DRAFT DECISION
Roma to Brisbane Gas Pipeline Access Arrangement 2017 to 2022

Attachment 8 – Corporate income tax

July 2017

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Note

This attachment forms part of the AER's draft decision on the access arrangement for the Roma to Brisbane Gas Pipeline for 2017–22. 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 - Value of imputation credits

Attachment 5 - Regulatory depreciation

Attachment 6 - Capital expenditure

Attachment 7 - Operating expenditure

Attachment 8 - Corporate income tax

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Attachment 10 - Reference tariff setting

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Attachment 12 - Non-tariff components

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Contents

Shortened forms

Shortened form	Extended form
AER	Australian Energy Regulator
ATO	Australian Tax Office
capex	capital expenditure
CAPM	capital asset pricing model
CPI	consumer price index
DRP	debt risk premium
ECM	(Opex) Efficiency Carryover Mechanism
ERP	equity risk premium
Expenditure Guideline	Expenditure Forecast Assessment Guideline
gamma	Value of Imputation Credits
MRP	market risk premium
NGL	National Gas Law
NGO	national gas objective
NGR	National Gas Rules
NPV	net present value
opex	operating expenditure
PTRM	post-tax revenue model
RBA	Reserve Bank of Australia
RFM	roll forward model
RIN	regulatory information notice
RPP	revenue and pricing principles
SLCAPM	Sharpe-Lintner capital asset pricing model
STTM	Short Term Trading Market
TAB	Tax asset base
UAFG	Unaccounted for gas
WACC	weighted average cost of capital
WPI	Wage Price Index

8 Corporate income tax

When determining the total revenue for APTPPL, we include an estimate of APTPPL's cost of corporate income tax.[1] APTPPL has adopted the post-tax framework to derive its revenue requirement for the 2017–22 access arrangement period.[2] Under the post-tax framework, a separate corporate income tax allowance is calculated as part of the building blocks assessment.

8.1 Draft decision

We accept APTPPL's proposed approach to calculating its forecast corporate income tax allowance. APTPPL's proposed approach is consistent with the AER's post-tax revenue model (PTRM) for electricity service providers and the approach previously approved in gas access arrangement decisions. However, we do not approve APTPPL's proposed corporate income tax allowance of $8.3 million ($nominal) for the 2017–22 access arrangement period. Our draft decision on APTPPL's corporate income tax allowance over the 2017–22 access arrangement period is $3.4 million ($nominal). This represents a reduction of $4.9 million ($nominal) or 59.2 per cent of APTPPL's proposed forecast corporate income tax allowance.

The reduction reflects our amendments to APTPPL's proposed inputs for forecasting the cost of corporate income tax, including:

- the opening tax asset base (TAB) (section 8.4.1)
- remaining tax asset lives (section 8.4.3)
- the value of imputation credits (gamma) (attachment 4).

Our adjustments to the return on capital (attachments 2 and 3), regulatory depreciation (attachment 5), and forecast capex (attachment 6) building block costs affect revenues, which in turn impacts the tax calculation.[3]

We do not approve the proposed opening TAB of $134.6 million ($nominal) as at 1 July 2017. We instead determined an opening TAB of $126.4 million ($nominal). This is because we do not approve APTPPL's proposal to apply forecast tax depreciation when rolling forward the TAB for the 2012–17 access arrangement period. Our draft decision is to use actual tax depreciation to roll forward the TAB for the 2012–17 access arrangement period.

We approve APTPPL's proposed standard tax asset lives for the 2017–22 access arrangement period. They are consistent with the provisions of the Income Tax Assessment Act (ITAA) 1997 and the standard tax asset lives prescribed in the Tax

1 NGR, r. 76(c).

2 APTPPL, *RBP access arrangement revision submission 2017–22,* September 2016, p.192.

3 The changes affecting revenues are discussed in the overview.

Ruling 2016/1.[4] They are also consistent with the approved standard tax asset lives in the 2012–17 access arrangement.

We accept APTPPL's proposed weighted average method to calculate the remaining tax asset lives as at 1 July 2017. In accepting the weighted average method, we have updated APTPPL's proposed remaining tax asset lives as at 1 July 2017. This is due to changes we have made to the roll forward of the opening TAB for the 2012–17 access arrangement period and other inputs that affect the calculation of the remaining tax asset lives in APTPPL's proposed RFM (section 8.4.3).

In assessing APTPPL's proposal, we have had regard to the requirement of the NGO and the revenue and pricing principles.[5] Table 8.1 sets out our draft decision on the estimated cost of corporate income tax allowance for APTPPL over the 2017–22 access arrangement period.

Table 8.1 AER's draft decision on corporate income tax allowance for APTPPL ($million, nominal) over the 2017–22 access arrangement period

	2017–18	2018–19	2019–20	2020–21	2021–22	Total
Tax payable	1.9	1.8	1.8	0.1	0.0	5.6
Less: value of imputation credits	0.8	0.7	0.7	0.0	0.0	2.3
Net corporate income tax allowance	1.2	1.1	1.1	0.0	0.0	3.4

Source: AER analysis.

8.2 APTPPL's proposal

APTPPL proposed a corporate income tax allowance of $8.3 million ($nominal) for the 2017–22 access arrangement period as set out in table 8.2. It used the PTRM to calculate the corporate income tax allowance for each year of the 2017–22 access arrangement period. In estimating its corporate income tax allowance, APTPPL used:

- an opening TAB of $134.6 million ($nominal) as at 1 July 2017 (as shown in Table 8.3)
- an expected statutory income tax rate of 30 per cent per year
- a value for the assumed utilisation of imputation credits (gamma) of 0.25
- the standard tax asset lives as approved for the 2012–17 access arrangement

4 *ITAA 1997*, s. 40.102(5); Australian Taxation Office, *Taxation Ruling (TR 2016/1) Income Tax: effective life of depreciating assets (applicable from 1 July 2016)*.

5 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.

- the remaining tax asset lives which were calculated using a weighted average remaining life approach as contained in its proposed RFM.

APTPPL has used the AER's RFM for rolling forward the TAB over the 2012–17 access arrangement period. However, it has amended the RFM to apply the forecast tax depreciation amount when rolling forward the TAB.[6]

Table 8.2 APTPPL's proposed corporate income tax allowance for the 2017–22 access arrangement period ($million, nominal)

	2017–18	2018–19	2019–20	2020–21	2021–22	Total
Tax payable	3.4	3.3	2.4	1.0	1.0	11.1
Less: value of imputation credits	0.8	0.8	0.6	0.2	0.3	2.8
Net corporate income tax allowance	**2.5**	**2.5**	**1.8**	**0.7**	**0.8**	**8.3**

Source: APTPPL, *Proposed PTRM*, September 2016.

Note: Numbers may not add due to rounding.

APTPPL's proposed roll forward of its TAB over the 2012–17 access arrangement period is set out in table 8.3.

Table 8.3 APTPPL's proposed tax asset base roll forward over the 2012–17 access arrangement period ($million, nominal)

	2012–13	2013–14	2014–15	2015–16	2016–17
Opening tax asset base	134.8	124.1	122.2	131.9	128.8
Capex	5.8	10.4	23.0	9.9	18.2
Tax depreciation	–16.4	–12.3	–13.2	–13.0	–12.4
Closing tax asset base	124.1	122.2	131.9	128.8	134.6

Source: APTPPL, *Proposed RFM*, September 2016.

8.3 AER's assessment approach

Our approach to calculate APTPPL's cost of corporate income tax begins with an estimate of taxable income that would be earned by a benchmark efficient company operating APTPPL's pipeline. As part of this calculation, tax expenses such as interest and depreciation need to be estimated. Interest tax expense should be estimated using a benchmark 60 per cent gearing, rather than APTPPL's actual gearing. Tax depreciation is calculated using a separate TAB. All tax expenses (including other

[6] APTPPL, *Proposed RFM*, September 2016.

expenses such as operating expenditure) are offset against the service provider's forecast revenue to estimate the taxable income. The statutory income tax rate of 30 per cent is then applied to the estimated taxable income to arrive at a notional amount of tax payable. We then apply a discount to that notional amount of tax payable to account for the value of imputation credits (gamma). The value of imputation credits attachment (attachment 4) details our draft decision on gamma. The discounted nominal amount of tax payable is then included as a separate building block in determining APTPPL's total revenue.[7]

The corporate income tax allowance is an output of the AER's PTRM, which has been adopted by APTPPL. We have therefore assessed APTPPL's proposed corporate income tax allowance by analysing its proposed inputs to the PTRM for calculating the tax allowance. These inputs include:

- the opening TAB as at 1 July 2017
- the standard tax asset life for each asset class
- the remaining tax asset life for each asset class as at 1 July 2017
- the income tax rate
- the value of imputation credits (gamma).

In assessing APTPPL's proposal, we have had regard to the NGO and the revenue and pricing principles.[8]

The rules 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.[9]

We consider that the roll forward of the opening TAB to 1 July 2017 should be based on the approved opening TAB as at 1 July 2012 and APTPPL's actual capex in the 2012–17 access arrangement period. We consider that the calculation of the tax depreciation should be based on the actual capex over the 2012–17 access arrangement period. The value of the actual capex used for rolling forward the TAB is subject to our assessment of these values as discussed in attachment 6.

We assess APTPPL's proposed standard tax asset lives, where appropriate, by comparing them against the values approved in the 2012–17 access arrangement and for similar asset classes for other service providers, as well as those prescribed by the Commissioner for taxation in tax ruling 2016/1.[10]

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7 NGR, r. 76(c).

8 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.

9 NGR, r. 74(2).

10 Australian Taxation Office, *Taxation Ruling (TR 2016/1) Income Tax: effective life of depreciating assets (applicable from 1 July 2016)*.

Our standard method for determining the remaining tax asset lives is the weighted average method. The weighted average method rolls forward the remaining tax asset life for a tax asset class from the last year of the earlier access arrangement period (in APTPPL's case 1 July 2011–31 August 2012[11]) in order to take into account the actual capex for that year. This approach reflects the mix of assets within that tax asset class, when they were acquired over that period (or if they were existing assets at the beginning), and the remaining value of those assets (used as a weight) at the end of the period. We will assess the outcomes of other approaches against the outcomes of this standard approach.

8.3.1 Interrelationships

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

- pre-tax revenues
- tax expenses (including tax depreciation)
- the corporate tax rate
- the value of imputation credits (gamma)—the expected proportion of company tax that is returned to investors through the utilisation of imputation credits—which offsets 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 corporate income tax allowance.[12] Depending on the source of the revenue increase, the tax increase may be equal to or less than proportional to the company tax rate.[13]

The tax expenses 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 tax allowance (all else being equal). Tax expenses include:

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11 As discussed in attachment 2, RBP's 2006–11 access arrangement period ended in 31 August 2012 as there was a two months delay to the commencement of the 2012–17 access arrangement period.

12 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 revenue model should therefore be set up to run an iterative process until the revenue and tax allowances become stable.

13 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.

- 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 capital base funded through debt. It also depends on the allowed return on debt and the size of the capital base.
- General expenses – In the main these expenses will match the opex allowance.
- 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 and/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 0.3 per cent. The proposed gamma of 0.25 compared to the AER's decision of 0.4, would increase the corporate income tax allowance by 32 per cent and total revenues by about 1 per cent.

8.4 Reasons for draft decision

Our draft decision on APTPPL's corporate income tax allowance is $3.4 million ($nominal), which is a reduction of $4.9 million ($nominal) or 59.2 per cent of APTPPL's proposal.

We accept APTPPL's proposed approach for calculating the corporate income tax allowance. However, we adjusted several inputs in APTPPL's proposed PTRM for calculating the corporate income tax allowance. These relate to:

- changes to the opening TAB as at 1 July 2017 (section 8.4.1)
- updates to the remaining tax asset lives as at 1 July 2017 (section 8.4.3)
- changing the value of gamma to 0.4 from 0.25 (attachment 4)
- changes to other building block components including forecast rate of return (attachment 3) and forecast capex (attachment 6).[14]

8.4.1 Opening tax asset base as at 1 July 2017

Approach to roll forward the opening TAB

We do not accept APTPPL's proposal to apply the forecast tax depreciation amounts approved in the review of the 2012–17 access arrangement when rolling forward the TAB for the 2012–17 access arrangement period. The forecast tax depreciation amounts reflect the forecast capex approved for the 2012–17 access arrangement period. We do not accept APTPPL's proposed approach because we consider it is inconsistent with:

[14] NGR, r. 87A.

- 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.[15] However, the tax depreciation amounts that APTPPL applied in rolling forward the TAB reflects the forecast capex for the 2012–17 access arrangement period. Therefore, we consider that the proposed approach is not consistent with the ATO's requirement to use actual costs for calculating the tax depreciation.
- the approach we have applied for other the gas and electricity businesses. We note that the AER's RFM for electricity, consistent with the requirements of the ATO, requires the calculation of the tax depreciation for rolling forward the TAB to be based on the nominal actual net capex for the relevant period. APTPPL also applied the actual tax depreciation in rolling forward the TAB in all its past access arrangements.

For the reasons discussed above, we do not accept APTPPL's proposed approach. We consider APTPPL's proposed approach would result in an estimate of the taxable income that is not consistent with the amount that would be earned by a benchmark efficient entity as a result of the provision of reference services.[16] We consider the tax depreciation amounts applied in rolling forward the TAB should be based on the actual capex consistent with the AER's RFM and the ATO's guide for depreciating assets. Therefore, we have amended the proposed RFM so that the tax depreciation is calculated using the nominal net actual capex for the 2012–17 access arrangement period.

Other inputs

We also assessed other inputs APTPPL used to roll forward the TAB over the 2012–17 access arrangement period. This includes the opening TAB and remaining tax asset life values as at 1 September 2012, and actual capex for 2011–12 and 2012–17 access arrangement period.

We do not accept APTPPL’s proposed total opening TAB as at 1 September 2012 of $134.8 million ($nominal). As discussed in attachment 2, we accepted APTPPL's proposal to establish the opening capital base from the commencement of the current access arrangement period, 1 September 2012. As a result, we adjusted several inputs in the RFM to recognise the length of the 2011–12 regulatory year as 14 months and 2012–13 regulatory year as 10 months. Therefore, we have adjusted the approved opening TAB as at 1 July 2012[17] for two months of forecast capex and inflation for 2011–12 to establish an opening TAB as at 1 September 2012. Further, we have amended the allocation of the opening TAB as at 1 September 2012 between asset classes. As discussed in attachment 2, we have changed the proposed allocation of the residual asset values of the 'RBP 8 expansion' asset class between the 'Pipelines',

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15 ATO, *Guide to depreciating assets 2016*, June 2016, pp. 14 and15.

16 NGR, cl. 87A(1).

17 AER*, Final decision PTRM,* August 2012.

'Compressors' and 'Regulators and meters' asset classes. We have therefore applied the same reallocation to the opening TAB. We have determined an opening TAB as at 1 September 2012 of $134.2 million ($nominal) for the draft decision.

We amended the proposed remaining tax asset life as at 1 September 2012 to reflect the changes we made to APTPPL's proposed asset class consolidations and accelerated depreciation of redundant compressors. These changes are discussed in detail in attachment 2.

We do not accept APTPPL's proposed actual capex as conforming capex during the 2011–17 period. Our detailed assessment of the conforming capex is set out in attachment 6.

Our draft decision is to determine an opening TAB of $126.4 million ($nominal) as at 1 July 2017 for APTPPL. This represents a reduction of $8.2 million or 6.1 per cent to APTPPL's proposal. Table 8.4 sets out our draft decision on the roll forward of APTPPL's TAB values.

Table 8.4 AER's draft decision on APTPPL's tax asset base roll forward for the 2012–17 access arrangement period ($million, nominal)

	2012–13	2013–14	2014–15	2015–16	2016–17
Opening tax asset base	134.2	126.7	122.3	126.3	121.7
Capex	5.7	8.6	17.3	9.9	18.2
Tax depreciation	–13.2	–13.0	–13.3	–14.4	–13.5
Closing tax asset base	126.7	122.3	126.3	121.7	126.4

Source: AER analysis.

8.4.2 Standard tax asset lives

We approve APTPPL's proposed standard tax asset lives assigned to each of its asset classes for the 2017–22 access arrangement period. This is because they are consistent with the statutory cap on the effective life of gas transmission assets under the *Income Tax Assessment Act (ITAA)* 1997, and with the standard tax asset lives prescribed in the Tax Ruling 2016/1.[18] The proposed standard tax asset lives are also consistent with the approved standard tax asset lives in the 2012–17 access arrangement.[19]

As discussed in attachment 5, we have accepted APTPPL's proposal to consolidate its asset classes to number 11 from the previous 25 asset classes. We note that

18 *ITAA 1997*, s. 40.102(5); Australian Taxation Office, *Taxation Ruling (TR 2016/1) Income Tax: effective life of depreciating assets (applicable from 1 July 2016)*.

19 AER, *RBP final decision PTRM*, August 2012.

APTPPL's proposed asset class consolidation does not require any changes from the approved standard tax asset lives for the 2012–17 access arrangement period.

Our draft decision on APTPPL's standard tax asset lives for each of its asset classes for the 2017–22 access arrangement period is set out in Table 8.5.

8.4.3 Remaining tax asset lives as at 1 July 2017

We accept APTPPL's proposed weighted average method to calculate the remaining tax asset lives as at 1 July 2017. In accepting the weighted average method, we have updated APTPPL's remaining tax asset lives[20] as at 1 July 2017 to reflect our amendments to the proposed roll forward of the TAB as discussed in section 8.4.1.

Our draft decision on APTPPL's remaining tax asset lives for each of its asset classes for the 2017–22 access arrangement period is set out in Table 8.5.

Table 8.5 AER's draft decision on APTPPL's standard tax asset lives and remaining tax asset lives as at 1 July 2017 for the 2017–22 access arrangement period (year)

Tax asset class	Standard tax asset life	Remaining tax asset life as at 1 July 2017
Original pipeline (DN250)	20	19.0
Pipelines	20	9.5
Compressor	20	15.0
Regulators and meters	20	14.6
Easements	n/a	n/a
Communications	20	n/a
Other	20	1.8
Capitalised AA costs	5	4.9
Group IT	5	3.7
SIB capex	5	3.3
Redundant compressors	n/a	2.2

Source: AER analysis.

n/a Not applicable.

[20] We note that the capex determined in this draft decision for 2015–16 and 2016–17 are estimates. As part of the final decision, we expect the estimate of capex for 2015–16 to be replaced by actual values and the 2016–17 capex to be revised based on more up to date information, and that RBP may provide this revision in its revised proposal. The capex figures are used to calculate the weighted average remaining tax asset lives. Therefore, we may recalculate RBP's remaining tax asset lives using the method approved in this draft decision to reflect revisions to 2015–16 and 2016–17 capex values for the final decision.

8.5 Revisions

We require the following revisions to make the access arrangement proposal acceptable:

Revision 8.1 Make all necessary amendments to reflect this draft decision on the proposed corporate income tax allowance for the 2017–22 access arrangement period, as set out in table 8.1Table 8.1

Revision 8.2 Make all necessary amendments to reflect this draft decision on the opening tax asset base as at 1 July 2017, as set out in Table 8.4.

Revision 8.3 Make all necessary amendments to reflect this draft decision on the standard and remaining tax asset lives for the 2017–22 access arrangement period as set out in Table 8.5.