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CORPORATE ADVISORY

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Final

Assessment of Aurora Energy's proposed methodology and calculation of its tax asset base for the 2012 – 2017 regulatory control period

1. Introduction

I refer to the contract between the Australian Competition and Consumer Commission ("ACCC"), as represented by the Australian Energy Regulator ("AER"), and McGrathNicol Corporate Advisory ("McGrathNicol") for the provision of assistance in assessing the tax asset base of Aurora Energy Pty Ltd ("Aurora") for the 2012 – 2017 regulatory control period.

Specifically, this assessment relates to the methodology used to calculate Aurora's tax asset base.

2. Scope

McGrathNicol has been engaged to conduct a high level assessment of Aurora's tax asset base valuation methodology ("proposed methodology"), based on information provided by Aurora including its regulatory proposal for the 2012 – 2017 regulatory control period.

In assessing Aurora's proposed methodology, we have considered the following:

+ whether Aurora's proposed methodology is consistent with the National Electricity Rules ("NER") and the National Tax Equivalents Regime ("NTER"). Specifically, this involved:
  - assessing the starting point that Aurora has relied upon to establish the opening tax asset values;
  - reviewing historic depreciation and tax depreciation assumptions to determine whether these assumptions are appropriate in the context of Aurora's proposed methodology and generally accepted accounting principles ("GAAP");
  - examining the treatment of past additions and disposals and determining whether such treatment is appropriate in the context of Aurora's proposed methodology and GAAP;
  - reviewing Aurora's treatment of depreciation on capital contributions to determine if these have been applied correctly;
  - assessing the assumptions used to split assets between standard control, alternative control, negotiated and unregulated services to determine whether these assumptions are appropriate in the context of Aurora's proposed methodology;
  - reviewing Aurora's treatment of Work-In-Progress ("WIP"); and
  - reviewing Aurora's treatment of tax losses going forward.

- whether Aurora's tax asset base has been calculated in accordance with its proposed methodology;
- the validity of the documentation supporting the methodology, including whether financial records used by Aurora are verifiable by financial reports lodged with the Australian Securities and Investments Commission, the Australian Taxation Office and/or the Office of the Tasmanian Economic Regulator's ("OTTER") records and consultants' report that Aurora has relied upon in its proposed methodology; and
- the reasonableness of assumptions used by Aurora to reconcile financial reports and/or ATO lodgements to the estimated initial tax base as at 1 July 2012.

As part of the engagement, where we are able, we have also assessed the potential materiality of any deficiencies identified in respect of the above, and provided recommendations to address such deficiencies.

Disclaimer

We have reviewed Aurora Energy's proposed methodology and calculation of its tax asset base for the 2012 – 2017 regulatory control period. We have relied on the information provided by Aurora Energy and the ACCC, and have not attempted to verify its accuracy.

We note that we have not undertaken an audit of the tax asset values, the PTRM, the RFM and the supporting schedules provided, and provide no opinion in respect of their accuracy.

The purpose of our review is to determine if the methodology applied by Aurora appears reasonable. However, we do not warrant that we have been provided with all material relevant to make an assessment of reasonableness, and reserve our right to change our view should additional information be provided. We have not undertaken sufficient procedures to be able to form an opinion on whether the tax asset values have been determined in accordance with the methodology.

Neither McGrathNicol or any member or employee of the firm undertakes responsibility in any way whatsoever to any person or organisation other than the ACCC and the AER in respect of the information set out in this letter, including any errors, omissions or negligence however caused.

It is important to note that we are not tax accountants and the above assessment does not constitute tax advice.

3. Background

Revenue earned by DNSPs is regulated by the AER to ensure that they earn an allowable return on capital. Each reset period, the DNSPs submit their revenue proposal to the AER.

DNSPs adopt a "building block" approach to determine allowable revenue. To enable the determination of the tax building block (incorporating depreciation), DNSPs need to determine the tax asset values (as represented by the total future value depreciation allowable for tax purposes) of their regulatory assets as at the commencement of the next regulatory period.

As the monopoly provider of electricity distribution services within the Tasmanian jurisdiction, Aurora's distribution business is required to hold a distribution licence in accordance with the *Electricity Supply Industry Act 1995*. As a monopoly electricity distribution business, Aurora is also subject to economic regulation of its distribution services. To date, this has been undertaken by the jurisdictional regulator, OTTER. However, the current determination will conclude on 30 June 2012 and economic regulation of distribution services will transfer to the AER.

Aurora is therefore required to submit its regulatory proposal to the AER for its distribution services covering the five-year regulatory control period from 1 July 2012 to 30 June 2017.

The AER is to make its first electricity distribution determination for Tasmania under the new framework that is to commence on 31 May 2011. In the course of transitioning to the national regulatory framework, it has been identified that a number of transitional issues will require the AER to seek further guidance or assistance from McGrathNicol, including an assessment of Aurora's tax asset base.

Our assessment has been based on key guiding principles outlined in the AER's presentation, "Transition from pre-tax to post-tax regulation", dated 21 June 2007. These include:

+ the tax asset base should:
  - not include assets that are associated with unregulated activities;
  - include all remaining tax concessions associated with RAB assets; and
  - be reflective of transactions of a standalone entity (e.g. transfers of RAB tax depreciation concessions to other business units would not be appropriate);
+ the roll forward of the tax values to the commencement of post-tax regulation should take account of tax depreciation, capex and disposals; and
+ the time of transition to the NTER may provide an acceptable starting point from which to establish the tax asset base for government owned businesses.

4. Aurora's approach

Aurora's proposed methodology details the approach for calculating its tax asset base as at 1 July 2012 – the commencement of the 2012 – 2017 regulatory control period.

Broadly, Aurora's proposed methodology is based on the following assumptions:

- A starting point of 1 July 2002 (being the date when the previous asset data system, FAMIS, was decommissioned) upon which to calculate its tax asset base at 1 July 2012. Aurora has stated that tax asset values data is not available prior to 1 July 2002 because data extraction from the FAMIS system is no longer possible. The current financial system, Navision, was implemented on 1 July 2002. Therefore the starting point of 1 July 2002 was chosen.
- Historical acquisitions and disposals (pre 1 July 2002) are based on Aurora's tax asset register inherited from the former Hydro Electric Commission on 1 July 1998 after the disaggregation of that company which resulted in the subsequent formation of Aurora. The tax asset register, as maintained in Aurora's financial systems, was updated from that point.
- Historical acquisitions and disposals (post 1 July 2002) are based on data extracted from the historical cost asset register, which has been added to the tax asset data extracted from Navision as at 1 July 2002.
- Based on Aurora's Regulatory Information Notice ("RIN") spreadsheet which summarises the movements in the tax asset base, for the period 1 July 2002 to 30 June 2007, Aurora determined that the opening tax asset base as at 1 July 2007 was $526.092 million. For the period 1 July 2007 to 30 June 2012, Aurora used the RFM to roll forward the tax asset base. Aurora determined that the tax asset base as at 30 June 2012 will be $1.028 billion. However, Aurora has recorded $1.015 billion in its PTRM as the opening tax asset base as at 1 July 2012. Aurora has informed that this difference is attributable to a change in service classifications from the current to the forthcoming regulatory control period (from $1.028 billion to $1.015 billion).
- Prime cost (straight line) depreciation is applied using the Roll Forward Model ("RFM") and Post-Tax Revenue Model ("PTRM") for standard control services provided by the AER.
- Where assets have been subject to a capital contribution or prepayment, Aurora will amend the related revenue in relation to the provision of direct control services.
- Assets associated with the provision of standard control services have been allocated to the regulatory asset base. Assets associated with the provision of metering services, public lighting services, excluded services or other unregulated distribution services provided by Aurora are not allocated to the regulatory asset base.
- The tax asset register is based on an as incurred approach, in accordance with OTTER's 2007 pricing determination. WIP will be depreciated on the basis of the WIP balance at 30 June 2011.
- Aurora forecasts that it will have no carried forward tax losses as at 1 July 2012.

5. Sources of information

In assessing Aurora's proposed methodology, we reviewed and considered the following information:

- Aurora's regulatory proposal for the 2012 – 2017 regulatory period, including all supporting attachments;
- Aurora's PTRM for the 2012 – 2017 regulatory period;
- Aurora's RFM for the period 1 July 2007 to 30 June 2012;
- Aurora's capitalisation policy dated 1 January 2011;
- Aurora's capital contributions policy dated 22 July 2011;
- Aurora's excel models including RIN Template, FAR30June2007-DTT, Asset additions 03-07, Asset disposals 03-07 and Tax Dep to 2002;
- the AER's final Framework and Approach paper for Aurora for the regulatory control period commencing 1 July 2012;
- Deloitte's report, "Australian Energy Regulator: Asset review" – 3 May 2011;
- Aurora's "Regulatory Information Notice – Response Part A";
- the AER's "Transition from pre-tax to post-tax regulation (21 June 2007)", PowerPoint presentation;
- the AER's "Post-tax revenue model", Final decision – June 2008;
- the AER's "Post-tax revenue model handbook" – June 2008;
- the AER's "Roll forward model", Final decision – June 2008;
- the AER's "Roll forward model handbook" – June 2008;
- the application of Tax Depreciation Rules to Regulated Energy Entities Phase I Recommendations, prepared by Ernst & Young (30 August 2006);
- the "Independent report for the Application of Tax Deprecation Rules to Regulated Energy Entities for the period 26 February 1992 to 1 November 2006", prepared by Ernst & Young ("EY report");
- relevant sections of National Electricity Rules (Chapter 6), Australian taxation legislation and the Australian Accounting Standards;
- teleconference meeting with Aurora and the AER on 20 July 2011;
- Aurora's response to our draft review questions received on 20 July 2011; and
- teleconference meeting with Aurora on 26 July 2011.

6. Findings

We have set out below our findings from our review of Aurora's proposed methodology and supporting schedules. Our findings are presented in accordance with the four scope elements identified in our Order For Services, which are detailed in the Scope section of this report.

Scope item	Assessment area	Description of finding	Comments and recommendation
1	+ Whether Aurora's proposed methodology is consistent with the National Energy Rules ("NER") and the National Tax Equivalent Regime ("NTER"). Specifically this will involve the assessment areas set out at scope items 1(a) to 1(g) below.	Findings noted where applicable in the sections below.	Aurora is a Tasmanian Government owned company which was formed in July 1998 after the disaggregation of the former Hydro Electric Commission. The NTER came into place on 1 July 2001. Aurora first became registered under the NTER as of 1 July 2001. The AER's guidance for DNSPs rolling forward tax values to the commencement of post-tax regulation suggests that the starting point should commence from the earliest and most verifiable base. The date when a DNSP first became subject to the NTER is deemed to be a reliable starting point because the opening tax position will have been required to be determined at that date. We have detailed below our assessment of whether Aurora's proposed methodology is consistent with the NER and the NTER.
1 (a)	+ Assessing the starting point that Aurora has relied upon to establish the opening tax asset values;	Aurora used a starting point of 1 July 2002, as it considered that the tax asset register at this date was the most reliable.	Aurora used a starting point of 1 July 2002 (being the date when the previous asset data system, FAMIS, was decommissioned) upon which to calculate its tax asset base at 1 July 2012. Aurora states in its regulatory proposal that tax asset values data is not available prior to 1 July 2002 because data extraction from the FAMIS system is no longer possible. The current financial system, Navision, was implemented on 1 July 2002. Therefore Aurora has used the starting point of 1 July 2002. Aurora stated that although details of asset acquisitions were available from 1 July 1998 (the date of disaggregation), there was insufficient information to reliably segregate assets by class. However, Aurora stated that it established that the acquisitions information in the July 1998 asset register is consistent with the 2002 tax fixed asset register. To calculate the opening tax asset base at 1 July 2007, Aurora's proposed methodology involved sourcing data from two fixed asset registers maintained by Aurora, being: - Tax fixed asset register for assets acquired up to 30 June 2002; and - Accounting fixed asset register for assets acquired between 1 July 2002 and 30 June 2007. Aurora used its tax written down values as at 30 June 2002 in order to provide consistency between how Aurora actually depreciates assets for tax purposes under the NTER, with the method used to account for tax depreciation under the RFM and PTRM models in terms of the measurement of the effective lives of Aurora's assets. To derive the opening tax asset values as at 1 July 2012, Aurora used the roll forward model provided by the AER to roll forward the tax asset base from 1 July 2007.

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<tr><th>Scope item</th><th>Assessment area</th><th>Description of finding</th><th>Comments and recommendation</th></tr>
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<td>1 (b)</td>
<td>+ reviewing historic depreciation and tax depreciation assumptions to determine whether these assumptions are appropriate in the context of Aurora's proposed methodology and generally accepted accounting principles;</td>
<td>Aurora has not used the ATO rates to determine the straight line depreciation rates for its assets.

Aurora determined depreciation rates on an asset by asset basis.</td>
<td>Aurora has applied depreciation using a straight line basis. Depreciation on assets up to 2002 was calculated on a reducing balance basis, but an adjustment was made to equate reducing balance depreciation to prime cost (straight line) depreciation as at 30 June 2002. This calculation appears reasonable. Depreciation has been applied using the AER's RFM and PTRM without amendment.

Aurora has not adopted the effective lives published by the ATO in determining the straight line depreciation rates for its assets. Although effective lives could be allocated based on asset categories to align with the ATO's rates, Aurora considers that this approach would have resulted in less accurate outcomes than the self assessed lives allocated by Aurora on an asset by asset basis.

Based on the findings of Deloitte's report, Aurora's method of depreciation is deemed to be consistent with the effective lives of assets as used for NTER tax depreciation purposes.

The self assessed tax asset lives provided in Aurora's regulatory proposal would appear to meet the requirements of the company's auditors and the ATO. However, the remaining lives for tax purposes appear to be partly inconsistent with the RAB remaining lives. We note the following key question on this matter which was raised in our draft review and put to Aurora:
<table>
<tr><th>Question from draft review</th><th>McGrathNicol comments</th></tr>
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<td>In table 99, the remaining lives used in the calculation of the tax asset base have been set out. In table 97, the remaining lives derived from Aurora's ringed fenced accounts have been set out. Could Aurora please explain why there is such a discrepancy, and why across categories tax remaining lives exceed standard remaining lives?</td>
<td>Based on Aurora's written response, further discussions with Aurora and a review of Aurora's RFM including supporting Excel models, the remaining lives used in the calculation of Aurora's tax asset base appear reasonable.

At the starting point (1 July 2002), the opening tax asset values and regulatory asset values were quite different. Also, although similar methods will be used going forward to determine effective lives, this has not historically always been the case. The differences in effective lives for tax and regulatory purposes have resulted in differences in remaining lives. Accordingly, a difference between tax and regulatory remaining lives appears reasonable, and our review has focused on whether the tax remaining lives appear reasonable. We note that:

+ Aurora's RFM and supporting Excel models indicate that there was a significant amount of capex between 1 July 2002 and 1 July 2012 (including forecast capex) relative to the opening tax value of a number of asset classes;
+ For a sample of asset classes, we traced the numbers through the models to determine the reasonableness of the opening tax remaining lives at 1 July 2012 in table 99 of Aurora's regulatory proposal relative to those in Aurora's RFM at 1 July 2007; and</td>
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Scope item	Assessment area	Description of finding	Comments and recommendation
			+ Aurora adjusted its depreciation method from diminishing value to prime cost (straight line) as of 1 July 2002. The dollar value of assets at this date represents a small percentage of the tax asset base at 1 July 2012 due to the significant amount of capex and that these assets have depreciated over this period. Accordingly, we are satisfied that the methodology used by Aurora to determine its tax remaining lives by asset class as at 1 July 2012 is reasonable.
1 (c)	+ examining the treatment of past additions and disposals and determining whether such treatment is appropriate in the context of Aurora's proposed methodology and generally accepted accounting principles;	Acquisitions are recorded at cost and disposals at sale price, with any amount above WDV allocated to profit on sale.	Historical acquisitions and disposals (pre 1 July 2002) are based on Aurora's tax asset register inherited from the former Hydro Electric Commission on 1 July 1998 after the disaggregation of that company. The tax asset register, as maintained in Aurora's financial systems, was updated from that point. Historical acquisitions and disposals (post 1 July 2002) are based on data extracted from the historical cost asset register which have been added to the tax asset data extracted from Navision as at 1 July 2002. The RFM sets out net capex (acquisitions less disposals) by asset class for each year. Asset disposals are recognised in the year of disposal, with the written down value deducted from the RAB. Similarly, once deducted from the RAB it will not appear in the tax asset base. Aurora's methodology for the treatment of past additions and disposals appears appropriate.
1 (d)	+ reviewing the treatment of depreciation on capital contributions to determine if these have been applied correctly;	Aurora's treatment of depreciation on capital contributions is in accordance with the NER.	Under clause 6.21.2 (2) of the NER, Aurora may receive a capital contribution, prepayment and/or financial guarantee up to Aurora's future revenue related to the provision of direct control services for any new assets installed as part of a new connection or modification to an existing connection, including any augmentation to the distribution network. Under clause 6.21.2 (3) of the NER, the rules provide that where assets have been the subject of a contribution or prepayment, Aurora must amend its revenue related to the provision of direct control services. Aurora has not finalised or provided details of its treatment of depreciation on capital contributions in its regulatory proposal. Aurora noted that its capital contributions policy is currently being revised. Aurora subsequently provided the final version of its customer capital contributions policy following our draft review. However, this policy did not provide details of how Aurora proposes to treat depreciation on capital contributions with respect to its tax asset base methodology. Following a teleconference meeting with Aurora on 26 July 2011, Aurora provided a letter addressed to the AER which details its treatment of depreciation on capital contributions. Where assets have been subject to a capital contribution or prepayment, Aurora will amend the related revenue in relation to the provision of direct control services. Aurora's approach is in accordance with the NER.

Scope item	Assessment area	Description of finding	Comments and recommendation
1 (e)	+ assessing the assumptions used to split assets between standard control, direct control, alternative control, negotiated and unregulated services to determine whether these assumptions are appropriate in the context of Aurora's proposed methodology;	Only standard control assets have been included in the revenue proposal, and therefore in the tax asset base.	Assets associated with the provision of standard control services have been allocated to the regulatory asset base (tax asset base). Assets associated with the provision of metering services, public lighting services, excluded services or other unregulated distribution services provided by Aurora are not allocated to the regulatory asset base (tax asset base). Aurora removed the following items from its tax asset base: - fully depreciated assets; - land assets not eligible for depreciation; and - low value tax pooled assets that were in the tax asset register as at 30 June 2002. Aurora's argument for the removal of low value pool assets is that they have short effective lives and would be fully depreciated by 1 July 2012. Where separately identifiable, non-standard control services assets were also removed from the tax asset base model. This included: - the portion of shared assets that could not be attributed to standard control services; - alternative control services assets, where separately recorded as meters or streetlights; - meter data management system assets; and - Aurora retail assets. There are assets within the pool of standard control assets that are not solely used in distribution. These assets are referred to as "shared use" assets. Shared use assets are separately identified and apportioned based on the allocation of shared services in the Ringed Fenced Accounts for 2009/10. Aurora also tested the asset apportioned percentages to the 2008/09 data, and found the apportioned percentages to be consistent with the 2009/10 result. Aurora's approach appears appropriate.

Scope item	Assessment area	Description of finding	Comments and recommendation
1 (f)	+ reviewing the treatment of WIP;	Aurora states that it has recognised WIP on an as incurred approach basis.	The tax asset register is based on an as incurred approach, in accordance with OTTER's 2007 pricing determination, consistent with the AER's requirements. Aurora's regulatory proposal reflects the forecast WIP at 30 June 2012 based on currently available data and will be updated in its revised regulatory proposal for the actual WIP balance at 30 June 2011. WIP will be calculated and depreciated on the basis of the WIP balance at 30 June 2011. Aurora's approach to calculating its WIP as at 1 July 2012 and depreciating it over the 2012 – 2017 regulatory control period appears appropriate in the absence of any other information that can be used to accurately forecast WIP at this time. Based on a teleconference meeting between McGrathNicol, Aurora and the AER, held on 20 July 2011, Aurora confirmed that: + it will depreciate its 30 June 2011 WIP balance over the financial year ended 30 June 2012; + its treatment of WIP for the purpose of its regulatory proposal and calculation of its tax asset base is on an as incurred basis; and + its RFM includes WIP in the net capex for each asset class.
1 (g)	+ reviewing the treatment of tax losses going forward.	No tax losses at 1 July 2012.	Aurora recorded a carried forward tax loss equal to zero as at 1 July 2012. Based on our review of the information provided, there does not appear to be any tax losses associated with Aurora's distribution business and therefore no impact on Aurora's closing tax asset values.
2	+ whether Aurora's tax asset base has been calculated in accordance with its proposed methodology		From our high level review of the PTRM and the RFM, it appears as though Aurora has followed its proposed methodology in preparing these schedules and calculating its tax asset base. However, it is noted that we have not undertaken an audit of the data, and accordingly we are not able to confirm that the tax asset base has been calculated in all respects in accordance with the proposed methodology, or that it is correct.
3	+ the validity of the documentation supporting the methodology, including whether financial records used by Aurora are verifiable by financial reports lodged with the Australian Securities and Investments Commission, the Australian Taxation Office and/or OTTER's records and consultants' reports that Aurora has relied upon in its proposed methodology		The source and quality of the supporting documentation provided for the calculation of Aurora's tax asset base was appropriate (noting our limitations as detailed at section 2 of this report). Where we required clarification of issues with specific aspects of Aurora's methodology, Aurora provided an adequate response with additional supporting documentation where necessary.

Scope item	Assessment area	Description of finding	Comments and recommendation
4	+ the reasonableness of assumptions used by Aurora to reconcile financial reports and/or ATO lodgements to the estimated initial tax base as at 1 July 2012		As discussed above, the key assumptions of Aurora's tax asset base methodology appear appropriate.
N/A	+ Other matters identified during the course of our review.		As per page 12 of the Deloitte report, a reconciliation of source data to "a model" has been undertaken. It is not clear what model these figures relate to, though it would appear to be the model that supports the calculation of the tax asset base as at 30 June 2007, rolled forward from 1 July 2002. Further, it appears that although the source data did not match the final model figure derived, Aurora has used this final model figure in its calculation of RAB and or the tax asset base. Based on our draft review, we requested further clarification on this matter. Aurora subsequently provided additional Excel models, including the roll forward model to clarify our understanding of the above. The reconciled difference is immaterial and relates to assets which will be fully depreciated by 1 July 2012. Aurora's response is reasonable and addresses the concerns raised in our draft review.

7. Conclusion

Based on our review of the information provided by the AER and Aurora, together with Aurora's response to the questions raised in our draft review, Aurora's methodology for the calculation of its tax asset base for the 2012 – 2017 regulatory control period appears reasonable.

8. Contact

Should you have any questions in respect of the above, please contact Michael Dunnett or Scott O'Donnell on (02) 6222 1400.

Yours sincerely

McGrathNicol Advisory
Contact: Shane O'Keeffe