



DRAFT DECISION

TasNetworks Distribution Determination 2019 to 2024

Attachment 7 Corporate income tax

September 2018

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Note

This attachment forms part of the AER's draft decision on TasNetworks' 2019–24 distribution determination. 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

Attachment 13 – Control mechanism

Attachment 14 – Pass through events

Attachment 15 – Alternative control services

Attachment 16 – Negotiated services framework and criteria

Attachment 17 – Connection policy

Attachment 18 – Tariff structure statement

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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
NER	national electricity rules
NSP	network service provider

Shortened form	Extended form
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 TasNetworks' 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 allows TasNetworks 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 TasNetworks' 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), its proposed standard tax asset lives, and the year-by-year depreciation approach that it has 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 allowance of \$38.4 million (\$nominal) for TasNetworks in the 2019–24 regulatory control period. This represents a reduction of \$17.3 million (or 31.0 per cent) from TasNetworks' proposal of \$55.7 million (\$nominal).

The reduction to the tax allowance made in this decision reflects our amendments to TasNetworks' proposed value of imputation credits—gamma (section 2.2 of the overview) for forecasting the cost of corporate income tax. Our adjustments to the return on capital (attachments 2 and 3) 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.

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

Table 7.1 AER's draft decision on TasNetworks' 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	13.8	14.3	15.1	16.0	17.5	76.8
Less: value of imputation credits	6.9	7.2	7.6	8.0	8.8	38.4
Net corporate income tax allowance	6.9	7.2	7.6	8.0	8.8	38.4

Source: AER analysis.

¹ NER, cl. 6.4.3(a)(4).

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 TasNetworks' 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 TasNetworks' 2019–24 regulatory control period in April 2019.²

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. TasNetworks 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 TasNetworks 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 TasNetworks and other stakeholders have sufficient opportunity to comment on the changes to the regulatory models before the final decision is made.

7.2 TasNetworks' proposal

TasNetworks proposed a forecast cost of corporate income tax of \$55.7 million (\$nominal) using the AER's PTRM and a separate model containing a TAB depreciation schedule. TasNetworks adopted the straight-line tax depreciation approach with the following inputs for the PTRM:³

- an opening TAB as at 1 July 2019 of \$1347.5 million (\$nominal)
- depreciation of the opening TAB at 1 July 2019 for each asset class applying the year-by-year tracking approach calculated in the depreciation model
- an expected statutory income tax rate of 30 per cent per year
- a value for gamma of 0.4
- the same standard tax asset lives for tax depreciation purposes of new assets for the 2019–24 regulatory control period as approved for the 2017–19 distribution determination.

² AER, Initial Report–Review of regulatory tax approach, June 2018, pp. 4 and 5.

³ TasNetworks, *Transmission and Distribution Regulatory Proposal 2019–24*, January 2018, pp. 173–175.

Table 7.2 sets out TasNetworks' proposed corporate income tax allowance for the 2019–24 regulatory control period.

Table 7.2 TasNetworks' 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	16.8	17.4	18.4	19.5	20.7	92.8
Less: value of imputation credits	6.7	7.0	7.4	7.8	8.3	37.1
Net corporate income tax allowance	10.1	10.4	11.0	11.7	12.4	55.7

Source: TasNetworks, *Transmission and Distribution Regulatory Proposal 2019–24*, January 2018, p. 175.

7.3 AER's assessment approach

We make an estimate of taxable income for each regulatory year as part of our determination of the annual revenue requirement for TasNetworks' 2019–24 regulatory control period.⁴ Our estimate is the taxable income a benchmark efficient entity would earn for providing standard control services if it operated TasNetworks' 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:⁵

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 NER, cl. 6.5.3.

⁵ 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).

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 commencement of the 2017–19 regulatory control period and the distributor's actual capex incurred during the 2017–19 regulatory control period, and the final year (2016–17) of the previous regulatory control period.⁶
- **The standard tax asset life for each asset class:** We assess the distributor'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 2017–19 regulatory control period.
- **The income tax rate:** The statutory income tax rate is 30 per cent per year.
- **The value of gamma:** We have determined the gamma input for TasNetworks 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.

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.

⁶ 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.

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.⁷ Depending on the source of the revenue increase, the tax increase may be equal to or less than proportional to the company tax rate.⁸

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 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 TasNetworks, 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 determine an estimated cost of corporate income tax allowance of \$38.4 million for TasNetworks for the 2019–24 regulatory control period. This represents a reduction of \$17.3 million (or 31.0 per cent) from TasNetworks' proposal. This is because we adjusted the input value of imputation credits—gamma (section 2.2 of the overview) to the PTRM for tax purposes. Our adjustments to the return on capital (attachments 2, 3

⁷ 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.

⁸ 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.

and 5)⁹ 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 TasNetworks' proposed method to establish the opening TAB as at 1 July 2019 because it is based on the approach set out in our RFM. We note TasNetworks used a separate model for the TAB depreciation, based on the approach approved in the distribution determination for 2017–19, which then fed into the roll forward of the TAB in the RFM. We also accept TasNetworks' opening TAB value as at 1 July 2019 of \$1347.5 million (\$nominal) for this draft decision. We have reviewed the inputs to the TAB roll forward and found that they were correct and reconcile with relevant data sources such as annual reporting RIN and the 2017–19 decision models. We note that this opening TAB 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.¹⁰

Table 7.3 sets out our draft decision on the roll forward of TasNetworks' TAB values over the 2017–19 regulatory control period.

Table 7.3 AER's draft decision on TasNetworks' TAB roll forward for the 2017–19 regulatory control period (\$million, nominal)

	2017–18 ^a	2018–19 ^a
Opening TAB	1225.3	1294.1
Capital expenditure ^b	125.7	117.4
Less: tax depreciation	56.9	63.9
Closing TAB	1294.1	1347.5

Source: AER analysis.

(a) Based on estimated capex.

(b) Net of disposals.

7.4.2 Year-by-year tracking approach

We accept TasNetworks' continuation of using the year-by-year tracking approach for tax depreciation of its existing assets. This is consistent with our draft decision to accept TasNetworks' continued use of year-by-year tracking for regulatory depreciation purposes (attachment 4). Under this approach, the capex for each year of a regulatory

⁹ 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 TasNetworks' forecast capex.

¹⁰ At the time of this draft decision, the roll forward of TasNetworks' TAB includes estimated capex values for 2017–18 and 2018–19. We expect TasNetworks 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.

control period is depreciated individually for tax purposes. It will result in each tax asset class having an expanding list of sub-assets to reflect the regulatory year in which capital expenditures on those assets occurred. This extra data helps track remaining tax asset values and associated tax depreciation, and is therefore consistent with the NER.

We are satisfied the continued application of the year-by-year tracking method to calculate TasNetworks' tax depreciation of existing assets provides an estimate of the tax depreciation amount for a benchmark efficient distributor as required by the NER.¹¹

7.4.3 Standard tax asset lives

We accept TasNetworks' proposed standard tax asset lives because they are:

- broadly consistent with the values prescribed by the Commissioner for taxation in tax ruling 2018/4.¹²
- the same as the approved standard tax asset lives over the 2017–19 regulatory control period.

Table 7.4 sets out our draft decision on the standard tax asset lives for TasNetworks. We are satisfied that the standard tax asset lives are appropriate for application over the 2019–24 regulatory control period. We are also satisfied the standard tax asset lives provide an appropriate estimate of the tax depreciation for a benchmark efficient distributor as required by the NER.¹³

Table 7.4 AER's draft decision on TasNetworks' standard tax asset lives (years)

Asset class	Standard tax asset life
Overhead subtransmission Lines (urban)	44.5
Underground subtransmission Lines (urban)	50.0
Urban zone substations	32.8
Rural zone substations	32.8
SCADA	32.8
Distribution switching stations (ground)	36.3
Overhead high voltage lines urban	34.9
Overhead high voltage lines rural	33.4

¹¹ NER, cl. 6.5.3.

¹² ATO, *Taxation Ruling Income tax: effective life of depreciating assets (applicable from 1 July 2018)*, July 2018, <http://law.ato.gov.au/atolaw/view.htm?docid=%22TXR%2FTR20184%2FNAT%2FATO%2F00001%22>, accessed on 25 July 2018.

¹³ NER, cl. 6.5.3.

Voltage regulators on distribution feeders	45.5
Underground high Voltage lines	31.4
Underground high voltage lines SWER	31.4
Distribution substations HV (pole)	37.6
Distribution substations HV (ground)	33.2
Distribution substations LV (pole)	36.6
Distribution substations LV (ground)	34.1
Overhead low voltage lines underbuilt urban	37.4
Overhead low voltage lines underbuilt rural	38.7
Overhead low voltage lines urban	35.3
Overhead low voltage lines rural	36.7
Underground low voltage lines	42.5
Underground low voltage common trench	43.1
HVST service connections	36.4
HV service connections	36.4
HV metering CA service connections	36.4
HV/LV service connections	36.4
Business LV service connections	36.3
Business LV metering CA service connections	36.4
Domestic LV service connections	36.4
Domestic LV metering CA service connections	36.4
Emergency network spares	n/a
Motor vehicles	9.2
Minor assets	5.2
Non-system property	34.5
Spare parts	n/a
NEM assets	3.0
Business management systems	5.0
Land	n/a
Easements	n/a
Equity raising costs	5.0

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.