NT Power and Water Corporation (NTPWC)

Proposed tax asset base

9 August 2018

McGrathNicol

Contents

Disclaimer

This report has been prepared in accordance with the scope instructed by the AER as set out in the Order for Services dated 12 December 2017.

We have not carried out a statutory audit and accordingly, an audit opinion has not been provided. The scope of our work is different from a statutory audit and it cannot be relied upon to provide the same level of assurance as a statutory audit.

We have not verified the accuracy or completeness of any of the information given to us by NTPWC, the AER or any of the above parties. In addition, we reserve the right to amend any conclusions, if necessary, should any further information from NTPWC, the AER or any third party become available.

In accordance with our firm's policy, neither the firm nor any member or employee of the firm undertakes responsibility in any way whatsoever to any person (other than the AER) in respect of the information set out in this report including errors, omissions or negligence however caused.

We note that McGrathNicol are not taxation or legal experts. Accordingly, the contents of this report should not be construed as taxation advice and we are not able to comment on potential changes to Australian Corporations Law or Australian Tax Law that may arise due to current reviews.

1 Background and scope

1.1 Introduction

The Northern Territory National Electricity Rules (NTNER) requires the AER to estimate the cost of corporate income tax for a distribution network service provider for each regulatory year in accordance with the post-tax revenue model (PTRM).

We have been engaged to provide advice regarding the proposed tax asset base (TAB) developed by NT Power and Water Corporation (NTPWC) using tax asset values and tax lives provided in its regulatory proposal.

1.2 Scope

McGrathNicol has been engaged to provide advice on the assessment of NTPWC's proposal concerning the establishment of its TAB at 1 July 2019, in particular:

- the starting point for which NTPWC was subject to the National Tax Equivalent Regime, or if applicable the appropriateness of varying from such starting point, to establish the initial TAB as at 1 July 2019;
- the historical tax depreciation assumptions (including the standard tax asset lives used by NTPWC and the remaining tax asset lives calculated by PWC as at 1 July 2019);
- the treatment of past additions and disposals;
- the treatment of depreciation on capital contributions;
- the assumptions used to split assets between direct control (comprising standard control and alternative control), negotiated and unregulated services;
- the treatment of work-in-progress; and
- the size of any tax losses as at 1 July 2019 and the treatment of any such losses going forward.

Where a significant issue is identified in any aspect above, comment on whether these issues are:

- adequately explained by NTPWC;
- consistent with the NTNER and the National Tax Equivalent Regime; and
- supported by appropriate documentation.

Where one or more of the criterion above have not been satisfied, McGrathNicol is to provide advice on the alternative approach and values to be used, or steps to be taken to resolve the matter.

1.3 Background

Distribution Network Service Providers (DNSPs) adopt a "building block" approach to determine allowable revenue. To enable the determination of the tax building block (incorporating tax 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.

Under the post-tax framework, the AER uses the post-tax revenue model (PTRM) to calculate the estimated taxable income and the allowance for corporate income tax for a regulatory year. The AER's assessment of taxable income includes its findings on the efficient level of expenditure and the tax asset base (TAB). In deriving the allowance for corporate tax, the AER adopts the gearing ratio of a benchmark efficient entity and the corporate tax rate.

NTPWC is a NT government owned corporation. This regulated businesses based in the Northern Territory operates under a separate version of the National Electricity Rules (NTNER).

On 1 July 2015 the AER assumed responsibility for economic regulation of electricity distribution services provided by NTPWC from the NT's Utilities Commission. As such, NTPWC is required to submit a regulatory proposal for the period 1 July 2019 to 30 June 2024. NTPWC has the following service lines:

- Power networks;
- Water services;
- Remote operations;

- System control;
- Gas supply; and
- Business services (which supports the other service lines).

Power Networks is responsible for both regulated and non-regulated networks. Power Networks, along with parts of System Control's and Business Services' activities, are the focus of this regulatory proposal.

1.4 Sources of information

In assessing NTPWC's methodology, we have reviewed and considered the following information:

- NTPWC's regulatory proposal for the 2019 to 2024 financial years, including the following supporting attachments:
  - PWC01.2 – Regulatory Proposal – 31 Jan 18 – Public;
  - PWC01.12 – Establishment of the Opening TAB Document – 31 Jan 18 – Public;
  - PWC01.13 – Hayne_Co Pty Limited – Tax Life Validation Letter – 31 Jan 18 – Public;
  - PWC01.17 – Fixed Asset Plan – 31 Jan 18 – Public;
  - PWC11.1 – Response to Schedule 1 of AERs RIN – 31 Jan 18 – Public;
  - PWC11.2 – DRAFT – Basis of Preparation – Category Analysis Template for 2008-09 to 2016-17 – 31 Jan 18 – Public;
  - PWC11.5 – DRAFT – Category Analysis RIN Workbooks - Consolidated – 7 Feb 18 – Public;
  - PWC11.15 – CA RIN –TAB Allocation Model – 31 Jan 18 – Public;
  - PWC12.1 – SCS Post-tax Revenue Model – 31 Jan 18 – Public;
  - PWC12.2 – ACS Metering Post-tax Revenue Model – 31 Jan 18 – Public;
  - PWC12.11 – SCS and ACS Metering RFM – 31 Jan 18 – Public; and
  - PWC12.12 – Opening TAB – 31 Jan 18 – Public.
- NTPWC's responses to AER information requests dated:
  - 5 March 2018;
  - 29 March 2018;
  - 23 April 2018;
  - 10 May 2018;
  - 27 June 2018;
  - 18 July 2018; and
  - 30 July 2018.
- The following additional and updated documentation to support the NTPWC responses to AER information requests:
  - PWC Mapping and Standard Life Validation v7 – FINAL – 20 December 2017;
  - PWC 12.13 Opening RAB – 31 Jan 18;
  - PWC12.22 - Jacobs - Valuation - Corrected - 31 Jan 18;
  - PWC01.15 - Jacobs Group (Australia) Pty Limited - 2013 Regulatory Asset Valuation Report;
  - PWC11.2 - Basis of Preparation - Category Analysis Template for 2008-09 to 2016-17 - 7 Feb 18 – Public;
  - PWC11.5CP - Category Analysis RIN Workbooks - Consolidated - 16 Mar 18 – Public;
  - PWC11.15 - CA RIN - TAB Allocation Model - 16 Mar 18 – Public;

- PWC12.1 - SCS Post-tax Revenue Model - 16 Mar 18 – Public;
- PWC12.2 - ACS Metering Post-tax Revenue Model - 16 Mar 18 – Public;
- PWC12.11 - SCS and ACS Metering RFM - 16 Mar 18 – Public;
- PWC – IR001 – Tax Asset Base – 20180321 – Public;
- PWC – IR008 – (23 April Response) – 20180423 – Public;
- PWC – IR013 – (23 May Response) – Tax Asset Base – 20180523 – Public;
- PWC – IR016 - (31 May Response) – Tax Asset Base – 20180531 – Public;
- PWC information request #23 follow up request to IR#13;
- PWC – IR029 – follow questions to IR023; and
- PWC – IR029 – ALTERNATIVE – PWC12.12 – Opening TAB – 18 Jul 18 – Public.

▪ Relevant sections of the NTNER, Australian taxation legislation and the Australian Accounting Standards.

2 NTPWC's approach

In accordance with NTNER section 9, all transmission and distribution regulated assets have been deemed to be treated as distribution assets for regulation purposes.

NTPWC's proposed methodology details the approach for calculating its tax asset base as at 1 July 2019, the commencement of the 2019-2024 regulatory control period.

Broadly NTPWC's approach is based on the following key assumptions:

- NTPWC has established the opening TAB as at 30 June 2014 by combining:
  - Historical capital expenditure and year of installation data from internal accounting records that are used as the basis of tax filings with the Australian Taxation Office (ATO); and
  - Standard asset lives which have been:
    - sourced from the ATO's published lives; and
    - Verified by Hayne & Co chartered accountants.

3 Findings

We have set out below our findings from our review of NTPWC's proposed methodology and supporting schedules. Our findings are presented in accordance with the scope elements identified in our Order For Services, which are detailed in Section 1.2.

Table 1: Summary of findings and recommendations

Scope Item	Description of finding	Comments and recommendation
The starting point for which PWC was subject to the National Tax Equivalent Regime, or if applicable the appropriateness of varying from such starting point, to establish the initial TAB as at 1 July 2019.	30 June 2014 has been chosen by NTPWC as the starting point. This date is the end of the previous regulatory period. NTPWC has rebuilt their Tax Asset Register ("TAR") used for the purposes of the annual return with the ATO. To rebuild their TAR, NTPWC disaggregated the previous TAR, estimated the date assets were placed in service where this was unknown and assumed tax lives based on advice from a professional valuer. Rebuilding the TAR involved mapping data from the old register that had 52,000 assets to the new register that has 258,000 assets and aligns with NTPWC's Maximo asset management system.	NTPWC have advised that the main driver for the 30 June 2014 starting point is that this was the starting point for the last regulatory period. Prior to 30 June 2014 historical cost accounting had been used to value assets and there was limited source data available. This explanation appears satisfactory and it seems reasonable for NTPWC to use 30 June 2014 as a starting point. NTPWC has provided an updated tax asset base value as at 1 July 2014 to reflect the rebuilt TAR. NTPWC ensured that the total tax written down value of all assets was the same after the mapping from the old TAR to the new TAR. Further, NTPWC advised that "future tax depreciation deductions are derived by dividing the written down value for each asset by its assumed useful life. This ensures that the loss in relationship between cost and accumulated depreciation from the register rebuild does not impact the future allowable tax depreciation deductions in aggregate". Based on the above explanations, we have no concerns in respect of NTPWC using the rebuilt TAR for the establishment of the opening TAB at 1 July 2014, and for determining tax depreciation from that date.

Scope Item	Description of finding	Comments and recommendation
The historical tax depreciation assumptions (including the standard tax asset lives used by PWC and the remaining tax asset lives calculated by PWC as at 1 July 2019).	**Standard tax asset lives** NTPWC have provided a letter from Hayne & Co Chartered Accountants stating that asset lives provided in spreadsheet "*PWC-TAB Mapping and Standard Life Validation – v7 – FINAL – 20 December 2017.xlsx*" have been sourced from ATO standard tax lives as reasonably as possible. This letter describes a "review" being undertaken and "clearance" provided. We note that this is not a full audit of the information used and does not provide full details of the scope of work undertaken, methodology or relevant auditing or assurance standard the engagement has been undertaken under. There are 995 asset categories in the Fixed Asset Register (FAR) provided. Based on our review of the standard tax asset lives used, a number of the standard tax lives applied to individual assets in the opening TAB calculation differ from the lives provided for the respective category. 314 of the 995 categories on NTPWC's tax asset register have standard lives applied which differ from the ATO's guidance. As an example, the average tax remaining life for Communications category is higher than the standard ATO tax life for the Communications category.	We have been provided with a copy of the spreadsheet "*PWC-TAB Mapping and Standard Life Validation – v7 – FINAL – 20 December 2017.xlsx*" and from our review can confirm tax asset lives have been sourced from ATO standard lives where possible. From our review of the spreadsheet provided to the AER we can confirm asset lives are consistent with the asset lives used to calculate the tax asset base. The ATO categories for standard tax lives can contain a broad range of assets. NTPWC used their judgement and specialist knowledge to determine which of the ATO descriptions and lives were appropriate and where appropriate assigned alternate standard tax asset lives to some of the asset descriptions as they believe this was more accurate than the ATO lives. This judgement was independently reviewed by Hayne & Co Chartered Accountants. As a result of NTPWC's mapping of tax assets from the old TAR to the new TAR, some anomalies in the written down values of individual assets were observed at 1 July 2014. However, NTPWC have overcome these anomalies by writing off a number of small tax written down value balances at 31 July 2014 (where the asset should have been fully depreciated by 1 July 2014), and ensuring the total written down value of all assets is the same after mapping. These explanations appear reasonable and we consider the standard tax lives used are appropriate. Also, it appears reasonable to use a weighted average approach to determine tax standard lives for each asset class in the RFM for the depreciating new assets. The alternative standard tax asset lives provided by NTPWC on 18 July 2018 reflect this approach.

Scope Item	Description of finding	Comments and recommendation
	Installation date NTPWC have used the manufacture date of assets, rather than their installation date as a default. NTPWC have attributed this to the availability of manufacture dates, which have been marked on assets in many cases. In each instance, the manufacture date will be prior to the installation date. There are some known incorrect dates used (Basis of preparation page 90). Where assets with a known incorrect date were identified, the Basis of Preparation states that the date 24/12/1974 was used. We have not located any assets with this date in the Opening TAB calculation. We sought further explanation/commentary from NTPWC in support of the use of the date 24/12/1974 for these assets with known incorrect dates.	NTPWC's proposed approach is inconsistent with the guidance in the Income tax Assessment Act 1997, which provides that the starting date of a depreciating asset is the date when the asset is first used or installed ready for use. We have been advised by NTPWC that an asset management system is used to populate the asset age profile. Over the years there have been a number of systems used resulting in inconsistencies and conflicts in the install and manufacture date, and due to availability of data the manufacturing date has been used as a default. We note there are a small proportion of conflicts, and the difference between manufacturing date and installation date is likely to be reasonably small. Accordingly, in these circumstances it appears reasonable for NTPWC to use the manufacture date. The date 24/12/1974 was used by NTPWC as this was the date Cyclone Tracy hit Darwin, Northern Territory. These assets have now been fully written down. Accordingly, the approach of using 24/12/1974 where the manufacture date is unknown appears reasonable.

	Remaining tax asset lives A number of asset classes have average remaining tax lives which are relatively high in comparison to the RAB remaining asset lives. As this amount is calculated as a weighted average based on dollar values, this may be the result of an increase in the costs of certain categories of assets in recent years.	NTPWC undertook a significant rebuilding process to rectify black outs after a major cyclone, and as a result the majority of assets are relatively new, resulting in the relatively high remaining lives. In the meeting held on 7 March 2018, NTPWC advised that the valuation report prepared for the purpose of determining the opening RAB has been relied upon when calculating remaining tax lives. NTPWC have advised that for those assets where information was unavailable NTPWC had to determine an alternative method, being a function of historical cost and installation date. We have conducted further investigation into the differences between RAB and TAB remaining lives. McGrathNicol determined that differences in the RAB and TAB remaining lives appear to be the result of differences in both standard life and average age. RAB standard lives are determined by the businesses in accordance with the Utilities Commission of the Northern Territory determination for the 2014-2019 regulatory period, whereas NTPWC advised that TAB standard lives are determined in accordance with ATO rules and guidance. NTPWC provided an explanation of the differences, and highlighted that there is no direct relationship between the proposed TAB and RAB remaining lives. Further, NTPWC provided an explanation of the reason that tax remaining lives are proportionally closer to the tax standard lives than they are for the RAB. This is because: ▪ the tax standard lives are generally shorter than RAB standard lives; ▪ the written down value of existing assets inflate over time in the RAB, but not in the TAB, which means that proportionally more weight is placed on older assets that have shorter remaining lives

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		than younger assets when calculating a weighted average remaining life for RAB assets than they do for TAB assets; and ▪ for some assets, assumed asset lives for tax purposes were adjusted based on the advice from Hayne and Co, and therefore may be different from the standard asset lives in the RAB. It appears reasonable for NTPWC to use a weighted average for the purpose of determining tax remaining lives. Accordingly, we are satisfied with NTPWC's explanations and the tax remaining lives applied in determining the tax asset base.
	Depreciation method NTPWC has applied straight line depreciation to its tax asset base.	This is an appropriate method, consistent with Accounting Standards and the approach currently adopted in the AER's RFM and PTRM.
The treatment of past additions and disposals.	**Structural separation** NTPWC structurally separated into three business units in 2014.	We have been advised by NTPWC that each asset is allocated to a network business unit with non-regulated networks being separated from the regulated networks. Accordingly, with the exception of the corporate assets there are no shared assets. Corporate assets such as IT, finance and legal systems are held corporately and the cost is allocated by a corporate cost allocation method. NTPWC's approach seems reasonable as the cost allocation methodology should ensure only an appropriate proportion of shared costs are allocated to the regulated business.

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	Additions Corporate level assets have been acquired for regulatory purposes, increasing capex by $19.77 million in 2018/19. Additions are recorded based on historical cost.	NTPWC have been through a process to ensure assets are allocated to the correct business unit. It appears that NTPWC has in place processes to ensure assets are appropriately allocated to business units and the assets included in tax assets to the distribution business are appropriate. As additions are recorded at historical cost, we have no concerns regarding this approach.
	Disposals Data provided by NTPWC for the period between 2013/14 and 2016/17 shows asset disposals each year. Forecast years do not contain any disposal amounts. Disposals are removed from NTPWC's Tax Asset Register at the time of disposal at the written down value, net of any sales proceeds. The value of disposals provided in part 9.1.1 of the Category Analysis RIN ($883,818 in year 2014/15) are significantly higher than those values used in the RFM ($115,483 in year 2014/15).	These amounts are not material compared to other categories (between $98,000 and $298,000). NTPWC advised that there have been low disposals in recent times due to the reasonably high level of new assets, and therefore they have estimated zero forecast disposals. This explanation is considered reasonable. This difference in the value of disposals in the category analysis RIN compared to the RFM is due to the inclusions of non-regulated asset disposals in the RIN, noting that the lower amount (excluding non-regulated assets) has been used for the TAB roll forward. This appears appropriate.

Scope Item	Description of finding	Comments and recommendation
The treatment of depreciation on capital contributions.	Capital contributions of between $11.5 and $13.4 million have been forecast in each year for the period 2014/15 to 2018/19 as per the RFM. These amounts have been deducted from total forecast capital expenditure, and as a result not included in the forecast depreciation in the RAB roll forward.	Capital contributions for the period 2014/15 to 2018/19 have been included in the TAB roll forward, consistent with the approach as set out in the AER's current RFM and PTRM and Accounting Standards. Customer contributions have been included as revenue, consistent with the approach as set out in the AER's current RFM and PTRM and Accounting Standards. From our review it appears that NTPWC did not include capital contributions in the opening RAB or roll forward RAB. This is consistent with the approach as set out in the AER's current RFM and PTRM.
The assumptions used to split assets between direct control (comprising standard control and alternative control), negotiated and unregulated services.	**Asset allocation** The regulatory proposal shows that some unregulated revenue is generated from the use of assets that form part of the Standard Control Service (SCS) RAB. There has been an adjustment to the allocation of assets of Alternate Control Services (ACS)/SCS metering, which was split between ACS and SCS at 30 June 2019. Each asset class was directly assigned to either ACS or SCS. (PWC11.1 p.74).	NTPWC have been through a process to ensure assets are allocated to the correct business unit. ACS is primarily comprised of the meter fleet which is relatively old (20 to 30 years). Accordingly, we have no concerns with NTPWC's approach.
	Non RAB assets Non RAB assets make up a portion of NTPWC's asset base. Asset categorisation (mapping) was undertaken by asset class by subject matter experts.	The value of non RAB assets is relatively low as 95% of NTPWC's asset value sits in the regulated network. This seems reasonable.

Scope Item	Description of finding	Comments and recommendation
	Indigenous Essential Services (IES) A separate asset register is maintained for IES.	This appears to be appropriate given that non-for-profit entities are exempt from certain taxation requirements. IES has its own Board of Directors and objectives and is dealt with separately.
The treatment of work-in-progress.	Based on commentary provided in NTPWC's Fixed Asset Plan: *"Work in progress is valued at historical cost and transferred to Property, Plant and Equipment when it is ready for use (that is the item is in the location and condition ready to be operated in the manner intended by management). Depreciation commences at this point. (1.17 p.15).* *Quoted services with costs greater than $5k are accounted for as work in progress and expensed on completion. For RIN purposes the expenditure is reported when incurred. (PWC11.2 p.90).* *Expenditure is capitalised to the Tax Asset Register (TAR) once an asset is commissioned".* In response to AER queries, NTPWC amended the calculation of their tax asset base as at 1 July 2014 to include the value of work-in-progress. An amount of approximately $226 million was added.	NTPWC's original tax asset base submission adopted the "as incurred" approach for rolling forward the TAB from 1 July 2014 to 30 June 2019. However, it did not include any work-in-progress assets. NTPWC's revised tax asset base included the value of work-in-progress as at 1 July 2014, which properly reflects the transition to the "as incurred" roll forward approach. This is consistent with the approach as set out in the AER's current RFM and PTRM.
The size of any tax losses as at 1 July 2019 and the treatment of any such losses going forward.	NTPWC has assumed zero accumulated tax losses at the start of the regulatory period in the PTRM.	NTPWC stated that NTPWC's existing tax losses were fully utilised in its June 2014 return and NTPWC has not had any tax losses since that time. Accordingly, it appears reasonable for NTPWC to assume zero accumulated tax losses at the start of the 2019-24 regulatory period in the PTRM.

Scope Item	Description of finding	Comments and recommendation
Other matters identified during the course of our review.	**Standard deviation** For section 5.2 of the Category Analysis RIN (PWC11.5), the standard deviation of each asset's economic life is required to be provided. As the standard deviation was determined to be unavailable (see basis of preparation page 96), the square root of the average has been used.	NTPWC have advised that the calculation could not be undertaken as the data for disposed assets is not retained on the systems. This has little impact on the TAB, accordingly, no further action is required.

4 Conclusion

Based on our review of the information provided, by the AER and NTPWC it would appear that NTPWC's approach to calculating the opening TAB as revised on 18 July 2018 is reasonable.

5 Contact

Should you have any queries in respect of the above, please contact Mr Michael Dunnett on (02) 6222 1415.