income tax rate is 30 per cent per year.
- **The value of gamma:** The gamma input for ActewAGL is 0.40. Refer to attachment 4 for detailed discussion on this matter.

8.3.1 Interrelationships

The cost of corporate income tax building block feeds directly into the annual revenue requirement (ARR). This corporate income tax 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 offsets 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.⁵ Depending on the source of the revenue increase, the tax increase may be equal to or less than proportional to the company tax rate.⁶

The tax expenses 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,

⁴ 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.

⁵ 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.

⁶ 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.

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

A ten per cent increase in the corporate income tax allowance causes revenues to increase by about 0.6 per cent. The proposed gamma of 0.25, compared to the value in the AER's decision of 0.4, would increase the corporate income tax allowance by 24 per cent and total revenues by about 1.5 per cent.

8.4 Reasons for draft decision

We do not accept ActewAGL's proposed estimated cost of corporate income tax. We have instead determined corporate income tax allowances of \$31.4 million and \$4.4 million for its distribution and transmission networks respectively. This represent reductions of \$22.3 million (or 41.5 per cent) for ActewAGL's distribution network and \$4.5 million (or 50.3 per cent) for ActewAGL's transmission network.

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

- the standard asset life of equity raising costs (section 8.4.2)
- the value of gamma (attachment 4)
- other building block components including forecast opex (attachment 7) and forecast capex (attachment 6) that impact revenues, and therefore also impact the forecast corporate income tax allowance.⁷

8.4.1 Opening tax asset base

We accept ActewAGL's proposed opening TABs as at 1 July 2014 of \$609.1 million for its distribution network and \$137.1 million (\$nominal) for its transmission network. Although ActewAGL's transmission assets are to be regulated as dual function assets from 1 July 2014, the transmission TAB has been established by ActewAGL from 1 July 2009. This is similar to the approach to establish the RABs discussed in attachment 2 in respect of ActewAGL's distribution and transmission networks. To determine the opening TABs as at 1 July 2014, ActewAGL has rolled forward the distribution and transmission TABs over the 2009–14 regulatory control period using the approach set out in our RFM.

In the 2009 determination, we established ActewAGL's opening TAB as at 1 July 2009, which included estimated capex for 2008–09.^{8,9} This needs to be adjusted to account for actual capex for

⁷ NER, cl 6.5.3.

⁸ AER, *Final Decision - Australian Capital Territory distribution determination 2009–10 to 2013–14*, 28 April 2009, p.88.

⁹ We note that the estimation of the opening TAB as at 1 July 2008, the final year of the previous regulatory control period, is a matter particular to this determination. This is because the opening TAB as at 1 July 2009 was first established for

2008–09. Therefore, as part of the roll forward of the TAB in the RFM the following key inputs are required:

- The opening TAB for the final year of the previous regulatory control period, for ActewAGL this is the opening TAB as at 1 July 2008.
- The remaining and standard tax asset lives for each asset class based on those approved for the 2009–14 regulatory control period.

We developed a preferred approach to account for the difference in 2008–09 capex by establishing the opening TAB inputs as at 1 July 2008 based on the approved values and tax asset lives in the 2009 determination. Based on this approach, we estimated the opening TABs as at 1 July 2014 of \$616.1 million and \$138.1 million (\$ nominal) for ActewAGL's distribution and transmission networks respectively.

ActewAGL's approach to derive the proposed opening TAB inputs as at 1 July 2008 differs from our preferred approach. However, ActewAGL's approach is based on the approved method used to establish the 1 July 2009 TAB in the 2009 determination.¹⁰ This approach relies on the roll forward of ActewAGL's approved opening TAB as at 1 July 2009 derived using its national tax equivalent regime (NTER) entity register from 1 July 2001 to 1 July 2009. These 1 July 2008 inputs were then rolled forward by ActewAGL over the 2009–14 regulatory control period to estimate the opening TABs as at 1 July 2014 of \$609.1 million and \$137.1 million (\$ nominal) for its distribution and transmission network respectively.¹¹

Comparing the two approaches, the differences in the opening TABs as at 1 July 2014 for ActewAGL's distribution and transmission networks are 1.1 per cent and 0.7 per cent respectively. We are satisfied that the effect of substituting our approach to set the opening TAB inputs as at 1 July 2008 and rolling forward to 1 July 2014 on ActewAGL's proposed total revenue is not material—increases of 0.03 per cent for distribution and 0.02 per cent for transmission. We therefore accept ActewAGL's proposed opening TABs as at 1 July 2014 for this draft decision.¹²

ActewAGL at the 2009 determination and the RFM associated with that determination did not have the necessary inputs required for use in this reset. Going forward, the RFM for this reset will contain the necessary inputs to be used for establishing the opening TAB for the next reset.

¹⁰ AER, *Final decision- Australian Capital Territory distribution determination, 2009–10 to 2013–14*, 28 April 2009, p.88.

¹¹ We note ActewAGL's RFM proposed a tax standard life of 44.6 years for the 'Opening distribution assets' class, which differs slightly from the approved tax standard life of 44.4 years in the 2009 determination. We changed the tax standard life to reflect the 2009 approved value and it does not impact on the proposed opening TABs as at 1 July 2014 to one decimal place.

¹² At the time of this draft decision, the roll forward of ActewAGL's TAB includes estimated capex values for 2013–14. We will update the 2013–14 estimated capex values with the actual values for the final decision.

Table 8.5 and Table 8.6 set out our draft decision on the roll forward of ActewAGL's TABs over the 2009–14 regulatory control period for its distribution and transmission networks respectively.

Table 8.5 AER's draft decision on ActewAGL's TAB roll forward (\$ million, nominal) – distribution

	2009–10	2010–11	2011–12	2012–13	2013–14 ^b
Opening TAB	412.2	452.7	499.1	532.5	563.0
Capital expenditure ^a	58.0	66.0	55.2	54.2	72.7
Less: tax depreciation	17.5	19.6	21.8	23.7	26.6
Closing TAB	452.7	499.1	532.5	563.0	609.1

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

Table 8.6 AER's draft decision on ActewAGL's TAB roll forward (\$ million, nominal) - transmission

	2009–10	2010–11	2011–12	2012–13	2013–14 ^b
Opening TAB	59.4	69.5	81.0	97.4	118.7
Capital expenditure ^a	12.6	14.4	19.8	25.2	23.2
Less: Tax depreciation	2.5	2.9	3.4	3.9	4.8
Closing TAB	69.5	81.0	97.4	118.7	137.1

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

8.4.2 Standard tax asset lives

We accept the majority of ActewAGL's proposed standard tax asset lives for its distribution and transmission networks because they are:

- broadly consistent with the values prescribed by the Commissioner for taxation in tax ruling 2014/4¹³
- the same as those approved standard tax asset lives for the 2009–14 regulatory control period.

We are satisfied that the proposed standard tax asset lives remain appropriate for applying over the 2014–19 period.

However, we have changed the standard tax asset life for the 'Equity raising costs' asset class to 5 years from ActewAGL's proposed 44.5 years for tax depreciation purposes. This is because the Australian Taxation Office (ATO) requires equity raising costs to be amortised over a five-year period on a straight-line basis.¹⁴ In recent determinations, we adopted a standard tax asset life of 5 years for

¹³ ATO, *Taxation Ruling Income tax: effective life of depreciating assets (applicable from 1 July 2014)*, August 2014, <http://law.ato.gov.au/atolaw/view.htm?docid=%22TXR%2FTR20144%2FNAT%2FATO%2F0001%22>, accessed on 25 September 2014.

¹⁴ ATO, *Guide to depreciating assets 2001-02: Business related costs—section 40-880 deductions*, ATO reference; NO NAT7170, p. 25.

amortising equity raising costs for tax depreciation purposes.¹⁵ Therefore, we will apply the standard tax asset life of 5 years for tax depreciation purposes. We consider this standard tax asset life provides a better estimate of the tax depreciation amount for a benchmark efficient service provider as required by the NER.¹⁶

Table 8.7 and Table 8.8 present our draft decision on the standard tax asset lives for ActewAGL's distribution and transmission networks respectively.

8.4.3 Remaining tax asset lives

We accept ActewAGL's proposed remaining tax asset lives as at 1 July 2014. ActewAGL's proposed approach to calculate the remaining tax lives differs from the AER's preferred weighted average remaining life (WARL) approach. ActewAGL's approach calculates the remaining tax asset lives by using the opening TAB in 2013–14 and dividing by the tax depreciation from the final year of the 2009–14 regulatory control period. This is similar to ActewAGL's approach to calculate the RAB remaining asset lives.

For the same reasons as discussed in attachment 2, we have concerns with ActewAGL's approach to calculating the remaining tax asset lives as it tends to result in lower lives. In particular, it does not control well for when assets expire. For example, an asset may expire at the end of 2013–14, yet the depreciation associated with that asset for 2013–14 is effectively assumed to continue into the future under ActewAGL's approach.

In the present circumstances, however, the impact is not significant because of the value of the historical asset class ('Opening distribution assets') that makes up a large proportion of the TAB and does not have any capex added to it from 1 July 2009. The difference in tax allowance from applying ActewAGL's approach relative to our WARL approach is an increase in proposed total revenue of less than 0.13 per cent for ActewAGL's distribution and transmission networks over the 2014–19 period. Accordingly, we accept ActewAGL's proposed remaining tax asset lives for this draft decision.¹⁷ Further, given our concerns with ActewAGL's approach we will review this matter at the next determination.

Table 8.7 and Table 8.8 present our draft decision on remaining tax asset lives for ActewAGL's distribution and transmission networks respectively.

Table 8.7 AER's draft decision on ActewAGL's standard and remaining tax asset lives (years) – distribution

Asset class	Standard tax asset life	Remaining tax asset life as at 1 July 2014
Opening distribution assets	44.6	18.6
Sub-transmission overhead	47.5	n/a
Sub-transmission underground	47.5	n/a

¹⁵ AER, *Draft decision: Powerlink transmission determination 2012–13 to 2016–17*, 2011, pp. 265–266; AER, *Draft decision: ElectraNet transmission determination 2013–14 to 2017–18*, 2013, pp. 193–194.

¹⁶ NER, cl 6.5.3(a)(2).

¹⁷ At the time of this draft decision, the roll forward of ActewAGL's TAB includes estimated capex values for 2013–14. We will update the 2013–14 estimated capex values with the actual values for the final decision. The 2013–14 capex values are used to calculate the closing TAB values as at 30 June 2014 and therefore the remaining tax asset lives in the RFM. Accordingly, for the final decision we will recalculate ActewAGL's remaining asset lives as at 1 July 2014 based on this draft decision.

Zone substation	40.0	37.8
Distribution substations	40.0	38.0
Distribution overhead lines	45.0	42.9
Distribution underground lines	50.0	47.9
IT & Communication systems (networks)	10.0	9.4
Motor vehicles	8.0	7.2
Other non-system assets (networks)	5.8	3.6
IT systems (corporate)	4.1	3.3
Telecommunications (corporate)	6.7	3.4
Other non-system assets (corporate)	5.7	2.9
Land	n/a	n/a
Buildings	100.0	97.1
Equity raising costs	5.0	40.5

Source: AER analysis.
n/a: not applicable.

Table 8.8 AER's draft decision on ActewAGL's standard and remaining tax asset lives (years) – transmission

Asset class	Standard tax asset life	Remaining tax asset life as at 1 July 2014
Opening distribution assets	44.6	18.6
Sub-transmission overhead	47.5	45.1
Sub-transmission underground	47.5	n/a
Zone substations	40.0	38.7
IT & Communications systems (networks)	10.0	9.4
Motor vehicles	8.0	7.2
Other non-system assets (networks)	5.8	3.6
IT systems (corporate)	4.1	3.3
Telecommunications (corporate)	6.7	3.5
Other non-system assets (corporate)	5.7	2.9
Land	n/a	n/a
Buildings	100.0	97.1
Equity raising costs	5.0	40.5

Source: AER analysis.
n/a: not applicable.