DRAFT DECISION

Directlink
Transmission Determination
2020 to 2025

Attachment 7
Corporate income tax

October 2019

AUSTRALIAN ENERGY REGULATOR

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Note

This attachment forms part of the AER's draft decision on Directlink's 2020–25 transmission determination. It should be read with all other parts of the draft decision.

The draft decision includes the following attachments:

Overview

Attachment 1 – Maximum allowed revenue

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

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Shortened forms

Shortened form	Extended form
AER	Australian Energy Regulator
ATO	Australian Taxation Office
capex	capital expenditure
DV	diminishing value
ITAA	Income Tax Assessment Act 1997
NER	national electricity rules
opex	operating expenditure
PTRM	post-tax revenue model
RAB	regulatory asset base
RFM	roll forward model
SL	straight-line
TAB	tax asset base
TNSP	transmission network service provider

7 Corporate income tax

Our revenue determination includes the estimated cost of corporate income tax for Directlink's 2020–25 regulatory control period.[1] Under the post-tax framework, a corporate income tax allowance is calculated as part of the building block assessment using our post-tax revenue model (PTRM). This amount allows Directlink to recover the costs associated with the estimated corporate income tax payable during the 2020–25 regulatory control period.

This attachment presents our assessment of Directlink's proposed corporate income tax allowance for the 2020–25 regulatory control period. It also presents our assessment of its proposed opening tax asset base (TAB), and its proposed standard and remaining tax asset lives used to estimate tax depreciation for the purpose of calculating tax expenses.

7.1 Draft decision

Our draft decision on the estimated cost of corporate income tax is $0.6 million over the 2020–25 regulatory control period. This decision represents a reduction of $1.0 million (or 61.2 per cent) from Directlink's proposal. The key reasons for the reduction are:

- application of the latest version of the PTRM (version 4) released in April 2019 which implements the findings in our final report on the review of the regulatory tax approach (the tax review).[2] Specifically, for this draft decision, we have applied the diminishing value (DV) method for tax depreciation to all new depreciable assets except for forecast capital expenditure (capex) associated with buildings.[3] These changes have reduced Directlink's proposed corporate income tax allowance by about $0.5 million (or 32.1 per cent) (section 7.4.1)
- we have separated out land and easements assets from the new proposed asset class of 'Transmission assets' into new asset classes labelled 'Land' and 'Easements' respectively, which do not depreciate for tax purposes (section 7.4.3)
- we have removed Directlink's proposed new 'Restoration and rectification' asset class and its associated standard tax asset life of 21.2 years from the PTRM. This is because we do not approve the proposed forecast capex associated with this asset class (section 7.4.3 and attachment 5).

We reduced Directlink's proposed opening TAB values as at 1 July 2020 by $1.7 million. While we accept Directlink's approach for establishing the opening TAB, we have updated the 2018–19 actual capex as it has become available since the proposal

1 NER, cl. 6A.5.4(a)(4).

2 AER, *Final report, Review of regulatory tax approach*, December 2018.

3 All assets acquired prior to 30 June 2020 will continue to be depreciated using the straight-line depreciation method for regulatory tax purposes, until these assets are fully depreciated.

was submitted (section 7.4.2). The reductions on the opening TAB values have slightly increased the corporate income tax allowance.

We accept Directlink's proposal to assign the remaining tax asset life of its existing asset class and standard tax asset life of its forecast capex for the 2020–25 regulatory control period to align with the remaining technical life of Directlink, which is 21.2 years. This approach is the same as that approved in our previous determination.[4]

Our adjustments to the return on capital (attachments 2, 3 and 5) and the regulatory depreciation (attachment 4) building blocks affect revenues, which in turn impacts the tax calculation. The changes affecting revenues are discussed in attachment 1.

Table 7-1 sets out our draft decision on the estimated cost of corporate income tax for Directlink over the 2020–25 regulatory control period.

Table 7-1 AER's draft decision on Directlink's cost of corporate income tax for the 2020–25 regulatory control period ($million, nominal)

	2020–21	2021–22	2022–23	2023–24	2024–25	Total
Tax payable	0.4	0.3	0.3	0.3	0.3	1.6
Less: value of imputation credits	0.2	0.2	0.2	0.2	0.2	0.9
Net corporate income tax allowance	**0.2**	**0.1**	**0.1**	**0.1**	**0.1**	**0.6**

Source: AER analysis.

7.2 Directlink's proposal

Directlink proposed a forecast cost of corporate income tax of $1.7 million ($nominal) using the AER's version 3 PTRM, which adopted the straight-line (SL) tax depreciation approach with the following inputs:[5]

- an opening TAB value as at 1 July 2020 of $111.0 million ($nominal)
- remaining tax asset life at 1 July 2020 that aligns with the remaining technical life of Directlink, as approved in our 2015–20 transmission determination for Directlink
- an expected statutory income tax rate of 30 per cent per year
- a value of imputation credits (gamma) of 0.585.

At the time of the submission of Directlink's regulatory proposal, we had not finalised our version 4 PTRM for amendments to implement the tax review findings. Therefore, Directlink's proposal did not account for the changes to the regulatory tax approach from our tax review.

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4 AER, *Final decision, Directlink transmission determination 2015–16 to 2019–20, Attachment 8: Corporate income tax*, April 2015, p. 9.

5 Directlink, *Revenue proposal 2020–25*, 31 January 2019, pp. 44-45.

Table 7-2 sets out Directlink's proposed corporate income tax allowance for the 2020–25 regulatory control period.

Table 7-2 Directlink's proposed cost of corporate income tax allowance for the 2020–25 regulatory control period ($million, nominal)

	2020–21	2021–22	2022–23	2023–24	2024–25	Total
Tax payable	0.7	0.7	0.8	0.9	1.0	4.0
Less: value of imputation credits	0.4	0.4	0.5	0.5	0.6	2.3
Net corporate income tax allowance	**0.3**	**0.3**	**0.3**	**0.4**	**0.4**	**1.7**

Source: Directlink, Revenue proposal 2020–25, *Attachment 12-1 - Post Tax Revenue Model - Public*, 31 January 2019.

7.3 Assessment approach

We make an estimate of taxable income for each regulatory year as part of our determination of the annual building block revenue requirement for Directlink's 2020–25 regulatory control period.[6] Our estimate is the taxable income a benchmark efficient entity would earn for providing prescribed services if it operated Directlink's business, which is determined in accordance with the PTRM.

In May 2018, we commenced a review of our regulatory tax approach. We released the final report of the tax review in December 2018, which identified some required changes to our approach to estimating tax depreciation expenses in our regulatory models (PTRM and roll forward model (RFM)).[7] The changes to our regulatory tax approach require amending our models to:[8]

- recognise immediate tax expensing of some capex forecast for a regulatory control period
- adopt the DV method for tax depreciation to all future capex except for a limited number of assets which must be depreciated using the straight-line (SL) depreciation method under the tax law.[9]

In April 2019, we published a new version of the PTRM (version 4) which implements the changes to the tax depreciation approach. We have not yet amended the RFM because the tax review final report stated that the required changes to the tax depreciation approach would apply to new assets only. Therefore, only changes to the PTRM were required in the first regulatory control period when adopting the new tax

6 NER, cl. 6A.6.4.

7 AER, *Final report, Review of regulatory tax approach*, December 2018, p. 76. The PTRM specifies the manner in which the estimated cost of corporate income tax is to be calculated. The RFM calculates the TNSP's tax asset base which is an input to the PTRM for the calculation of the tax building block.

8 Capping of gas asset tax lives was also a finding from the final report, but does not require a model change.

9 We will continue to apply SL tax depreciation for assets acquired prior to 1 July 2020 for the 2020–25 regulatory control period and until they are fully depreciated.

approach. As such, no immediate change to the RFM would be required until the subsequent regulatory control period—in this case, the current RFM remains appropriate for Directlink's 2020–25 transmission determination. An amended RFM will be required at the next reset to roll forward the TAB during the 2020–25 regulatory control period with capex being depreciated using the DV method.

How the estimated cost of corporate income tax is calculated in the PTRM

Our approach for calculating a transmission network service provider's (TNSP's) estimated cost of corporate income tax allowance is set out in our PTRM[10] and involves the following steps:[11]

1. we estimate the annual assessable income (taxable revenue) that would be earned by a benchmark efficient entity operating the TNSP's business. This is the approved forecast revenues for the transmission business that we determined using the building block approach[12]
2. we then estimate the benchmark tax expenses such as operating expenditure (opex), interest expense, tax depreciation in the following ways:
    - operating expense is set equal to the opex building block[13]
    - interest expense is a function of the size of the regulatory asset base (RAB), the benchmark gearing assumption (60 per cent) and the regulated cost of debt
    - tax depreciation expense is calculated using a separate value for the TAB, and standard and remaining tax asset lives for taxation purposes. Previously, the PTRM applied the SL method for calculating tax depreciation for all assets. Consistent with the findings of the tax review, the new amended PTRM (version 4) applies the SL tax depreciation method for existing assets and the DV tax depreciation method[14] for all assets acquired after 30 June 2020 except for in-house software, buildings and equity raising costs. The expenditure for these assets are to be depreciated using the SL method under the tax law. The amended PTRM (version 4) also accounts for the value of certain forecast capex to be immediately expensed when estimating the benchmark tax expense. The value of immediately expensed capex is deducted from the net capex being depreciated for tax purposes for

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10 AER, *Transmission PTRM (version 4)*, April 2019.

11 The PTRM must specify the manner in which the estimated cost of corporate income tax is to be calculated: NER, cl. 6A.5.3(b)(4).

12 The total revenue for tax purposes is the sum of the building blocks including return on capital, return of capital, operating expenditure and cost of corporate taxation. It may also include other revenue adjustments, but the assessment of whether they should give rise to a tax allowance will occur on a case by case basis.

13 Our assessment approach for the opex building block is discussed in attachment 6 of the draft decision.

14 For more explanation of how we calculate depreciation using the DV method, please see: AER, *Transmission PTRM handbook*, April 2019, pp. 22-23.

the year in which it is forecast to be incurred.[15] The immediately expensed amount is then included in the total tax depreciation amount for the relevant year

There may be other revenue adjustments, but the assessment of whether they should give rise to a tax allowance occurs on a case by case basis

3. we estimate the annual taxable income that would be earned by a benchmark efficient entity operating the TNSP's business by subtracting the benchmark estimates of tax expenses (step 2) from the approved forecast revenues for the transmission business (step 1)
4. we apply the statutory income tax rate to the estimated annual taxable income (after adjustment for any tax loss carried forward) to arrive at a notional amount of tax payable
5. we deduct the expected value for the utilisation of imputation credits (gamma) by investors from the notional amount of tax payable. The tax payable net of the expected value of imputation credits represents the corporate income tax allowance and is included as a separate building block in determining the TNSP's annual building block revenue requirement.

How we assess the tax inputs to the PTRM

The estimated cost of corporate income tax allowance is an output of our PTRM. We therefore assess the TNSP's proposed cost of corporate tax by analysing the proposed inputs to the PTRM for calculating that cost. While our assessment approach for most of the tax inputs remain largely the same as the determination for the current 2015–20 regulatory control period, our amended PTRM (version 4) requires two new sets of inputs for the calculation of tax depreciation—the forecast immediate expensing of certain capex and the assets to be exempted from the DV method of tax depreciation.

Our assessment approach for each of the tax inputs required in the PTRM including the two new inputs are discussed in turn below:

- **the opening TAB as at the commencement of the 2020–25 regulatory control period:** We consider that the roll forward of the opening TAB should be based on the approved opening TAB as at 1 July 2015 and Directlink's actual capex incurred during the 2015–20 regulatory control period, and the final year (2014–15) of the previous regulatory control period.[16] We do not adjust the TAB value for immediate expensing of past capex in the roll forward process. This is consistent with our 2015–20 transmission determination which applied SL tax depreciation to capex commissioned during that period as prescribed in the PTRM

[15] That is, the net capex to be added to the TAB for tax depreciation purposes is the amount of gross capex, less disposals, less the immediately deductible capex.

[16] The tax depreciation is therefore recalculated based on actual capex. The same tax depreciation approach of using actual capex applies to the roll forward of the TAB at the next reset.

The roll forward of the opening TAB for 2015–20 is calculated in our RFM. We have not amended the RFM to implement the tax review. This is because the tax review final report set out that the required changes to the tax depreciation approach would apply to new assets only. As such, the approach for determining the opening TAB value remains the same as the previous determination for the purposes of this draft decision. We have commenced our review of the RFM, to implement the findings of the tax review and plan to release draft amendments in December 2019 for public consultation.[17] We expect that the final amended RFM will then be used for the purposes of the TAB roll forward for 2020–25 at the next reset

This opening TAB value is used to estimate forecast tax depreciation for the 2020–25 regulatory control period, including new assets to be added to the TAB over this period. We will continue to apply the SL method of tax depreciation for the opening TAB value. However, for all new assets forecast to be added to the TAB in the 2020–25 regulatory control period (with some exceptions discussed further below), we will apply the DV method of tax depreciation

- **the standard tax asset life for each asset class:** Our assessment of a TNSP's proposed standard tax asset lives is generally guided by the effective life of depreciating assets determined by the Commissioner for Taxation. However, as discussed in attachment 4, Directlink has a finite technical life and it will cease to operate in 2041–42. Consistent with the 2015–20 transmission determination, Directlink has proposed to align the standard tax asset lives for its new capex with the remaining technical life of Directlink. Our draft decision on Directlink's standard tax asset lives is discussed in section 7.4.3

  As discussed above, the new amended PTRM (version 4) applies the DV tax depreciation method for all new assets except for in-house software, buildings and equity raising costs. It provides designated asset classes for these assets to be depreciated using the SL method for tax purposes.[18] We note that the tax effective lives for in-house software, buildings and equity raising costs are not covered under the ATO taxation ruling 2019/5.[19] Therefore, our assessment of the standard tax asset lives for these asset classes are guided by the *Income Tax Assessment Act 1997* (ITAA). Specifically, we consider that the standard tax asset life should be:

  - 40 years for buildings – this is consistent with the number of years required to completely depreciate a capital works asset such as buildings for tax purposes when applying sections 43.15, 43.140 and 43.210 of the ITAA

    However, for Directlink we have aligned the standard tax asset life of the 'Buildings' asset class with the remaining technical life of Directlink, which is less than 40 years. This is further discussed in section 7.4.3

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17 See https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/roll-forward-models-transmission-and-distribution-2020-amendment.

18 Our assessment approach on new assets to be exempted from the DV method is discussed in detail below.

19 ATO, *Taxation Ruling TR2019/5 - Income tax: effective life of depreciating assets (applicable from 1 July 2019)*.

- 5 years for in-house software – this is consistent with section 40.95(7) of the ITAA
- 5 years for equity raising costs – this is consistent with section 40.880 of the ITAA

- **the income tax rate:** The statutory income tax rate is 30 per cent per year, which was adopted in Directlink's proposal
- **the value of gamma:** The gamma input for Directlink is 0.585 for this draft decision. This is consistent with the 2018 *Rate of return instrument*, which requires us to use a gamma value of 0.585, and adopted in Directlink's proposal.[20] Refer to attachment 3 for further discussion on this matter
- **the size and treatment of any tax losses as at 1 July 2020:** Where a business has tax losses, we require the provision of this value to determine the appropriate estimated taxable income for a regulatory control period. If there is an amount of tax losses accumulated, the forecast taxable income for the regulatory control period will be reduced by this amount. Directlink does not have any accumulated tax losses as at the start of the 2020–25 regulatory control period[21]
- **forecast immediate expensing of capex:** The amended PTRM (version 4) requires a forecast for immediately deductible capex to be provided for each regulatory year of the 2020–25 regulatory control period. Our assessment of forecast immediate expensing of capex will be guided by the TNSP's actual immediate expensing of capex from the previous regulatory control period. We will collect actual data relating to this expenditure in our annual regulatory accounts to further inform our decision on the amount of forecast immediate expensing of capex in future regulatory determinations. Benchmarking may also be considered going forward[22]
- **diminishing value multiplier:** The amended PTRM (version 4) applies the following formula to calculate the tax depreciation under the DV method:[23]

$$D_t = \left(Nominal\ net\ capex_i - \sum_{n=0}^{t-1} D_n \right) \times DV\ multiplier \div standard\ tax\ asset\ life$$

where:

D_t is the tax depreciation in year t

$D_0 = 0$

$t = 1,2,3, \ldots$

$i = year\ 0$

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[20] AER, *Rate of return instrument*, December 2018, p. 19.

[21] Directlink, *Revenue proposal 2020–25, Attachment 12-1 - Post Tax Revenue Model - Public*, 31 January 2019.

[22] AER, *Final report, Review of regulatory tax approach*, December 2018, pp. 66-67.

[23] This formula shows how the tax depreciation for capex in a particular year is calculated under the DV method in the PTRM.

The PTRM provides an input section for the 'DV multiplier' in the above formula to be recorded for each year of the regulatory control period. This is labelled as the 'diminishing value multiplier' in the PTRM. We note that currently the DV multiplier is set at 200 per cent by the ATO. Our assessment approach for the standard tax asset life inputs is discussed above. The assessment approach for capex is discussed in attachment 5

- **new assets to be exempted from the diminishing value method:** The amended PTRM (version 4) applies the DV method for tax depreciation purposes to all new depreciable assets except for certain assets. It provides for asset classes 47 to 50 to be depreciated using the SL method for tax purposes rather than the DV method. These asset classes are to contain new assets associated with in-house software, buildings and equity raising costs

  We consider that the benchmark allowance for equity raising costs should not be depreciated using the DV method. We note that section 40.880 of the ITAA and the ATO's taxation ruling 2011/6[24] require that businesses claim deductions on equity raising costs in equal proportions over a five-year period. Therefore, in the PTRM, we apply the SL method for calculating the tax depreciation for equity raising costs, consistent with the ITAA and ATO's requirements.[25] Further, the TNSP may propose capex associated with buildings and in-house software to be exempted from the DV method of tax depreciation in the PTRM if the proposal satisfies the following requirements:

  - **buildings**: We consider that capex for buildings may be exempted from the DV method in the PTRM, consistent with sections 43.15, 43.140 and 43.210 of the ITAA. However, such capex must be consistent with the definition of a capital work under section 43.20 of the ITAA and in ATO taxation ruling 97/25.[26] We note that this includes new buildings and structural improvements to existing buildings.[27] However, capex on separate assets within a building such as air-conditioning units, transformers and converters are not consistent with the definition of a capital work, and therefore are required to be depreciated using the DV method in the PTRM
  - **in-house software**: We consider that capex for in-house software may be exempted from the DV method in the PTRM, consistent with section 40.72 of the ITAA. However, such capex must be consistent with the definition of in-house software under section 995.1 of the ITAA and in ATO taxation ruling 2016/3.[28] We note that this includes computer software, or the right to use computer software that the TNSP acquires, develops or has someone else develop for the TNSP's business use.[29] However, capex associated with

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[24] ATO, *Taxation Ruling 2011/6*, July 2016.

[25] The benchmark allowance for equity raising costs is determined within the PTRM.

[26] ATO, *Taxation Ruling 97/25*, July 2017.

[27] ITAA, section 43.20.

[28] ATO, *Taxation Ruling 2016/3*, October 2018.

[29] ITAA, section 995.1.

other IT assets such as computer hardware is not consistent with the definition of in-house software, and therefore is required to be depreciated using the DV method in the PTRM.

7.3.1 Interrelationships

The cost of corporate income tax building block feeds directly into the annual building block revenue requirement. This allowance is determined by four factors:

- pre-tax revenues
- tax expenses (including tax depreciation)
- the corporate tax rate
- gamma—the expected proportion of company tax that is returned to investors through the utilisation of imputation credits—which is offset against the corporate income tax allowance.

Of these four factors, the corporate tax rate is set externally by the Government. The higher the tax rate the higher the required tax allowance.

The pre-tax revenues depend on all the building block components. Any factor that affects revenue will therefore affect pre-tax revenues. Higher pre-tax revenues can increase the tax allowance.[30] Depending on the source of the revenue increase, the tax increase may be equal to or less than proportional to the company tax rate.[31]

The tax expenses (or deductions) depend on various building block components and their size. Some components give rise to tax expenses, such as opex, interest payments and tax depreciation of assets. However, others do not, such as increases in return on equity. Higher tax expenses offset revenues as deductions in the tax calculation and therefore reduce the cost of corporate income tax allowance (all things being equal). Tax expenses include:

- interest on debt – interest is a tax offset. The size of this offset depends on the ratio of debt to equity and therefore the proportion of the RAB funded through debt. It also depends on the allowed return on debt and the size of the RAB
- general expenses – these expenses generally will match the opex allowance including any revenue adjustments, but the assessment of whether they should be treated as a tax expense occurs on a case by case basis

[30] In fact, there is an iterative relationship between tax and revenues. That is, revenues lead to tax, being applied, which increases revenues and leads to slightly more tax and so on. The PTRM is therefore set up to run an iterative process until the revenue and tax allowances become stable.

[31] For example, although increased opex adds to revenue requirement, these expenses are also offset against the revenues as deductions in determining tax, so there is no net impact in this case. A higher return on equity, in contrast, gives rise to no offsetting tax expenses and therefore increases the tax allowance in proportion to the company tax rate.

- tax depreciation – a separate TAB is maintained for the TNSP's reflecting tax rules. This TAB is affected by many of the same factors as the RAB, such as capex, although unlike the RAB value it is maintained at its historical cost with no indexation. The TAB is also affected by the depreciation rate/method and asset lives assigned for tax depreciation purposes.

A business that has tax expenses which are greater than its taxable revenue in a period would not be subject to pay tax and generate a tax loss. A tax loss from previous period(s) can be carried forward to offset against tax payable in the current period.

For Directlink, a 10 per cent increase in the corporate income tax allowance causes revenues to increase by about 0.2 per cent.

7.4 Reasons for draft decision

We determine a cost of corporate income tax of $0.6 million for Directlink over the 2020–25 regulatory control period. This represents a reduction of $1.0 million (or 61.2 per cent) from Directlink's proposal.

As discussed above, we applied the new amended PTRM (version 4) for this draft decision to implement the changes to our regulatory tax approach identified in the tax review final report. These changes have reduced the proposed cost of corporate income tax allowance by $0.5 million (or 32.1 per cent).

We have reduced the proposed opening TAB as at 1 July 2020 to $109.2 million ($nominal). We have made amendments to Directlink's proposed standard and remaining tax asset lives for its land and easements assets. We also determine a standard tax asset life of 21.2 years for the new 'Buildings' asset class that is subject to the SL method of tax depreciation. Further, we have removed the 'Restoration and rectification' asset class from the PTRM. The reasons for our draft decision are discussed below.

Discussed in other attachments and the overview, our draft decision on Directlink's proposed return on capital (attachments 2, 3 and 5) and the regulatory depreciation (attachment 4) building blocks affect total revenues, and therefore also impact the forecast corporate income tax allowance.

7.4.1 Implementation of the tax review

Directlink prepared its proposed estimate of corporate income tax using version 3 of our PTRM, and was submitted prior to the amended PTRM (version 4) being published.

We published the new amended PTRM (version 4) in April 2019, which implements the changes identified from the final report of the tax review. Specifically, we made the following two changes which affect the calculation of tax depreciation in the PTRM:

- **immediate expensing of capex –** we allow for certain capex to be immediately expensed when estimating the benchmark tax expense

- **diminishing value depreciation method –** we apply the DV method for tax depreciation purposes to all new depreciable assets except for capex associated with in-house software, equity raising costs and buildings.[32]

We consulted with Directlink on the PTRM changes and new inputs for implementing the new tax depreciation approach resulting from the tax review. While Directlink was not required to provide these inputs as part of its regulatory proposal, it has actively engaged with us in the lead up to this draft decision in order to provide the relevant tax input requirements of the amended PTRM.

Our assessment of the new tax inputs submitted by Directlink are discussed below.

Forecast immediate expensing of capex

Certain capex (such as refurbishment capex) is able to be 'immediately expensed' under tax legislation. The amended PTRM (version 4) requires a forecast for immediately deductible capex to be provided for each asset class for each regulatory year of the 2020–25 regulatory control period.

Directlink submitted that historically it has not immediately expensed any capex for income tax purposes. It therefore has not forecast any of its capex as immediately deductible during the 2020–25 regulatory control period based on its previous experience and nature of proposed forecast capex.[33]

For this draft decision, we accept Directlink's submission that it has no forecast for immediately expensing of capex for the 2020–25 regulatory control period. This approach is consistent with Directlink's experience during the 2015–20 regulatory control period. As discussed above, we will collect actual data relating to this expenditure in our annual regulatory accounts to further inform our decision on the amount of forecast immediate expensing of capex in the next regulatory determination for Directlink.

Assets exempt from the diminishing value method

Directlink's proposal used version 3 of the PTRM, which applies the SL method to calculate tax depreciation for all asset classes. The amended PTRM (version 4) continues to apply the SL tax depreciation method to the opening TAB at 1 July 2020, but applies the DV method as the new regulatory benchmark for tax depreciation to all new capex.[34] However, as discussed above, there are some exceptions to this approach under the tax law such as assets relating to in-house software, buildings and equity raising costs.[35] In the PTRM, the benchmark allowance for equity raising costs is determined within the model and depreciated using the SL tax depreciation method as

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32 The buildings asset class may be classified as system or non-system assets in the PTRM.

33 Directlink, *Response to AER Information Request #004 – Amended PTRM inputs*, dated 16 May 2019.

34 AER, *Final report, Review of regulatory tax approach*, December 2018, p. 76.

35 Asset classes 47, 48, 49 and 50 in the PTRM (version 4) provide for this.

default. As part of our consultation on the new inputs for Directlink's forecast capex, we asked Directlink to propose any relevant forecast capex to be exempted from the DV tax depreciation method.

In its response to our information request, Directlink submitted that $0.6 million ($2019–20) of forecast capex associated with buildings is to be exempted from the DV tax depreciation method. It provided us with the reallocation of the forecast capex related to this asset from the asset class of 'Transmission assets' to the prescribed SL tax depreciation asset class for 'Buildings' in the PTRM.

We accept Directlink's proposed allocation of forecast capex for buildings to be depreciated using the SL method for tax depreciation purposes. This is because the proposed forecast capex for buildings satisfies the definition of a capital work under section 43.20 of the ITAA and in ATO taxation ruling 97/25.[36] Therefore, this forecast capex is not required to be depreciated using the DV method for tax purposes.

The overall impact of our draft decision to apply the DV tax depreciation method to new assets is to reduce Directlink's proposed estimated corporate income tax allowance by $0.5 million ($nominal, or 32.1 per cent), all else being equal.

7.4.2 Opening tax asset base as at 1 July 2020

We accept Directlink's proposed method to establish the opening TAB at 1 July 2020 as it is based on the approach set out in our RFM. We determine an opening TAB value as at 1 July 2020 of $109.2 million ($nominal) for Directlink. This is $1.7 million (or 1.5 per cent) lower than the value of $111.0 million proposed by Directlink. This is because we have updated Directlink's 2018–19 estimated capex with actuals as they have become available since the submission of the proposal.[37]

We have reviewed the inputs to the proposed TAB roll forward and found that they were correct and reconcile with relevant data sources such as annual regulatory accounts and the 2015–20 decision models. We will reconcile Directlink's inputs for the 2018–19 actual capex against the audited 2018–19 regulatory accounts at the final decision stage and make any updates if required. Further, the opening TAB as at 1 July 2020 may also be updated to reflect any revised 2019–20 capex estimates as part of the final decision.[38]

Table 7-3 sets out our draft decision on the roll forward of Directlink's TAB values over the 2015–20 regulatory control period.

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[36] ATO, *Taxation Ruling 97/25*, July 2017.

[37] Directlink, *Response to AER Information Request #012 - Proposed capital expenditure sharing scheme,* 5 August 2019, p. 1.

[38] At the time of this draft decision, the roll forward of Directlink's TAB includes estimated capex values for 2019–20. The 2019–20 capex estimates may be revised based on more up-to-date information in Directlink's revised proposal. We will update this value in the final decision accordingly.

Table 7-3 AER's draft decision on Directlink's TAB roll forward for the 2015–20 regulatory control period ($million, nominal)

	2015–16	2016–17	2017–18	2018–19	2019–20[a]
Opening TAB	99.0	99.2	98.6	104.6	106.4
Capital expenditure[b]	3.9	3.3	10.0	6.2	7.5
Less: tax depreciation	3.7	3.9	4.0	4.4	4.6
Closing TAB	**99.2**	**98.6**	**104.6**	**106.4**	**109.2**

Source: AER analysis.

(a) Based on estimated capex.

(b) As-commissioned, net of disposals.

7.4.3 Standard and remaining tax asset lives as at 1 July 2020

We accept Directlink's proposal to assign the remaining tax asset life of its existing asset class and standard tax asset life of its forecast capex for the 2020–25 regulatory control period to align with the remaining technical life of Directlink, which is 21.2 years. This is because the ATO allows an asset to be written-off for tax purposes if the business no longer holds or uses the asset.[39] We note Directlink's assets would not have any useful life when Directlink ceases to operate in 2041–42. Therefore, we consider this proposed alignment of the standard and remaining tax asset lives is appropriate for tax depreciation purposes. This is consistent with our decision on the standard and remaining tax asset lives for Directlink in the 2015–20 regulatory control period.[40]

Based on this approach, we accept Directlink's proposal to assign a standard and remaining tax asset life of 21.2 years to its asset class of 'Transmission assets.' However, we have separated out land and easements allocated to this asset class into two new asset classes labelled 'Land' and 'Easements' respectively. These two asset classes do not depreciate for tax purposes. This is because land and easements are not considered depreciable assets under the tax rules.[41] In response to our information request, Directlink did not raise any concerns with this approach.[42]

Discussed in section 7.4.1, as part of the implementation of the new tax depreciation approach, Directlink proposed to reallocate forecast capex associated with buildings into the prescribed SL tax depreciation asset class of 'Buildings' in the amended PTRM. The forecast capex in this asset class related to structural improvements to the building housing the equipment at the converter stations. We determine a standard tax

39 ITAA, section. 40.295.

40 AER, *Final decision, Directlink transmission determination 2015–16 to 2019–20, Attachment 8: Corporate income tax*, April 2015, p. 9.

41 ITAA, section. 40.30.

42 Directlink, *Response to AER Information Request #007 - Proposed new merged asset class*, 14 May 2019, p. 1.

asset life of 21.2 years for this asset class to align with the remaining technical life of Directlink, consistent with our treatment for the rest of Directlink's forecast capex. In its response to our information request, Directlink did not raise any concerns with this approach.[43]

We did not retain Directlink's proposed standard tax asset life of 21.2 years for the 'Restoration and rectification' asset class in the PTRM for tax depreciation purposes. This is because we do not accept the proposed forecast capex allocated to this asset class for the 2020–25 regulatory control period, as discussed in attachment 5. Therefore, a standard tax asset life is not required for this asset class. This is consistent with our decision in attachment 4 regarding the standard asset life for this asset class.

Table 7-4 sets out our draft decision on the standard and remaining tax asset lives as at 1 July 2020 for Directlink. We are satisfied that the standard and remaining tax asset lives are appropriate for application over the 2020–25 regulatory control period. We are also satisfied the standard and remaining tax asset lives provide an estimate of the tax depreciation amount that would be consistent with the tax expenses used to estimate the annual taxable income for a benchmark efficient service provider.[44]

Table 7-4 AER's draft decision on Directlink's standard and remaining tax asset lives as at 1 July 2020 (years)

Asset class	Standard tax asset life	Remaining tax asset lives as at 1 July 2020[a]
Transmission assets	21.2[b]	21.2
Easements	n/a	n/a
Land	n/a	n/a
Buildings	21.2[a]	n/a

Source: AER analysis.

(a) Used for straight-line method of tax depreciation.

(b) Used for diminishing value method of tax depreciation.

n/a not applicable. We have not assigned a standard tax asset life to the 'Land' and 'Easements' asset classes because the assets allocated to these asset classes are non-depreciating assets for tax purposes. We have not assigned a remaining tax asset life to the 'Buildings' asset class because it does not have an opening TAB value as at 1 July 2020.

[43] Directlink, *Response to AER Information Request #009 - Modelling questions*, 24 June 2019, p. 1.

[44] NER, cl. 6A.6.4.