



DRAFT DECISION

TasNetworks Transmission Determination 2019 to 2024

Attachment 7 Corporate income tax

September 2018

© Commonwealth of Australia 2018

This work is copyright. In addition to any use permitted under the Copyright Act 1968, all material contained within this work is provided under a Creative Commons Attributions 3.0 Australia licence, with the exception of:

- the Commonwealth Coat of Arms
- the ACCC and AER logos
- any illustration, diagram, photograph or graphic over which the Australian Competition and Consumer Commission does not hold copyright, but which may be part of or contained within this publication. The details of the relevant licence conditions are available on the Creative Commons website, as is the full legal code for the CC BY 3.0 AU licence.

Requests and inquiries concerning reproduction and rights should be addressed to the:

Director, Corporate Communications
Australian Competition and Consumer Commission
GPO Box 3131, Canberra ACT 2601

or publishing.unit@acc.gov.au.

Inquiries about this publication should be addressed to:

Australian Energy Regulator
GPO Box 520
Melbourne Vic 3001

Tel: 1300 585 165

Email: AERInquiry@aer.gov.au

Note

This attachment forms part of the AER's draft decision on TasNetworks' 2019–24 transmission determination. It should be read with all other parts of the draft decision.

The draft decision includes the following attachments:

Overview

Attachment 1 – Maximum allowed revenue

Attachment 2 – Regulatory asset base

Attachment 3 – Rate of return

Attachment 4 – Regulatory depreciation

Attachment 5 – Capital expenditure a

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 – Pricing methodology

Attachment 12 – Pass through events

Contents

Note	7-2
Contents	7-3
Shortened forms	7-4
7 Corporate income tax	7-6
7.1 Draft decision	7-6
7.2 TasNetworks' proposal	7-7
7.3 Assessment approach	7-8
7.3.1 Interrelationships.....	7-9
7.4 Reasons for draft decision	7-11
7.4.1 Opening tax asset base as at 1 July 2019	7-11
7.4.2 Year-by-year tracking approach	7-12
7.4.3 Standard tax asset lives	7-13

Shortened forms

Shortened form	Extended form
AARR	aggregate annual revenue requirement
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
ASRR	annual service revenue requirement
augex	augmentation expenditure
capex	capital expenditure
CCP	Consumer Challenge Panel
CCP13	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
EBSS	efficiency benefit sharing scheme
ERP	equity risk premium
F&A	framework and approach
MAR	maximum allowed revenue
MRP	market risk premium
NEL	national electricity law
NEM	national electricity market
NEO	national electricity objective
NER	national electricity rules
NSP	network service provider
opex	operating expenditure
PTRM	post-tax revenue model

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

7 Corporate income tax

Our revenue determination 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 tracking depreciation approach that it has used to estimate tax depreciation for the purpose of calculating tax expenses.

7.1 Draft decision

Our draft decision on the estimated cost of corporate income tax is \$10.9 million over the 2019–24 regulatory control period. TasNetworks proposed a cost of corporate income tax allowance of \$20.1 million (\$nominal). This decision represents a reduction of \$9.2 million (or 45.7 per cent) from TasNetworks' proposal.

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

- the opening TAB as at 1 July 2019 (section 7.4.1)
- the value of imputation credits—gamma (section 2.2 of the overview).

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	2.9	3.7	4.1	5.0	6.0	21.8
Less: value of imputation credits	1.5	1.8	2.1	2.5	3.0	10.9

¹ NER, cl. 6A.5.4(a)(4).

Net corporate income tax allowance	1.5	1.8	2.1	2.5	3.0	10.9
------------------------------------	-----	-----	-----	-----	-----	------

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 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 \$20.1 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 \$1155.0 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.

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.

- 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 transmission determination.

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	5.2	5.9	6.4	7.4	8.5	33.5
Less: value of imputation credits	2.1	2.4	2.6	3.0	3.4	13.4
Net corporate income tax allowance	3.1	3.5	3.9	4.5	5.1	20.1

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

7.3 Assessment approach

We make an estimate of taxable income for each regulatory year as part of our revenue determination 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' transmission network business. Our approach for calculating a TNSP'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 TNSP's business.⁶ A TNSP's taxable income is calculated by subtracting from the approved forecast revenues the benchmark estimates of tax expenses. Using the PTRM, we model the TNSP's benchmark tax expenses, including interest tax expense and tax depreciation, over the regulatory control period. The interest tax expense is estimated using the benchmark 60 per cent gearing 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 TNSP's forecast revenue to estimate the taxable income.
2. The statutory income tax rate is then applied to the estimated annual taxable income (after adjustment for any tax loss carried forward) to arrive at a notional amount of tax payable.

⁴ NER, cl. 6A.6.4.

⁵ The PTRM must specify the manner in which the estimated cost of corporate income tax is to be calculated: NER, cl. 6A.5.4(b)(4).

⁶ NER, cl. 6A.6.4.

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 TNSP's annual building block revenue requirement.

The cost of corporate income tax allowance is an output of our PTRM. We therefore assess the TNSP'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 2014–19 regulatory control period and TasNetworks' actual capex incurred during the that 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 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. We will assess the outcomes of other approaches against the outcomes of this preferred approach.
- **The standard tax asset life for each asset class:** We assess TasNetworks' 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 TasNetworks' transmission determination for the 2014–19 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

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.

The cost of corporate income tax building block feeds directly into the annual building block 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.⁸ Depending on the source of the revenue increase, the tax increase may be equal to or less than proportional to the company tax rate.⁹

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 TNSPs reflecting tax rules. This TAB is affected by many of the same factors as the RAB, such as capex, although unlike the RAB value it is maintained at its historical cost with no indexation. The TAB is also affected by the depreciation rate and asset lives assigned for tax depreciation purposes.

⁸ 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.

⁹ 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.

For TasNetworks, a 10 per cent increase in the corporate income tax allowance causes revenues to increase by about 0.2 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 0.5 per cent.

7.4 Reasons for draft decision

We determine an estimated cost of corporate income tax allowance of \$10.9 million for TasNetworks for the 2019–24 regulatory control period. This represents a reduction of \$9.2 million (or 45.7 per cent) from TasNetworks' proposal.

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

- the opening TAB value at 1 July 2019 (section 7.4.1)
- the value of imputation credits—gamma (section 2.2 of the overview).

Our adjustments to the return on capital (attachments 2, 3 and 5)¹⁰ 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 at 1 July 2019 as it is based on the approach set out in our RFM. However, we corrected some input errors in the proposed RFM, for the reasons as discussed in attachment 2. Based on the proposed approach and the corrected inputs, we have determined the opening TAB value as at 1 July 2019 of \$1154.7 million (\$nominal) for TasNetworks for this draft decision. This is \$0.3 million or 0.02 per cent (\$nominal) less than TasNetworks' proposed opening TAB value as at 1 July 2019 of \$1155.0 million (\$nominal). We note that this opening TAB as at 1 July 2019 will be updated to reflect the actual capex for 2018–19 and any updated capex estimates for 2019–20 as part of the final decision.¹¹

We have reviewed the inputs to the proposed TAB roll forward and found that they were largely correct and reconcile with relevant data sources such as annual regulatory accounts and the 2014–19 decision models. However, we have corrected 2013–14 asset disposals for the 'Other – short life (9)', 'Other – short life (4)' and 'Land and easements' asset classes as they did not reflect the regulatory accounts for that year. We have also corrected as de-commissioned asset disposal inputs for the asset class 'Other – short life (9)' in the three years from 2014–15 to 2016–17. TasNetworks

¹⁰ 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.

¹¹ 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.

reported as-incurred asset disposals for this asset class, however did not record an equivalent disposal in the as de-commissioned section of the RFM. We have updated as de-commissioned asset disposals to reflect the equivalent values reported by TasNetworks for as-incurred asset disposals. TasNetworks agreed with these amendments in its response to our information request on these matters.¹²

Table 7.3 sets out our draft decision on the roll forward of TasNetworks' TAB values over the 2014–19 regulatory control period.

Table 7.3 AER's draft decision on TasNetworks' TAB roll forward for the 2014–19 regulatory control period (\$million, nominal)

	2014–15	2015–16	2016–17	2017–18 ^a	2018–19 ^a
Opening TAB	1137.4	1125.6	1105.9	1088.3	1121.4
Capital expenditure ^b	31.3	24.9	27.7	77.3	79.0
Less: tax depreciation	43.2	44.6	45.4	44.1	45.6
Closing TAB	1125.6	1105.9	1088.3	1121.4	1154.7

Source: AER analysis.

(a) Based on estimated capex.

(b) As-commissioned, net of disposals.

7.4.2 Year-by-year tracking approach

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

The year-by-year tracking depreciation approach increases depreciation in the short term compared to our preferred approach. For tax depreciation, it therefore increases tax expenses and decreases the tax allowance and the overall revenue, all things being equal.

We are satisfied the application of the year-by-year tracking method to calculate TasNetworks' tax depreciation of existing assets provides an estimate of the tax

¹² TasNetworks, *Response to information request #012 – Transmission RFM, PTRM & depreciation models*, April 2018.

depreciation amount for a benchmark efficient TNSP as required by the NER.¹³ The use of year-by-year tracking means it is no longer necessary to explicitly calculate remaining tax asset lives as at 1 July 2019.¹⁴

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 2018/4.¹⁵
- the same as the approved standard tax asset lives over the 2014–19 regulatory control period.

However, we did not retain TasNetworks' proposed standard tax asset life of 10 years for the new 'Business management systems' asset class. This is because TasNetworks has not proposed any forecast capex for this asset class during the 2019–24 regulatory control period. As a result, we are not required to assess the proposed standard tax asset life for this asset class for tax depreciation purposes. TasNetworks agreed with this amendment in its response to our information request on this matter.¹⁶

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 TNSP as required by the NER.¹⁷

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

Asset class	Standard tax asset life
Transmission line assets – long life (60)	60.0
Transmission line assets – medium life (45)	45.0
Transmission line assets – short life (10)	10.0
Substation assets – long life (60)	60.0

¹³ NER, cl. 6A.6.4.

¹⁴ Remaining tax asset lives as at 1 July 2014 and standard tax asset lives are used in the year-by-year tracking method, and these are consistent with our 2014–19 transmission determination for TasNetworks.

¹⁵ 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.

¹⁶ TasNetworks, *Response to information request #012 – Transmission RFM, PTRM & depreciation models*, April 2018.

¹⁷ NER, cl. 6A.6.4.

Substation assets – medium life (45)	45.0
Substation assets – short life (15)	15.0
Protection and control – short life (15)	15.0
Protection and control - short life (4)	4.0
Transmission operations – short life (10)	10.0
Transmission operations – short life (4)	4.0
Other – medium life (40)	40.0
Other – short life (9)	9.0
Other – short life (4)	4.0
Land and Easements ^a	n/a
Communication assets – long life (45)	45.0
Communication assets – medium life (10)	10.0
Communication assets – short life (5)	5.0
Equity raising costs ^b	n/a

Source: AER analysis; TasNetworks, *Post Tax Revenue Model (PTRM) Transmission, 31 January 2018*.

n/a not applicable.

- (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.
- (b) For this draft decision, TasNetworks does not satisfy the requirements to incur benchmark equity raising costs associated with its forecast capex for the 2019–24 regulatory control period. Therefore, a standard tax asset life for equity raising costs is not required for the 2019–24 period.