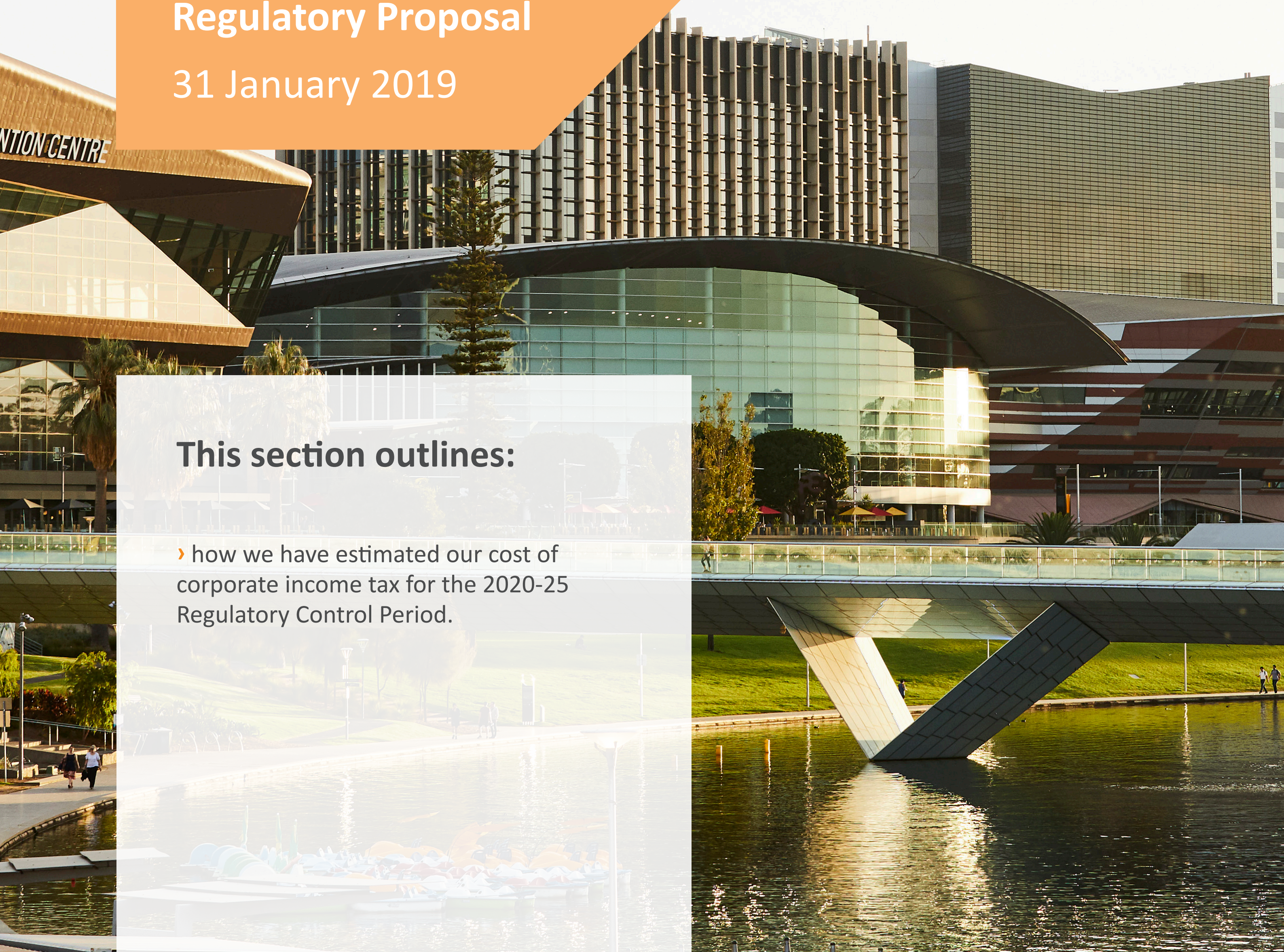
SA Power Networks

Attachment 7

Corporate income tax

2020-25 Regulatory Proposal

31 January 2019



This section outlines:

› how we have estimated our cost of corporate income tax for the 2020-25 Regulatory Control Period.

Company information

SA Power Networks is the registered Distribution Network Service Provider (**DNSP**) for South Australia. For information about SA Power Networks visit www.sapowernetworks.com.au

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Disclaimer

This document forms part of SA Power Networks' Regulatory Proposal (**the Proposal**) to the Australian Energy Regulator (**AER**) for the 1 July 2020 to 30 June 2025 regulatory control period (2020-25 **RCP**). The Proposal and its attachments were prepared solely for the current regulatory process and are current as at the time of lodgment.

This document contains certain predictions, estimates and statements that reflect various assumptions concerning, amongst other things, economic growth and load growth forecasts. The Proposal includes documents and data that are part of SA Power Networks' normal business processes, and are therefore subject to ongoing change and development.

Whilst care was taken in the preparation of the information in this Regulatory Proposal, and it is provided in good faith, SA Power Networks, its officers and shareholders accept no responsibility or liability for any loss or damage that may be incurred by any person acting in reliance on this information or assumptions drawn from it for a different purpose or in a different context.

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Note

This attachment forms part of our Proposal for the 2020-25 RCP. It should be read in conjunction with the other parts of the Proposal.

Our Proposal comprises the overview and attachments listed below, and the supporting documents that are listed in Attachment 18:

Document	Description
	Regulatory Proposal overview
	Customer and stakeholder engagement report
Attachment 1	Annual revenue requirement and control mechanism
Attachment 2	Regulatory asset base
Attachment 3	Rate of Return
Attachment 4	Regulatory depreciation
Attachment 5	Capital expenditure
Attachment 6	Operating expenditure
Attachment 7	***Corporate income tax***
Attachment 8	Efficiency benefit sharing scheme
Attachment 9	Capital expenditure sharing scheme
Attachment 10	Service target performance incentive scheme
Attachment 11	Demand management incentives and allowance
Attachment 12	Classification of services
Attachment 13	Pass through events
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Attachment 15	Negotiated services framework and criteria
Attachment 16	Connection policy
Attachment 17	Tariff Structure Statement
Attachment 18	List of Proposal documentation

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7 Corporate Income Tax

7.1. Overview

Under the post-tax revenue framework, a corporate income tax allowance is calculated for each Disrribution Network Service Provider (**DNSP**) using the Australian Energy Regulator's (AER) post-tax revenue model (**PTRM**). The DNSP's estimate of the cost of corporate income tax for each regulatory year of the RCP forms part of the DNSP's building block proposal for that RCP.

The building block for the estimated cost of corporate income tax takes into account the DNSP's estimated taxable revenue and tax expenses (such as depreciation, interest and operating expenditure), the statutory corporate income tax rate and the value of imputation credits.

In December 2018, the AER completed its review of the regulatory tax approach. The purpose of the AER review was to investigate the nature of any identified difference between the regulatory forecast of tax costs under the post-tax revenue framework and actual tax payments[1]. The AER examined the drivers of these differences and considered whether changes to the regulatory tax approach were required[2]. In particular, the AER considered whether an alternative regulatory treatment would better measure efficient tax costs[3].

In considering possible changes to the regulatory approach to assessing tax costs, the AER stated that it was not seeking to reduce the tax difference as an aim in itself (the AER noted that there may be valid and enduring reasons for the regulatory forecast of tax costs and actual tax payments to differ[4]). Rather, the AER focused on the promotion of the National Electricity Objective (**NEO**)[5] by seeking to identify the best method of fixing efficient tax costs.

The focus on the long term interest of electricity consumers was also reflected in the AER's comments concerning inter-generational equity (ensuring that customers only pay costs relevant to the delivery of the services they receive), shorter effective regulatory asset lives for refurbished capital expenditure (**capex**) and capitalisation policies and efficient capex/opex tradeoffs. As explained in section 7.3 below, we have reflected this focus in a number of other sections of our Proposal.

7.2. Rule requirements

Clauses 6.3.1(b) and (c) of the National Electricity Rules (**NER**) require SA Power Networks to submit a building block proposal to the AER. The building block proposal forms part of our Proposal and must be prepared in accordance with the PTRM and the requirements set out in Part C of Chapter 6 and Schedule 6.1 of the NER.

One component of the building block proposal[6] is the estimated cost of corporate income tax determined in accordance with clause 6.5.3 of the NER. Clause 6.5.3 of the NER relevantly states that the estimated cost of corporate income tax for SA Power Networks must be estimated for each regulatory year of the 2020-25 RCP in accordance with the following formula:

$ETCt = (ETIt \times rt)\ (1 – y)$

where:

[1] *AER, Final report – Review of regulatory tax approach*, 17 December 2018, *p 2.*
[2] *Ibid.*
[3] *Ibid.*
[4] *Ibid.*
[5] *Ibid.*
[6] *Clause 6.4.3(b)(4) of the NER.*

- ETIt is an estimate of the taxable income for that regulatory year that would be earned by a benchmark efficient entity as a result of the provision of standard control services (**SCS**) if such an entity, rather than SA Power Networks, operated the SA Power Networks regulated network business, such estimate being determined in accordance with the PTRM;
- rt is the expected statutory income tax rate for that regulatory year as determined by the AER; and
- y is the value of imputation credits.

7.3. Outcomes from the Final Tax Report

As noted above, the AER completed its review of the regulatory tax approach in December 2018. The primary recommendations from the review were[7]:

- Immediate expensing – The current regulatory tax approach should be adjusted to address depreciation mismatches arising from immediate expensing of some capex by NSPs (which in practice is not currently recognised in the AER's models – the AER's forecast tax costs currently assume that capex is depreciated over many years8).
- The AER concluded that this type of tax deduction should be recognised in its forecast of tax costs for each DNSP. The AER also recognised that regard should be had to the circumstances of the DNSP and the use of 'immediate expensing' more broadly across the sector.
- Diminishing value approach to depreciating tax assets – The current regulatory tax approach should be adjusted to address depreciation mismatches arising from the use of straight line (SL) depreciation in the AER's forecast of tax costs and diminishing value (DV) depreciation by privately owned NSPs in actual tax returns9. In particular10, the AER recommended that:
  - the SL depreciation approach should continue to be applied for all existing assets; and
  - the DV depreciation approach should be applied for all new assets/capex with the exception of assets qualified under section 40.72 of Income Tax Assessment Act 1997 (Cth).

The second recommendation is discussed in more detail in Attachment 4 - Regulatory depreciation of our Proposal.

Implementing these recommendations will require changes to the AERs' models and the AER has stated that it will be conducting a formal model change process covering the changes that need to be made to the current PTRM and Roll Forward Model (**RFM**)[11] to implement these recommendations.

The formal model change process for the PTRM is expected to commence in late January 2019 and will not be completed until several months after our Proposal has been submitted[12] to the AER. However, calculating our estimated cost of corporate income tax for inclusion in our Proposal using the current PTRM will result in a tax allowance that does not reflect the recommendations of the Final Tax Report. This would not be a useful approach for the AER or consumers and would distort our proposed corporate income tax proposal.

Accordingly, we have considered how the recommendations of the Final Tax Report are likely to impact the PTRM and the quantum of our building block for the estimated cost of corporate income tax. In 7.5 below below, we have explained this impact and the approach we have adopted to ensure that the estimated cost of corporate income tax included in our Proposal is indicative of the estimate that would be generated

[7] *AER, Final report – Review of regulatory tax approach*, 17 December 2018*, p 20.*
[8] *Ibid, p 15.*
[9] *Ibid, p 16.*
[10] *Ibid, p 73.*
[11] *Ibid, p 3.*
[12] *Ibid, p 5.*

using the PTRM as amended to reflect the recommendations from the Final Tax Report. We will incorporate the outcome of the review of the PTRM in our revised regulatory proposal.

The Final Tax Report also recognised that the recommended changes might give rise to material adverse consequences such as inter-generational inequity (eg a short term benefit to current customers at the expense of future customers) and cash-flow concerns for NSPs[13]. For this reason, the AER recognised that other aspects of an NSP's proposal might be reviewed and changed to ensure a balanced outcome is reached for the benefit of both customers and NSPs in the long term. In particular, the AER stated that:

- the recommended approach to immediate expensing of capex did not exclude the option available to NSPs to propose new asset classes (and shorter regulatory asset lives) for 'refurbishment' capex that is immediately deductible for tax purposes;
- the decision concerning whether to include new asset classes is considered during each revenue determination process taking into account the information provided by the NSP concerning the type of capex that will be allocated to each asset class;
- reviewing the regulatory asset life of refurbishment capex will go some way to addressing the major inter-generational equity and cash-flow concerns raised in submissions to the review14; and
- NSPs are able to propose in their proposals changes to their capitalisation policies that allocate identified repair and refurbishment costs to opex rather than capex and the AER will consider the resulting capex/opex 'step changes' in the normal way (i.e. assessing the relative efficiency of this step change and the long term interests of customers) during the revenue determination process15.

As a consequence, we have reviewed various other aspects of our Proposal to ensure that a balanced outcome is reached, for the long term benefit of both customers and our regulated network business and, which contributes to the achievement of the NEO to the greatest degree. That review has identified a number of issues that, unless addressed, may have material adverse consequences for both customers and our regulated network business over the long term. As a result, SA Power Networks is proposing to:

- Adopt three new asset classes covering assets that have an economic life that is less than the standard asset lives applying to new replaced network assets (for example, for refurbished line assets and substation assets and electronic network assets). These new asset classes (and their regulatory asset lives) will apply for the purposes of calculating regulatory depreciation for the 2020-25 RCP. Further details in relation to this proposal are set out in Attachment 4 – Regulatory depreciation of our Proposal.
- Treat some minor works as opex, with a resulting step change to opex for expenditure associated with cable and conductor minor repairs. This expenditure has historically been categorised as replacement capital expenditure (repex). However, we consider that the inter-generational equity concerns raised during the AER's tax review warrant re-categorising this type of expenditure as opex rather than capex. Cable and conductor minor repairs are better classed as maintenance and benefit current customers. For these reasons, SA Power Networks is proposing to remove this type of expenditure from its repex forecast and include a capex/opex trade off step change in its opex forecast for this type of expenditure. Further details in relation to this proposal are set out in section 6.7.2.5 of Attachment 6 -Operating expenditure of our Proposal.

SA Power Networks believes that this suite of changes is efficient and in the long term interests of customers in that they will deliver lower network costs and charges to current customers during the 2020-25 RCP (as compared to the level of network costs and charges which would have been determined if the proposed changes to the calculation of the estimated cost of corporate income tax did not apply),

[13] *AER, Final report – Review of regulatory tax approach, 17 December 2018, p 65 to 78.*

[14] *Ibid, p 65.*

[15] *Ibid, p 70.*

without imposing material and inappropriate additional costs on future customers. In other words, an appropriate balance between the interests of current and future customers (i.e. inter-generational equity) will be achieved by adopting changes which ensure that both current and future customers only pay costs relevant to the delivery of the services they receive. As noted above, inter-generational equity was an important consideration in the AER's Final Tax Report and in our view is important in achieving the NEO.

Our proposed changes will result in current customers enjoying a reduction in charges during the 2020-25 RCP without imposing a disproportionate burden on future customers (i.e. future customers will not be forced to pay costs that are only relevant to the delivery of services to current customers).

The changes are net present value neutral. By classifying this expenditure as opex, it will lead to a lower regulatory asset base (**RAB**) and return on capital over time and this will benefit customers in the long term and once again help achieve inter-generational equity.

During our customer engagement program (in a Deep Dive workshop in 2018 which pre-dated the publication of the Final Tax Report), customers and other stakeholders raised the matter of inter-generational equity between current and future customers in conversations about managing network risk in the long-term and our proposed replacement program at that time.

In January 2019, we presented updates to our internal Customer Consultative Panel (**CCP**) on our Proposal including the opex step change for cable and conductor minor repairs now being proposed to further address inter-generational equity matters identified following the Final Tax Report. The CCP confirmed their view of the importance of maintaining inter-generational equity and noted the AER will assess the efficiency of our proposed step change.

Aside from our CCP, we have not yet had the opportunity to consult with customers and other stakeholders concerning these proposals because the Final Tax Report was only issued on 17 December 2018. We intend to do so as soon as possible after the submission of our Proposal.

For similar reasons, SA Power Networks is also considering whether further changes should be made to its capitalisation policy to accommodate the expensing of network overheads. As noted in Attachment 6 – Operating expenditure, SA Power Networks already expenses corporate overheads and recovers these costs from current customers via its opex allowance.

We have not had sufficient time between the issue of the Final Tax Report and the lodgment of our Proposal to properly consider all of the issues that will need to be taken into account and addressed before a decision can be made concerning the expensing of network overheads. For example, the adoption of this change in approach would require significant and material changes to, and the auditing of, the information currently included in our response to the Reset Regulatory Information Notice.

However, we are intending to continue our consideration of this option in consultation with the AER with a view to revisiting the issues once the recommendations from the Final Tax Report have been implemented through changes to the PTRM and RFM and, the AER has responded to the other changes referred to in section 7.3 above.

7.4. Opening tax asset base

SA Power Networks has rolled forward the tax asset base (**TAB**) to 30 June 2020 using the AER's RFM in accordance with the NER.

In accordance with our 2015-20 distribution determination, the tax depreciation on the opening TAB at 1 July 2015 has been calculated using the year-by-year tracking approach. These calculations are made in a separate depreciation model (provided in Supporting Document SAPN - 4.1 - RAB Depreciation Model).

The depreciation amounts have been substituted directly into the RFM. This tax depreciation on the opening TAB at 1 July 2015 matches the calculation made in our 2015-20 distribution determination, except for necessary changes arising from replacing the forest capex for the 2014/15 regulatory year with actual capex for the 2014/15 regulatory year.

In doing this, SA Power Networks determined the roll forward of the TAB value from 1 July 2015 to 30 June 2020 to be $3,479.8 (nominal, $ million) for SCS.

This TAB value is based on the forecast/estimated capex for the 2018/19 and 2019/20 regulatory years. This value will be updated in our Revised Regulatory Proposal to reflect the latest available information concerning our actual and estimated capex for those regulatory years.

Further details concerning the roll forward of SA Power Networks' TAB over the 2015-20 RCP are set out in Table 7-1: SCS TAB roll forward to 30 June 2020 (nominal, $ million).

Table 7-1: SCS TAB roll forward to 30 June 2020 (nominal, $ million)

	2015/16	2016/17	2017/18	2018/19	2019/20
Opening TAB	2,466.3	2,607.0	2,759.1	2,994.2	3,233.1
Plus capex, net of contributions and disposals	302.0	324.7	420.5	438.5	446.4
Less straight line depreciation	(161.3)	(172.6)	(185.4)	(199.6)	(199.7)
Closing TAB	2,607.0	2,759.1	2,994.2	3,233.1	3,479.8

7.5. Estimated costs of corporate income tax for the 2020-25 RCP

SA Power Networks estimates that, as a result of recommendations in the Final Tax Report, the estimated cost of corporate income tax for the 2020-25 RCP will be a notional amount only.

If SA Power Networks was to use the current PTRM model to determine the estimated cost of corporate income tax to be included in its Proposal, the resulting amount would be material and would create the impression that SA Power Networks is seeking a tax allowance well in excess of the tax allowance that would be approved under the recommendations from the Final Tax Report. SA Power Networks believes that adopting this approach (i.e. using the current PTRM) would create confusion and unnecessary debate prior to the finalisation of the revised PTRM later in the year.

As new AER models reflecting the recommendations from the Final Tax Report are not currently available to properly calculate the estimated costs of corporate income tax and the regulatory tax allowance, our Proposal does not contain detailed workings for the tax building block. Instead, we have used a placeholder value of $1 for the building block for the estimated costs of corporate income tax.

We note that in accordance with the PTRM, the Rate of Return Instrument published by the AER on 17 December 2018 and the Final Tax Report, SA Power Networks has adopted a statutory income tax rate of 30% and the value of imputation of credits of 0.585 for the purpose of setting this notional placeholder value.

We think that this notional value will turn out to be very close to the estimate of corporate income tax which will eventually be determined and included in our Revised Regulatory Proposal following the finalisation and adoption of the new AER models and using the above rates and values.

As noted above, adopting an estimated costs of corporate income tax and regulatory tax allowance calculated using the current PTRM will materially distort our proposed annual revenue requirement and related pricing outcomes and create a misleading impression concerning the likely impact on customers of our Proposal.

We will revisit our placeholder value and our response to the implementation of the recommendations of the Final Tax Report in our Revised Regulatory Proposal when we would have had an opportunity to fully consider the implications of the new AER models to our Proposal.
To summarise, under our Proposal (in $2020):

- our taxation allowance for the 2020-25 RCP will fall as compared to our taxation allowance for the 2015-20 RCP by an estimated $270 million;
- the proposed step change for cable and conductor minor repairs will increase opex for the 2020-25 RCP by $68 million;
- the net regulatory depreciation changes during the 2020-25 RCP from accelerating shorter life assets are $7 million; and
- the RAB as at the end of the 2020-25 RCP will be around $83 million lower than it otherwise would have been if the above changes were not adopted in our Proposal.

The net reduction in the revenue for the 2020-25 RCP as a result of these changes is still very significant: estimated at $209 million.

We believe our Proposal properly addresses the matters raised by the AER in its Final Tax Report and is a balanced and proportionate response: current customers will still enjoy a significant price reduction; and future customers will not bear the costs of works undertaken for the benefit of today's customers.

Shortened Forms

AER	*Australian Energy Regulator*
capex	*Capital Expenditure*
CCP	*Consumer Challenge Panel*
DNSP	*Distribution Network Service Provider*
DV	Diminishing Value
NEO	*National Electricity Objective*
NER	*National Electricity Rules*
PTRM	*Post Tax Revenue Model*
RAB	*Regulatory Asset Base*
repex	Replacement Capital Expenditure
RFM	*Roll Forward Model*
SCS	*Standard Control Services*
TAB	*Tax Asset Base*