M^cN+
McGRATHNICOL
CORPORATE ADVISORY

2 October 2009

Mr Moston Neck
Australian Energy Regulator
PO Box 10048
Adelaide Street Post Office
Brisbane QLD 4000

Assessment of Ergon Energy's proposed methodology and calculation of its tax asset base for the 2010-2015 regulatory control period

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 ("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 Ergon Energy Corporation Limited's ("Ergon Energy") tax asset base for the 2010-2015 regulatory control period.

2. Scope

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

In assessing Ergon Energy's Proposed Methodology, we have considered the following:

+ whether Ergon Energy's Proposed Methodology is consistent with the National Electricity Rules ("NER") and the National Tax Equivalents Regime ("NTER"). Specifically, this involved:
    - identifying an appropriate starting point to establish Ergon Energy's initial tax asset base as at 1 July 2010;
    - reviewing Ergon Energy's historic depreciation and tax depreciation assumptions to determine whether these assumptions are appropriate in the context of its Proposed Methodology and Generally Accepted Accounting Principles ("GAAP");
    - examining Ergon Energy's treatment of past additions and disposals, and determining whether such treatment is appropriate in the context of its proposed methodology and GAAP;
    - reviewing Ergon Energy's treatment of depreciation on capital contributions to determine if these have been applied correctly;

  - assessing Ergon Energy's assumptions used to split assets between standard control, alternative control, negotiated and unregulated services to determine whether these assumptions are appropriate in the context of its Proposed Methodology;
  - reviewing Ergon Energy's treatment of Work-In-Progress ("WIP"); and
  - reviewing Ergon Energy's treatment of tax losses.
+ whether Ergon Energy's tax asset base has been calculated in accordance with its Proposed Methodology;
+ the validity of documentation supporting Ergon Energy's Proposed Methodology; and
+ the ability to audit the documentation supporting the calculation of Ergon Energy's tax asset base.

As part of the engagement, we have also provided recommendations to address any identified 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 their allowable revenue. To enable the determination of the tax building block (incorporating depreciation), DNSPs will 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. Ergon Energy's Approach

Ergon Energy's Proposed Methodology details its approach for calculating its tax asset base as at 1 July 2010 – the commencement of the 2010-2015 regulatory control period.

Broadly, Ergon Energy's Proposed Methodology is based on the following assumptions:

+ a start date of 1 July 2005 on which to establish its operating tax asset base for the 2010-2015 regulatory control period;
+ depreciation is based on the weighted average life of various AER asset categories;
+ the application of the prime cost (straight-line) depreciation method;
+ asset acquisitions and disposals information is based on actual expenditure and the written down value of assets;[1] and
+ no tax asset value has been approved by a previous regulator.

[1] Acquisitions and disposals for the 2008-2009 and 2009-2010 years are based on forecast information.

5. Sources of information

In assessing Ergon Energy's Proposed Methodology, we reviewed and considered the following information:

+ Ergon Energy's regulatory proposal for the 2010-2015 regulatory control period, including all supporting attachments;
+ the AER's "Final framework and approach paper Application of schemes – Energex and Ergon Energy 2010-2015", November 2008;
+ 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 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 Ergon Energy's Proposed Methodology and supporting schedules. Our findings are presented in accordance with the four scope elements identified in our Order For Services, which are detailed in the Scope section of this report.

6.1 Whether Ergon Energy's Proposed Methodology to calculate its tax asset base is consistent with the National Electricity Rules and the National Tax Equivalents Regime

Ergon Energy's regulatory proposal states that the Queensland Communication Authority ("QCA") did not establish a tax asset base for Ergon Energy for the current regulatory period. The QCA determined that Ergon Energy should include a zero allowance for corporate income tax.

However, for the purposes of the 2010-2015 regulatory control period, the estimate of the corporate income tax building block must be based on a benchmark efficient entity. Ergon Energy has applied the Post Tax Revenue Model and Roll Forward Model to ensure compliance with the AER's requirements.

The table below details the findings identified in our assessment of Ergon Energy's Proposed Methodology. As part of our assessment, we:

+ reviewed each individual assessment area (as identified in Section 2 of this report);
+ provided a description of the identified finding;
+ 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 recommendations
1.	Identifying an appropriate starting point to establish the initial asset base as at 1 July 2010.	Ergon Energy appears to have identified a start date of 1 July 2005 upon which to establish its opening tax asset base for the 2010-2015 regulatory control period.	38.2	Ergon Energy's selection of 1 July 2005 as an appropriate starting point to establish its opening tax asset base as at 1 July 2010 appears to be based on the fact that: + 1 July 2005 represents the start date of the current regulatory control period; and + a separate and detailed asset register was maintained and updated as part of the QCA's determination at this time. Ergon Energy confirmed that all asset included in its asset register as at 1 July 2005, and subsequent additions, have been depreciated at tax depreciation rates as set by the ATO and have been used for the purposes of calculating its tax asset base as at 1 July 2010. In addition to the above, Ergon Energy has confirmed that in establishing its tax asset base as at 1 July 2010, it has not used NTER values as provided by the ATO. NTER values have not been used because Ergon Energy also owns non-regulated system assets, which are currently included in the NTER values. Ergon Energy states that working papers were maintained at a consolidated level, which meant that accurate data at the detailed level required was either not available or would have required significant time and effort to determine. Based on the information provided, Ergon Energy's identification of 1 July 2005 as an appropriate starting point appears reasonable.

Finding	Assessment area	Description of finding	Reference	Comments and recommendations
2.	Reviewing historic depreciation and tax depreciation assumptions to determine whether these assumptions are appropriate in the context of each DNSP's proposed methodology and GAAP.	Ergon Energy's Proposed Methodology applies tax depreciation useful lives as set by the ATO.	38.2	In rolling forward its tax asset base to 30 June 2010, Ergon Energy proposes to apply tax depreciation lives as set by the Australian Taxation Office ("ATO"). This approach appears reasonable.
3.	Reviewing historic depreciation and tax depreciation assumptions to determine whether these assumptions are appropriate in the context of each DNSP's proposed methodology and GAAP.	Ergon Energy uses the prime cost (straight line) approach when depreciating the value of assets, or asset classes, for the purposes of calculating its opening tax asset base as at 1 July 2010.	37.1	This approach appears appropriate and consistent with: + the NER; + the AER's preferred method for depreciation (straight line); + Ergon Energy's historic approach to calculating depreciation; and + GAAP.
4.	Reviewing historic depreciation and tax depreciation assumptions to determine whether these assumptions are appropriate in the context of each DNSP's proposed methodology and GAAP.	Ergon Energy proposes that deprecation for establishing its regulatory asset base at the commencement of the 2010-2015 regulatory control period is based on: + actual capital expenditure for the period 2005-06 to 2007-08; and + forecast capital expenditure for the period 2008-09 to 2009-10.	37.2	Although Ergon Energy states that this approach applies to the valuation of its regulatory asset base, it has separately confirmed that this approach also applies for the valuation of its opening tax asset base. For the purposes of establishing its tax asset base as at 1 July 2010, Ergon Energy should base deprecation on actual capital expenditure where such information is available.[2]

[2] Ergon Energy confirmed that, at the time of preparing its Regulatory Proposal, actual capital expenditure information for 20008-09 was not available.

Finding	Assessment area	Description of finding	Reference	Comments and recommendations
5.	Examining the treatment of past additions and disposals and determining whether such treatment is appropriate in the context of each DNSP's proposed methodology and GAAP.	Ergon Energy's disposals are valued based on their respective depreciated (written down value) value. Adjustments appear to be made for the disposal of assets where the proceeds differ from the written down value.	Email confirmation from Ergon Energy.	This approach appears appropriate and consistent with: + Ergon Energy's historic approach to recognising disposals; and + GAAP.
6.	Examining the treatment of past additions and disposals and determining whether such treatment is appropriate in the context of each DNSP's proposed methodology and GAAP.	Ergon Energy appears to value its opening tax asset base on forecast 2008-09 capital expenditure.	22	For the purposes of establishing its tax asset base as at 1 July 2010, Ergon Energy should base deprecation on actual capital expenditure where such information is available.[3]
7.	Reviewing the treatment of depreciation on capital contributions to determine if these have been applied correctly.	Ergon Energy includes the value of capital contributions[4] in its tax asset base.[5]	47.6	Ergon Energy's Proposed Methodology states that it includes capital contributions in its tax asset base. In accordance with clause 6.21.2 of the NER, Ergon Energy adjusts (downwards) its revenue cap for the value of capital contributions (be it cash and / or gifted assets). Ergon Energy states that the downwards adjustment is forecast by the regulator at the time of making its distribution determination, and that there is an annual unders / overs adjustment to account for the actual value of capital contributions received. Ergon Energy calculates depreciation on capital contributions in line with its method of depreciating asset in its tax asset base. That is, depreciation is calculated based on the nature of the asset e.g. cash, plant / machinery, land etc.

[3] Ergon Energy confirmed that, at the time of preparing its Regulatory Proposal, actual capital expenditure information for 20008-09 was not available.
[4] Capital contributions comprise all contributed assets, including portions thereof.
[5] Ergon Energy should reduce its revenues in order to ensure it does not recover the value of the capital contributions twice.

Finding	Assessment area	Description of finding	Reference	Comments and recommendations
8.	Assessing the assumptions used to split assets between standard control, alternative control, negotiated and unregulated services to determine whether these assumptions are appropriate in the context of each DNSP's proposed methodology.	Ergon Energy states that it does not split assets between the categories of distribution services it provides. All assets are included in its standard control services tax asset base.	Email confirmation from Ergon Energy	Including all assets under standard control services has the potential to overstate Ergon Energy's tax asset base. In order to avoid double counting, Ergon Energy confirmed that, in accordance with Transitional Rule 11.16.3, it makes revenue adjustments to offset (downwards) revenue for non-standard control services asset usage. This approach appears consistent with the NER.
9.	Assessing the assumptions used to split assets between standard control, alternative control, negotiated and unregulated services to determine whether these assumptions are appropriate in the context of each DNSP's proposed methodology.	In order to ensure that standard control services are not 'funding' the use of assets by alternative control services, Ergon Energy makes a revenue adjustment for the use of 'shared assets' in the provision of alternative control services. This adjustment is made to Ergon Energy's Annual Revenue Requirement.	Email confirmation from Ergon Energy.	Ergon Energy's Proposed Methodology appears consistent with clause 11.16.3(c) of the NER (Transitional Arrangements). Although Ergon Energy confirmed that it provides standard and alternative control services, it is not clear from the information provided, how Ergon Energy calculates the revenue adjustment associated with the use of assets by alternative control services, and whether this is appropriate. The AER may wish to consider requesting that Ergon Energy provide details of the assumptions it uses to calculate the revenue adjustment arising from the inclusion of all 'shared assets' in its tax asset base.[6]
10.	Reviewing the treatment of work-in-progress.	Ergon Energy's opening tax asset base has been prepared from its asset register as at 30 June 2005 and rolled forward using the AER's Roll Forward Model. WIP was not included in Ergon Energy's opening tax asset base at this time. Accordingly, WIP has not been included for the purposes of calculating its opening tax asset base as at 1 July 2010.	Email response from Ergon Energy	Ergon Energy's Proposed Methodology appears reasonable and consistent with its historic treatment of WIP.

[6] Ergon Energy confirmed that the valuation of its shared assets has been covered in a separate response to the AER. McGrathNicol has not received nor reviewed this information.

Finding	Assessment area	Description of finding	Reference	Comments and recommendations
11.	Other issues.	Ergon Energy has not completed Table 3 of pro forma 2.4.5 of the RIN in relation to non-RAB assets.	38.2	Ergon Energy claims that it was unable to complete Table 3 of pro forma 2.4.5 of the RIN because it cannot separate NTER values into RAB and non RAB assets. The AER may wish to follow up this matter with Ergon Energy.
12.	Other issues.	Discrepancies in Ergon Energy's reported tax asset base.	16.4.1 Regulated Tax Asset Base Roll Forward Model	There appears to be a reconciling difference between: + the opening tax asset value for 2010/2011 as reported in Ergon Energy's Roll Forward Model of $4,022.27 million; and + the value stated in its regulatory proposal of $4,000.39 million. Ergon Energy confirmed that there is no reconciling difference in the values quoted. The identified difference of $21.88 million is attributable to the value of street lighting assets which constitutes Ergon Energy's alternative control services.

6.2 Whether the proposed asset base for tax purposes has been calculated in accordance with Ergon Energy's Proposed Methodology.

Based on the information provided, there is nothing to indicate that Ergon Energy's tax asset base has not been calculated in accordance with its Proposed Methodology.

6.3 Assess the validity of the documentation supporting Ergon Energy's Proposed Methodology.

The validity of documentation supporting Ergon Energy's Proposed Methodology appears sound.

Ergon Energy's Proposed Methodology is contained within its regulatory proposal for the 2010-2015 regulatory control period, and is supported by numerous attachments which include:

+ a letter from the ATO assessing Ergon Energy's NTER asset values for the period 1 July 2001 to 30 June 2008;
+ various excel models detailing how Ergon Energy calculates its tax asset base; and
+ a version of Ergon Energy's Roll Forward Model in the AER's prescribed format.

6.4 Assess the ability to audit the documentation supporting the calculation of Ergon Energy's tax asset base.

Based on the information provided, there is nothing which indicates an inability to audit Ergon Energy's calculation of its tax asset base for the 2010-2015 regulatory control period.

7. Conclusion

Based on the information provided, and with the following exception, Ergon Energy's Proposed Methodology for the calculation of its tax asset base appears to be reasonable.

We note that we are unable to provide any commentary in relation to Ergon Energy's treatment of tax losses due to insufficient information provided in respect of the above.

8. Contact

Should you have any questions in respect of the above, please contact Aidan Hardy or Michael Dunnett on (02) 6222 1400.

Yours sincerely

McGrathNicol Advisory

McGrathNicol Advisory
Contact: Shane O'Keeffe

Disclaimer

We have reviewed Ergon Energy's methodology in establishing the opening regulated tax written down value as at 1 July 2010. We have relied on the information provided by Ergon Energy 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 an errors, omissions or negligence however caused.