DRAFT DECISION
Australian Gas Networks (SA)
Access Arrangement

2021 to 2026

Attachment 7
Corporate income tax

November 2020

AUSTRALIAN ENERGY REGULATOR

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Note

This attachment forms part of the AER's draft decision on the access arrangement that will apply to Australian Gas Networks (SA) ('AGN') for the 2021–2026 access arrangement period. It should be read with all other parts of the draft decision.

The draft decision includes the following documents:

Overview

Attachment 1 – Services covered by the access arrangement

Attachment 2 – Capital 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 carryover mechanism

Attachment 9 – Reference tariff setting

Attachment 10 – Reference tariff variation mechanism

Attachment 11 – Non-tariff components

Attachment 12 – Demand

Attachment 13 – Capital expenditure sharing scheme

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7 Corporate income tax

Our determination of the total revenue for AGN includes the estimated cost of corporate income tax for AGN's 2021–26 access arrangement period.[1] Under the post-tax framework, a corporate income tax amount is calculated as part of the building blocks assessment using our post-tax revenue model (PTRM). This amount allows AGN to recover the estimated cost of corporate income tax during the 2021–26 period.

This attachment presents our assessment of AGN's proposed corporate income tax amount for the 2021–26 access arrangement period. It also presents our assessment of its proposed opening tax asset base (TAB), its proposed standard tax asset lives, and the year-by-year tracking depreciation that it has used to estimate tax depreciation for the purpose of calculating tax expenses.

7.1 Draft decision

We accept AGN's proposed approach to calculate its forecast cost of corporate income tax. AGN has used our post-tax revenue model (PTRM) for gas pipeline service providers which implemented the findings from our 2018 *Review of the regulatory tax approach* (tax review).[2]

We determine an estimated cost of corporate income tax of zero for AGN in the 2021–26 period, consistent with AGN's proposal. We expect AGN to incur a forecast tax loss over the 2021–26 access arrangement period.[3] For this reason, our draft decision is to set out the cost of corporate income tax at zero for the 2021–26 period. We have determined that $205.3 million in tax losses as at 30 June 2026 will be carried forward to the 2026–31 access arrangement period where it can be used to offset future tax liabilities. The forecast tax losses arise because AGN's forecast tax expenses will exceed its revenue for tax assessment purposes over the 2021–26 access arrangement period. This is mostly due to the implementation of our findings from the tax review, where the introduction of immediate expensing of capital expenditure (capex) and diminishing value method of tax depreciation have resulted in a significant increase of forecast tax depreciation.[4]

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1 National Gas Rules (NGR), r. 76(c).

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

3 A forecast tax loss occurs when the forecast assessable income is lower than the forecast tax expense. In this event no tax is payable. Any residual amount of tax loss will be carried forward over to future access arrangement periods to offset future taxable income until the tax loss is fully exhausted.

4 The third key finding from the 2018 tax review relates to capping tax lives for gas assets to 20 years. However, AGN has historically assigned tax asset lives of 20 years or less to its asset classes, hence this change does not affect AGN.

We accept AGN's proposed standard tax asset lives for all of its existing asset classes as they are broadly consistent with the tax asset lives prescribed by the Australian Tax Office's (ATO) taxation ruling 2020/3 (section 7.4.4).[5]

We also accept AGN's proposal to use the year-by-year tracking method to estimate forecast tax depreciation over 2021–26 access arrangement period for the purpose of calculating tax expenses. In doing so, AGN has used our depreciation tracking module attached to the RFM.

Further, we determine an opening TAB value as at 1 July 2021 of $913.4 million ($ nominal) for AGN. This represents a small reduction of $0.01 million compared to AGN's proposed value. While we accept AGN's proposed method to establish the opening TAB, we have updated the actual capex, asset disposal and capital contributions inputs for 2015–19 in the RFM to be consistent with the values reported in the annual RIN. These updates did not result in a material change to the total opening TAB value as at 1 July 2021.

We have also adjusted the opening TAB value as at 1 July 2021 for the 'Mains' and 'Inlets' asset classes to account for the accelerated depreciation of replaced mains assets, consistent with the approach for the capital base (attachment 2).[6] However these changes do not affect the total opening TAB value as at 1 July 2021.

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 the Overview.

7.2 AGN's proposal

AGN proposed an estimated cost of corporate income tax of zero ($nominal) for the 2021–26 access arrangement period using our PTRM,[7] with the following inputs:[8]

- an opening TAB as at 1 July 2021 of $913.4 million ($nominal)
- an expected statutory income tax rate of 30 per cent per year
- a value of imputation credits (gamma) of 0.585
- immediately expensed capex amount of $299.4 million ($2020–21)
- a forecast tax depreciation schedule as calculated through the depreciation tracking module

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5 ATO, *Taxation Ruling TR2020/3 – Income tax: effective life of depreciating assets (applicable from 1 July 2020),* p. 181.

6 AER, *Draft decision – AGN(SA) access arrangement 2021–26 – Attachment 2 – Capital base,* November 2020.

7 Our published gas PTRM uses the diminishing value (DV) tax depreciation approach for all assets with the exception of in-house software, buildings and equity raising costs.

8 AGN, *2021–26 Access Arrangement Proposal – Attachment 1.4 – PTRM*, July 2020.

- the same standard tax asset lives for tax depreciation purposes of new assets for its existing asset classes in the 2021–26 access arrangement period as approved for the 2016–21 decision.

While AGN adjusted its opening capital base at 1 July 2021 to reflect the proposed accelerated depreciation of replaced mains assets, it did not do so for its opening TAB at 1 July 2021.

Table 7.1 sets out AGN's proposed TAB roll forward over the 2016–21 access arrangement period.

Table 7.1 AGN's proposed tax asset base roll forward over the 2016–21 access arrangement period ($million, nominal)

	2016–17	2017–18	2018–19	2019–20[a]	2020–21[a]
Opening tax asset base	576.3	636.5	698.3	758.7	817.4
Capital expenditure[b]	98.8	105.6	109.6	110.7	155.4
Less: tax depreciation	38.5	43.8	49.2	52.0	59.4
Closing tax asset base	**636.5**	**698.3**	**758.7**	**817.4**	**913.4**

Source: AGN, *2021–26 Access Arrangement Proposal – Attachment 1.2 – RFM*, July 2020.

(a) Based on estimated capex.

(b) Net of disposals.

7.3 Assessment approach

We make an estimate of taxable income for each regulatory year of the access arrangement period as part of our determination of the total revenue requirement for AGN's 2021–26 access arrangement period.[9] Our estimate is the taxable income a benchmark efficient entity would earn for providing reference services if it operated AGN's business.

In April 2020, we published our first version of the RFMs and PTRMs for gas pipeline service providers under new provisions in the NGR. The gas models have been developed using our published electricity distribution and transmission regulatory models, which incorporates relevant findings from our final report on the tax review.[10] They also incorporate several amendments to account for gas specific requirements. Gas distribution businesses are required to use the gas models for the purposes of their access arrangement proposals.[11]

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9 NGR, r. 87A(1).

10 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 gas pipeline service provider's tax asset base which is an input to the PTRM for the calculation of the tax building block.

11 NGR, r. 75A.

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

Our approach for calculating a gas pipeline service provider's estimated cost of corporate income tax is set out in our PTRM[12] and involves the following steps:[13]

1. We estimate the annual assessable income (taxable revenue) that would be earned by a benchmark efficient entity operating the gas pipeline service provider's business. This is the approved forecast revenues for the gas pipeline service provider that we determined using the building block approach.[14] It includes capital contributions where these are subject to taxation.
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[15]
    - interest expense is a function of the size of the capital base, 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/or remaining tax asset lives for taxation purposes. Previously, AGN's access arrangements applied the straight-line (SL) method for calculating tax depreciation for all assets. Consistent with the findings of the tax review, the published gas PTRM applies the SL tax depreciation method for existing assets and the DV tax depreciation method[16] for all assets acquired after 30 June 2021 except for in-house software, buildings and equity raising costs. The expenditure for these assets are to be depreciated using the SL method under Australian tax law. The PTRM 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 the year in which it is forecast to be incurred.[17] 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 cost of corporate tax occurs on a case by case basis.

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12 AER, *Distribution PTRM,* April 2020.

13 The PTRM must specify the manner in which the estimated cost of corporate income tax is to be calculated: NGR, r. 75B(2)(e).

14 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, and any capital contributions. It may also include other revenue adjustments, but the assessment of whether they should give rise to a cost of corporate tax will occur on a case by case basis.

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

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

17 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.

3. We estimate the annual taxable income that would be earned by a benchmark efficient entity operating the gas pipeline service provider's business by subtracting the benchmark estimates of tax expenses (step 2) from the approved forecast revenues for the service provider (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 amount and is included as a separate building block in determining the gas pipeline service provider's total revenue requirement.

How we assess the tax inputs to the PTRM

The estimated cost of corporate income tax is an output of the PTRM. We therefore assess the gas pipeline service provider's proposed cost of corporate income 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 (2016–21) access arrangement period, our gas PTRM 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:

- **opening TAB as at the commencement of the 2021–26 access arrangement period:** We consider that the roll forward of the opening TAB should be based on the approved opening TAB as at 1 July 2016 and AGN's actual capex incurred during the 2016–21 access arrangement period, and the final year (2015–16) of the previous access arrangement period.[18] We do not adjust the TAB value for immediate expensing of past capex in the roll forward process. This is consistent with our 2016–21 access arrangement that the benchmark efficient entity at the time will not immediately expense any capex during that period.

  The roll forward of the opening TAB for the 2016–21 period is calculated in AGN's RFM. 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 published the new

[18] 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.

gas RFM to implement the findings of the tax review.[19] We expect that this RFM will continue to be used for the purposes of the TAB roll forward for 2021–26 at the next reset.

This opening TAB value is used to estimate forecast tax depreciation for the 2021–26 access arrangement 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.[20] However, for all assets forecast to be added to the TAB in the 2021–26 access arrangement period (with some exceptions discussed further below), we will apply the DV method of tax depreciation.

- **standard tax asset life for each asset class:** Our assessment of a gas pipeline service provider's proposed standard tax asset lives is generally guided by the effective life for depreciating assets determined by the Commissioner for Taxation. The ATO sets a statutory life cap of 20 years on certain classes of gas transmission and distribution assets.[21] We consider that the standard tax asset lives for AGN's asset classes should be consistent with the ATO taxation ruling 2020/3 regarding the effective life of depreciating assets where possible.[22]

  As discussed above, the PTRM applies the DV tax depreciation method for all new assets except for in-house software, buildings and capital works, and equity raising costs. It provides designated asset classes for these assets to be depreciated using the SL method for tax purposes.[23] The tax effective lives for in-house software, buildings and capital works, and equity raising costs are not covered under the ATO taxation ruling 2020/3. 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 and capital works – 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
  - 5 years for in-house software – This is consistent with section 40.95(7) of the ITAA

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19 See https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/gas-financial-models-roll-forward-and-revenue-2020.

20 The tax review final report stated that the required changes to the tax depreciation approach would apply to new assets only. Therefore, the SL approach to tax depreciation that applied for AGN's 2016–21 access arrangement remains appropriate for use in the roll forward of the TAB to 1 July 2021.

21 ATO, *Taxation Ruling TR2020/3 – Income tax: effective life of depreciating assets (applicable from 1 July 2020)*, p. 181. For transmission assets: compressor station assets, gas pipeline LNG station assets, pipelines–transmission, spur or lateral, regulators and underground gas storage asset. For distribution assets: low pressure gas storage holders, pipelines (high, medium and low pressure trunks, primary or secondary mains or services) and regulators.

22 ATO, *Taxation Ruling TR2020/3 – Income tax: effective life of depreciating assets (applicable from 1 July 2020*), p. 181.

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

- 5 years for equity raising costs – This is consistent with section 40.880 of the ITAA.

- **income tax rate:** The statutory income tax rate is 30 per cent per year for the businesses of the size we regulate, which was adopted in AGN's proposal.
- **value of gamma:** The gamma input for AGN is 0.585 for this draft decision. This is consistent with the 2018 *R*ate of return *instrument*, which requires us to use a gamma value of 0.585, and was adopted in AGN's proposal.[24] Refer to section 4.2 of the Overview for this draft decision for further discussion on this matter.
- **size and treatment of any tax losses as at 1 July 2021:** Where a business has tax losses under our benchmark approach, we require the provision of this value to determine the appropriate estimated taxable income for an access arrangement period. If there is an amount of tax losses accumulated, the forecast taxable income for the period will be reduced by this amount. AGN does not have any accumulated tax losses as at the start of the 2021–26 period.[25]
- **forecast immediate expensing of capex:** The PTRM requires a forecast for immediately deductible capex to be provided for each regulatory year of the 2021–26 access arrangement period. Our assessment of forecast immediate expensing of capex is guided by the gas pipeline service provider's actual immediate expensing of capex from the previous access arrangement period.[26] We will collect actual data relating to this expenditure in our annual reporting Regulatory Information Notices (RINs) to further inform our decision on the amount of forecast immediate expensing of capex in future access arrangements. Benchmarking may also be considered going forward.[27]
- **diminishing value multiplier:** The PTRM applies the following formula to calculate the tax depreciation under the DV method:[28]

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

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

[25] AGN, *2021–26 Access Arrangement Proposal – Attachment 1.4 – PTRM*, July 2020.

[26] In the tax review final report, we labelled our approach to determining the amount of capex that is to be immediately expensed as an 'actuals informed approach'. AER, *Final report, Review of regulatory tax approach*, December 2018, p. 66.

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

[28] 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 access arrangement period. This is labelled as the 'diminishing value multiplier' in the PTRM. 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 PTRM applies the DV method for tax depreciation purposes to all new depreciable assets except for certain assets. It provides for the PTRM 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 equity raising costs should not be depreciated using the DV method. Section 40.880 of the ITAA and the ATO's taxation ruling 2011/6[29] 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.[30] Further, the gas pipeline service provider 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.[31] This includes new buildings and structural improvements to existing buildings.[32] 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. AGN did not propose this type of capex for the 2021–26 access arrangement period.
  - **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.[33] This includes computer software, or the right to use computer software that the gas pipeline service provider acquires, develops or has

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

[30] The benchmark amount for equity raising costs is determined within the PTRM.

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

[32] ITAA, section 43.20.

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

someone else develop for the gas pipeline service provider's business use.[34] However, capex associated with 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. AGN did not propose this type of capex for the 2021–26 access arrangement period.

In assessing AGN's proposal, we have had regard to the National Gas Objective (NGO) and the revenue and pricing principles.[35] The NGR also require that any forecast must be arrived at on a reasonable basis and must represent the best forecast or estimate possible in the circumstances.[36]

7.3.1 Interrelationships

The cost of corporate income tax building block feeds directly into the total revenue requirement. This amount is determined by five factors:

- pre-tax revenues
- tax expenses (including tax depreciation)
- the corporate tax rate
- any tax losses carried forward
- 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 payable.

Of these five factors, the corporate tax rate is set externally by the Government. The higher the tax rate, the higher the required cost of corporate tax.

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 payable.[37] Depending on the source of the revenue increase, the tax increase may be equal to or less than proportional to the company tax rate.[38]

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

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34 ITAA, section 995.1.

35 National Gas Law (NGL), s. 28; NGR, r. 100(1). The NGO is set out in NGL, s. 23. The revenue and pricing principles are set out in NGL, s. 24.

36 NGR, r. 74(2).

37 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 amounts become stable.

38 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 corporate tax amount in proportion to the company tax rate.

return on equity. Higher tax expenses offset revenues as deductions in the tax calculation and therefore reduce the cost of corporate income tax (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 capital base funded through debt. It also depends on the allowed return on debt and the size of the capital base.
- general expenses – These expenses generally will match the opex forecast including any revenue adjustments, but the assessment of whether they should be treated as a tax expense occurs on a case by case basis.
- tax depreciation – A separate TAB is maintained for the service provider reflecting tax rules. This TAB is affected by many of the same factors as the capital base, such as capex, although unlike the capital base 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 the previous period(s) can be carried forward to offset against tax payable in the current period.

7.4 Reasons for draft decision

We determine a cost of corporate income tax of zero for AGN over the 2021–26 access arrangement period. This is consistent with AGN's proposal. AGN has no forecast tax loss at the beginning of the 2021–26 access arrangement period. However, as a result of applying our tax review findings, we forecast a tax loss of $36.3 million ($ nominal) in 2021–22, increasing to $205.3 million by the end of 2025–26. This is primarily due to the impact of immediate expensing of capex proposed by AGN in relation to its mains replacement program and the implementation of the DV method of tax depreciation.

We accept AGN's proposal to establish the opening TAB as at 1 July 2021. However, we have made a small reduction of $0.01 million to the proposed value due to input updates we made in the RFM.

We also reallocated $1.7 million of the opening TAB from AGN's existing 'Mains' and 'Inlets' asset classes to its proposed new asset classes of 'Low pressure mains depreciation' and 'Low pressure inlets depreciation' for accelerated depreciation purposes. However this reallocation does not affect the total opening TAB value as at 1 July 2021.

We have reduced AGN's forecast immediately expensed capex to $212.6 million ($2020–21) as a result of our draft decision on forecast mains replacement capex (attachment 5).

We accept AGN's proposed standard tax asset lives for all of its existing asset classes. We also accept AGN's proposal to calculate forecast tax depreciation of its existing assets using the year-by-year tracking method. AGN has use the depreciation tracking

module attached to the RFM in determining the tax depreciation schedule for the 2021–26 access arrangement period.

Discussed in other attachments and the Overview, our draft decision on AGN'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 amount.[39]

7.4.1 Implementation of the tax review

We published the new gas PTRM in April 2019. Specifically, the PTRM includes the following two components which affect the calculation of tax depreciation:

- **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.[40]

AGN has used our PTRM which implemented the changes identified from the final report of the tax review to estimate the corporate income tax for its proposal.[41] Our assessment of the tax inputs submitted by AGN are discussed below.

Forecast immediate expensing of capex

AGN proposed forecast capex of $299.4 million ($2020–21, or 51.7 per cent of total capex)[42] that will be immediately expensed for tax purposes in the 2021–26 access arrangement period.[43] In response to an information request, AGN stated that the entire $299.4 million expensing is exclusively linked to its mains replacement expenditure for the 2021–26 period.[44]

We are satisfied that AGN's proposed approach for determining the forecast immediate expensing of its capex over the 2021–26 access arrangement period is reasonable. As discussed in attachment 5, we have reduced AGN's proposed forecast mains replacement capex by 29 per cent. Our draft decision has therefore made a corresponding reduction to AGN's forecast immediate expensing of capex to $212.6 million ($2020–21).

We will collect actual data relating to the immediate expensing of capex in our annual reporting RINs to further inform our decision for this type of expenditure in the next access arrangement for AGN.

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39 NGR, r. 87A.

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

41 AGN, *2021–26 Access Arrangement Proposal – Attachment 1.4 – PTRM*, July 2020.

42 Compared with the proposed gross capex of $578.8 million ($2020–21).

43 AGN, *2021–26 Access Arrangement Proposal – Attachment 1.4 – PTRM*, July 2020

44 AGN, *Response to AER information request 001 – question 4,* August 2020.

Assets exempt from the diminishing value method

The new gas PTRM continues to apply the SL tax depreciation method to the opening TAB at 1 July 2021, but applies the DV method as the new regulatory benchmark for tax depreciation to all new capex.[45] 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. In the PTRM, the benchmark equity raising costs is determined within the model and depreciated using the SL tax depreciation method as default.

AGN has not proposed any forecast capex that are to be depreciated using the SL method for tax depreciation purposes. As a result, all of AGN's assets are subject to the DV method of tax depreciation. We accept AGN's proposal and have not allocated any forecast capex to be depreciated under the SL method for tax depreciation.

Gas asset life caps

Our new regulatory tax approach applies a 20 year cap on the tax asset lives for certain new gas assets. This is consistent with ATO's tax ruling which sets a statutory life cap of 20 years on certain classes of gas transmission and distribution assets.[46]

We note that AGN has historically capped its standard tax asset lives for its gas pipeline assets at 20 years. AGN has proposed to continue this in the 2021–26 access arrangement period, reflecting our new regulatory tax approach. We therefore accept AGN's capped standard tax asset lives for its gas pipeline assets.

7.4.2 Opening tax asset base as at 1 July 2021

We accept AGN's proposed method to establish the opening TAB as at 1 July 2021. This is because AGN's proposed approach is based on our RFM and consistent with that previously approved for the 2016–21 access arrangement.

We determine an opening TAB value as at 1 July 2021 of $913.4 million ($nominal) for AGN. This represents a small reduction of $0.01 million compared to AGN's proposed value. This is because we updated the actual capex, asset disposal and capital contributions added to the TAB to reflect the historical annual reporting RIN that was lodged after submission of AGN's proposal.

In reviewing other inputs to the TAB roll forward, we found that they were correct and reconcile with relevant data sources, such as historical data RINs and the 2016–21 decision models. However, the opening TAB as at 1 July 2021 may be further updated

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[45] AER, *Final report, Review of regulatory tax approach*, December 2018, p. 76.

[46] ATO, *Taxation Ruling TR2020/3 – Income tax: effective life of depreciating assets (applicable from 1 July 2020)*, p. 181. For transmission assets–compressor station assets, Gas pipeline LNG station assets, pipelines–transmission, spur or lateral, regulators and underground gas storage asset. For distribution assets low pressure gas storage holders, pipelines (high, medium and low pressure trunks, primary or secondary mains or services) and regulators.

to reflect actual capex for 2019–20 and any revised 2020–21 capex estimates as part of the final decision.

We have also made adjustments to the opening TAB values for the asset classes of 'Mains' and 'Inlets' and the new asset classes of 'Low pressure mains depreciation' and 'Low pressure inlets depreciation'. This is to reflect a reallocation of assets for accelerated tax depreciation purposes as a result of AGN's mains replacement program. This reallocation for accelerated tax depreciation purposes does not affect the total opening TAB value as at 1 July 2021.

Table 7.2 sets out our draft decision on the roll forward of AGN's TAB values over the 2016–21 period.

Table 7.2 AER's draft decision on AGN's TAB roll forward for the 2016–21 access arrangement period ($million, nominal)

	2016–17	2017–18	2018–19	2019–20[a]	2020–21[b]
Opening TAB	576.3	636.5	698.3	758.7	817.4
Capital expenditure[c]	98.8	105.6	109.6	110.7	155.4
Less: tax depreciation	38.5	43.8	49.2	52.0	59.4
Closing TAB	**636.5**	**698.3**	**758.7**	**817.4**	**913.4**

Source: AER analysis.

(a) Based on estimated capex. We expect to update the TAB roll forward for actual capex in the final decision.

(b) Based on estimated capex. We expect to update the TAB roll forward with a revised capex estimate in the final decision.

(c) Net of disposals.

7.4.3 Year-by-year tracking approach

We accept AGN's proposal to transition to a year-by-year tracking approach for tax depreciation of its existing assets. AGN has adopted our depreciation tracking module published in April 2019 to calculate its forecast tax depreciation on its existing assets. This is consistent with our draft decision to accept AGN's proposed year-by-year tracking approach for regulatory depreciation purposes (attachment 4). Under this approach, the capex for each year of an access arrangement period is depreciated individually for tax purposes. It will result in each tax asset class having an expanding list of sub-assets to reflect the regulatory year in which capital expenditures on those assets occurred. This extra data helps track remaining tax asset values and associated tax depreciation, and is therefore consistent with the NGR.

We are satisfied the application of the year-by-year tracking method through the depreciation tracking module to calculate AGN's tax depreciation of existing assets provides an estimate of the tax depreciation amount for a benchmark efficient service

provider as required by the NGR.[47] The use of year-by-year tracking means it is no longer necessary to explicitly calculate remaining tax asset lives as at 1 July 2021.[48]

Accelerated tax depreciation of replaced mains and inlets

As discussed in attachment 4, AGN has proposed to accelerate the depreciation of a number of replaced assets (or forecast to be replaced) that are now redundant (or will no longer be in use by 30 June 2026). However, AGN did not provide any corresponding TAB reallocations for accelerated tax depreciation purposes. In response to our information request asking for more clarification on any remaining tax value for these redundant assets, AGN indicated that there is a remaining tax value of $2.2 million ($2020–21) for these assets.[49] For the reasons discussed in attachment 4, we accept the reallocations of these assets for accelerated depreciation purposes.[50] We therefore also accept the TAB reallocations submitted by AGN for accelerated tax depreciation purposes. This is reflected in the RFM and depreciation tracking module as a final year asset adjustment.

In the same response to our information request, AGN provided a remaining tax asset life of 16.3 years for 'Mains' and 14.2 years for the 'Inlets' asset classes in relation to the $2.2 million to be subject to accelerated tax depreciation. We have reviewed this material and do not agree with AGN's calculation of these remaining lives. Following further engagement with AGN on this matter, we have determined a remaining tax life of 9.3 years and 4 years for the 'Mains' and 'Inlets' asset classes respectively. During these discussions, AGN did not raise any concerns with the revised remaining tax lives to be applied. The inclusion of the accelerated tax depreciation does not materially change the forecast tax modelling.

7.4.4 Standard tax asset lives

We accept AGN's proposed standard tax asset lives assigned to its existing asset classes for the 2021–26 access arrangement period because they are:

- broadly consistent with the tax asset lives prescribed by the Commissioner for Taxation in ATO taxation ruling 2020/3[51]
- the same as the approved standard tax asset lives for the 2016–21 access arrangement period
- consistent with the statutory cap on the effective life of 20 years for gas pipeline assets under the ITAA.[52]

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47 NGR, r. 87A(1).

48 Remaining tax asset lives as at 1 July 2016 and standard tax asset lives are used in the year-by-year tracking method, as required by our depreciation tracking module.

49 AGN, *Response to information request 002 – question 2 – CONFIDENTIAL,* August 2020.

50 AER, *Draft decision – AGN – Attachment 4 – Regulatory depreciation,* November 2020.

51 ATO, *Taxation Ruling TR2020/3 – Income tax: effective life of depreciating assets* (applicable from 1 July 2020).

52 AGN has historically capped its standard tax asset lives of its pipeline assets to 20 years.

Our draft decision on AGN's standard tax asset lives for each of its asset classes is set out in Table 7.3. We are satisfied that the standard tax asset lives are appropriate for application over the 2021–26 period. We are also satisfied that the standard 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.[53]

Table 7.3 AER's draft decision on AGN's standard tax asset lives (years)

Asset class[a]	Standard tax asset life
Mains	20
Inlets	20
Meters	15
Telemetry	10
IT system	4
Other distribution system equipment	20
Other	10
Low pressure mains depreciation	n/a[b]
Low pressure inlets depreciation	n/a[b]

Source: AER analysis.

(a) All asset classes apply the diminishing value method of tax depreciation for new capex.

n/a Not applicable. We have not assigned a standard tax asset life to the 'Low pressure mains depreciation' and 'Low pressure inlets depreciation' asset classes because they have no new capex allocated to them for the 2021–26 access arrangement period. This is because the assets within these asset classes were reallocated from the 'Mains' and 'Inlets' asset classes for accelerated tax depreciation purposes. We expect the residual tax value for these asset classes will be fully depreciated over the 2021–26 period.

7.5 Revisions

We require the following revisions to make the access arrangement proposal acceptable as set out in Table 7.4:

[53] NGR, r. 87A(1).

Table 7.4 AGN's corporate income tax revisions

Revision 7.1	Make all necessary amendments to reflect this draft decision on the proposed estimated cost of corporate income tax for the 2021–26 access arrangement period.
Revision 7.2	Make all necessary amendments to reflect this draft decision on the opening tax asset base as at 1 July 2021, as set out in Table 7.2.

Shortened forms

Shortened form	Extended form
AER	Australian Energy Regulator
AGN	Australian Gas Networks (SA)
ATO	Australian Tax Office
capex	Capital expenditure
DV	Diminishing value
gamma	Value of Imputation Credits
ITAA	Income Tax Assessment Act 1997
NGL	National Gas Law
NGO	National Gas Objective
NGR	National Gas Rules
opex	Operating expenditure
PTRM	Post-tax revenue model
RFM	Roll forward model
RIN	Regulatory Information Notice
SL	Straight-line
TAB	Tax asset base