ELECTRICITY AND GAS INFORMATION DISCLOSURE SEMINAR

JAMES COOK HOTEL GRAND CHANCELLOR, WELLINGTON
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COMMERCE COMMISSION

Regulatory Tax – A Primer

Presentation to Information Disclosure Seminar
March 2013

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1. Tax payable - the "old" approach

	Earnings before interest and tax (EBIT)		-
add	Total Regulatory Depreciation	-	
	Other Permanent Differences - not deductible		
	Other Temporary Adjustments - Current Period		
			-
less	Non Taxable Capital Contributions and Vested Assets		
	Tax Depreciation		
	Deductible Discretionary Discounts and Customer Rebates		
	Deductible Interest	-	
	Other Permanent Differences - Non Taxable		
	Other Temporary Adjustments - Prior Period		
			-
	Regulatory taxable income for Year		**-**
less	Tax Losses Available at Start of Year		
	Net taxable income		**-**
	Statutory Tax Rate		
	Regulatory Tax Allowance		**-**

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1.1 Fundamentals of deferred tax

- Temporary differences are:
- Main temporary difference is depreciation temporary differences driven from asset values
- IRD rules can allow accelerated depreciation on assets using methods and rates different to comparable economic depreciation rates.
- Example – Transformers:
  - IRD assigns a diminishing value (DV) depreciation rate of 8% or straight line depreciation rate of 6%.
  - IM determination (Schedule A) assigns a standard physical asset life of 45 years (equivalent to a straight line depreciation rate of 2.22%).

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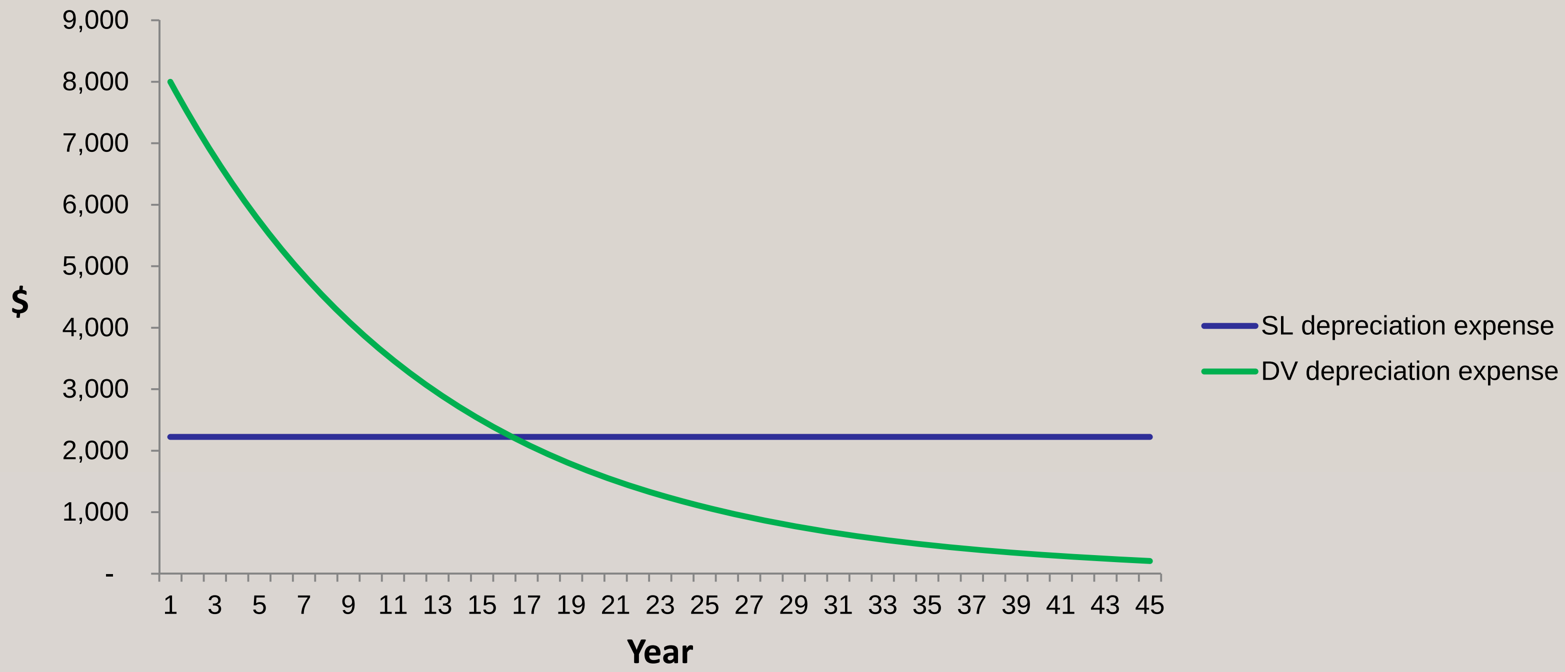
1.2 Annual Depreciation Expense



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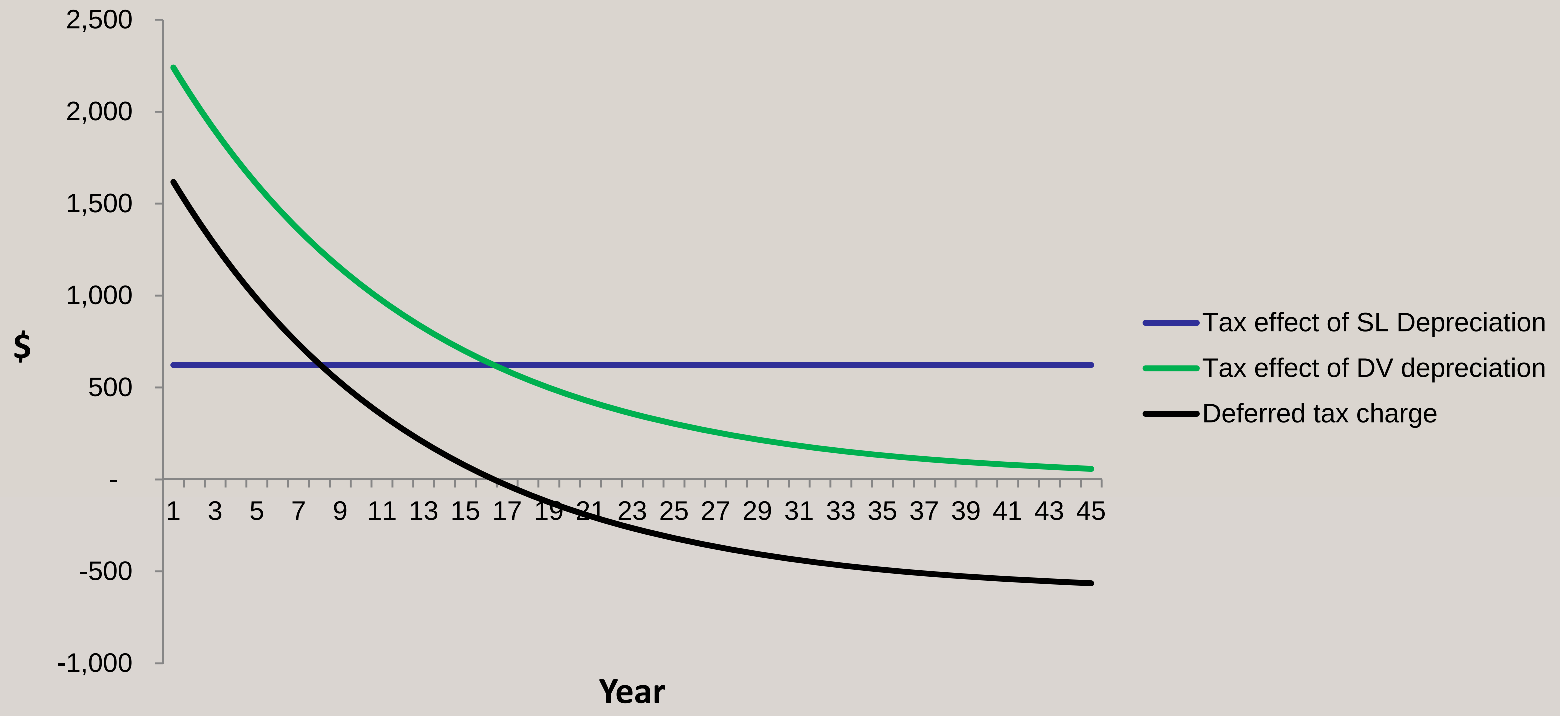
1.3 Deferred Tax Charge



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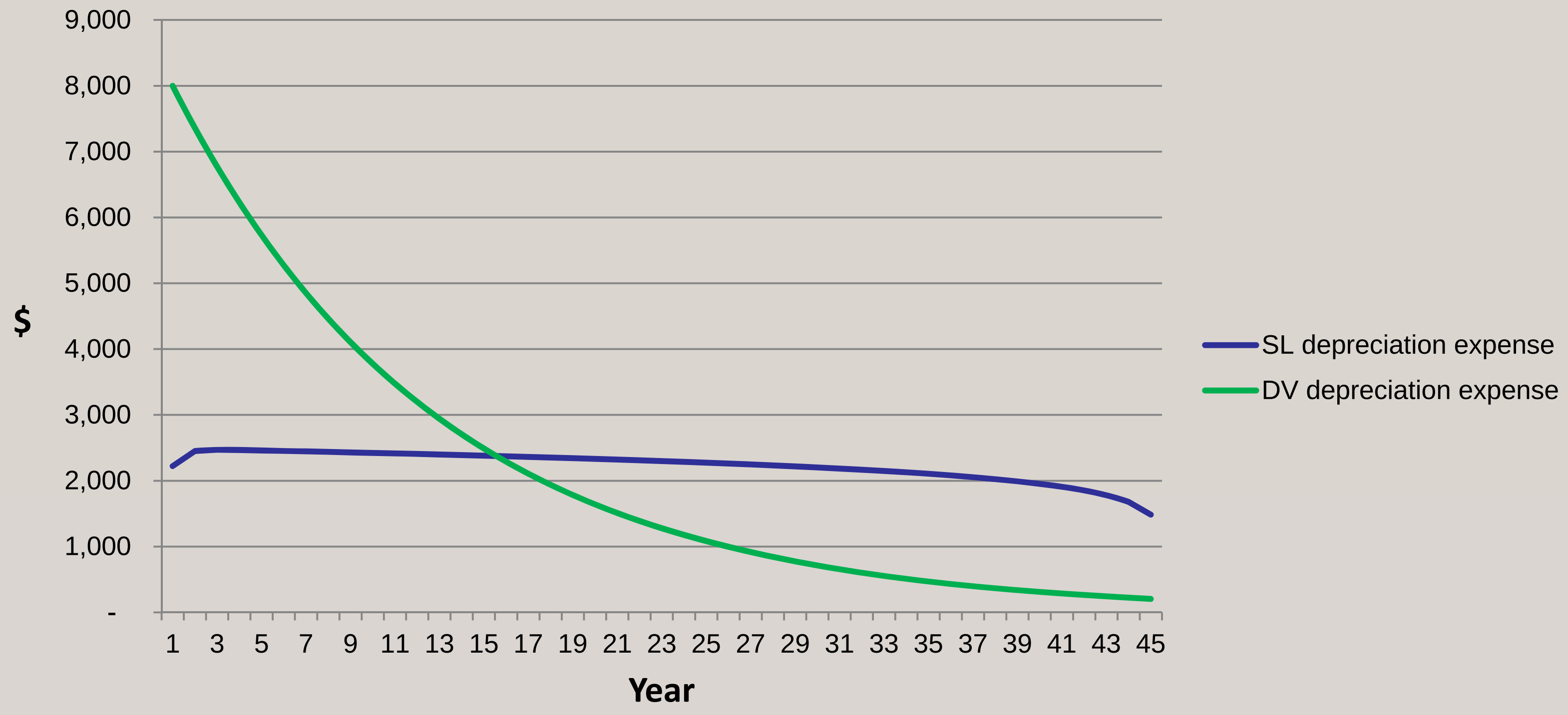
1.4 Effect of Revaluations



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1.5 Some other common temporary differences

- Capital contributions (after 20 May 2010 if spread over 10 years for tax purposes)
- Renewals expenditure (deductible for tax purposes but capital under GAAP)
- Loss on disposal of assets (must be physically disposed of for tax purposes)
- Provisions for employee remuneration, holiday pay
- Doubtful debt provisions
- Equipment leases

2. Tax methodology – measurement issues

- Tax costs associated with supply of a particular regulated service cannot be observed directly
- Allocating tax costs directly could be inconsistent with allocation of other costs.
- Treatment of tax losses in a regulated supplier’s wider tax group
- Capturing tax effect of changes in asset allocation

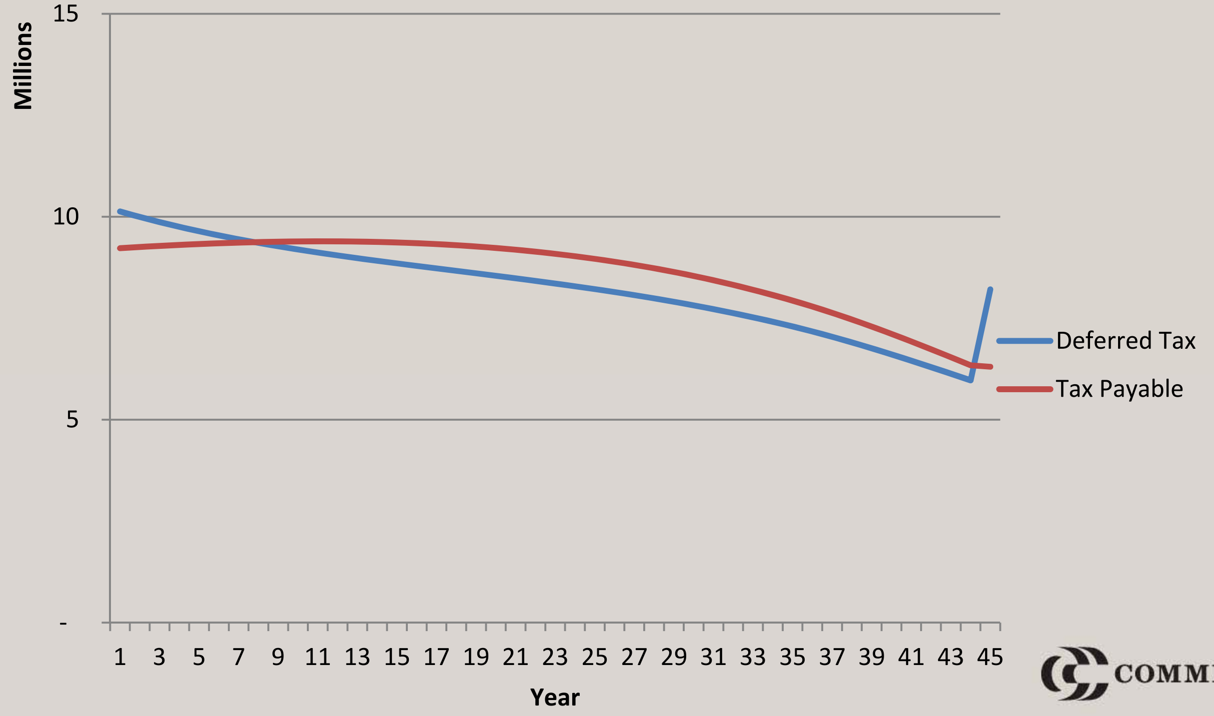
2. Tax methodology – origin of present approach

- Deferred tax approach under NZ(IAS)12 does not meet FCM
- A variety of modified approaches that are NPV-neutral are potentially feasible
- Alternative deferred tax approaches were proposed by Vector and by CRA (on behalf of Unison).
- Modified deferred tax approach adopted was developed by PwC (on behalf of the ENA) - supported by the majority of regulated suppliers
- Modified deferred tax approach results in greater up-front cash flows for suppliers in respect of new investments.

2. Nominal cash flows under modified deferred tax

ASSUMPTIONS:

WACC	**9.00%**	**Useful life**	**45**
Leverage	**44.00%**	**Cost**	**100 M**
Cost of debt	**7.00%**	**DV**	**5.5%**
Revaluation rate	**2%**		



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3. Key features of the regulatory tax approach - the regulatory tax components

		Regulatory Tax Allowance		Deferred Tax Balance	
	Regulatory profit / (loss) before tax	-			Does not include financing costs
plus/minus	Permanent differences				
plus/minus	Regulatory tax adjustments				Includes amortisation of initial differences and revaluations, notional deductible interest.
	Regulatory taxable income				
less	Utilised tax losses				
	Regulatory net taxable income				
	Corporate tax rate (%)	0.28			
	Regulatory tax allowance				
			Opening		
plus/minus	Temporary differences				Includes tax effect of adjusted depreciation less tax depreciation
plus/minus	Regulatory tax adjustments				Includes tax effect of amortisation of initial differences
	Tax payable		Closing		

3. Key features of regulatory tax approach – divergence from GAAP

- “Ring-fencing” of regulated services including tax losses
- Regulatory investment value used for assessing profitability under ID regulation is the RAB value plus the deferred tax balance
- Capping of regulatory tax asset values where initial values are greater than regulatory asset values means values will diverge from IRD tax asset values
- Amortisation of the difference between the initial RAB and the initial regulatory tax asset value over the residual lifetime of the assets
- Regulatory tax asset value matched to equivalent RAB asset for cost allocation purposes
- Amortisation of any future revaluations over the residual lifetime of the assets
- Separate line item disclosure of discretionary discounts and consumer rebates
- No regulatory balance sheet equivalent - so no current tax payable

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4. The regulatory tax allowance - Schedule 5a(i)

5a(i): Regulatory Tax Allowance

			($000)
Regulatory profit / (loss) before tax			-
plus	Income not included in regulatory profit / (loss) before tax but taxable	*	
	Expenditure or loss in regulatory profit / (loss) before tax but not deductible	*	
	Amortisation of initial differences in asset values	-	
	Amortisation of revaluations	-	
			-
less	Income included in regulatory profit / (loss) before tax but not taxable	*	
	Discretionary discounts and consumer rebates		
	Expenditure or loss deductible but not in regulatory profit / (loss) before tax**	*	
	Notional deductible interest	-	
			-
Regulatory taxable income			-
less	Utilised tax losses		
	Regulatory net taxable income		-
	Corporate tax rate (%)		
Regulatory tax allowance			-

* Workings to be provided in Schedule 14

** Excluding discretionary discounts and consumer rebates

4. The regulatory tax allowance - permanent differences

- Positive permanent differences excludes any amounts that are-

a. amortisation of initial differences in asset values; or

b. amortisation of revaluations.

- Negative permanent differences excludes amounts that are-

a. discretionary discounts and customer rebates

- Capital contributions:
  - Previously treated as income - permanent difference
  - Election to spread income over 10 years or to treat as reduction in cost of asset – depreciated over remaining useful life
  - Temporary difference only if spread over 10 years

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4. Permanent differences - schedule 14

5a(ii): Disclosure of Permanent Differences

In Schedule 14, Box 8, provide descriptions and workings of items recorded in the asterisked categories in Schedule 5a(i).

Regulatory tax allowance: disclosure of permanent differences (5a(i) of Schedule 5a)

1. In the box below, provide descriptions and workings of the following items, as recorded in the asterisked categories in 5a(i) of Schedule 5a-

   1.1 income not included in regulatory profit / (loss) before tax but taxable;

   1.2 expenditure or loss in regulatory profit / (loss) before tax but not deductible;

   1.3 income included in regulatory profit / (loss) before tax but not taxable;

   1.4 expenditure or loss deductible but not in regulatory profit / (loss) before tax.

Box 5: Regulatory tax allowance: permanent differences [Insert text here]

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4. The regulatory tax allowance – regulatory tax adjustments

- Amortisation of initial differences in asset values
  - Initial differences in asset values $333.33 per example
  - Divide by weighted average remaining useful life of relevant assets i.e. assets in initial regulatory asset base at 1 April 2009
  - Adjustment required to unamortised balance for assets sold
- Amortisation (depreciation) of revaluations
  - Total depreciation - adjusted depreciation
- Notional deductible interest
  - Allocation of debt costs is not covered by the cost allocation IM
  - Instead a prescriptive formula based on assumed debt costs and an assumed leverage is used

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4. Schedules 5a(iii) and 5a(iv)

5a(iii): Amortisation of Initial Difference in Asset Values		**($000)**
Opening unamortised initial differences in asset values	-	
Amortisation of initial differences in asset values	-	
Adjustment for unamortised initial differences in assets acquired		
Adjustment for unamortised initial differences in assets disposed		
Closing unamortised initial difference in asset values		-
Opening weighted average remaining asset life (years)		

5a(iv): Amortisation of Revaluations		**($000)**
Opening Sum of RAB values without revaluations		
Adjusted depreciation		
Total depreciation		
Amortisation of revaluations		-

5. The deferred tax balance

- Roll-forward formula: = opening deferred tax + tax effect of temporary differences - tax effect of amortisation of initial difference in asset values + deferred tax balance relating to assets acquired in the disclosure year in question + cost allocation adjustment.
- Calculation of deferred tax balance relating to assets acquired
- Cost allocation adjustment - concept of matching asset

5. Schedule 5a(vi)

5a(vi): Calculation of Deferred Tax Balance			($000)
	Opening deferred tax		
plus	Tax effect of adjusted depreciation		
less	Tax effect of total tax depreciation		
plus	Tax effect of other temporary differences*		
less	Tax effect of amortisation of initial differences in asset values	-	
plus	Deferred tax balance relating to assets acquired in the disclosure year		
less	Deferred tax balance relating to assets disposed in the disclosure year		
plus	Deferred tax cost allocation adjustment		
	Closing deferred tax		-

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5. Temporary differences - schedule 14

5a(vii): Disclosure of Temporary Differences

In Schedule 14, Box 9, provide descriptions and workings of items recorded in the asterisked category in Schedule 5a(vi) (Tax effect of other temporary differences).

Regulatory tax allowance: disclosure of temporary differences (5a(vi) of Schedule 5a)

1. In the box below, provide descriptions and workings of items recorded in the asterisked category 'Tax effect of other temporary differences' in 5a(vi) of Schedule 5a.

Box 6: Temporary differences / Tax effect of other temporary differences (current disclosure year)
[Insert text here]

6. Determining the regulatory tax asset values

Capping the initial tax asset values

1. Add unallocated initial RAB values
2. Add adjusted tax values (IRD values)
3. If 1 < 2 then notional tax asset value, otherwise adjusted tax value
4. To calculate notional tax asset value adjust the adjusted tax value to account proportionately for the difference between 1 and 2.

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6. Capping the initial tax asset values

Proportion of 1 to 2	0.88	
1	2	
Sum of Unallocated Initial Asset Values $000	Sum of Adjusted Tax Values $000	Notional Tax Asset Values $000
1,500	1,700	1,488
37,500	41,000	35,875
46,000	56,000	49,000
1,500	2,000	1,750
4,200	5,000	4,375
39,220	45,000	39,375
103,500	115,000	100,625
75,000	87,000	76,125
19,730	22,000	19,250
13,000	14,500	12,688
3,800	5,000	4,375
2,800	3,200	2,800
2,250	2,600	2,275
350,000	400,000	350,000

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6. Determining the regulatory tax asset values
- initial regulatory tax asset values and roll-forward

Allocating initial tax values:

1. Take notional tax asset value or adjusted tax asset value
2. Multiply by result of asset allocation ratio

Roll-forward tax asset values:

1. Depreciate using tax rules
2. Multiply by result of asset allocation ratio

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6. Asset allocation ratio and deferred tax cost allocation adjustment

Applies to businesses that cost allocate assets:

Opening ratio	0.83	RAB		Tax Value	x result of Asset
		Unallocated	**Allocated**	**Unallocated**	***Allocation Ratio***
Opening values		1,200.00	1,000.00	800.00	666.67
Depreciation		92.31	76.92	119.74	99.79
Reval		24.00	20.00	-	-
Unallocated closing		1,131.69	943.08	680.26	566.88
Closing asset usage & allocated value			1,018.52		612.23
Adjustment from application of 2.1.1			75.45		45.35
Closing ratio	0.90				
		Difference	(30.10)		
		Tax Effect	(8.43)		

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6. Schedule 5a(viii)

5a(viii): Regulatory Tax Asset Base Roll-Forward

		($000)	
	Opening Sum of regulatory tax asset values	-	
less	Tax depreciation		
plus	Regulatory tax asset value of assets commissioned		
less	Regulatory tax asset value of asset disposals		
plus	Lost and found assets adjustment		
plus	Adjustment resulting from asset allocation		
	Closing sum of regulatory tax asset values		-

7. Regulatory tax record-keeping

- Some record-keeping matters to consider:
  - Identification of assets (and their remaining asset lives) contributing to initial differences in asset values
  - Roll-forward of tax asset values by asset
  - Adjusted depreciation from initial value date
  - Roll-forward analysis of deferred tax balance
  - Mapping of regulatory tax assets to regulatory assets for purpose of calculating asset allocation ratio
  - Mapping of regulatory tax assets to IRD tax assets, particularly where initial tax asset values are capped

8. Worked example of calculations

- **Refer Excel schedule**

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6. Schedule 5a – Report on Regulatory Tax Allowance

- **Refer schedule 5a**

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These slides formed the basis of the seminar presented to suppliers and auditors by Commission staff in March 2013. They are intended to be used as general guidance only, and do not replace or summarise the information disclosure determinations themselves. In order to comply fully with the requirements of the determinations, suppliers and auditors should read the EDB, GDB and GTB determinations published on 1 October 2012. These documents can be found at:

- http://www.comcom.govt.nz/current-electricity-information-disclosure-requirements/ for EDBs; and
- http://www.comcom.govt.nz/gas-information-disclosure/ for GPBs.

www.comcom.govt.nz

CONTACT

To contact the Commission with information
about false or misleading trading practices,
or anti-competitive behavior by businesses:

CALL the Contact Centre on 0800 943 600
WRITE to Contact Centre, PO Box 2351, Wellington
EMAIL contact@comcom.govt.nz

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