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CORPORATE ADVISORY

29 March 2010

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Final

Assessment of the revised proposal of Energex's tax asset base

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's tax asset base.

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 Revised Regulatory Proposal for the 2010-2015 regulatory control period.

Specifically, we have identified any significant changes from the original regulatory proposal in the following aspects of Energex's tax asset base:

+ the starting point for calculating the initial tax asset base as at 1 July 2010;
+ the historic depreciation and tax depreciation assumptions (including the standard tax asset lives used by the DNSPs and the remaining tax asset lives calculated by the DNSPs as at 1 July 2010);
+ the treatment of past additions and disposals;
+ the treatment of depreciation on capital contributions;
+ the assumptions used to split assets between standard control, direct control, alternative control, negotiated and unregulated services;
+ the treatment of work in progress; and
+ the size of any tax losses as at 1 July 2010 and the treatment of any such losses going forward.

Where a significant change was identified in any item above, additional commentary has been provided to explain whether the identified changes are:

+ adequately explained by the DNSP (including whether the change is consistent with the methodology proposed by the DNSP in its original proposal);
+ consistent with the National Electricity Rules and the National Tax Equivalents Regime; and
+ supported by appropriate documentation.

We have provided advice in relation to the materiality of any deficiencies identified in respect of the above and proposed recommendations to address such 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 as 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 Revised Regulatory Proposal for the 2010 to 2015 regulatory period, including all supporting attachments;
+ 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 AER's Framework and Approach – Preliminary position paper for Queensland;
+ the AER's Framework and approach paper – ETSA Utilities 2010-2015 – November 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, as set out in its Revised Regulatory Proposal 2010-2015, to identify whether there are any significant changes to the Proposed Methodology set out in the DNSP's original proposal. Our findings are presented in accordance with the scope elements identified in our Order For Services, which are detailed in the Scope section of this report.

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6.1 Significant changes in the Revised Regulatory Proposal of Energex's tax asset base

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 (significant change between the DNSP's original regulatory proposal and Revised Regulatory Proposal);
+ 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.	The starting point for calculating the initial tax asset base as at 1 July 2010.	No significant changes identified.		
2 (a).	The historic depreciation and tax depreciation assumptions (including the standard tax asset lives used by the DNSPs and the remaining tax asset lives calculated by the DNSPs as at 1 July 2010).	No significant changes identified.	5.1.2 (Revised proposal)	We note that Energex has updated its 2008-09 capex figures for actuals. However, Energex has not revised its forecasts for 2009-10 capex. The AER may wish to request Energex to revise its forecasts for 2009-10 capex.
2 (b).	The historic depreciation and tax depreciation assumptions (including the standard tax asset lives used by the DNSPs and the remaining tax asset lives calculated by the DNSPs as at 1 July 2010).	The revision of the regulated asset base at 1 July 2010 to account for actual capital expenditure in 2008-09. This is deemed to be a significant change.	5.2.2.1 (Revised proposal)	Energex's remaining standard lives at 1 July 2010 were established by rolling forward the lives at 1 July 2005 in accordance with clause 6.5.5(b)(2) of the NER. The revision of the regulated asset base at 1 July 2010 to account for actual capital expenditure in 2008-09 impacts on the calculation of remaining lives. The revised remaining asset lives are based on the same methodology reviewed and accepted by the AER in its draft decision. This appears appropriate.

Finding	Assessment area	Description of finding	Reference	Comments and recommendation
3.	The treatment of past additions and disposals.	No significant changes identified.		
4.	The treatment of depreciation on capital contributions.	No significant changes identified.		
5.	The assumptions used to split assets between standard control, direct control, alternative control, negotiated and unregulated services.	No significant changes identified.	5.1.2 (Revised proposal)	Energex has used the same methodology, reviewed and accepted by the AER in its Draft Determination, to split its asset base between standard control services and alternative control services.
6.	The treatment of WIP.	No significant changes identified.	Email response from Energex	Energex did not include WIP in its opening tax asset base. Accordingly, WIP has not been included in Energex's opening regulatory tax asset base for the 2010-2015 regulatory control period.
7.	The size of any tax losses as at 1 July 2010 and the treatment of any such losses going forward.	No significant changes identified.	16.4 (original proposal)	Energex has estimated nil tax losses as at 1 July 2010.

Summary of significant changes between Energex's original proposal and Revised Regulatory Proposal

Energex has revised its allowance for corporate income tax in response to matters raised by the AER in the Draft Determination. Energex's revised allowance for corporate income tax incorporates the impact of changes to:

+ the forecast operating expenditure to reflect the AER's interim escalation rates;
+ the forecast capital expenditure to reflect the AER's interim escalation rates; and
+ the exclusion of adjustments for overs and unders in the Post Tax Revenue Model ("PTRM").

Although the allowance for corporate income tax has changed in the Revised Regulatory Proposal, Energex has not made any significant changes to the methodology for calculating its tax asset base.

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 Michael Dunnett or Scott O'Donnell on (02) 6222 1400.

Yours sincerely,

McGrath Nicol 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 any errors, omissions or negligence however caused.