



DRAFT DECISION

Power and Water Corporation Distribution Determination 2019 to 2024

Attachment 7 Corporate income tax

September 2018

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Note

This overview forms part of the AER's draft decision on the distribution determination that will apply to Power and Water Corporation 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 attachments:

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 14 – Pass through events

Attachment 15 – Alternative control services

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Shortened forms

Shortened form	Extended form
ACS	alternative control services
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
augex	augmentation expenditure
capex	capital expenditure
CCP	Consumer Challenge Panel
CCP 13	Consumer Challenge Panel, sub-panel 13
CESS	capital expenditure sharing scheme
CPI	consumer price index
DRP	debt risk premium
DMIAM	demand management innovation allowance (mechanism)
DMIS	demand management incentive scheme
distributor	distribution network service provider
DUoS	distribution use of system
EBSS	efficiency benefit sharing scheme
ERP	equity risk premium
Expenditure Assessment Guideline	Expenditure Forecast Assessment Guideline for Electricity Distribution
F&A	framework and approach
MRP	market risk premium
NEL	national electricity law
NEM	national electricity market
NEO	national electricity objective
NT NER or the rules	National Electricity Rules As in force in the Northern Territory

Shortened form	Extended form
NSP	network service provider
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
RPP	revenue and pricing principles
SAIDI	system average interruption duration index
SAIFI	system average interruption frequency index
SCS	standard control services
SLCAPM	Sharpe-Lintner capital asset pricing model
STPIS	service target performance incentive scheme
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 Power and Water's 2019–24 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 enables Power and Water 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 Power and Water'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 do not accept Power and Water's proposed cost of corporate income tax allowance of \$37.4 million (\$nominal). Our draft decision on the estimated cost of corporate income tax is \$20.1 million over the 2019–24 regulatory control period. This represents a reduction of \$17.3 million (or 46.2 per cent) from Power and Water's proposal.

The majority of this reduction is due to our amendments to Power and Water's proposed return on capital (attachments 2 and 3) and the regulatory depreciation (attachment 4) building blocks. These building blocks affect total revenues, which in turn impacts the tax calculation.² Our decision to increase the value of imputation credits (gamma) to 0.50 from Power and Water's proposed 0.40 also results in a material contribution to this reduction (section 2.2 of the overview).

We amended other proposed inputs for forecasting the cost of corporate income tax which further reduced the estimated tax allowance. Discussed in this attachment, these inputs are:

- the opening TAB as at 1 July 2019 (section 7.4.1)
- standard tax asset lives (section 7.4.2)
- remaining tax asset lives as at 1 July 2019 (section 7.4.2).

Table 7.1 sets out our draft decision on the estimated cost of corporate income tax allowance for Power and Water over the 2019–24 regulatory control period.

¹ NT NER, cl. 6.4.3(a)(4).

² The changes affecting revenues are discussed in attachment 1.

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

	2019–20	2020–21	2021–22	2022–23	2023–24	Total
Tax payable	7.7	8.0	8.2	8.1	8.3	40.3
Less: value of imputation credits	3.9	4.0	4.1	4.1	4.1	20.1
Net corporate income tax allowance	3.9	4.0	4.1	4.1	4.1	20.1

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 Power and Water'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 Power and Water'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. Power and Water is due to submit its revised 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 Power and Water 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 Power and Water and other stakeholders have sufficient opportunity to comment on the changes to the regulatory models before the final decision is made.

7.2 Power and Water's proposal

Power and Water proposed a forecast cost of corporate income tax of \$37.4 million (\$ nominal).⁴ It stated that this allowance was calculated using an approach consistent with the NT NER and the AER's PTRM. Power and Water assumed zero accumulated

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

⁴ Power and Water, *PWC12.1 - SCS Post-tax Revenue Model - 16 Mar 18 - Public*, March 2018.

tax losses as at the start of the 2019–24 regulatory control period.⁵ It proposed an expected statutory income tax rate of 30 per cent per year and a value for gamma of 0.40.

As part of its transition to the NT NER and the AER’s PTRM which operates under a post-tax framework, Power and Water established an opening TAB value for the first time for regulatory purposes. This is because the determination for the 2014–19 regulatory control period was set by the Utilities Commission using a pre-tax framework. Power and Water proposed to establish an opening TAB of \$445.6 million as at 1 July 2014. It then estimated an opening TAB of \$690.2 million⁶ (\$nominal) as at 1 July 2019 by rolling forward the 1 July 2014 opening TAB to 1 July 2019 by means of the AER’s RFM, using:⁷

- the same gross capex, capital contributions and asset disposal values, and asset classes consistent with those used for its RAB roll forward purposes
- published ATO asset lives to determine the standard and remaining tax lives to calculate its proposed opening TAB as at 1 July 2019.

Table 7.2 sets out Power and Water’s proposed roll forward of its TAB values over the 2014–19 regulatory control period.

Table 7.2 Power and Water’s proposed TAB roll forward (\$million, nominal)

	2014–15	2015–16	2016–17	2017–18 ^a	2018–19 ^a
Opening TAB	445.6	517.5	576.6	613.7	641.9
Capital expenditure ^b	88.0	78.3	58.9	52.3	75.3
Less: tax depreciation	16.1	19.2	21.8	24.1	26.9
Closing TAB	517.5	576.6	613.7	641.9	690.2
Closing TAB as at 30 June 2019 (SCS and ACS)					690.2
Closing TAB as at 30 June 2019 (ACS only)					16.7
Closing TAB as at 30 June 2019 (SCS only)					673.5

Source: Power and Water, *PWC12.11 - SCS and ACS Metering RFM - 16 Mar 18 - Public*, March 2018.

(a) Based on estimated capex.

(b) Net of disposals.

Table 7.3 sets out Power and Water’s proposed corporate income tax allowance for the 2019–24 regulatory control period.

⁵ Power and Water, *Regulatory Proposal*, 16 March 2018, pp. 111 and 112.

⁶ Power and Water, *PWC12.11 - SCS and ACS Metering RFM - 16 Mar 18 - Public*, March 2018. Reflecting both standard control and alternative control assets.

⁷ Power and Water, *Establishment of the opening TAB document*, PWC1.12, 31 January 2018.

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

	2019–20	2020–21	2021–22	2022–23	2023–24	Total
Tax payable	13.7	13.2	12.3	11.4	11.8	62.4
Less: value of imputation credits	5.5	5.3	4.9	4.6	4.7	25.0
Net corporate income tax allowance	8.2	7.9	7.4	6.9	7.1	37.4

Source: Power and Water, *PWC12.1 - SCS Post-tax Revenue Model - 16 Mar 18 - Public*, March 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 Power and Water's 2019–24 regulatory control period.⁸ Our estimate is the taxable income a benchmark efficient entity would earn for providing standard control services if it operated Power and Water's energy 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:⁹

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 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.

⁸ NT NER, cl. 6.5.3.

⁹ 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).

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:** Our assessment approach for this input is discussed below.
- **The remaining tax asset life for each asset class at the commencement of the 2019–24 regulatory control period:** Our standard method in the RFM 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 to calculate the remaining tax lives at the end of the period.
- **The standard tax asset life for each asset class:** We assess Power and Water's proposed standard tax asset lives against the effective life of depreciating assets determined by the Commissioner for Taxation.¹⁰
- **The income tax rate:** The statutory income tax rate is 30 per cent per year.
- **The value of gamma:** The gamma input for Power and Water 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 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.

Establishing the tax asset base as at 1 July 2019

In the determination for the 2014–19 regulatory control period, Power and Water was regulated under a pre-tax framework by the Utilities Commission. Under this framework, the allowance for tax is embedded in the rate of return requirement. Therefore, the Utilities Commission did not determine a separate tax building block for that period. The NT NER operating for Power and Water's 2019–24 regulatory control period establishes that the post-tax framework is to apply. This means a transition from a pre-tax to a post-tax framework is required for the 2019–24 distribution determination.

One of the key steps of this transition is to establish an opening TAB at the commencement of the 2019–24 regulatory control period which is required to estimate the forecast tax depreciation. The value of the opening TAB has an explicit impact on

¹⁰ ATO, *Taxation Ruling TR2018/4– Income tax: effective life of depreciating assets (applicable from 1 July 2018)*.

the estimated cost of corporate income tax because the associated tax depreciation influences the amount of taxable income. We consider that the establishment of the opening TAB value should reflect Power and Water's tax asset value as assessed by the ATO for its annual tax returns. If the TAB value is set too high compared to the ATO assessed values, a shortfall in the allowance for tax may occur. Similarly, if the TAB is set too low, the allowance for tax may be higher than appropriate.

Consistent with our previous decisions for establishing the TAB value for the first time, our assessment for Power and Water involves a review of the following key elements associated with the proposed opening TAB as at 1 July 2019:

- The opening TAB as at 1 July 2014 (PWC's proposed starting point to establish the opening TAB as at 1 July 2019)
- The standard and remaining tax asset live as at 1 July 2014 for calculating the tax depreciation during the 2014–19 regulatory control period
- Gross capex, asset disposals, capital contribution values incurred during the 2014–19 regulatory control period
- Treatment of work-in-progress capex
- Assumptions used to split assets between different service classifications.

We have engaged McGrathNicol to assist us with reviewing the detailed information behind Power and Water's proposed TAB and to advise us whether it has been appropriately determined for estimating the cost of corporate income tax. We have taken into account McGrathNicol's views when assessing Power and Water's proposal.

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.¹¹ Depending on the source of the revenue increase, the tax increase may be equal to or less than proportional to the company tax rate.¹²

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.
- 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 Power and Water, 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.

7.4 Reasons for draft decision

We do not accept Power and Water's proposed cost of corporate income tax allowance of \$37.4 million (\$nominal). We have instead determined a cost of corporate income tax allowance of \$20.1 million. This represents a reduction of \$17.3 million (or 46.2 per cent) from Power and Water's proposal.

This reduction is due to the fact that we have reduced Power and Water's proposed revenue requirements for the 2019–24 regulatory control period. Our adjustments to the return on capital (attachments 2, 3 and 5) and the return of capital (attachment 2, 4 and 5) building blocks affect total revenues, and therefore also impact the forecast

¹¹ 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.

¹² 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.

corporate income tax allowance.¹³ Our decision to increase the value of imputation credits (gamma) to 0.50 from the proposed value of 0.40 also contributed to this reduction (section 2.2 of the overview).

Discussed in this section, we also amended the following proposed inputs to the PTRM for tax purposes:

- the opening TAB as at 1 July 2019 (section 7.4.1)
- the standard tax asset live for one asset class (section 7.4.2)
- remaining tax asset lives as at 1 July 2019 (section 7.4.2).

The net impact of these input changes is a further reduction to the estimated tax allowance by about \$2.3 million (\$nominal) over the 2019–24 regulatory control period.

7.4.1 Opening tax asset base as at 1 July 2019

We accept Power and Water's proposed method to establish the opening TAB as at 1 July 2019. To establish its opening TAB, Power and Water used our RFM to roll forward its proposed opening TAB as at 1 July 2014 to 1 July 2019, with the following inputs:¹⁴

- The opening TAB value as at 1 July 2014 extracted from its tax asset register used for its annual tax return with the ATO.
- The same gross capex, capital contributions and asset disposal values, and asset classes consistent with those used for its RAB roll forward purposes.
- The standard and remaining tax lives as at 1 July 2014 which has been determined based on the asset lives published by the ATO.

While we consider the proposed approach to be appropriate, we have made changes to some of the proposed input values, including the opening TAB as at 1 July 2014, the standard tax asset lives and remaining tax asset lives as at 1 July 2014. Based on the proposed approach and our amended input values, we have determined the opening TAB value¹⁵ as at 1 July 2019 to be \$972.5 million (\$nominal). This is \$299.0 million or 44.4 per cent (\$ nominal) higher than Power and Water's proposal of \$673.5 million (\$nominal). This higher opening TAB results in a reduction to the proposed estimated tax allowance.¹⁶

Opening tax asset base as at 1 July 2014

¹³ The changes affecting revenues are discussed in attachment 1.

¹⁴ Power and Water, *Establishment of the opening TAB document*, PWC1.12, 31 January 2018.

¹⁵ This opening TAB value is for Power and Water's assets providing standard control services (SCS). We have determined an opening TAB amount of \$15.3 million as at 1 July 2019 for Power and Water's alternative control service (ACS) assets.

¹⁶ This is because a higher tax depreciation amount is calculated with this higher opening TAB value. This results in a lower estimated taxable income, and in turn a lower estimated tax allowance.

We accept Power and Water's proposal to use the opening TAB value at 1 July 2014 as the starting point to establish its opening TAB value at 1 July 2019. Power and Water (as currently structured) was first subject to regulation by the Utilities Commission in 2014. To establish the RAB, the Utilities Commission undertook a full valuation of Power and Water's regulatory asset base at the 2014 determination. Therefore, our view is that the asset data as at 1 July 2014 provides a reasonable starting point for the purposes of establishing the TAB. Further, Power and Water submitted that it has limited source data available prior to 1 July 2014 under its previous structure. Therefore, we consider 1 July 2014 is an appropriate starting point to establish the TAB. This view is supported by our consultant, McGrathNicol.¹⁷

For this draft decision, we accept Power and Water's alternative proposed opening TAB value of \$769.2 million (\$nominal) as at 1 July 2014 which it submitted on 18 July 2018. This is \$323.7 million (or 72.6 per cent) higher than the \$445.6 million (\$nominal) contained in Power and Water's initial proposal submitted on 16 March 2018. This alternative proposed opening TAB value is higher due to the following reasons:

- Power and Water added \$96.2 million (\$nominal)¹⁸ to the initial proposed opening TAB value as at 1 July 2014 to reflect its rebuilt tax asset register used for its annual tax return purposes.
- Power and Water added \$227.5 million (\$nominal)¹⁹ to the initial proposed opening TAB as at 1 July 2014 to account for the value of work in progress capex incurred prior to 1 July 2014.

In establishing the opening TAB value as at 1 July 2014, Power and Water has used the detailed asset value data extracted from its tax asset register used for the purposes of its annual tax return lodged with the ATO. We requested Power and Water to confirm whether its proposed opening TAB value was consistent with the annual tax return as lodged and assessed by the ATO. In its response to our information request, Power and Water noted that it had re-lodged its 2014–15 and 2015–16 tax returns with the ATO on 22 August 2017. This re-lodgement was made following a complete re-build of its tax asset register.²⁰ However, its initial proposed opening TAB value reflected the tax asset value before the re-build of the tax asset register.

Power and Water has subsequently developed an alternative opening TAB value as at 1 July 2014 to reflect the rebuilt tax asset register. The alternative opening value is \$96.2 million (\$nominal) higher than the initial value due to the higher tax asset lives applied in the rebuilt tax asset register. We note that, at the time of this draft decision, the ATO has not completed its assessment of the re-lodged tax returns for 2014–15 and 2015–16 for Power and Water. However, Power and Water has indicated to us

¹⁷ McGrathNicol, *NT Power and Water Corporation proposed tax asset base*, 9 August 2018, p. 7.

¹⁸ Power and Water, *Response to information request #029 – follow up questions to IR023 about revised tax asset base*, 18 July 2018.

¹⁹ Power and Water, *Response to information request #029 – follow up questions to IR023 about revised tax asset base*, 18 July 2018.

²⁰ Power and Water, *Response to information request #13 – Tax asset base*, 10 May 2018.

that it expects the assessment to be finalised by the ATO soon.²¹ We expect Power and Water to provide an update on the outcome of the ATO's assessment in its revised proposal. We have therefore adopted the alternative opening TAB value to reflect the rebuilt tax asset register used for Power and Water's annual tax returns for the purposes of this draft decision. McGrathNicol also had no concerns with using the rebuilt tax asset register for establishing the opening TAB value as at 1 July 2014.²²

Power and Water's initial proposed opening TAB value reflected the amount of as-commissioned assets as at 1 July 2014 and did not include any work-in-progress capex.²³ However, Power and Water has used the RFM in rolling forward the TAB value which applies the as-incurred approach in terms of asset values. Therefore, to properly transition to the as-incurred approach for the TAB roll forward, the proposed as-commissioned opening TAB value should include the amount of work-in-progress capex incurred as at 1 July 2014. We raised this issue as part of our discussion with Power and Water regarding the development of an alternative opening TAB value to reflect its rebuilt tax asset register. Power and Water agreed to also include the amount of work-in-progress capex incurred at 1 July 2014 as part of the alternative opening TAB value.²⁴

We note the amount of work-in-progress capex at 1 July 2014 of \$227.5 million (\$nominal) included in Power and Water's alternative proposed opening TAB value as at 1 July 2014 is relatively high. Power and Water explained that there was a significant backlog of capital projects that had finished, but not yet capitalised. This is partly due to issues following its move from the old asset management system to its current system in late 2012. It stated that this backlog has been caught up by the end of 1 July 2018. We consider this explanation to be reasonable, and therefore have adopted the full amount of the work-in-progress capex to the alternative opening TAB as at 1 July 2014. McGrathNicol considered the inclusion of the work in progress capex properly reflects the transition to the as-incurred approach as set out in the AER's RFM and PTRM.²⁵

Standard and remaining tax asset lives as at 1 July 2014

We accept Power and Water's proposed weighted average approach for determining its remaining tax asset lives at 1 July 2014 for the purposes of establishing the opening TAB as at 1 July 2019. We also accept Power and Water's proposal to apply the weighted average approach to calculate the standard tax asset lives.²⁶ It has

²¹ Power and Water, *Response to information request #23 – follow up request to IR#13 re tax asset base re-estimation* – 19 June 2018, 27 June 2018.

²² McGrathNicol, *NT Power and Water Corporation proposed tax asset base*, 9 August 2018, p. 7.

²³ Power and Water, *Response to information request #13 – Tax asset base*, 10 May 2018; Power and Water's tax asset register only include as-commissioned asset values. Work in progress capex are capex incurred but not yet capitalised to the tax asset register as at that date.

²⁴ AER, *Information request #023 – follow up questions to IR013 re tax asset base re-estimation*, 27 June 2018.

²⁵ McGrathNicol, *NT Power and Water Corporation proposed tax asset base*, August 2018, p. 14.

²⁶ Power and Water, *Response to information request #023 – follow up questions to IR013 re tax asset base re-estimation*, 27 June 2018.

calculated the tax asset lives as at 1 July 2014 by taking the weighted average of the individual asset lives in its fixed asset register, and using the tax asset value as at 1 July 2014 for each asset as the weights.

We consider that the detailed asset lives that Power and Water used to calculate the weighted average tax asset lives broadly reflect the ATO's standard tax lives. McGrathNicol noted that Power and Water has sourced the asset lives from the ATO's standard lives where possible. It further noted that the ATO's categories for standard tax lives can contain a broad range of assets. Power and Water used its judgement and specialist consultant knowledge to determine which of the ATO asset descriptions and lives were appropriate. Power and Water assigned alternative asset lives to some of the assets where it considered the alternative lives were more accurate than the ATO lives.²⁷ Power and Water's consultant, Hayne & Co Chartered Accountants, also confirmed that the assigned asset lives were sourced from the ATO as reasonably as possible.²⁸ We accept the approach, and the detailed asset lives used to calculate the weighted average standard and remaining tax asset lives as at 1 July 2014. However, we have updated these values to reflect the revised opening TAB value as at 1 July 2014.²⁹

Actual capex, asset disposals and capital contributions

We accept the actual capex, asset disposal and capital contribution values for 2014–15 to 2016–17 for rolling forward the TAB over the 2014–19 regulatory control period.³⁰ These values are consistent with those used for the purposes of rolling forward the RAB and are consistent with values in the category analysis RIN.³¹ We note that at the time of this draft decision, the roll forward of Power and Water's TAB includes estimated values for 2017–18 and 2018–19. We will update the 2017–18 estimated values with actuals in the final decision. Power and Water may provide updates to the 2018–19 estimated values in its revised proposal, which we may adopt for the final decision.

Roll-in of corporate assets to the TAB

As discussed in attachment 2, we accept Power and Water's proposal to roll-in \$19.6 million (\$nominal) to its RAB and at 1 July 2019 for the capitalisation of expenditure related to the use of corporate assets. Therefore, we consider it is also appropriate to

²⁷ McGrathNicol, *NT Power and Water Corporation proposed tax asset base*, August 2018, p. 8.

²⁸ Power and Water, *PWC01.13 – Hayne & Co Pty Limited Chartered Accountants letter to Power and Water re: Electricity distribution and transmission assets regulatory asset lives dated 20 December 2017*, 31 Jan 2018.

²⁹ Power and Water, *Response to information request #029 – follow up questions to IR023 about revised tax asset base*, 18 July 2018.

³⁰ In this draft decision, we have adopted Power and Water's proposal to include capital contributions incurred in the 2014–19 regulatory control period in its opening TAB as at 1 July 2019. However, we note that in the past we have accepted a service provider's proposal to only include capital contributions in the TAB after the transition into the post-tax framework.

³¹ Power and Water, *PWC11.5CP - Category Analysis RIN Workbooks - Consolidated - 16 Mar 18 - PUBLIC*, March 2018.

roll-in the same amount to the TAB. However, for the reasons discussed in attachment 2, we have changed the modelling approach in the RFM. This results in the amount of corporate assets being added as a final year adjustment instead of being treated as estimated capex for 2018–19 as proposed by Power and Water. The proposed corporate assets are associated with the 'Property', 'Land and easements', 'IT and communications' and 'Plant and equipment' asset classes. For tax depreciation purposes, we need to determine the appropriate remaining tax asset lives as at 1 July 2019 for the corporate assets allocated to each of these asset classes. We have applied a remaining tax asset life of 18.3, 7.4 and 5.0 years for the 'Property', 'IT and communications' and 'Plant and equipment' asset classes respectively. We have calculated these remaining tax asset lives using a weighted average approach and the detailed asset lives data provided in Power and Water's proposed corporate assets model. We have not assigned a remaining tax asset life to the 'Land and easements' asset class as land and easements are non-depreciable assets.

Table 7.4 sets out our draft decision on the roll forward of Power and Water's TAB values over the 2014–19 regulatory control period.

Table 7.4 AER's draft decision on Power and Water's TAB roll forward (\$million, nominal)

	2014–15	2015–16	2016–17	2017–18 ^a	2018–19 ^a
Opening TAB	769.2	834.8	888.2	920.1	943.4
Capital expenditure ^b	88.0	78.3	58.9	52.3	55.7
Less: tax depreciation	22.5	24.8	27.0	29.0	31.0
Interim closing TAB	834.8	888.2	920.1	943.4	968.2
Roll-in of corporate assets					19.6
Closing TAB as at 30 June 2019 (ACS and SCS)					987.7
Closing TAB as at 30 June 2019 (ACS only)					15.3
Closing TAB as at 30 June 2019 (SCS only)					972.5

Source: AER analysis.

(a) Based on estimated capex.

(b) Net of disposals.

7.4.2 Standard and the remaining tax asset lives as at 1 July 2019

We consider the weighted average standard tax asset lives determined in section 7.4.1 above are also appropriate for the purposes of calculating the tax depreciation of forecast capex over the 2019–24 regulatory control period for the majority of Power and Water's asset classes. This is because the underlying asset lives used to calculate the weighted average standard tax asset lives broadly reflect the ATO's effective life for depreciating assets.

However, we have changed the proposed standard tax asset life for the 'Property' asset class to 40 years from 16 years.³² The assets proposed for allocation to this asset class during the 2019–24 regulatory control period include buildings, road upgrades, sewerage systems, electrical, communications, security systems, fencing and other property related assets.³³ While some of these assets such as security systems, electrical and communications assets have an ATO effective life of 5 to 10 years, other assets such as buildings and sewerage systems have much longer effective lives than the proposed 16 years (40 to 80 years). On balance, we consider that a standard tax asset life of 40 years for this asset class reflects the ATO's effective lives as per tax ruling 2018/04 for these asset types. Therefore, we are satisfied that this standard tax asset life provides a better estimate of the tax depreciation amount for a benchmark efficient distributor.³⁴

Further, we accept the proposed standard tax asset life of 15.8 years and 5.7 years for the new 'Property leases' and 'Fleet leases' asset classes, respectively. These new asset classes are for the purposes of depreciating the capitalised property and fleet leases.³⁵ Power and Water has set the standard tax asset lives to be the same as the proposed standard asset lives for regulatory depreciation purposes for these asset classes. We consider this approach to be reasonable. It appears that the ATO has not provided a specific ruling on the effective life for capitalised leases. Given this, we consider it appropriate to use the economic life of the capitalised leases as the standard tax asset life, which is consistent with the ATO's guidance on determining the effective life of an asset.³⁶ As discussed in attachment 5, we have approved the proposed standard asset lives for these asset classes. This is because they reflect the expected economic lives of leases to be capitalised in the 'Property leases' and 'Fleet leases' asset classes over the 2019–24 regulatory control period. Therefore, in accepting the proposed standard tax asset lives for these asset classes, we consider they provide a reasonable estimate of the tax depreciation amount for a benchmark efficient distributor.³⁷

We accept Power and Water's proposed approach to use the RFM to determine the remaining tax asset lives as at 1 July 2019. However, we have updated the remaining tax asset lives to reflect the updated inputs in the RFM on the opening TAB values and remaining tax asset lives as at 1 July 2014 discussed in section 7.4.1 above.

³² This reflects the revised weighted average standard tax asset life provided on 18 July for this asset class; Power and Water, *Response to information request #029 – follow up questions to IR023 about revised tax asset base*, 18 July 2018.

³³ Power and Water, *Response to information request #021 – assessment of standard lives for asset classes*, 20 June 2018.

³⁴ NT NER, cl. 6.5.3.

³⁵ Power and Water, *Response to information request #021 – assessment of standard lives for asset classes*, 20 June 2018.

³⁶ ATO, *Taxation Ruling TR2018/4– Income tax: effective life of depreciating assets (applicable from 1 July 2018)*, p. 10; Income tax assessment ACT 1997, Section 40.105.

³⁷ NT NER, cl. 6.5.3.

Table 7.5 sets out our draft decision on the standard and remaining tax asset lives as at 1 July 2019 for Power and Water. We are satisfied the approved standard and remaining tax asset lives as at 1 July 2019 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.³⁸

Table 7.5 AER's draft decision on Power and Water's standard and remaining tax asset lives as at 1 July 2019 (years)

Asset class	Standard tax asset life	Remaining tax asset lives as at 1 July 2019
Substations	44.5	34.8
Distribution lines	57.3	39.5
Transmission lines	50.6	43.5
LV services	18.3	15.0
Distribution substations	43.9	32.1
Distribution switchgear	37.1	31.8
Protection	36.2	28.9
SCADA	12.0	8.2
Communications	22.6	17.8
Land and easements ^a	n/a	n/a
Property	40.0	17.5
IT and communications	5.7	4.9
Motor vehicles	5.0	0.9
Plant and equipment	14.0	8.5
Property leases	15.8	n/a
Fleet leases	5.7	n/a
Equity raising costs	5.0	n/a

Source: AER analysis.

(a) We have not assigned a standard tax asset life to the 'Land and easements' asset class because the assets allocated to this asset class are non-depreciating assets.

n/a not applicable.

³⁸ NT NER, cl. 6.5.3.