DRAFT DECISION
Murraylink transmission determination
2018 to 2023

Attachment 8 – Corporate income tax

September 2017

AUSTRALIAN ENERGY REGULATOR

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Note

This attachment forms part of the AER's draft decision on Murraylink's transmission determination for 2018–23. It should be read with all other parts of the draft decision.

The draft decision includes the following documents:

Overview

Attachment 1 – Maximum allowed revenue

Attachment 2 – Regulatory asset base

Attachment 3 – Rate of return

Attachment 4 – Value of imputation credits

Attachment 5 – Regulatory depreciation

Attachment 6 – Capital expenditure

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Shortened forms

Shortened form	Extended form
AARR	aggregate annual revenue requirement
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
ASRR	annual service revenue requirement
augex	augmentation expenditure
capex	capital expenditure
CCP	Consumer Challenge Panel
CESS	capital expenditure sharing scheme
CPI	consumer price index
DMIA	demand management innovation allowance
DRP	debt risk premium
EBSS	efficiency benefit sharing scheme
ERP	equity risk premium
MAR	maximum allowed revenue
MRP	market risk premium
NEL	national electricity law
NEM	national electricity market
NEO	national electricity objective
NER	national electricity rules
NSP	network service provider
NTSC	negotiated transmission service criteria
opex	operating expenditure
PPI	partial performance indicators
PTRM	post-tax revenue model
RAB	regulatory asset base
RBA	Reserve Bank of Australia
repex	replacement expenditure
RFM	roll forward model
RIN	regulatory information notice

Shortened form	Extended form
RPP	revenue and pricing principles
SLCAPM	Sharpe-Lintner capital asset pricing model
STPIS	service target performance incentive scheme
TNSP	transmission network service provider
TUoS	transmission use of system
WACC	weighted average cost of capital

8 Corporate income tax

Our revenue determination includes the estimated cost of corporate income tax for Murraylink's 2018–23 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 Murraylink to recover the costs associated with the estimated corporate income tax payable during the 2018–23 regulatory control period.

This attachment sets out our draft decision on Murraylink's proposed corporate income tax allowance for the 2018–23 regulatory control period. It also presents our assessment of the proposed opening tax asset base (TAB), and the standard and remaining tax asset lives used to estimate tax depreciation for the purpose of calculating tax expenses.

8.1 Draft decision

We do not accept Murraylink's proposed cost of corporate income tax allowance of $5.0 million ($nominal). Our draft decision on the estimated cost of corporate income tax is $2.5 million ($nominal) over the 2018–23 regulatory control period. This represents a reduction of $2.5 million (or 50.8 per cent) from Murraylink's proposal.

The reduction reflects our amendments to Murraylink's proposed inputs for forecasting the cost of corporate income tax including the opening TAB (section 8.4.1), the remaining tax asset lives (section 8.4.3) and the value of imputation credits—gamma (attachment 4). Our adjustments to the return on capital (attachments 2, 3 and 6)[2] and the return of capital (attachment 5) building blocks affect revenues, which in turn impact the tax calculation. The changes affecting revenues are discussed in attachment 1.

Table 8.1 sets out our draft decision on the estimated cost of corporate income tax allowance for Murraylink over the 2018–23 regulatory control period.

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

2 The forecast capex amount is a key input for calculating the return of and return on capital building blocks. Attachment 6 sets out our draft decision on Murraylink's forecast capex.

Table 8.1 AER's draft decision on Murraylink's cost of corporate income tax allowance for the 2018–23 regulatory control period ($million, nominal)

	2017–18	2018–19	2019–20	2020–21	2021–22	Total
Tax payable	0.7	0.7	0.8	0.9	1.0	4.1
Less: value of imputation credits	0.3	0.3	0.3	0.4	0.4	1.6
Net corporate income tax allowance	**0.4**	**0.4**	**0.5**	**0.5**	**0.6**	**2.5**

Source: AER analysis.

8.2 Murraylink's proposal

Murraylink proposed a forecast cost of corporate income tax of $5.0 million ($nominal) using the AER's PTRM, which adopts a straight-line tax depreciation approach and the following inputs:[3]

- an opening TAB as at 1 July 2018 of $84.5 million ($nominal)
- an expected statutory income tax rate of 30 per cent per year
- a value for gamma of 0.25
- remaining tax asset lives for each asset class in existence as at 1 July 2018 calculated using a weighted average approach
- asset classes and standard tax asset lives as approved at the 2013–18 transmission determination. In addition, Murraylink proposed a standard tax asset life of 10 years for a new 'Test equipment' asset class.

Murraylink has used the AER's RFM for rolling forward the TAB over the 2013–18 regulatory control period. However, it has amended the RFM to apply the forecast tax depreciation amount when rolling forward the TAB.[4]

Table 8.2 sets out Murraylink's proposed corporate income tax allowance for the 2018–23 regulatory control period.

[3] Murraylink, *Revenue proposal – Attachment 10.1 – PTRM*, 31 January 2017.

[4] Murraylink, *Revenue proposal – Attachment 5.1 – RAB roll forward model*, 31 January 2017.

Table 8.2 Murraylink's proposed corporate income tax allowance for the 2018–23 regulatory control period ($million, nominal)

	2018–19	2019–20	2020–21	2021–22	2022–23	Total
Tax payable	1.2	1.2	1.3	1.4	1.5	6.6
Less: value of imputation credits	0.3	0.3	0.3	0.4	0.4	1.7
Net corporate income tax allowance	**0.9**	**0.9**	**1.0**	**1.1**	**1.1**	**5.0**

Source: Murraylink, *Revenue proposal*, 31 January 2017, p. 111; Murraylink, *Revenue proposal – Attachment 10.1 – PTRM,* 31 January 2017.

8.3 Assessment approach

We make an estimate of taxable income for each regulatory year as part of our revenue determination.[5] Our estimate is for the taxable income a benchmark efficient entity would earn for providing prescribed transmission services if it operated Murraylink's business. Our approach for calculating a TNSP's cost of corporate income tax is set out in our PTRM and involves the following steps:[6]

1. We estimate the annual taxable income that would be earned by a benchmark efficient entity operating the TNSP's business.[7] A TNSP's taxable income is calculated by reducing the approved forecast revenues by benchmark estimates of tax expenses. Using the PTRM, we model the TNSP's benchmark tax expenses, including interest tax expense and tax depreciation, over the regulatory control period. The interest tax expense is estimated using the benchmark 60 per cent gearing. Tax depreciation is calculated using the TAB (which may have a different value from the RAB), and standard and remaining tax asset lives for taxation purposes. All tax expenses (including other expenses such as opex) are offset against the TNSP's forecast revenue to estimate the taxable income.
2. The statutory income tax rate is then applied to the estimated annual taxable income (after adjustment for any tax loss carried forward) to arrive at a notional amount of tax payable.
3. We apply a discount to that notional amount of tax payable to account for the assumed utilisation of imputation credits (gamma) by investors.
4. The tax payable net of assumed utilised 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.

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

[6] 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).

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

The corporate income tax allowance is an output of our PTRM. We therefore assess Murraylink's proposed cost of corporate income tax allowance by analysing the proposed inputs to the PTRM for calculating that allowance. These inputs include:

- **The opening TAB as at the commencement of the 2018–23 regulatory control period:** We consider that the roll forward of the opening TAB should be based on the approved opening TAB as at commencement of the 2013–18 regulatory control period and Murraylink's actual capex incurred during that period and the final year (2012–13) of the previous regulatory control period.[8]
- **The standard tax asset life for each asset class:** We assess Murraylink's proposed standard tax asset lives, where necessary, against those prescribed by the Commissioner for taxation in tax ruling 2017/2[9] and the approved standard tax asset lives in Murraylink's transmission determination for the 2013–18 regulatory control period.
- **The remaining tax asset life for each asset class at the commencement of the 2018–23 regulatory control period:** Our roll forward model (RFM) determines the remaining tax asset lives using the weighted average method.[10] We consider the weighted average method provides a better reflection of the mix of assets within an asset class. We will assess the outcomes of other approaches against the outcomes of this standard method in the RFM.
- **The income tax rate:** The statutory income tax rate is 30 per cent per year.
- **The value of gamma:** We determine the value of gamma value to be 0.40. Refer to attachment 4 for detailed discussion on this matter.

The CCP submitted that the AER's current approach may overestimate the tax expense of the benchmark efficient entity. It provided evidence from the Commonwealth Treasury, Credit Suisse and National Audit Office in the UK to support its concerns that the reported actual tax paid and effective tax rate for infrastructure owners may be much less than the forecast of 30 per cent per year, due to their specific organisational structure. The CCP also submitted that the AER should review its approach to the estimation of tax expense of the benchmark efficient entity as part of its next review of the *Rate of return guideline*.[11]

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8 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.

9 ATO, *Taxation Ruling Income tax: effective life of depreciating assets (applicable from 1 July 2017),* June 2017, http://law.ato.gov.au/atolaw/view.htm?docid=%22TXR%2FTR20172%2FNAT%2FATO%2F00001%22, accessed on 17 July 2017.

10 The weighted average method involves weighting the remaining life of each capital stream within an asset class (that is, the opening tax capital value and the capital expenditures for each year) by the closing tax capital value of that capital stream as a proportion of the total closing tax capital value of the asset class as a whole. The resulting individual values for each capital stream are then added together to obtain the overall weighted average remaining life of the asset class.

11 CCP, *CCP subpanel 9 - Response to proposals from Murraylink*, 12 May 2017, pp. 25–27.

As noted above, we are required to estimate the cost of corporate income tax based on a benchmark efficient entity operating the TNSP's business.[12] This estimate must be determined in accordance with the manner set out in the PTRM.[13] The PTRM models benchmark cash flows and applies the statutory income tax rate of 30 per cent per year for estimating the forecast tax payment, in accordance with the requirements of the NER.[14] We have consistently applied this approach to all regulated gas and electricity network businesses to date. The CCP acknowledged that the current approach is embedded within the PTRM and should not be changed for this Murraylink transmission determination. We agree with the CCP that the current approach should remain unchanged. Any amendment to the current approach may require a broader review of the current framework.

8.3.1 Interrelationships

The cost of corporate income tax building block feeds directly into the annual building block revenue requirement. This tax 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. This is discussed further at attachment 4.

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.[15]

Depending on the source of the revenue increase, the tax increase may be equal to or less than proportional to the company tax rate.[16]

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

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12 NER, cl. 6A.6.4.

13 NER, cll. 6A.6.4 and 6A.5.3(b)(4).

14 NER, cl. 6A.6.4.

15 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.

16 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.

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 which 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 will match the opex allowance including any revenue increments or decrements generated from the EBSS and CESS.
- Tax depreciation – A separate TAB is maintained for the TNSPs 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 or asset lives assigned for tax depreciation purposes.

A ten per cent increase in the corporate income tax allowance would cause revenues to increase by about 0.5 per cent.

8.4 Reasons for draft decision

We do not accept Murraylink's proposed cost of corporate income tax of $5.0 million ($nominal) for the 2018–23 regulatory control period. We have instead determined a cost of corporate income tax of $2.5 million. This represents a reduction of $2.5 million (or 50.8 per cent) from Murraylink's proposal. This is because we adjusted the following proposed inputs to the PTRM for tax purposes:

- the opening TAB value at 1 July 2018 (section 8.4.1)
- the remaining tax asset lives (section 8.4.3)
- the value for gamma (attachment 4).

We have accepted the proposed standard tax asset lives (section 8.4.2).

Our adjustments to the return on capital (attachments 2, 3 and 6)[17] and the return of capital (attachment 5) building blocks affect revenues, and therefore also impact the forecast corporate income tax allowance.

8.4.1 Opening tax asset base at 1 July 2018

We do not accepted Murraylink's proposed opening TAB value of $84.5 million ($nominal) as at 1 July 2018. We instead determine an opening TAB value of $84.4 million ($nominal). This represents a reduction of $0.1 million (or 0.1 per cent). This reduction is due to our amendment to Murraylink's proposed approach to roll forward

[17] The forecast capex amount is a key input for calculating the return of and return on capital building blocks. Attachment 6 sets out our draft decision on Murraylink's forecast capex.

the opening TAB. We also made minor changes to the standard tax asset life and actual capex inputs to the proposed RFM which also affect the opening TAB value as at 1 July 2018. These amendments are discussed in turn below.

8.4.1.1 Approach to roll forward the opening TAB

We do not accept Murraylink's proposal to apply the forecast tax depreciation amounts approved in the 2013–18 transmission determination when rolling forward the TAB for the 2013–18 regulatory control period. The forecast tax depreciation amounts reflect the forecast capex approved for the 2013–18 regulatory control period. We do not accept Murraylink's proposed approach because we consider it is inconsistent with:

- The ATO's guide on depreciating assets. The ATO defines the cost of a depreciating asset for the purposes of calculating the tax depreciation as the cost paid to hold and improve the asset.[18] However, the tax depreciation amounts that Murraylink applied in rolling forward the TAB reflects the forecast capex rather than its actual capex incurred.
- The approach we have applied for other gas and electricity businesses. Our RFM for electricity, consistent with the requirements of tax law, requires the calculation of the tax depreciation for rolling forward the TAB to be based on the nominal actual capex for the relevant period. Murraylink also applied the actual tax depreciation in rolling forward the TAB in all its previous transmission determinations and has not explained the reasons for departing from this approach.

Therefore, in rolling forward Murraylink's TAB for the 2013–18 regulatory control period, we have applied the tax depreciation values based on actual capex rather than forecast capex. We are satisfied that this approach will provide an appropriate estimate of the cost of corporate income tax for a benchmark efficient TNSP as required by the NER.[19]

8.4.1.2 Other inputs

We also assessed other inputs Murraylink used to roll forward the TAB over the 2013–18 regulatory control period. This includes the opening TAB and remaining tax asset life values as at 1 July 2013, standard tax asset lives and actual capex for 2012–13 and 2013–18 regulatory control period.

We accept the proposed inputs for the opening TAB and remaining tax asset life values as at 1 July 2013. We also accept the actual capex inputs for the purposes of the TAB roll forward, subject to some minor adjustments as discussed in attachment 2. However, for the reasons as discussed in attachment 2, we do not accept Murraylink's proposal to apply a standard tax asset life of 10 years to the 'Test equipment' asset class in rolling forward its TAB over the 2013–18 regulatory control period. This is

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[18] ATO, *Guide to depreciating assets 2017*, June 2017, p. 15. https://www.ato.gov.au/Forms/Guide-to-depreciating-assets-2017/ accessed 17 July 2017.

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

because this standard tax asset life was not approved in our 2013 final decision for Murraylink's 2013–18 regulatory control period. Therefore, we changed the standard tax asset life for the 'Test equipment' asset class from 10 years to 'not applicable', which is consistent with our final decision for Murraylink's 2013–18 regulatory control period.[20]

Table 8.3 sets out our draft decision on the roll forward of Murraylink's TAB values.[21]

Table 8.3 AER's draft decision on Murraylink's TAB roll forward for the 2013–18 regulatory control period ($million, nominal)

	2013–14	2014–15	2015–16	2016–17[b]	2017–18[b]
Opening TAB	81.3	78.9	77.0	75.3	73.9
Capital expenditure[a]	0.3	0.7	0.9	1.3	13.3
Less: tax depreciation	2.7	2.6	2.6	2.7	2.8
Closing TAB	**78.9**	**77.0**	**75.3**	**73.9**	**84.4**

Source: AER analysis.

(a) As commissioned, net of disposals.

(b) Based on estimated capex.

8.4.2 Standard tax asset lives

We accept Murraylink's proposed standard tax asset lives for existing asset classes because they are:

- broadly consistent with the values prescribed by the Commissioner for taxation in tax ruling 2017/2[22]
- the same as those approved standard tax asset lives for the 2013–18 regulatory control period.

However, we did not retain Murraylink's proposed standard tax asset life of 10 years for the 'Test equipment' asset class in the PTRM for tax depreciation purposes. This is because that we do not accept the proposed forecast capex for the 2018–23 regulatory control period, as discussed in attachment 6. Therefore, a standard tax asset life is not required for this asset class. This is consistent with our decision in attachment 5 regarding the standard asset life for this asset class.

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20 We have also changed the standard asset life for the 'Test equipment' asset class to 'not applicable' for RAB roll forward purposes. See section 2.4.1 of attachment 2 of this draft decision.

21 At the time of this draft decision, the roll forward of Murraylink's TAB includes estimated capex values for 2016–17 and 2017–18. We will update the 2016–17 estimated capex values with the actual values for the final decision, and may update the estimate of 2017–18 capex.

22 ATO, *Taxation Ruling Income tax: effective life of depreciating assets (applicable from 1 July 2017),* June 2017, http://law.ato.gov.au/atolaw/view.htm?docid=%22TXR%2FTR20172%2FNAT%2FATO%2F00001%22, accessed on 17 July 2017.

We are satisfied that the standard tax asset lives approved in this draft decision are appropriate for applying over the 2018–23 regulatory control period. We are also satisfied the standard tax asset lives approved in this draft decision provide an appropriate estimate of the tax depreciation amount for a benchmark efficient TNSP as required by the NER.[23] Table 8.4 sets out our draft decision on Murraylink's standard tax asset lives for the 2018–23 regulatory control period.

8.4.3 Remaining tax asset lives

We accept Murraylink's proposed weighted average method to calculate the remaining tax asset lives as at 1 July 2018. The proposed method applies the approach as set out in the RFM.

In accepting the weighted average method, we have updated the proposed remaining tax asset lives to reflect our adjustments to Murraylink's roll forward of the TAB in its proposed RFM, as discussed in section 8.4.1. This is because the TAB values in each year of the 2013–18 regulatory control period are inputs for calculating the weighted average remaining tax asset lives in the RFM. We will also update the proposed remaining tax asset lives for the final decision for any changes to estimated capex, which in turn affect the TAB values.[24] Table 8.4 sets out our draft decision on the remaining tax asset lives as at 1 July 2018 for Murraylink.

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

[24] At the time of this draft decision, the roll forward of Murraylink's TAB includes estimated capex values for 2016–17 and 2017–18. We will update the 2016–17 estimated capex values with the actual values for the final decision, and may further update the estimate of 2017–18 capex. The capex values are used to calculate the weighted average remaining tax asset lives in the RFM. Therefore, for the final decision we will recalculate Murraylink's remaining tax asset lives as at 1 July 2018 using the method approved in this draft decision.

Table 8.4 AER's draft decision on Murraylink's standard and remaining tax asset lives as at 1 July 2018 (years)

Asset class	Standard tax asset life	Remaining tax asset life as at 1 July 2018
Switchyard	40.0	25.8
Transmission line	40.0	25.4
Easements	n/a	n/a
Ancillary 15 - control systems	15.0	13.9
Ancillary 30	30.0	28.7
Ancillary 7 - pressure vessel testing and inspection	7.0	4.2
Other operating assets	5.0	4.9
Office machines	3.0	1.0

Source: AER analysis.

n/a: not applicable. We have not assigned a standard tax asset life to some asset classes because the assets allocated to those asset classes are not subject to tax depreciation.