DRAFT DECISION
Evoenergy
Distribution Determination

2019 to 2024

Attachment 7
Corporate income tax

September 2018

AUSTRALIAN ENERGY REGULATOR

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Note

This attachment forms part of the AER's draft decision on the distribution determination that will apply to Evoenergy for the 2019–2024 regulatory control period. It should be read with all other parts of the draft decision.

The draft decision includes the following documents:

Overview

Attachment 1 – Annual revenue requirement

Attachment 2 – Regulatory asset base

Attachment 3 – Rate of return

Attachment 4 – Regulatory depreciation

Attachment 5 – Capital expenditure

Attachment 6 – Operating expenditure

Attachment 7 – Corporate income tax

Attachment 8 – Efficiency benefit sharing scheme

Attachment 9 – Capital expenditure sharing scheme

Attachment 10 – Service target performance incentive scheme

Attachment 11 – Demand management incentive scheme

Attachment 12 – Classification of services

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Attachment 17 – Connection policy

Attachment 18 – Tariff structure statement

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Shortened forms

Shortened form	Extended form
capex	capital expenditure
CESS	capital expenditure sharing scheme
distributor	distribution network service provider
NER	national electricity rules
opex	operating expenditure
PTRM	post-tax revenue model
RAB	regulatory asset base
RFM	roll forward model
RIN	regulatory information notice
WACC	weighted average cost of capital

7 Corporate income tax

Our determination of the annual revenue requirement includes the estimated cost of corporate income tax for Evoenergy's distribution and transmission (dual function assets) networks for the 2019–24 regulatory control period.[1] Evoenergy's dual function assets are high voltage assets which support the broader NSW/ACT transmission network owned and operated by TransGrid. The AER has decided to apply transmission pricing to these assets.[2] 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 Evoenergy to recover the costs associated with the estimated corporate income tax payable during the 2019–24 regulatory control period.

This attachment presents our assessment of Evoenergy's proposed corporate income tax allowance for the 2019–24 regulatory control period. It also presents our assessment of its 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.

7.1 Draft decision

We determine an estimated cost of corporate income tax of $23.2 million and $3.4 million ($ nominal) for Evoenergy in the 2019–24 regulatory control period for its distribution and transmission networks respectively. This represents reductions of $10.3 million (or 30.8 per cent) for its distribution network and $1.9 million (or 35.7 per cent) for its transmission network compared to Evoenergy's proposal of $33.6 million and $5.2 million ($ nominal) respectively.

The reductions to the tax allowance made in this decision reflect our amendments to Evoenergy's proposed inputs for forecasting the cost of corporate income tax, including:

- the opening TAB (section 7.4.1)
- remaining tax asset lives (section 7.4.2)
- proposed tax treatment of revenue adjustments associated with the capital expenditure sharing scheme (CESS) (section 7.4.3)
- the value of imputation credits—gamma (section 2.2 of the overview).

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.

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1 NER, cl. 6.4.3(a)(4).

2 AER, *Framework and approach ActewAGL Regulatory control period commencing 1 July 2019,* July 2017, p. 13

Table 7.1 and Table 7.2 set out our draft decision on the estimated cost of corporate income tax allowance for Evoenergy over the 2019–24 regulatory control period for its distribution and transmission networks respectively.

Table 7.1 AER's draft decision on Evoenergy's cost of corporate income tax allowance for the 2019–24 regulatory control period – distribution ($ million, nominal)

	2019–20	2020–21	2021–22	2022–23	2023–24	Total
Tax payable	8.2	8.8	9.2	10.0	10.3	46.4
Less: value of imputation credits	4.1	4.4	4.6	5.0	5.1	23.2
Net corporate income tax allowance	**4.1**	**4.4**	**4.6**	**5.0**	**5.1**	**23.2**

Source: AER analysis.

Table 7.2 AER's draft decision on Evoenergy's cost of corporate income tax allowance for the 2019–24 regulatory control period – transmission ($ million, nominal)

	2019–20	2020–21	2021–22	2022–23	2023–24	Total
Tax payable	1.1	1.2	1.3	1.5	1.6	6.7
Less: value of imputation credits	0.6	0.6	0.7	0.7	0.8	3.4
Net corporate income tax allowance	**0.6**	**0.6**	**0.7**	**0.7**	**0.8**	**3.4**

Source: AER analysis.

Application of the tax review in the final decision

For this draft decision, we have used our current regulatory models (PTRM and RFM) to calculate the various components required to estimate Evoenergy's cost of corporate income tax for the 2019–24 regulatory control period. Our assessment approach for this draft decision is discussed in section 7.3. We are currently undertaking a review of our regulatory tax approach (the tax review). As discussed in the initial report to the tax review published on 28 June 2018, we intend to apply any changes to our regulatory models arising from the tax review to the final decision for Evoenergy's 2019–24 regulatory control period in April 2019.[3]

As indicated in the initial tax report, it is intended that any required changes to our regulatory models will be proposed in December 2018 as part of the final position of the tax review. After consultation on the proposed amended models, final model amendments will be released by April 2019. Evoenergy is due to submit its revised

[3] AER, *Initial Report–Review of regulatory tax approach*, June 2018, pp. 4 and 5.

regulatory proposal in November 2018. This means that any proposed changes to our regulatory models will be made shortly after the submission of the revised regulatory proposal.

We will consult with Evoenergy directly on specific implementation issues and possible interactions with other aspects of the revenue determination as soon as the likely direction of the tax review and any model changes are evident. We consider that early and extensive consultation on any proposed changes to the regulatory models will ensure that Evoenergy and other stakeholders have sufficient opportunity to comment on the changes to the regulatory models before the final decision is made.

7.2 Evoenergy's proposal

Evoenergy proposed a forecast cost of corporate income tax of $33.6 million and $5.2 million ($ nominal) for its distribution and transmission networks respectively using the AER's PTRM, which adopted a straight-line tax depreciation approach and the following inputs:[4]

- opening TAB values as at 1 July 2019 of $734.4 million and $155.9 million for its distribution and transmission networks respectively ($ nominal)
- an expected statutory income tax rate of 30 per cent per year
- a value for gamma of 0.40
- remaining tax asset lives of assets in existence as at 30 June 2019 calculated using a weighted average approach as set out in the AER's RFM
- the same standard tax asset lives for tax depreciation purposes of new assets for the 2019–24 regulatory control period as approved for the 2014–19 distribution determination.

Table 7.3 and Table 7.4 set out Evoenergy's proposed corporate income tax allowance for the 2019–24 regulatory control period for its distribution and transmission networks respectively.

[4] Evoenergy, *Proposed PTRM – Distribution*, January 2018; Evoenergy, *Proposed PTRM – Transmission*, January 2018

Table 7.3 Evoenergy's proposed cost of corporate income tax allowance for the 2019–24 regulatory control period – distribution ($ million, nominal)

	2019–20	2020–21	2021–22	2022–23	2023–24	Total
Tax payable	10.0	10.5	11.1	12.0	12.4	55.9
Less: value of imputation credits	4.0	4.2	4.4	4.8	4.9	22.4
Net corporate income tax allowance	**6.0**	**6.3**	**6.7**	**7.2**	**7.4**	**33.6**

Source: Evoenergy, *Proposed PTRM*, January 2018.

Table 7.4 Evoenergy's proposed cost of corporate income tax allowance for the 2019–24 regulatory control period – transmission ($ million, nominal)

	2019–20	2020–21	2021–22	2022–23	2023–24	Total
Tax payable	1.5	1.6	1.7	1.9	2.0	8.7
Less: value of imputation credits	0.6	0.6	0.7	0.8	0.8	3.5
Net corporate income tax allowance	**0.9**	**1.0**	**1.0**	**1.1**	**1.2**	**5.2**

Source: Evoenergy, *Proposed PTRM*, January 2018.

7.3 Assessment approach

We make an estimate of taxable income for each regulatory year as part of our determination of the annual revenue requirement for Evoenergy's 2019–24 regulatory control period.[5] Our estimate is the taxable income a benchmark efficient entity would earn for providing standard control services if it operated Evoenergy's distribution network business. Our approach for calculating a distributor's cost of corporate income tax allowance 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 distributor's business. A distributor's taxable income is calculated by subtracting from the approved forecast revenues the benchmark estimates of tax expenses. Using the PTRM, we model the distributor'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 used for the rate of return calculation. Tax depreciation is calculated using a separate value for the TAB, and standard and remaining tax asset lives for taxation purposes. The PTRM (and RFM) uses the

[5] NER, cl. 6.5.3.

[6] The PTRM must specify the manner in which the estimated cost of corporate income tax is to be calculated: NER, cl. 6.4.2(b)(4).

straight-line method for tax depreciation. All tax expenses (including other expenses such as opex) are offset against the distributor'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 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 distributor's annual revenue requirement.

The cost of corporate income tax allowance is an output of our PTRM. We therefore assess the distributor's proposed cost of corporate 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 2019–24 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 2014 and Evoenergy's actual capex incurred during the 2014–19 regulatory control period, and the final year (2013–14) of the previous regulatory control period.[7]
- **The remaining tax asset life for each asset class at the commencement of the 2014–19 regulatory control period:** 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 as at 1 July 2014 for an asset class in order to take into account the actual capex for the 2014–19 regulatory control period. This approach reflects the mix of assets within that tax asset class, when they were acquired over that period and the remaining tax asset lives of existing assets at the end of that period. The residual asset values of all assets are used as weights at the end of the period.
- **The standard tax asset life for each asset class:** We assess Evoenergy's proposed standard tax asset lives against those prescribed by the Commissioner for Taxation in tax ruling 2018/4 and the approved standard tax asset lives in the distributor's distribution determination for the 2014–19 regulatory control period.[8]
- **The income tax rate:** The statutory income tax rate is 30 per cent per year.
- **The value of gamma:** The gamma input for Evoenergy is 0.50. Refer to section 2.2 of the overview for further discussion on this matter.
- **The size and treatment of any tax losses as at 1 July 2019**: Where a business has tax losses, we require the provision of this value to determine the appropriate

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7 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.

8 ATO, *TR 2018/4—Income tax: effective life of depreciating assets (applicable from 1 July 2018)*, July 2018.

estimated taxable income for a regulatory control period. If there is an amount of tax losses accumulated, the forecast taxable income for the regulatory period will be reduced by this amount.

7.3.1 Interrelationships

The cost of corporate income tax building block feeds directly into the annual 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.[9] Depending on the source of the revenue increase, the tax increase may be equal to or less than proportional to the company tax rate.[10]

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 increments or decrements generated from the EBSS, DMIA and CESS.

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9 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.

10 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 businesses 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 and asset lives assigned for tax depreciation purposes.

For Evoenergy, a 10 per cent increase in the corporate income tax allowance causes revenues to increase by about 0.4 per cent. An increase in the gamma from 0.40 to 0.50 would decrease the corporate income tax allowance by 19.6 per cent and total revenues by about 0.8 per cent.[11]

7.4 Reasons for draft decision

We determine an estimated cost of corporate income tax allowance of $23.2 million and $3.4 million ($ nominal) for Evoenergy in the 2019–24 regulatory control period for its distribution and transmission networks respectively. This represents reductions of $10.3 million (or 30.8 per cent) for the distribution network and $1.9 million (or 35.7 per cent) for the transmission network from Evoenergy's proposal.

This is because we amended the following proposed inputs to the PTRM for tax purposes:

- the opening TAB value at 1 July 2019 (section 7.4.1)
- the remaining tax asset life for the 'Equity raising costs' asset class (section 7.4.2)
- proposed tax treatment of revenue adjustments associated with the capital expenditure sharing scheme (CESS) (section 7.4.3)
- the value of imputation credits—gamma (section 2.2 of the overview).

Our adjustments to the return on capital (attachments 2, 3 and 5)[12] and the return of capital (attachment 4) building blocks affect revenues, and therefore also impact the forecast corporate income tax allowance.

7.4.1 Opening tax asset base as at 1 July 2019

We accept Evoenergy's proposed method to establish the opening TAB as at 1 July 2019 because it is based on the approach set out in our RFM. Based on the proposed approach, we have determined the opening TAB values as at 1 July 2019 of $734.4 million and $155.9 million ($ nominal) for Evoenergy's distribution and transmission networks respectively.[13]

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11 We have analysed the sensitivity of the corporate income tax allowance relative to total revenue, and compared the effects of the two gamma values based on input data from Evoenergy's proposed PTRMs.

12 The forecast capex amount is a key input for calculating the return of and return on capital building blocks. Attachment 5 sets out our draft decision on Evoenergy's forecast capex.

13 This represents reductions of $0.013 million for its distribution network and $0.003 million for its transmission network compared to its proposal.

We have reviewed the inputs to the TAB roll forward and found that they were largely correct and reconcile with relevant data sources such as annual reporting RINs and the 2014–19 decision models. However, the 2014–15 equity raising costs input was updated as part of the remittal decision for the 2014–19 regulatory control period. We have therefore amended the input for equity raising costs in Evoenergy's RFMs.

We also note that these opening TAB values as at 1 July 2019 may be updated to reflect actual capex for 2017–18 and any updated 2018–19 capex estimates as part of the final decision.[14]

Table 7.5 and Table 7.6 set out our draft decision on the roll forward of Evoenergy's TAB values over the 2014–19 regulatory control period for its distribution and transmission networks respectively.

Table 7.5 AER's daft decision on Evoenergy's TAB roll forward for the 2014–19 regulatory control period – distribution ($ million, nominal)

	2014–15	2015–16	2016–17	2017–18[a]	2018–19[a]
Opening TAB	608.6	644.5	667.7	684.2	714.3
Capital expenditure[b]	67.3	58.1	53.8	66.1	58.2
Less: tax depreciation	31.4	34.8	37.3	36.0	38.1
Closing TAB	**644.5**	**667.7**	**684.2**	**714.3**	**734.4**

Source: AER analysis.

(a) Based on estimated capex.

(b) Net of disposals.

Table 7.6 AER's daft decision on Evoenergy's TAB roll forward for the 2014–19 regulatory control period – transmission ($ million, nominal)

	2014–15	2015–16	2016–17	2017–18[a]	2018–19[a]
Opening TAB	137.1	143.1	146.4	148.3	149.2
Capital expenditure[b]	11.8	9.8	8.9	7.8	14.1
Less: tax depreciation	5.8	6.5	7.0	6.9	7.3
Closing TAB	**143.1**	**146.4**	**148.3**	**149.2**	**155.9**

Source: AER analysis.

(a) Based on estimated capex.

(b) Net of disposals.

[14] At the time of this draft decision, the roll forward of Evoenergy's TAB includes estimated capex values for 2017–18 and 2018–19. We expect Evoenergy will provide actual capex for 2017–18 and the 2018–19 capex estimates may be revised based on more up to date information in its revised proposal. We will update these values in the final decision accordingly.

7.4.2 Standard and remaining tax asset lives

We accept the majority of Evoenergy's proposed standard tax asset lives for its asset classes because they are:

- broadly consistent with the values prescribed by the Commissioner for taxation in tax ruling 2018/4[15]
- the same as the approved standard tax asset lives over the 2014–19 regulatory control period.

The only exception is the existing 'Opening distribution assets' asset class for which we have assigned a value of 'n/a' to reflect the fact that it will no longer have any allocated capex going forward. This asset class is therefore not required to have an assigned standard tax asset life.

We accept Evoenergy's proposed weighted average method to calculate the remaining tax asset lives as at 1 July 2019. The proposed method applies the approach as set out in our RFM. In accepting the weighted average method, we have updated Evoenergy's remaining tax asset life for the 'Equity raising costs' asset class. This value has been amended to reflect the updated 2014–15 equity raising costs input arising from the remittal decision for the 2014–19 regulatory control period.[16] We note we will update the remaining tax asset lives for the final decision for any changes to any estimated capex values in the RFM because they are used as inputs for calculating the remaining tax asset lives.[17]

Table 7.7 and Table 7.8 set out our draft decision on the standard and remaining tax asset lives for Evoenergy for its distribution and transmission networks respectively. We are satisfied the standard and remaining tax asset lives are appropriate for application over the 2019–24 regulatory control period. We are also satisfied the standard and remaining tax asset lives provide an appropriate 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 distributor as required by the NER.[18]

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15 ATO, *TR 2018/4—Income tax: effective life of depreciating assets (applicable from 1 July 2018)*, July 2018.

16 AER, *Draft Decision Evoenergy 2014–19 electricity distribution determination*, September 2018.

17 At the time of this draft decision, the roll forward of Evoenergy's TAB includes estimated capex values for 2017–18 and 2018–19. We will update the 2017–18 estimated capex values with the actual values for the final decision, and may further update the estimate of 2018–19 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 Evoenergy's remaining tax asset lives as at 1 July 2019 using the method approved in this draft decision.

18 NER, cl. 6.5.3.

Table 7.7 AER's draft decision on Evoenergy's standard and remaining tax asset lives – distribution (years)

Asset class	Standard tax asset life	Remaining tax asset lives as at 1 July 2019
Opening distribution assets	n/a	13.6
Zone substation	40.0	36.3
Distribution substations	40.0	35.5
Distribution overhead lines	45.0	40.6
Distribution underground lines	50.0	45.6
IT & communication systems (Networks)	10.0	7.2
Motor vehicles	8.0	5.3
Other non-system assets (Networks)	5.8	4.4
IT systems (Corporate)	4.1	3.3
Telecommunications (Corporate)	6.7	0.0
Other non-system assets (Corporate)	5.7	3.2
Land	n/a	n/a
Buildings	100.0	94.9
Equity raising costs	5.0	29.2

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 or no longer have any allocated capex going forward.

Table 7.8 AER's draft decision on Evoenergy's standard and remaining tax asset lives – transmission (years)

Asset class	Standard tax asset life	Remaining tax asset lives as at 1 July 2019
Opening distribution assets	n/a	13.6
Sub-transmission overhead	47.5	42.5
Sub-transmission underground	47.5	46.5
Zone substation	40.0	34.6
IT & communication systems (Networks)	10.0	7.4
Motor vehicles	8.0	5.5
Other non-system assets (Networks)	5.8	4.4
IT systems (Corporate)	4.1	3.3

Asset class	Standard tax asset life	Remaining tax asset lives as at 1 July 2019
Telecommunications (Corporate)	6.7	5.0
Other non-system assets (Corporate)	5.7	3.2
Land	n/a	n/a
Buildings	100.0	95.6
Equity raising costs	5.0	27.9

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 or no longer have any allocated capex going forward.

7.4.3 Tax treatment of other revenue adjustments

We do not accept Evoenergy's proposed tax treatment of the revenue adjustments arising from the operation of the CESS over the 2014–19 regulatory control period. The approach is inconsistent with the incentives developed for the scheme.

Evoenergy's proposed PTRMs had the switch for tax expense to 'no' in relation to this revenue adjustment, while it had the switch for revenues to 'yes' which means they are recognised as income for the tax calculation. Evoenergy did not explain this approach in its regulatory proposal. This approach adds an additional tax penalty or reward to the revenues associated with the scheme. In contrast, if the revenue adjustments are recognised in the PTRM as both income and expenses for tax purposes, no additional tax penalty or reward is calculated.[19] An equivalent outcome occurs in the PTRM if the revenue adjustment is completely excluded from the tax calculation, counted as neither tax income nor tax expense.[20] In both cases, the amount of the revenue adjustments reflect the parameters of the scheme only.

We consider that the CESS revenue adjustment should be given identical income and expense tax status in the PTRM.[21] We also note that Evoenergy clarified in response to an information request that its tax treatment of CESS was unintentional and it had not changed the tax treatment inputs from the AER PTRM template.[22]

19 This can be done in the PTRM by setting both the tax income and tax expense switches to 'yes'.

20 This can be done in the PTRM by setting both the tax income and tax expense switches to 'no'.

21 Whether the switches for tax income and tax expenses are set 'yes, yes' or 'no, no' for these revenue adjustments brings the same tax outcome.

22 Evoenergy, *Response to IR13*, 10 April 2018.