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CORPORATE ADVISORY

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Assessment of Energex's proposed methodology and calculation of its tax asset base for the 2010-2015 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 bases of the South Australian and Queensland electricity Distribution Network Service Providers ("DNSPs").

Specifically, this assessment relates to the methodology used to calculate Energex Limited's ("Energex") tax asset base for the 2010-2015 regulatory control period.

2. Scope

McGrathNicol has been engaged to conduct a high level assessment of Energex's tax asset base valuation methodology ("Proposed Methodology") based on information contained in its regulatory proposal for the 2010-2015 regulatory control period.

In assessing Energex's Proposed Methodology, we have considered the following:

+ whether Energex's Proposed Methodology is consistent with the National Electricity Rules ("NER") and the National Tax Equivalents Regime ("NTER"). Specifically, this involved:
  - identifying an appropriate starting point to establish Energex's initial tax asset base as at 1 July 2010;
  - reviewing Energex's historic depreciation and tax depreciation assumptions to determine whether these assumptions are appropriate in the context of its Proposed Methodology and Generally Accepted Accounting Principles ("GAAP");
  - examining Energex's treatment of past additions and disposals and determining whether such treatment is appropriate in the context of its proposed methodology and GAAP;
  - reviewing Energex's treatment of depreciation on capital contributions to determine if these have been applied correctly;

  - assessing Energex's 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 its Proposed Methodology;
  - reviewing Energex's treatment of Work-In-Progress ("WIP"); and
  - reviewing Energex's treatment of tax losses.
- whether Energex's tax asset base has been calculated in accordance with its Proposed Methodology;
- the validity of documentation supporting Energex's Proposed Methodology; and
- the ability to audit the documentation supporting the calculation of Energex's tax asset base.

As part of the engagement, we have also provided recommendations to address any identified deficiencies.

3. Background

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

For this upcoming reset period, in accordance with the NER, DNSPs are required to use a post tax methodology to determine allowable revenue.

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 at the commencement of the next regulatory period.

Based on the recommendations from Ernst & Young, the AER should track the effects of tax depreciation provisions and changes on regulated assets from February 1992, as any alterations in depreciation laws mostly affect assets acquired after the relevant change, and will have minimal impact on assets acquired prior to this date.

4. Energex's Approach

Energex's Proposed Methodology details the approach for calculating its tax asset base as at 1 July 2010 – the commencement of the 2010-2015 regulatory control period.

Broadly, Energex's Proposed Methodology is based on the following assumptions:

- the use of Energex's most recent NTER tax return as the starting point for determining its tax asset base for regulatory purposes at 1 July 2010;
- no tax asset value has been approved by a previous regulator;
- depreciation is based on the weighted average life of various AER asset categories; and
- asset acquisitions and disposals information is based on actual expenditure and the written down value of assets.

In addition, Energex states that the valuation of its tax asset base is based on similar assumptions used to calculate the value of its regulatory asset base. For example, the use of straight line depreciation and the treatment of capital contributions.

5. Sources of information

In assessing Energex's Proposed Methodology, we reviewed and considered the following information:

+ Energex's regulatory proposal for the 2010-2015 regulatory control period, including all supporting attachments[1];
+ AER's "Final framework and approach paper Application of schemes – Energex and Ergon Energy 2010-2015", November 2008;
+ AER's "Transition from pre-tax to post-tax regulation (21 June 2007)", PowerPoint presentation;
+ AER's "Post-tax revenue model", Final decision – June 2008;
+ AER's "Post-tax revenue model handbook" – June 2008;
+ AER's "Roll forward model", Final decision – June 2008;
+ 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"); and
+ relevant sections of Australian taxation legislation and the Australian Accounting Standards.

6. Findings

We have set out below our findings from our review of Energex'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.

[1] Supporting documentation includes a report, prepared by an independent consultant, which details the estimation of Energex's regulatory asset base for tax purposes.

6.1 Whether Energex's Proposed Methodology to calculate its tax asset bases is consistent with the National Electricity Rules and the National Tax Equivalents Regime

We note that Energex states in its current determination, that the Queensland Competition Authority ("QCA") 'decided to adopt the actual cost of tax paid and will include the forecast cost of tax for each DNSP (as approved by the QCA at the start of the regulatory period), with any differences between forecast and actual tax paid subject to an unders and overs process on an annual basis'. As a result, there have been no previous tax asset values approved by a previous regulator.

The following table details the findings identified in our assessment of Energex's Proposed Methodology. In determining the above, we have:

+ reviewed each individual assessment area (as identified in Section 2 of this report);
+ provided a description of the identified finding;
+ referenced the source of the finding; and
+ provided comments and recommendations, where applicable, for each finding.

Finding	Assessment area	Description of finding	Reference	Comments and recommendation
1.	Identifying an appropriate starting point to establish the initial asset base as at 1 July 2010.	In established its opening tax asset base as at 1 July 2010, Energex adopts the regulatory tax asset base from its most recent NTER tax return to the Australia Taxation Office ("ATO") as it starting point. That is, the tax asset base value as at 30 June 2008.	16.4.1	This approach is based on Energex's most recent tax return (year ended 30 June 2008) as submitted to the ATO. Accordingly, the tax asset values included in Energex's tax return are likely to reflect the most up-to-date figures on which to calculate its initial tax asset base for the 2010-2015 regulatory control period. Based on the information provided, Energex's Proposed Methodology appears reasonable.
2.	Identifying an appropriate starting point to establish the initial asset base as at 1 July 2010.	Energex's 2008 tax asset base was based on the tax written down values for the Energex consolidated group as per its 2008 tax return.	Independent consultants report	We note that Energex's 2008 tax asset base was based on the tax written down values for the Energex consolidated group ($2.382 billion) as per its 2008 tax return. Energex states that this value has been adjusted by $30 million to reflect the tax written down value for Energex Limited only - its distribution business ($2.352 billion). The $30 million adjustment is based on the tax fixed asset register for Energex Limited as a stand-alone entity. Separate tax fixed asset registers are maintained for each of the Energex group's entities.

Finding	Assessment area	Description of finding	Reference	Comments and recommendation
3.	Reviewing historic depreciation and tax depreciation assumptions to determine whether these assumptions are appropriate in the context of each DNSP's proposed methodology and GAAP.	Energex proposes to value its tax asset base as at 30 June 2010 by applying the prime cost (straight-line) method of depreciation.	14.5.2 15	This approach appears appropriate and consistent with: + the AER's default method for depreciation for tax purposes; + Energex's historic approach to calculating depreciation; and + GAAP.
4.	Reviewing historic depreciation and tax depreciation assumptions to determine whether these assumptions are appropriate in the context of each DNSP's proposed methodology and GAAP.	Energex's assets have been grouped into asset categories, which are comprised of assets with different standard lives. A weighted average life is calculated based on the ATO's allowable depreciation rates, and applied to each asset category.	15.3	This approach appears appropriate and consistent with: + the NER; + Energex's historic approach to calculating depreciation; and + GAAP. Energex has also provided a report titled 'Tax Asset Base for Regulatory Purposes as at 1 July 2008', prepared by an independent consultant, which provides details of the tax standard and remaining lives for each of the AER's prescribed asset categories.
5.	Examining the treatment of past additions and disposals and determining whether such treatment is appropriate in the context of each DNSP's proposed methodology and GAAP.	Treatment of past additions is based on actual capital expenditure in the year in which the asset is acquired.	14.5.2	Energex's Proposed Methodology appears reasonable. Energex confirms that the value of its tax asset base as at 30 June 2008 takes into consideration the tax written down values for its asset disposals.
6.	Reviewing the treatment of depreciation on capital contributions to determine if these have been applied correctly.	Energex includes capital contributions in its tax asset base.	Email response from Energex 18.3	Energex's Proposed Methodology states that it includes capital contributions in its tax asset base, which is consistent with clause 6.21.2 of the NER. The AER confirmed that Energex treats depreciation on capital contributions on the same basis as those assets used in the provision of standard control services. That is, Energex depreciates capital contributions based on the nature of the asset. This approach appears reasonable.

Finding	Assessment area	Description of finding	Reference	Comments and recommendation
7.	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 each DNSP's proposed methodology.	Energex has stated that: + its assets relate predominantly to standard control services; + alternative control services assets are separately identified in the asset class – Street lighting; and + it does not provide negotiated services.	Email response from Energex	Energex confirmed that it provides standard and alternative control services. The AER confirmed that it has undertaken a process of classifying the categories of distribution services provided Energex, and that the AER is comfortable with the assumptions Energex uses to split these services.
8.	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 each DNSP's proposed methodology.	Energex has stated that it has adopted clause 11.16.3(c) of the NER (Transitional Arrangements) and all 'shared assets' are included in its standard control services tax asset base. A revenue adjustment is account for the inclusion of shared assets in Energex's tax asset base in order to avoid double counting.	Email response from Energex	The AER confirmed that it has undertaken a process of classifying the distribution services provided Energex, and that the AER is comfortable with the assumptions Energex uses to split these services.
9.	Reviewing the treatment of work-in-progress.	Energex has stated that WIP was not included in its opening ATO tax asset base. Accordingly, WIP has not been included in Energex's opening regulatory tax asset base for the 2010-2015 regulatory control period.	Email response from Energex	Based on the information provided, Energex's treatment of WIP appears reasonable.
10.	Reviewing the treatment of tax losses going forward.	Energex has estimated nil tax losses as at 1 July 2010.	16.4	Based on the information provided, Energex has not incorporated any allowances for tax losses.

Finding	Assessment area	Description of finding	Reference	Comments and recommendation
11.	Other issues.	Forecast capital expenditure is based on a realistic expectation of forecast demand and cost inputs; and represents efficient costs to meet the requirements of the Queensland Government and electricity customers in South East Queensland. A similar approach has been adopted for forecast disposals.	1.5.4	This appears to be in accordance with Section 6.5.7 of the NER. In addition, the AER confirmed that it is comfortable with this approach.
12.	Other issues.	The tax value of Energex's assets as at 30 June 2008 has been separated into RAB assets and non-RAB assets.	16.4.1	This appears appropriate.
13.	Other issues.	Discrepancies in Energex's reported tax asset base.	16.4.1 Regulated Tax Asset Base Roll Forward Model	There appears to be a reconciling difference between: + the opening tax asset value for 2010/2011 as reported in Energex's Roll Forward Model of $3,795.12 million; + the value stated in its regulatory proposal of $3,758.74 million; and + the value stated in the independent consultant's report of $3,785.66 million. Energex confirmed the following: + $3,795.12 million is the opening tax value for Energex's assets as at 1 July 2010, rolled over from the closing value at 30 June 2010. The 30 June 2010 value includes both standard and alternative control assets as is appropriate for the current regulatory period; + $3,758.74 million is the opening tax value for Energex's standard control services regulatory asset base which excludes Energex's allocation of $36.38 million to Alternative Control Services (Street Lighting); and + $3,785.66 million is the value in the independent consultant's report. This value was based on initial estimates for the 2008/09 & 2009/10 years and preceded the final values used for Energex's regulatory proposal.

Finding	Assessment area	Description of finding	Reference	Comments and recommendation
14.	Other issues.	Energex states that the calculation of its tax asset base includes contributed assets.	18.3 Email response from Energex Regulated Tax Asset Base Roll Forward Model	Energex's approach appears reasonable. In Queensland, capital contributions are accounted for as a revenue deduction and the total value of the contributed asset is included in the tax asset base. This appears consistent with the NER.
15.	Other issues.	There are discrepancies between the forecast capital expenditure as reported in: + Energex's Roll Forward Model; and + the independent consultant's calculation of Energex's tax asset base.	Roll Forward Model Independent consultant's report	There appears to be a reconciling difference between: + the forecast capital expenditure amounts for 2008-09 and 2009-10, as reported in Energex's Roll Forward Model of $869.11 million and $1,020.53 million; and + the forecast capital expenditure amounts for 2008-09 and 2009-10, as reported in the independent consultant's report of $869.07 million and $1,011.10 million. Energex confirmed that the value of forecast capital expenditure for 2008-09 and 2009-10 is $869.11 million and $1,020.53 million respectively, as stated in its Roll Forward Model. The independent consultant's report was based on the best available estimates at the time the review was undertaken.
16.	Other issue.	Significant increase in Energex's forecast capital expenditure	14.5 14.6	There appears to be a significant increase in Energex's forecast capital expenditure between 2008-09 and 2014-15, compared to historic figures (i.e. 2005-06 to 2007-2008). The AER confirmed that the increase in Energex's capital expenditure is consistent with the AER's expectations.

6.2 Whether the proposed asset base for tax purposes has been calculated in accordance with Energex's Proposed Methodology.

Based on the information provided, there appears to be no indication that Energex's proposed asset base for tax purposes has not been calculated in accordance with its Proposed Methodology.

6.3 Assess the validity of the documentation supporting Energex's Proposed Methodology.

The validity of documentation supporting Energex's Proposed Methodology appears sound.

Energex's Proposed Methodology is contained within its regulatory proposal for the 2010-2015 regulatory control period, and is supported by numerous attachments which include:

+ various excel models detailing how Energex calculates its tax asset base;
+ a version of Energex's Roll Forward Model in the AER's prescribed format; and
+ an estimation of Energex's tax asset base for regulatory purposes, prepared by an independent consultant.

Based on the information provided, nothing has come to our attention which raises concerns in respect of the validity of Energex's submitted information.

6.4 Assess the ability to audit the documentation supporting the calculation of Energex's tax asset base.

Based on the information provided, nothing indicates an inability to audit Energex's calculation of its tax asset base for the 2010-2015 regulatory control period.

7. Conclusion

Based on the information provided, Energex's Proposed Methodology for the calculation of its tax asset base appears reasonable.

8. Contact

Should you have any questions in respect of the above, please contact Aidan Hardy or Michael Dunnett on (02) 6222 1400.

Yours sincerely,

McGrathNicol Advisory

McGrathNicol Advisory
Contact: Shane O'Keeffe

Disclaimer

We have reviewed Energex's methodology in establishing the opening regulated tax written down value as at 1 July 2010. We have relied on the information provided by Energex and the AER.

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

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 an errors, omissions or negligence however caused.