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CORPORATE ADVISORY

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Final

**Assessment of the revised proposal of ETSA Utilities' tax asset base**

## 1. Introduction

I refer to the contract between the Australian Competition and Consumer Commission ("ACCC"), as represented by the Australian Energy Regulator ("AER"), and McGrathNicol Corporate Advisory ("McGrathNicol") for the provision of assistance in assessing the tax asset bases of the South Australian and Queensland electricity Distribution Network Service Providers ("DNSPs").

Specifically, this assessment relates to the methodology used to calculate ETSA Utilities' tax asset base.

## 2. Scope

McGrathNicol has been engaged to conduct a high level assessment of ETSA Utilities' tax asset base valuation methodology ("Proposed Methodology"), based on information contained in its Revised Regulatory Proposal for the 2010-2015 regulatory control period.

Specifically, we have identified any significant changes from the original regulatory proposal in the following aspects of ETSA Utilities' tax asset base:

+ the starting point for calculating the initial tax asset base as at 1 July 2010;
+ the historic depreciation and tax depreciation assumptions (including the standard tax asset lives used by the DNSPs and the remaining tax asset lives calculated by the DNSPs as at 1 July 2010);
+ the treatment of past additions and disposals;
+ the treatment of depreciation on capital contributions;
+ the assumptions used to split assets between standard control, direct control, alternative control, negotiated and unregulated services;
+ the treatment of work in progress; and
+ the size of any tax losses as at 1 July 2010 and the treatment of any such losses going forward.

Where a significant change was identified in any item above, additional commentary has been provided to explain whether the identified changes are:

+ adequately explained by the DNSP (including whether the change is consistent with the methodology proposed by the DNSP in its original proposal);
+ consistent with the National Electricity Rules and the National Tax Equivalents Regime; and
+ supported by appropriate documentation.

We have provided advice in relation to the materiality of any deficiencies identified in respect of the above and proposed recommendations to address such deficiencies.

## 3. Background

Revenue earned by DNSPs is regulated by the AER to ensure that they earn an allowable return on capital. Each reset period, DNSPs are required to submit their revenue proposal to the AER.

For this upcoming reset period, in accordance with the NER, DNSPs are required to use a post tax methodology to determine allowable revenue.

DNSPs adopt a "building block" approach to determine allowable revenue. To enable the determination of the tax building block (incorporating depreciation), DNSPs need to determine the tax asset values (as represented by the total future value depreciation allowable for tax purposes) of their regulatory assets as at the commencement of the next regulatory period.

Based on the recommendations from Ernst & Young, the AER should track the effects of tax depreciation provisions and changes on regulated assets from February 1992, as any alterations in depreciation laws mostly affect assets acquired after the relevant change, and will have minimal impact on assets acquired prior to this date.

## 4. ETSA Utilities' Approach

ETSA Utilities' Proposed Methodology, as incorporated in its Revised Regulatory Proposal 2010-2015, details the approach for calculating its tax asset base as at 1 July 2010 – the commencement of the 2010-2015 regulatory control period.

Broadly, ETSA Utilities' Proposed Methodology is based on the following assumptions:

+ a starting point of 11 October 1999 (being the date of regulation) upon which to calculate its tax asset base at 1 July 2010;
+ prime cost (straight line) depreciation;
+ historical acquisitions and disposals (pre 11 October 1999) are based on a combination of balance sheet and cash flow movements;
+ historic acquisitions and disposals (post 11 October 1999) are based on regulatory accounts;
+ the majority of ETSA Utilities' assets acquired in the period prior to 11 October 1999 are attributable to standard control services.[1] The balance is attributable to negotiated services;

[1] ETSA Utilities appears to have classified 'variable' metering costs for small customers and 'exceptional cases' of legacy Type 1-4 metering of large customer metering installations as standard control services, as opposed to alternative control services. ETSA Utilities states that it has adopted this classification of distribution metering services to better meet the requirements of the NER.

+ exclusion of shorter life asset acquisitions and disposals from the calculation of its tax asset base pre 11 October 1999;
+ WIP is included in its tax asset base as a one-off transitional item as at 1 July 2010; and
+ no carried forward tax losses.

## 5. Sources of information

In assessing ETSA Utilities' Proposed Methodology, we reviewed and considered the following information:

+ ETSA Utilities' Revised Regulatory Proposal for the 2010 to 2015 regulatory period, including all supporting attachments;
+ the AER's "Transition from pre-tax to post-tax regulation (21 June 2007)", PowerPoint presentation;
+ the AER's "Post-tax revenue model", Final decision – June 2008;
+ the AER's "Post-tax revenue model handbook" – June 2008;
+ the AER's "Roll forward model", Final decision – June 2008;
+ the AER's "Roll forward model handbook" – June 2008;
+ the AER's Framework and Approach – Preliminary position paper for South Australia;
+ the AER's Framework and approach paper – ETSA Utilities 2010-2015 – November 2008;
+ the application of Tax Depreciation Rules to Regulated Energy Entities Phase I Recommendations, prepared by Ernst & Young (30 August 2006);
+ the "Independent report for the Application of Tax Deprecation Rules to Regulated Energy Entities for the period 26 February 1992 to 1 November 2006", prepared by Ernst & Young ("EY report"); and
+ relevant sections of Australian taxation legislation and the Australian Accounting Standards.

## 6. Findings

We have set out below our findings from our review of ETSA Utilities' Proposed Methodology and supporting schedules, as set out in its Revised Regulatory Proposal 2010-2015, to identify whether there are any significant changes to the Proposed Methodology set out in the DNSP's original proposal. Our findings are presented in accordance with the scope elements identified in our Order For Services, which are detailed in the Scope section of this report.

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### 6.1 Significant changes in the Revised Regulatory Proposal of ETSA Utilities' tax asset base

The following table details the findings identified in our assessment of ETSA Utilities' Proposed Methodology. In determining the above, we have:

+ reviewed each individual assessment area (as identified in Section 2 of this report);
+ provided a description of the identified finding (significant change between the DNSP's original regulatory proposal and Revised Regulatory Proposal);
+ referenced the source of the finding; and
+ provided comments and recommendations, where applicable, for each finding.

| Finding | Assessment area | Description of finding | Reference | Comments and recommendation |
|---|---|---|---|---|
| 1. | The starting point for calculating the initial tax asset base as at 1 July 2010. | No significant changes identified. | | |
| 2. | The historic depreciation and tax depreciation assumptions (including the standard tax asset lives used by the DNSPs and the remaining tax asset lives calculated by the DNSPs as at 1 July 2010). | No significant changes identified. | | |
| 3. | The treatment of past additions and disposals. | No significant changes identified. | | We have noted a number of findings, as identified in our initial review dated 2 October 2009, which do not appear to have been addressed by ETSA Utilities in its Revised Regulatory Proposal 2010-2015. See Finding 1 in the table below for details. |
| 4. | The treatment of depreciation on capital contributions. | No significant changes identified. | | |

| Finding | Assessment area | Description of finding | Reference | Comments and recommendation |
|---|---|---|---|---|
| 5. | The assumptions used to split assets between standard control, direct control, alternative control, negotiated and unregulated services. | Revised classification of services | 2.2 (Revised proposal) | ETSA Utilities deems that the AER's decision to classify certain metering services as alternative control services is inappropriate as it is inconsistent with regulatory arrangements, has not been adequately justified or consulted upon, and results in inefficient outcomes. Despite taking this position, ETSA Utilities confirmed in its Revised regulatory proposal that it will implement the AER's requirements by 1 July 2010, although it will require interim arrangements be put in place initially.<br>This appears appropriate. |
| 6. | The treatment of WIP. | No significant changes identified. | | We have noted a number of findings, as identified in our initial review dated 2 October 2009, which do not appear to have been addressed by ETSA Utilities in its Revised Regulatory Proposal 2010-2015. See Finding 2 in the table below for details. |
| 7. | The size of any tax losses as at 1 July 2010 and the treatment of any such losses going forward. | No significant changes identified. | 15.8 (original proposal) | ETSA Utilities' Proposed Methodology confirms that there are no tax losses attributable to the provision of standard control services to be carried forward at 30 June 2010. |
| 8. | Other comments. | No significant changes identified. | Email correspondence from AER | In September 2009, ETSA Utilities agreed to make a change to the schedules deriving the opening tax base. In the workings for the original proposal, the allocation of assets into asset classes for pre-1999 CAPEX was based on an average of the capex for the years 2000 to 2004 inclusive.<br>Following queries and discussions with the AER, ETSA Utilities agreed to change this averaging calculation to the years 2001 to 2004 inclusive. This allocation of assets is calculated on Schedule 5.0 of Attachment J2 and the change has a small impact on tax depreciation and the opening tax base.<br>Due to an administrative error, Attachments J.1 to J.4 of the Revised Regulatory Proposal did not reflect this agreed change. Corrected attachments, reflecting this change are now provided.<br>It is important to note that the Roll Forward Model (Attachment H.1) and the Post Tax Revenue Model (Attachment K.1) provided for the Revised Regulatory Proposal were based on the correct schedules. This error was only in the versions of the schedules provided in Attachments J.1 to J.4 of the Revised Regulatory Proposal, not in the underlying workings of Attachments H.1 or K.1. |
| 9. | Other comments. | No significant changes identified. | Email correspondence from AER | Table 15.1 of the Revised Regulatory Proposal was initially completed using the incorrect schedules mentioned in Finding 8 above. A corrected version of this table, with changes marked-up, was subsequently provided. Only the tax roll forward from 1997 to 2004 is affected. |

| Finding | Assessment area | Description of finding | Reference | Comments and recommendation |
|---|---|---|---|---|
| 10. | Other comments – additional information set out in the Revised Regulatory Proposal. | The roll forward for the tax base in the revised proposal to 1 July 2010 incorporates actual capital expenditure for 2008-09, as required by the AER in its Draft Determination. | 15.3 (Revised proposal) | This appears appropriate. |
| 11. | Other comments – additional information set out in the Revised Regulatory Proposal. | The roll forward for the tax base in the Revised Regulatory Proposal to 1 July 2010 incorporates the previously determined capital expenditure allowance by ESCOSA for 2009-10 as the forecast for that year. | 15.3 (Revised proposal) | This is consistent with ETSA Utilities' original proposal. |
| 12. | Other comments – additional information set out in the Revised Regulatory Proposal. | The roll forward for the tax base in the Revised Regulatory Proposal to 1 July 2010 incorporates the most recent forecast CPI for 2009-10. This is based on actual CPI to September 2009 plus forecast CPI as per the Reserve Bank of Australia's Statement of Monetary Policy, released in November 2009. | 15.3 (Revised proposal) | This appears appropriate. However, the AER has advised that it intends to update the CPI for 2009-10 based on March 2010 CPI in its final decision. |

We have noted a number of findings, as identified in our initial review dated 2 October 2009, which do not appear to have been addressed by ETSA Utilities in its Revised Regulatory Proposal 2010-2015. The AER may wish to consider requesting further information from ETSA Utilities to confirm ETSA Utilities' position on the findings outlined in the table below.

| Finding | Assessment area | Description of finding | Reference | Comments and recommendation |
|---|---|---|---|---|
| 1. | The treatment of past additions and disposals. | ETSA Utilities' Proposed Methodology does not include shorter life asset acquisitions in the calculation of its tax asset base before 1998.<br>Similarly, ETSA Utilities' Proposed Methodology does not include shorter life asset disposals in the calculation of its tax asset base before 1998.<br>ETSA Utilities adopted the same approach for shorter life asset | 15.4.1 (original proposal) | *Additions*<br>For the period pre-regulation, it is not clear what quantum of shorter life assets ETSA Utilities acquired on an annual basis, and whether such acquisitions were material in the context of ETSA Utilities':<br>+ total acquisitions for the relevant year; and<br>+ rolled forward tax asset base for the relevant year.<br>As a result, ETSA Utilities' tax asset base would have been understated for those years where shorter life asset acquisitions were not included in the calculation of its tax asset base. |

| Finding | Assessment area | Description of finding | Reference | Comments and recommendation |
|---|---|---|---|---|
| | | acquisitions and disposals from 1 July 1998 to 10 October 1999[2]. | | *Disposals*<br>ETSA Utilities' Proposed Methodology states that there are no known disposals of distribution systems assets acquired before regulation.<br>Accordingly, ETSA Utilities' tax asset base would have been overstated for those years where shorter life asset disposals, if any, were not included in the calculation of its tax asset base.<br>*Net impact*<br>In the absence of financial information, it is not clear what net impact, if any, shorter life asset acquisitions and disposals would have had on ETSA Utilities' tax asset base during the period before regulation.<br>However, we note that ETSA Utilities' Proposed Methodology may be appropriate given that all shorter life asset acquisitions and disposals (that have been excluded to date) are likely to have been fully depreciated by the start of the 2010-2015 regulatory control period (as they would be at least 12 years old).<br>For the 2010-2015 regulatory period, ETSA Utilities should ensure that all asset acquisitions and disposals are accounted for when calculating its tax asset base. |
| 2. | The treatment of WIP. | ETSA Utilities' WIP as at 1 July 2010 will be calculated based on the work-in-progress balance as at 30 June 2009.<br>The work-in-progress balance will not be depreciated for tax purposes for the period 1 July 2009 to 30 June 2010. | 15.6 (original proposal) | ETSA Utilities' approach to calculating its WIP as at 1 July 2010 appears appropriate in the absence of any other information that can be used to accurately forecast WIP at this time.<br>However, by not depreciating its WIP for the 12 months ended 30 June 2010, ETSA Utilities may report an overstated tax asset base at this time. This in turn may overstate ETSA Utilities' opening WIP balance as at 1 July 2010 when WIP is included in the opening tax asset base as a one-off transitional arrangement.<br>Conversely, ETSA Utilities' tax asset base may be overstated as at 1 July 2010 in the event that there are additions to ETSA Utilities' WIP balance during the 2009-2010 financial year. |

[2] Shorter life assets were originally included in the calculation of ETSA Utilities' tax asset base during this period. However, a later adjustment was made to exclude these values, as they would have been fully depreciated by 1 July 2010.

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**Summary of significant changes between ETSA Utilities' original proposal and Revised Regulatory Proposal**

ETSA Utilities has revised its allowance for corporate income tax in response to matters raised by the AER in the Draft Determination. ETSA Utilities' revised allowance for corporate income tax incorporates the impact of changes to:

+ the forecast capital expenditure;
+ the forecast operating expenditure;
+ the opening RAB for valuation of easements and ESCOSA's treatment of capital contributions; and
+ Weighted Average Cost of Capital ("WACC") parameters.

Although the allowance for corporate income tax has changed in the Revised Regulatory Proposal, ETSA Utilities has not made any significant changes to the methodology for calculating its tax asset base.

## 7. Conclusion

Based on the information provided, ETSA Utilities' Proposed Methodology for the calculation of its tax asset base appears reasonable.

## 8. Contact

Should you have any questions in respect of the above, please contact Michael Dunnett or Scott O'Donnell on (02) 6222 1400.

Yours sincerely,

McGrathNicol Advisory

McGrathNicol Advisory
*Contact: Shane O'Keeffe*

**Disclaimer**

We have reviewed ETSA Utilities' methodology in establishing the opening regulated tax written down value as at 1 July 2010. We have relied on the information provided by ETSA Utilities and the AER.

We note that we have not undertaken an audit of the tax asset values and the supporting schedules provided, and provide no opinion in respect of their accuracy.

Neither McGrathNicol or any member or employee of the firm undertakes responsibility in any way whatsoever to any person or organisation other than the ACCC and the AER in respect of the information set out in this letter, including any errors, omissions or negligence however caused.