29 March 2010

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

Final

Assessment of the revised proposal of Ergon Energy's 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 Ergon Energy's tax asset base.

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 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 Ergon Energy's 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. 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 Ergon has updated its 2008-09 capex figures for actuals and revised its forecasts for 2009-10 capex.

5. Sources of information

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

+ Ergon Energy's Revised Regulatory Proposal for the 2010 to 2015 regulatory 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, 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.

6.1 Significant changes in the Revised Regulatory Proposal of Ergon Energy's tax asset base

The following table details the findings identified in our assessment of Ergon Energy's 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 (a).	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).	Ergon Energy proposes that depreciation 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 (original proposal)	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. Ergon Energy confirmed that, at the time of preparing its original regulatory proposal, actual capital expenditure information for 2008-09 was not available. Ergon Energy has subsequently provided and applied actual depreciation for 2008-09 and revised forecast depreciation for 2009-10 in determining its regulatory asset base for the regulatory control period commencing 1 July 2010. Based on previous confirmation from Ergon Energy in the review of its original proposal, it appears that this approach also applies for the valuation of its opening tax asset base.

Finding	Assessment area	Description of finding	Reference	Comments and recommendation
2 (b).	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.	13.3.1 (Revised proposal)	Ergon Energy made an error in the way remaining asset lives were calculated by dividing real depreciation figures by a nominal closing balance. Ergon Energy has corrected this arithmetic error in its Revised Regulatory Proposal.
3.	The treatment of past additions and disposals.	No significant changes identified.		
4.	The treatment of depreciation on capital contributions.	No significant changes identified.		
5.	The assumptions used to split assets between standard control, direct control, alternative control, negotiated and unregulated services.	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 Ergon Energy in its Revised Regulatory Proposal 2010-2015. See Finding 1 in the table below for details.
6.	The treatment of WIP.	No significant changes identified.		
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.	Email correspondence from Ergon Energy 19.3	Ergon Energy changed the tax loss carried forward for 2009-10 from $297m in its original PTRM to $148m in its revised PTRM. The difference in the Revised Regulatory Proposal is primarily due to the incorporation of 2008-09 actual CAPEX. A decrease in CAPEX will decrease expenses and subsequently decrease the carried forward tax loss for 2009-10. Based on the limited information provided, this appears reasonable. 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 Ergon Energy in its Revised Regulatory Proposal 2010-2015. See Finding 2 in the table below for details.

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 Ergon Energy in its Revised Regulatory Proposal 2010-2015. The AER may wish to consider requesting further information from Ergon Energy to confirm Ergon Energy's position on the findings outlined in the table below.

Finding	Assessment area	Description of finding	Reference	Comments and recommendation
1.	The assumptions used to split assets between standard control, direct control, alternative control, negotiated and unregulated services.	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.[2] The AER may wish to confirm its position on this matter.
2.	The size of any tax losses as at 1 July 2010 and the treatment of any such losses going forward.	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.		We note that Ergon Energy provided limited information regarding its treatment of tax losses. The AER may wish to request Ergon Energy to provide further supporting information on the size of the tax losses as at 1 July 2010 and the proposed treatment of losses going forward.
3.	Other comments.	Ergon Energy has not completed Table 3 of pro forma 2.4.5 of the RIN in relation to non-RAB assets.	38.2 (original proposal)	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.

[2] 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.

Summary of significant changes between Ergon Energy's original proposal and Revised Regulatory Proposal

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

+ the forecast capital expenditure;
+ the forecast operating expenditure;
+ the calculation of depreciation as requested in the AER's Draft Distribution Determination;
+ Weighted Average Cost of Capital ("WACC") parameters;
+ the application of inflation as requested by the AER;
+ the use of the PTRM to recalculate a revised corporate income tax building block; and
+ the allowances for capital contributions and accelerated depreciation in accordance with the AER's Draft Distribution Determination.

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

7. Conclusion

Based on the information provided, Ergon Energy's 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 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 any errors, omissions or negligence however caused.