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Ofwat PR 19 Taxation

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1 Background

1.1 Ofwat's approach to taxation[1] at PR14 was to provide companies with an allowance in respect of corporation tax, primarily by taking into account interest expense and capital allowances, broadly as follows:

a. Average capital allowance writing-down rates were used; and

b. Debt interest payments were calculated by using the higher of companies' actual proportion of debt financing and the proportion of debt financing assumed in Ofwat's notional capital structure, which assumed gearing of 62.5%.

1.2 Tax allowances were set ex ante as part of the final price determinations. If there is a one-off step change in gearing in any subsequent year which exceeds those assumed in setting price controls, then the tax benefit can be clawed back at a future price review.[2]

1.3 This approach has been examined in reports by the Public Accounts Committee (PAC)[3], the National Audit Office (NAO)[4] and Alvarez & Marsal (A&M).[5]

1.4 The PAC report stated that "Ofwat has consistently over-estimated water companies' financing and taxation costs when setting price limits. As a result, companies have made substantial windfall gains from customers' bills being higher than they needed to be."[6] The figure provided as the "windfall gain" is £1.2 billion for AMP5.[7]

1.5 The PAC report also notes that "other regulators have adopted different approaches to setting revenue allowances for tax and debt costs. For example, the energy regulator Ofgem updates these allowances annually to reflect changes in corporation tax and the market cost of debt for companies with similar characteristics to those it regulates".[8]

1.6 In other words, the issue is that actual tax costs for AMP5 were lower than tax allowances, and there was no formal process to pass the benefit of this reduction on to customers. On the other hand, the PAC report does acknowledge that "companies bear the risk of losses if [tax] costs turn out to be higher than expected".[9]

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[1] Set out in paragraphs 5.4.1 and 9.4.2 of "Setting price controls for 20150-20 – final methodology and expectations for companies business plans (July 2013)"
[2] In addition, there may also be scope for price limits to be reopened in very limited circumstances, for example, as a result of changes in tax law for circumstances that are beyond prudent management control, which lead to a net increase or decrease in the costs of an efficient company, although this would depend on the circumstances at the time. In order for the price limits to be reopened, they will need to meet the 'substantial effect clause' which assesses the materiality of the impact.
[3] Fifteenth Report of Session 2015-16, published on 16 December 2015 (further referred to as the "PAC report")
[4] The economic regulation of the water sector", published on 14 October 2015 (further referred to as the "NAO report")
[5] "Targeted review of corporation tax" issued by A&M on 13 May 2016 (further referred to as the "A&M report")
[6] PAC report, page 5
[7] AMP5 (Asset Management Period 5), which runs from 2010/11 to 2014/15
[8] PAC report, page 5
[9] PAC report, page 7

1.7 Whilst this approach generally encourages efficiency, by allowing companies to keep benefits from any efficiency savings they make, the PAC report notes that some aspects of company costs, including taxation, are outside the companies' control.[10] In particular, a reduction in the corporation tax rate under this approach may result in a windfall gain.

1.8 The PAC report does not contain any detailed analysis of the figure of £1.2 billion or whether this represents an amount which could, or should, be passed on to customers. This figure is, however, analysed in the NAO[11] and A&M reports.

1.9 The NAO report estimates that the gap between actual tax payments (including payments for group relief) and the tax allowances in the PR09 price determination, is not in fact £1.2 billion, but rather £710 million, as set out in the table below. For comparison, we have also shown the figures estimated by A&M.[12] £710million represents less than 1.5% of total revenues over AMP5.[13]

Description	NAO (£m)	A&M (£m)
Unpaid-for group relief	480	480
Reduction in Corporation Tax rate	410	211
One-off accounting adjustments	320	293
Other (including effect of tax on higher profits[14])	(500)	-
Difference between actual and assumed tax costs	710	-

1.10 The NAO report acknowledges that Ofwat would find it difficult to adjust for some of the factors causing lower than expected tax payments. However, prima facie, movements in corporation tax rates appear more straightforward to tackle, although the NAO report (like the PAC report) also recognises that under a risk-sharing mechanism, customers "could have lost out if borrowing costs or tax rates had risen".[15]

1.11 It is against this background that we have prepared this report for Ofwat in order to provide advice and recommendations for the PR19 methodology, on which Ofwat will consult in July 2017.

[10] PAC report, page 7
[11] NAO report, pages 8, 10, 11 and 35
[12] The table is also shown in Appendix 2 of the A&M report
[13] Total AMP revenues using 2007/08 prices were expected to be £48billion, of which £710million represents 1.5%. As inflation was positive over AMP 5, actual revenues would have been greater than £48billion.
[14] The figure of £500m is not stated in the NAO report, but is the difference between the sum of 480, 410, 320 (which total 1,210) and 710, all of which are stated in the report.
[15] NAO report, pages 10, 35. Also quoted in the A&M report, page 57

2 Scope

Scope of report

2.1 The scope of this report is set out in Ofwat's "Invitation to Tender for: PR19 – Taxation" dated 2 November 2016 (Reference Proc.01.0535).[16] In particular, the ITT sets out ten specific areas which are to be addressed. For the purposes of clarity, we have set out in the table below these specific areas and the sections of this report in which they are considered.

Overall Approach to corporation tax	Section addressed in this report
1) How should companies be compensated for the corporation tax expense that they face? Is it right to fund a specific corporation tax allowance or would an alternative approach be more appropriate?	5 (Approach to corporation tax) 8 (Alternative models)
2) Many of the regulated companies are part of larger groups and as a result they may be able to surrender tax losses to other group members or to benefit from loss relief from other companies. Up to the existing price control period, companies have received a revenue allowance to cover their expected tax charge, but where they have received group relief they have not always paid for it in full. How should we address the issue of sharing group relief? Is it right that companies should pay less than market value of the use of group relief? Is it right for regulated companies to surrender losses to other group companies which could otherwise be retained and used for the benefit of future customers?	7 (Group Relief)
3) The proposed introduction of the BEPS legislation may limit the amount of interest that companies are able to deduct against their profits for the purpose of calculating corporation tax. Should we take account of the overall group position when determining the level of interest that companies can offset against their trading profits in any year or should we focus only on the regulated entity on a 'stand-alone' basis? Given that groups may have complex structures and undertake activities outside the regulatory ring fence and within different tax jurisdictions how could/should we determine what level of restriction the legislation would place on the deductibility of interest?	7 (Interest restriction)
4) How should we take account of capital allowances in our calculations? Is the simplified approach adopted at PR14 still appropriate?	7 (Capital Allowances)

[16] Referred to further as the "ITT".

5) Should we allow for the reset of any tax allowance as a result of any subsequent changes in tax legislation in the price control period, for example, as a result of changes in tax rates? Are there any other circumstances in which it would be appropriate to make an ex post adjustment to tax allowances? Is the proposed approach consistent with other aspects of the price control where we make adjustments?	8 (Alternative models)
6) Our regulatory approach sets out a number of incentive mechanisms (including for example totex menu incentives, outcome delivery incentives and incentives related to the collection of revenue) in which adjustments are made ex post to revenues and RCV. For example where companies over or underspend on totex this is shared with customers. What are the principles which should be applied in determining whether to make an allowance for tax as part of that true up? Does the impact of tax mean that the incentives as proposed for PR19 are not operating in the way that they were designed to operate?	6 (Incentives)
7) Are there any other areas of corporation tax which are expected to change over the next price review period or which merit further review?	7 (Areas of complexity)
Implementation of Policy	
1) How should the overall tax liability of an appointed business be allocated across different price controls? This is particularly important where companies may have both profitable and loss making activities. Should tax allowances for each control be set on a stand-alone basis? Should customers be required to pay for a tax allowance in a profit making part of the business where the company is not going to have to make a corporation tax payment as a result of losses made in another part of the business? As we move to more competition and separation of the value chain is this approach right where not all companies are undertaking the same activities?	6 (Price controls)
2) What information do we need to collect from companies in their business plans to enable us to deliver our policy approach? We have a suite of business plan tables which were developed for PR14, and these will need to be updated to capture the information that we require for PR19, the Contractor will recommend changes that are necessary for us to collect the information necessary to assess tax proposals in company business plans.	9 (Transparency, Monitoring and Reporting)
3) What tests and assessment should Ofwat undertake in carrying out a proportionate assessment of the information provided to us in company business plans in regard to tax allowances?	9 (Transparency, Monitoring and Reporting)

Note: This report is based on UK taxation legislation, practice and case law as at the date of this report. This is particularly relevant given that the report is being issued before Budget 2017 and certain aspects mentioned in this report – in particular, rules relating to interest restrictions

(and the Public Benefit Infrastructure Exemption) and loss relief – are due to change in Finance Bill 2017.

3 Executive Summary

3.1. The aim of this report is to provide Ofwat with clear recommendations regarding the approach to tax for PR19 in the following areas:

i. How companies should be compensated for corporation tax;

ii. How the tax liability of a company should be allocated across the different price controls;

iii. How the existing incentive mechanisms should interact with the tax allowance;

iv. How the new interest restriction legislation should be incorporated into the tax allowance;

v. How Ofwat should take account of group relief;

vi. Whether the existing approach to capital allowances is suitable;

vii. Whether Ofwat should introduce a formal mechanism for ex post adjustments; and

viii. What information should be collected from companies, and what review of this information should Ofwat carry out.

3.2. In order to develop the recommendations, we have taken Ofwat's policy objectives and applied them to taxation; this has led to the following seven criteria against which any tax-related proposals can be evaluated:

i. The tax allowance should be based on clear rules which are applied consistently by companies and Ofwat;

ii. The approach to taxation should incentivise companies to manage their tax affairs responsibly, benefitting from statutory reliefs and exemptions and taking into account the long-term impact of their actions; any action taken as part of managing group tax affairs would not be included in the tax allowance;

iii. Companies should receive a fair tax allowance to cover their forecast tax costs, taking account of the tax profiles of the companies;

iv. The risks or rewards of tax costs outside the control of companies should be borne by the companies and customers on a fair, proportionate basis;

v. The tax methodology should not place an undue burden on either the companies or Ofwat;

vi. Any changes should be as far as possible simple to implement and consistent with the existing price control methodology; and

vii. Tax allowances should be calculated on a stand-alone basis, i.e. as an assumed notional single entity.

Approach to corporation tax

3.3. In order to assess Ofwat's approach to taxation, we have reviewed the approach used by a range of other regulators in the United Kingdom and Ireland. The approach to taxation adopted by different regulators is principally driven by how each regulator calculates the cost of equity. Broadly, regulators use either a pre-tax cost of equity (under which a generic headline tax rate is used) or a post-tax cost of equity (under which tax is treated as a cost of the business and a specific allowance is calculated for tax). A post-tax approach enables forecast tax liabilities to be closer to actual tax liabilities, as tax-adjusting items can be taken account of. This generates clear advantages in cases where the tax cost may be different from the headline rate, because it enables the company's forecast tax costs to be factored into the revenue entitlement which it derives from customers.

3.4. This is of particular importance to Ofwat as the regulated water companies have a wide range of tax profiles. In order to ensure that each company receives a fair tax allowance, the varying tax profiles need to be taken account of by the tax allowance methodology. A post-tax cost of capital approach enables this flexibility by requiring each company to forecast its tax charge.

3.5. The post-tax approach is adopted by the majority of regulators in the UK, with Ofwat, Ofgem, the Office for Rail Regulation (ORR) and the Northern Ireland Authority for Utility Regulation (NIAUR) adopting this approach; and the Civil Aviation Authority (CAA) and the Water Industry Commission for Scotland (WICS) adopting this approach when regulating companies for the first time. The approach of these regulators is consistent with, and supports, Ofwat's approach to taxation. We therefore do not consider that any fundamental change is required to Ofwat's approach, other than in certain specific areas noted below.

Interaction of tax and Ofwat's business model

Price controls

3.6. PR14 introduced the use of price controls for different parts of a water company's business. There are up to four separate price controls: one for each of the wholesale water and wastewater services (for which separate tax allowances were calculated); and one for each of the household and non-household retail businesses (which receive an allowance to cover costs, but for which no separate tax allowances were calculated).[17]

3.7. Despite this, the wholesale and retail businesses remained part of the same legal entity. As a result, the tax position of the legal entity may be different from the tax allowances given to the price control units. A reconciliation of the tax allowances per the price controls and the actual tax charge for the appointed business is now provided in the Annual Performance Reports (APRs).

3.8. For PR19, there will be four price controls relating to wholesale business: water resources, water network plus, wastewater network plus and bioresources. Thus there will be two wholesale controls (increased from one) price controls for water only companies ("WoC") and four wholesale controls (increased from two) for water

[17] Thames Water has five separate price controls: in addition to the four price controls listed above, Thames Water has an additional wholesale price control in respect of the Thames Tideway Tunnel project.

and sewerage companies ("WaSC") for the purpose of binding price controls and reporting.[18] At this point, there is no requirement for any separation of the business from a legal entity structural perspective.

3.9. To comply with the stand-alone principle at a price control level, which is necessary as the price controls are to be binding and costs and RCVs will be assessed separately for each, separate tax calculations should be performed for each price control on a notional single entity basis.

3.10. Ofwat currently makes one minor departure from the strict stand-alone principle at the price control level: the aggregate of the tax allowances for individual price controls cannot exceed the total forecast tax charge for the appointed business. We consider that this is fair for both customers and companies, as it ensures that customers only fund tax allowances to the extent that the appointed business is forecasting overall taxable profits.

3.11. In this context, the tax reconciliation in the APR will be an important mechanism to monitor forecast versus actual tax. We set out in our report some recommendations to improve the transparency and consistency of the APR reconciliations.

Incentive mechanisms

3.12. We have reviewed the treatment of tax in relation to Outcome Delivery Incentives, Export and Import Trading Incentives, the Wholesale Revenue Forecasting Incentive Mechanism and Retail Incentives.[19] In all cases, we consider that the tax treatment is in accordance with Ofwat's objectives and appears to be fair.

3.13. We have also examined the tax treatment of totex incentives and, in this case, we consider that the mechanism can lead in some cases to mismatches between the tax effect of any underspend or overspend, and the tax effect of the consequent totex adjustment. This arises because the tax treatment of totex depends on whether it is revenue expenditure or capital expenditure for tax purposes, whereas the tax treatment of the totex adjustment is fixed, regardless of the tax nature of the original underspend or overspend. We set out in Appendix 2 a theoretical means of eliminating such mismatches, but we acknowledge that in practice this may lead to an undue level of complexity and regulatory burden; as such, it would not be workable in practice.

Interest deductibility

3.14. From 1 April 2017, the UK will introduce new legislation potentially restricting interest deductibility for corporates, broadly capping tax relief for interest payable at 30% of "tax-EBITDA" (although the rules are fairly complex and in some cases the 30% figure can be higher). At the time of this report, draft legislation has been published for inclusion in Finance Bill 2017.

3.15. Included within the draft legislation is a provision to protect investment in infrastructure that has a public benefit (a Public Benefit Infrastructure Exemption or "PBIE"). The exemption will apply by way of an election which can be revoked after

[18] Thames Water will continue to maintain its separate wholesale price control in respect of the Thames Tideway Tunnel project for PR19. As a result, the wholesale controls in Thames Water will increase to five (from three) from PR19.

[19] "PR14 Reconciliation rulebook policy document", July 2015, pages 6-8 (Overview of taxation treatment), 19-22 (ODI taxation), 43-47 (Totex sharing), 58-60 (WRFIM), 69-70 (Trading Incentives), 85-87 (Retail incentives).

five years. Whilst the exemption will need to be considered on a case by case basis, the draft legislation has included water and sewerage facilities as examples of qualifying infrastructure.

3.16. Companies which qualify for this exemption will have no restriction placed on tax deductions for "qualifying interest", which is defined as interest paid to unrelated parties, or to other "qualifying infrastructure companies" within the companies' groups, who only have recourse to the income and assets of qualifying companies.

3.17. The water companies will be subject to the proposed legislation like any other industry. Our high level analysis (see Section 7 for details) indicates that the impact on companies, applying the 30% of tax-EBITDA restriction metric on a single-entity basis, may be quite varied but a number of companies would be adversely affected. However, in principle it appears the water companies could qualify for the PBIE, but it may be that a certain amount of restructuring will be required in order to satisfy the conditions for the PBIE.

3.18. We consider that there are broadly two approaches, regarding interest deductibility assumptions for PR19, which Ofwat could adopt:

i. The tax allowance methodology could assume that the PBIE is available to all water companies and that all interest expense is paid to third parties or other "qualifying infrastructure companies". As a result, all interest would be treated as tax deductible. The argument for this approach is that Ofwat may reasonably expect a company to structure its financing arrangements in such a way as to maximise its interest deductions. Introducing this assumption for PR19 will allow the water companies three years to review and restructure their financing arrangements to minimise any tax inefficiencies.

ii. Alternatively, the tax allowance could be calculated based on the expected actual application of the new rules to each company, i.e. the company would provide the figure for tax-deductible interest expense along with supporting calculations. Under this approach, companies could choose to elect into the PBIE or not, and this would accordingly be taken into account in the forecast tax costs.

3.19. The first option is simple and clear; it is arguably a direct application of the stand-alone basis and it should incentivise companies to manage their tax affairs so that interest deductions are maximised, which should benefit customers.

3.20. The second option is arguably fairer for companies as it would take into account their actual expected position, which is how the majority of other areas of tax are treated, but it may reduce the incentive for companies to manage their tax affairs responsibly.

3.21. In addition, it is necessary to consider the interaction of the new legislation with Ofwat's gearing assumptions. For PR14, Ofwat assumed a notional gearing of 62.5% and a set cost of debt, with the tax allowance calculated using the higher of notional gearing and actual gearing. A variant of the first option would be to assume the PBIE applies, but to take account of any related party interest, which would be non-deductible unless paid to qualifying companies. This would arguably provide a fairer outcome for companies but would need to be monitored and contain provision for Ofwat to clawback allowances if companies subsequently restructured to increase their tax deductions for interest expense.

3.22. The first option is arguably fairer for customers and should incentivise companies to restructure their financing to ensure full deductibility of debt. This is consistent with the notional single entity concept, and make uses of a statutory exemption which is designed to cover infrastructure companies such as water. However, if companies are unable to do so, or the cost would be prohibitive, then the first option would not fund companies for the tax cost of any such disallowed interest. The second option, by taking account of the actual position, would be arguably fairer for companies. However, it would not incentivise companies to maximise the tax deductibility of debt and therefore arguably is not in the best interests of customers.

Group relief

3.23. UK tax legislation allows UK resident companies under common ownership to surrender tax losses to each other via group relief or consortium relief. Any payments or receipts for tax losses are not subject to UK corporation tax, provided that the payment does not exceed the gross amount of the loss. These payments are accounted for as part of the company's tax charge in the financial statements.

3.24. Within the water industry, it is common for a regulated entity which has taxable profits to claim group relief from the wider group. Water companies currently have different approaches to payment for group relief or consortium relief and related disclosures in APRs.

3.25. It is a regulatory requirement that all transactions between regulated entities and related parties be undertaken on an arm's length basis. In practice, it may be difficult to establish an arm's length price for tax losses as there is no open market for losses surrendered via group relief and the value of losses surrendered may be different to the two companies involved in the transaction. We consider that the most transparent approach for PR19 would be to require that regulated companies pay for (or charge for) group relief at full tax value on the basis that this is the value of the loss to the water company. Conceptually, a payment for group relief at full value should be treated as effectively identical to a payment made to HMRC, on the basis that both amounts are based on taxable profits and have the same economic impact on the regulated company. This is consistent with the stand-alone concept, and would also aid transparency and eliminate an aspect of inconsistency of approach amongst the companies.

3.26. In the event that a company nonetheless pays less than tax value for group relief, a fair outcome to customers may be for the difference between the tax allowance and the price paid for group relief to be clawed back. However, in a scenario whereby group relief is claimed to shelter profits as a result of a capital allowance disclaimer, it may be of less concern to Ofwat what price is paid for group relief as capital allowance disclaimers are not funded in the tax allowance.

3.27. In the event that a company forecasts group relief in its business plan, and forecasts that it will pay less than full tax value for these losses, then the tax allowance should be reduced accordingly.

Capital allowances

3.28. Our review of capital allowances has focused on three areas: the simplified approach adopted for PR14; capital allowance disclaimers; and the computation of opening pools in business plans. In order to support our work, we have sought the views of all regulated water companies and received replies from fourteen of them. Our work on each of the areas has been informed by the responses received.

3.29. At PR14, Ofwat adopted a simplified approach to capital allowances, under which an average writing down rate for a single pool was used for tax forecasts rather than using separate forecasts for each capital allowance pool. Of the companies surveyed, only one company considered that this approach had reduced the time required to prepare the business plan, with the majority of companies stating that they continue to prepare more detailed models and in many cases the simplified approach entailed more work than before. In addition, with the increase in price controls at PR19, an allocation of capital allowance pools will be required; the simplified approach will likely make this more complex than using actual pools. We therefore recommend that the simplified approach be removed for PR19.

3.30. Where regulated companies are members of larger groups, it is common to disclaim capital allowances in order to realise taxable profits against which losses from elsewhere in the group can be group relieved. However, business plans and Ofwat's financial model assume full capital allowance claims and prices are set on this basis. If capital allowances are disclaimed as part of voluntary group tax planning, a straightforward application of the "stand-alone" concept would require companies to reverse all capital allowance disclaimers for the purposes of completing the opening capital allowance pool for the next price review. We therefore recommend that, in line with the "stand-alone" concept, the tax allowance for PR19 should be calculated assuming that full capital allowances are claimed. The capital allowance pools carried forward to the next price review period should also assume that full capital allowances have been claimed, i.e. if a water company chooses to disclaim its allowances (thereby keeping its capital allowance pools higher than if full claims had been made) the tax effect is a matter for the company rather than the customer.

3.31. Finally, we consider how companies estimate the capital allowance pool at the start of each AMP. Companies currently compute this in different ways – some base the pool value on the latest submitted tax computations; some reverse the effect of capital allowance disclaimers, but at least one does not. We consider that in order for the approach to tax to be fair, it is important that all companies interpret and apply it consistently. We recommend that for PR19 companies should take the latest available capital allowance pools per the tax returns, add any estimated expenditure to reach the position at the start of the next price control period, and eliminate the effect of any capital allowance disclaimers made in AMP6 (albeit consideration could be given to going back further than AMP6). There are, however, some complexities with the precise calculation which we set out in the body of this report.

Tax trigger

3.32. As mentioned above, Ofwat's approach to taxation at PR14 was to provide companies with a specific allowance in respect of corporation tax. Tax allowances were set ex ante as part of the final price determination, with few circumstances where adjustments could be made. This has meant that in years where actual tax costs are lower than the calculated tax allowance, there is no formal mechanism to pass this benefit onto customers.

3.33. We have therefore considered whether it would be appropriate for Ofwat to introduce a mechanism to make an ex post adjustment to taxation allowances. The introduction of a formal adjustment mechanism would require Ofwat to change the approach to tax risk taken in previous price reviews. Broadly, tax risk for companies arises from the potential for future tax costs to differ from expected levels due to changes in tax rates or other tax legislation (as opposed to from variations in the performance of the business or the responsible management of tax). In previous

periods Ofwat has allocated this risk entirely to the companies, which has resulted in the accompanying benefits also being realised by the companies, albeit it should be acknowledged that if tax rates had increased then the companies would have incurred the additional cost.

3.34. Whilst Ofwat is not the only regulator to adopt this approach, our work has identified the following regulators who share tax risk with customers to varying degrees:

i. Ofgem has introduced a "Tax Trigger" mechanism which adjusts for legislative changes to corporation tax rates and changes to other areas of legislation, HMRC interpretation, case law or accounting standards;

ii. NIAUR in relation to Northern Ireland Water has a mechanism to review the tax allowance at an interim period due to uncertainty over recently refiled tax returns;

iii. NIAUR in relation to Northern Ireland Electricity calculates the tax allowance by reference to the full amount of capital allowances actually available to be claimed, i.e. capital allowances are dealt with on a pass-through basis; and

iv. NIAUR in relation to SGN Natural Gas in Northern Ireland has an "uncertainty mechanism" which covers unexpected changes in a wide range of areas, including the headline rate of corporation tax.

3.35. We consider that the introduction of a formal tax trigger mechanism in specific areas would be a fairer allocation of tax risk between companies and customers. However, the mechanism would impose an increased regulatory burden on Ofwat and the water companies; it may also reduce the incentive for companies to outperform Ofwat's financial model as regards tax, as part of such savings may go to customers.

3.36. Were a tax trigger to be introduced, there are several features of the tax trigger that would need to be carefully considered:

i. Symmetry: It would seem fair and reasonable for any mechanism to apply equally to both tax savings and tax costs.

ii. Frequency: Whilst it is arguably fairer for an adjustment to be made annually, an adjustment every year would impose a greater burden on both companies and Ofwat than a single end-of-period adjustment.

iii. Materiality: Ofgem's tax trigger uses a threshold to prevent immaterial adjustments being made. Whether or not to introduce a materiality threshold will need to be decided in conjunction with the frequency of adjustments, e.g. if there is only a single tax adjustment at the end of the price control period, it may not be necessary to include a materiality threshold.

iv. Areas to be covered by the tax trigger: Whilst in theory a tax trigger could apply to all differences between assumed and actual tax costs, this could result in customers bearing the cost of some tax risks which are fully within the control of the companies. This would also be inconsistent with Ofwat's overall approach in other areas, where companies are incentivised to outperform the business plan assumptions. It will therefore be necessary to determine the cases where adjustments would be made.

Our overall view is that, as a minimum, the effect of any changes to the headline tax rate and the capital allowance rate should be included in an 'adjustment mechanism'. Any other changes identified in this report (such as interest restriction) can be specifically modelled for PR19; if any further changes to the legislation arise, they can be taken account of at the next price review. In particular, we note that capital allowance disclaimers and group relief are examples of tax management by individual companies (in some cases taking account of the wider group tax). It would be consistent with the above analysis for the benefit or cost of such items to remain with companies.

Transparency, Disclosure and Monitoring

3.37. We have set out in the report details of the changes to the financial model, the reporting requirement in the APRs, some changes to RAG 5.06 and certain other areas of monitoring by Ofwat which we consider would be required to implement the changes described in this report.

3.38. Specifically, we recommend:

a. Ofwat should monitor the reconciliation of tax allowances to actual tax charge during an AMP.

b. Ofwat should provide clear instructions to companies regarding their reporting requirements.

c. The wording of RAG5.06 should be amended in order to include the policy for payment of tax losses.

d. Ofwat should consider introducing a mechanism for checking that companies are calculating their capital allowances in accordance with the revised capital allowance methodology for PR19.

e. The financial model employed by Ofwat should be amended to reflect the new loss utilisation rules.

4 Ofwat's Objectives

4.1 The overall objective of this report is to provide Ofwat with clear recommendations regarding the approach to taxation for PR19. In order to do so, we have taken Ofwat's policy objectives and considered how best to apply these to taxation.

4.2 We have set out below our understanding of Ofwat's approach, split into three areas; in each case we have also set out our understanding of how these areas are relevant to taxation and, in particular, the issues in this report. We have also set out details of an existing Regulatory Asset Guideline (RAG 5.06) and certain terms of the licences of the appointed businesses which deal with related party transactions and which are therefore relevant for the overall approach to taxation.

Key objectives

4.3 Ofwat's statutory objectives address various problems and themes, as set out below.

Ofwat's policy objective	Application to taxation
1. Protecting consumer interest wherever appropriate through promoting competition	The tax allowance granted to the regulated companies (and therefore the cost passed on to the consumer) must be fair and transparent; some form of sharing tax benefits with the consumers should be considered.
2. Promoting efficiency	The tax allowance methodology should incentivise companies to manage their tax affairs responsibly.
3. Maintaining resilience by promoting long-term planning which takes account of environmental and population changes	The tax allowance granted to regulated companies must encourage them to undertake responsible tax planning which takes account of the long term impact of their strategies.
4. Protecting environment	Not directly relevant for tax.
5. Ensuring affordability with regard being given to vulnerable customers	The methodology must ensure that consumers do not disproportionately bear the tax costs incurred by the regulated companies.
6. Ensuring that water companies are financially viable and able to provide their services	The methodology should ensure that regulated companies receive an appropriate allowance to cover tax costs and do not disproportionately bear the impact of tax matters outside of their control (such as the changing of the statutory tax rate).

How to achieve these objectives

4.4 We have further set out below the means by which Ofwat seeks to achieve the above objectives through its regulatory model.

Ofwat's approach	Application to taxation
1. Pro-market approach based on (i) promotion of markets, (ii) avoiding undue discrimination between customers and market participants and (iii) promoting competition wherever appropriate	The tax allowance must be fair and transparent, sharing the tax risks and rewards between regulated companies and consumers. The tax allowance should incentivise water companies to manage their tax affairs responsibly.
2. Better regulation principles including (i) proportionate and targeted intervention, (ii) use a broad range of regulatory tools, (iii) flexibility and responsiveness, (iv) emphasis on transparency and predictability	The tax allowance methodology should be easy to understand and operate, not placing an undue burden on either the water companies or Ofwat. The methodology should offer specific and targeted guidance on how to calculate the tax allowance; this will help ensure that the approach to tax is clear and transparent. The tax allowance should be sufficiently flexible to fairly accommodate the different tax profiles of the companies Ofwat regulates.
3. Focus on customer outcomes rather than outputs	Tax should be aligned with other functions; these should operate coherently and consistently to allow the water companies to meet their obligation towards consumers.
4. Focus on efficiency including (i) providing effective incentives to companies to be efficient, (ii) encouraging ownership and accountability by companies of their compliance strategy and (iii) fostering innovation.	The tax allowance should incentivise companies to responsibly manage their tax affairs.

Practical issues

4.5 When addressing any proposal relating to the regulatory framework, it is necessary to ensure that it meets the test of practicality, as set out below.

Ofwat's approach	Application to taxation
1. What are the resources required to implement the proposal?	The tax methodology should not place undue burden on either companies or Ofwat. The methodology should be easy to understand and implement for the regulated companies, and easy to review and monitor for Ofwat.

2. What are the costs of implementation?	Consideration should be given to the processes already in place and the practices already undertaken within the regulated companies and Ofwat.
3. How quickly can the change be seen?	Proposed changes to the tax methodology should be simple and efficient to implement such that their benefits will be quickly realised.

Related party transactions

4.6 When considering the appropriate methodology for the tax allowance, of specific relevance from a regulatory perspective are the various requirements that transactions between related parties should be undertaken on arm's length terms.

4.7 Specifically, the relevant conditions of appointees' licences are:

a. Paragraph 6.1 of Licence Condition F[20], which states: "The Appointee shall ensure that every transaction between the Appointed Business and any Associated Company (or between the Appointed Business and any other business or activity of the Appointee) is at arm's length, so that it neither gives to nor receives from the other any cross-subsidy".

b. Paragraph 6.8 of Licence Condition F, which states: "The Appointee shall not, in respect of any Charging Year, make any payments to any Associated Company in respect of the services rendered to the Appointee by that company, which exceeds: (i) [a price ascertained through market testing] or (ii) if, in the opinion of [Ofwat], the Appointee has demonstrated that market testing as described in (i) above is inappropriate, such proportion as [Ofwat] may agree of the Associated Company's costs in providing to the Appointee the service in question (including a reasonable return to the Associated Company)". Paragraph 2.3(2) in the definition part of Licence Condition F notes that, "references to the supply of a service include references to anything […] being made available".

4.8 RAG 5.06[21] also state the undertakers' disclosure obligations in their Licences.

4.9 It is also important to note that companies cannot transfer costs between the price control units in setting prices and preparing regulatory accounting statements.[22] In accordance with RAG 5.06, transfer prices for transactions between price control units should be based on market price unless no market exists, in which case transfer prices should be based on cost.[23]

Single entity concept

4.10 Although RAG 5.06 makes no explicit reference to tax, we assume that the same principle of no cross-subsidy should also apply for tax purposes. This would mean that each business should be treated on a notional "stand alone" basis and its tax

[20] In the case of South West Water, these provisions are in condition P and in the case of Bazalgette Tunnel in condition K
[21] "RAG 5.06 – Guideline for transfer pricing in the water and sewerage sectors" dated February 2015
[22] RAG 5.06, Para 1.1
[23] RAG 5.06, Para 7.7

computed as if it were a separate entity. This is also consistent with the overall approach to tax set out in section 5.

4.11 We summarise the above requirements as the "single entity concept"; it requires each price control unit to be treated on a notional "stand alone" basis, with its tax computed as if it were a separate entity.[24] Along with Ofwat's objectives, this concept will inform the conclusions drawn throughout the report.

Overall tax principles

4.12 On the basis of the above, we consider that the main tax principles are:

i. The tax allowance should be based on clear rules which are applied consistently by companies and Ofwat;

ii. The approach to taxation should incentivise companies to manage their tax affairs responsibly, benefitting from statutory reliefs and exemptions and taking into account the long-term impact of their actions; any action taken as part of managing group tax affairs would not be included in the tax allowance;

iii. Companies should receive a fair tax allowance to cover their forecast tax costs, taking account of the tax profiles of the companies;

iv. The risks or rewards of tax costs outside the control of companies should be borne by the companies and customers on a fair, proportionate basis;

v. The tax methodology should not place an undue burden on either the companies or Ofwat;

vi. Any changes should be as far as possible simple to implement and consistent with the existing price control methodology; and

vii. Tax allowances should be calculated on a stand-alone basis, i.e. as an assumed notional single entity.

4.13 We note that the evaluation is qualitative, rather than quantitative, and that it is important to form an overall judgement. We also understand that an important part of the overall stability and integrity of the regulatory framework is that any changes should only be prospective and not retrospective.

4.14 The recommendations in this report regarding the approach to tax for PR19 have been developed in line with these objectives.

[24] RAG 5.06, Para 1.4 states that there should be no cross-subsidy between different price control units.

5 Approach to Corporation Tax

Introduction

5.1. As part of our review of taxation, we have been asked to consider how companies should be compensated for the corporation tax expense that they face; and whether it is right to fund a specific corporation tax allowance, or whether an alternative approach would be more appropriate.

5.2. In order to address this, we have reviewed the approach to taxation used by Ofwat and by a range of other regulators in the UK and Ireland: the Civil Aviation Authority (CAA), Office of Communications (Ofcom), Office of Gas and Electricity Markets (Ofgem), Office of Rail Regulation (ORR), the Water Industry Commission for Scotland (WICS), the Northern Ireland Authority for Utility Regulation (Utility Regulator or NIAUR), and the Commission for Energy Regulation (CER).

Overview of approaches to tax

5.3 In practice, the approach to tax by regulators whose approach to tax we have reviewed can, with one exception (the Water Industry Commission for Scotland), be categorised as follows:

a. Regulators who use a post-tax cost of equity (such as Ofwat, the Office of Gas and Electricity Markets (Ofgem), the Office of Rail Regulation (ORR) and the Northern Ireland Authority for Utility Regulation (NIAUR)), in which case a specific tax allowance is set for tax; or

b. Regulators who use a pre-tax cost of equity (the Civil Aviation Authority (CAA), the Office of Communications (Ofcom) and the Commission for Energy Regulation (CER)), in which case a generic tax rate (typically the headline rate) is used and no specific tax allowance is calculated.

5.4 As explained further below, in each case the cost of equity is an input into a calculation of WACC, which is then used to calculate an allowed revenue return.

5.5 In theory there are intermediate approaches to the two outlined above, e.g. a pre-tax cost of equity using the expected effective tax rate of the company. However, our review of the approaches to tax taken by regulators in the UK and Ireland shows that in practice the approaches fall into the one or other of the above two categories and either a specific tax allowance is calculated (as per (a) above), or a headline tax rate is used (as per (b) above).

5.6 The cost of equity is the return that a company is expected to deliver to its shareholders. As it is generated from post-tax profits, an adjustment (sometimes referred to as the "tax wedge") is made in order to determine what level of pre-tax profits the company must generate in order to deliver the required return to shareholders. This converts the post-tax cost of equity, sufficient to meet the requirements of equity investors, to a pre-tax cost of equity. In practice, regulation

on a pre-tax basis, typically uses only a notional tax charge, and the standard formula for pre-tax WACC is:

$$gR_d + \left(\frac{1}{1-t}\right) R_e(1-g)$$

g = gearing; R_d = return on debt; R_e = return on equity; t = tax rate

5.7 The alternative approach is to use what is generally referred to as 'vanilla' WACC, which is the approach currently used by Ofwat. In this case, the post-tax cost of equity is not adjusted. Instead, the assessment of likely corporation tax liabilities for the regulated business is treated as a cash flow item and added to the operating costs of the business. In this case, the formula is:

$$gR_d + R_e(1-g)$$

5.8 Finally, as mentioned above, there is a fundamentally different approach taken by Water Industry Commission for Scotland (WICS) in relation to Scottish Water which is discussed in more detail below.

Overview of Ofwat's approach

5.9 The approach currently taken by Ofwat in relation to corporation tax is based on its use of a post-tax cost of equity, consistent with which it is necessary to treat tax as cost of the business and, as such, to calculate a specific allowance for tax.[25]

5.10 Ofwat's calculation uses the following adjustments to profit before tax (PBT) in order to calculate the tax allowance:

a. Items added back to PBT
   i. Depreciation
   ii. Change in general provision
   iii. Other adjustments to taxable profit
   iv. Other adjustments
   v. Preference share dividends
   vi. Non-deductible expenses
   vii. Issuance costs
   viii. Correction to interest for gearing adjustment.

b. Items deducted from PBT
   i. Capital allowances (split into water and wastewater)
   ii. Finance lease depreciation
   iii. Adjustments for pension contributions
   iv. Grants and contributions taxable on receipt; and amortisation of these.

5.11. Under the current approach, both profitable and loss making companies are required to submit business plans which include the tax allowance calculation. One option for PR19 would be to allow loss making companies to make an election not to receive a tax allowance (and thereby negate the need to perform the calculation). However,

[25] In theory both a pre-tax and post-tax approach to cost of capital can be equivalent. If detailed tax modelling is undertaken to estimate what the tax liability of a company will be during the price control period, a tax adjustment to the post-tax cost of equity figure can be calculated, providing a revenue stream with the same net present value (NPV) as the NPV of the tax costs. However, the equivalence breaks down if precise liabilities are not calculated.

this would likely lead to additional work in the period in which those companies become tax paying e.g. to reconcile opening balances.

5.12. Whilst we have outlined below the position adopted by other regulators, it is important to make various distinctions between Ofwat's position and that of other regulators, as follows:

a. Ofwat regulates 17[26] companies; most regulators regulate either a single entity (e.g. ORR) or a small number of entities (e.g. CER); the only exception is Ofgem which sets prices for circa 28 companies.[27]

b. The entities regulated by Ofwat are all in private ownership, with private shareholders (with one exception – Welsh Water – which is a company limited by guarantee, without shareholders); some other regulated entities are in public ownership (e.g. Network Rail).

c. The entities regulated by Ofwat have very different tax profiles[28]; some other regulated entities currently have very simple tax profiles (e.g. Irish Water and NI Water do not currently pay any tax).

5.13. Given these distinctions, it is not necessarily the case that the approach to taxation taken by other regulators of direct relevant to Ofwat. However, it is interesting to compare approaches and to see whether there are any specific points which can help inform Ofwat's situation.

Overview of other regulators

5.14. Our review is based on publicly available information and some direct engagement with Ofgem (in order to clarity certain points relating to their approach to taxation). As such, our comments are based on our understanding of the various approaches and may not reflect the views of the regulators or the regulated entities. We have endeavoured to cover a large proportion of the regulated entities in the UK and Ireland, but our review is not exhaustive.

5.15. The main points arising from our review are as follows:

a. Three regulators (Ofcom, CAA and CER) use a pre-tax cost of capital, whilst three (Ofgem, ORR and NIAUR) use a post-tax cost of capital (and therefore calculate specific tax allowances).The final regulator reviewed, the Water Industry Commission for Scotland (WICS) which regulates Scottish Water, uses a fundamentally different approach which does not involve setting prices on the basis of the return to the regulated entity. In any case, Scottish Water is a publicly owned entity which is not currently taxpaying.

b. In the case of Ofcom, the price controls are, first, only a pre-tax basis and, secondly, only in relation to a very specific part of much larger businesses. This is so fundamentally different from the companies regulated by Ofwat (for which price controls broadly encompass all, or almost all, of their businesses) that we do not consider that is provides any helpful comparison in relation to tax. Nonetheless, Ofcom does state that it will adjust the "tax wedge" in the pre-tax cost of equity if the headline rate of tax changes,

[26] There were 18 water companies at PR14, but Bournemouth Water is now part of South West Water
[27] Mainly gas and electricity distribution and transmission companies
[28] See the effective tax rates in Ofwat's report "Monitoring Financial Resilience", Nov 2016, Page 24

thereby removing from companies the benefit (or cost) of any change in tax rates.

c. Network Rail currently pays an immaterial amount of tax, so the approach to tax has little practical effect in calculating its prices. It is interesting to note that the move from a pre-tax to post-tax cost of capital in 2009 involved a clawback of tax allowances deemed to have been given to Network Rail; this is an early example of how the difference between assumed versus actual tax allowances has been addressed, although the context (i.e. a change from pre- to post-tax WACC) was different from the issues outlined in section 1 of this report and the change was (arguably) made retrospectively. We also note that Network Rail is now controlled and funded by the Government.

d. In the case of Northern Ireland Water (regulated by the NIAUR), owing to uncertainty over the actual tax position of the regulated entity during the current price control period, the company has requested that tax allowances be revisited at an interim stage of the price control period, although this is not a formal "true up" or "clawback" mechanism, but rather a one-off reconsideration.

e. The issue of disclaimed capital allowances has arisen in relation to Northern Ireland Electricity (also regulated by the NIAUR); the issue was referred to the Competition Commission (now the Competition and Markets Authority or CMA), which determined that a "notional" basis should be used where capital allowances had been disclaimed, on the basis that this was a fair approach for both the company and customers. This is of interest when considering Ofwat's approach to capital allowances (see section 7).

f. NIAUR has established a true up mechanism for the Northern Irish Gas Distribution Networks, although the mechanism only adjusts for changes in the corporation tax rate

g. Overall, the position of Ofgem appears closest to that of Ofwat and, in particular, Ofgem's "tax trigger" appears to be of most relevance in illustrating how changes in tax legislation can be incorporated into price controls. The question of how Ofwat could apply such a mechanism is discussed in section 8.

Commentary on approaches taken by other regulators

5.16. In the text below, we have provided a commentary on the approaches taken by regulators who use a pre-tax cost of capital and a post-tax cost of capital respectively. As approaches may change over time and individual regulators may deal with more than one regulated business, we have outlined in the tables at the start of the respective sections the specific price controls which we have reviewed.

Pre-tax cost of capital

Regulator	Treatment of tax
CAA – Heathrow, Gatwick and Stansted 2003-2008; Heathrow and Gatwick 2008-13	Headline rate of 30% (2003-8), 28% (2008-13)

Ofcom – Wholesale Line Rental (WLR) and Local Loop Unbundling (LLU)	Headline rate of 20%
CER – Bord Gáis, Irish Water, Electricity Transmission and Distribution (ESB Network Ltd)	Headline Irish rate of 12.5%

Civil Aviation Authority (CAA)

5.17. In the price determination for 2003-8, the CAA used a headline rate of 30% to convert the post-tax cost of equity to a pre-tax cost of equity. The CAA noted that the use of a headline rate in converting the post-tax cost of equity to the pre-tax cost of equity (i.e. 30%) "probably creates some headroom for BAA", as "the actual corporate tax rate might be lower than the standard corporate tax rate used in the modelling, e.g. effect of capital allowances and other timing difference", but that "this should be seen as part of an overall package of regulatory policies".[29] As such, it is interesting that the CAA was aware of the likely difference between allowed and actual tax, but considered this acceptable. In the 2008-13 price determination, the CAA made no change to its approach to taxation, other than to adjust the headline rate from 30% to 28%.[30]

Office of Communications (Ofcom)

5.18. In the price determination for Local Loop Unbundling (LLU) and Wholesale Line Rental (WLR) for the period running from 1 April 2014 -31 March 2017, Ofcom used a headline tax rate of 20% to calculate the pre-tax cost of capital. Ofcom notes that the tax rate used in the price determination will take account of any changes to the corporation tax rate proposed by the Government.[31]

Commission for Energy Regulation (CER)

5.19. The CER has set the cost of capital for Bord Gáis[32], Irish Water[33] and ESB Network Ltd (for electricity distribution)[34] on a pre-tax basis, using the headline corporate tax rate in Ireland of 12.5%.

5.20. The CER also regulates other entities, including EirGrid, the transmission system operator for Ireland, and the Single Electricity Market, the wholesale electricity market which covers both Northern Ireland and the Republic of Ireland. Since 1 July 2014, the CER has not regulated Bord Gáis, although it continues to monitor certain benchmarks (such as market share) to ensure that sufficient competition in the marketplace is retained.

[29] "Economic Regulation of BAA London Airports, (Heathrow, Gatwick and Stansted), 2003 – 2008 - CAA Decision" (February 2003), paragraphs 4.60-4.62
[30] "Economic Regulation of Heathrow and Gatwick Airports, 2008-2013 - CAA decision" (11 March 2008), paragraphs 10.53-10.54
[31] "Fixed access market reviews: Approach to setting LLU and WLR Charge Controls: Annexes" (20 August 2013), paragraphs A15.151 and A15.152.
[32] "Decision on October 2012 to September 2017 distribution revenue for Bord Gáis Networks – Decision Paper – CER/12/194" of 23 November 2012.
[33] Irish Water's price control IPC1 for 27 months from October 2014 used a pre-tax cost of capital.
[34] Decision on 2011 to 2015 distribution revenue for ESB Networks Ltd – Decision Paper – CER/10/198" of 19 November 2010

5.21. In advance of the IRC2 price control for Irish Water (from January 2017 onwards), the CER commissioned a report from Europe Economics on setting WACC, including consideration of taxation.[35] The report compared the two main approaches to tax allowances noted above, i.e. a pre-tax cost of capital with a headline tax rate, or a post-tax cost of capital with specific modelling of tax. In relation to the former, the report notes that the "revenue provided for tax liabilities under this approach may be either higher or lower than the company's actual tax liabilities".[36] In concluding that the pre-tax approach to cost of capital should be retained, the report states: "Our main view of substance is that the approaches based upon the headline rate of tax are conceptually superior to those based upon the effective rate, since they leave the discretion to change investment incentives across the economy, via tax allowances, with the tax authorities (where they should lie) instead of with the regulator."[37] This is fundamentally different from Ofwat's post-tax approach. Whilst the CER report acknowledges the potential for actual tax liabilities to differ from forecast ones, it does not appear to assign this factor the same importance as has been assigned to it in the PAC and NAO reports on Ofwat.

5.22. We also consider it relevant to note the actual tax positions of the entities regulated by the CER, as follows:

a. Bord Gáis is currently paying immaterial levels of corporation tax. The December 2015 financial statements disclosed Euro 4,000 of tax payable in 2015, with zero tax payable in 2014.[38]

b. Irish Water is not currently in a taxpaying position. For example, its December 2015 financial statements disclosed zero tax payable and gross tax losses of Euro 274 million.[39]

5.23. We note however that ESB Networks Ltd is currently in a tax paying position, so that the modelling of tax is of current relevance to it, e.g. the December 2015 financial statements disclosed Euro 1.2m and Euro 1.3m of corporation tax payable in 2015 and 2014 respectively.[40] However, this is still very low compared to the levels of tax paid by companies regulated by Ofwat.

Post-tax cost of capital

Regulator	Treatment of tax
Ofgem – Electricity DNOs from DPCR4 onwards, (i.e. from 1 April 2005)	Specific allowance calculated for each company, with a tax trigger introduced from DPCR5 onwards designed to adjust for changes in the tax regime.
Ofgem – Gas DNOs from RIIO-GD1 onwards	Specific allowance calculated for each company, with a tax trigger identical to that for the Electricity DNOs.
ORR – Network Rail PR08 and PR13	Specific modelling of corporation tax. There is no tax trigger included in the current price control period, but the ORR previously introduced a

[35] "Consultancy Support for Water Division" report of 26 September 2016 by Europe Economics
[36] Paragraph 9.2.1(a)
[37] Paragraph 9.5
[38] Bord Gáis Energy Limited Financial Statements to 31 December 2015, Note 9a
[39] Irish Water Financial Statements to 31 December 2015, Note E5
[40] ESB Networks Limited Financial Statements to 31 December 2015, Note 7

	mechanism to claw back the over funding of tax in the previous price control period.
NIAUR – Northern Ireland Water – PC15 (2015-21)	Specific allowance calculated, but no tax paid owing to losses. Due to significant uncertainty over the possibility of cash tax arising following the resubmission of computations, NIAUR may review the price control at the mid-term review (although this is not under a formal tax trigger mechanism).
NIAUR – Northern Ireland Electricity Transmission and Distribution (2012-17)	Specific tax allowance calculated. There is no tax trigger mechanism. The most recent price control period was referred to the Competition Commission. This established that the tax allowance should be calculated assuming full capital allowance claims (regardless of whether actually claimed).
NIAUR – Gas Distribution Network GD17	Specific allowance calculated, but no tax anticipated in current price control period owing to losses. Uncertainty mechanism in place to allow for changes to statutory tax rate.

Ofgem – Electricity Distribution Network Operators

5.24. Prior to DPCR4 (i.e. up to 31 March 2005), Ofgem used a pre-tax cost of capital in setting the price controls for Distribution Network Operators ("DNOs") on the basis that this provided network companies with a strong incentive to manage their tax liabilities responsibly, by allowing companies to out-perform the regulator's assumptions.

5.25. From DPCR4 onwards, (i.e. from 1 April 2005), Ofgem started calculating the cost of capital on a post-tax basis, meaning that a specific tax allowance had to be calculated for each company. This therefore raised the issue of how to set this allowance. It was agreed that there were broadly two options: (i) an ex ante allowance in each DNO's price controlled allowed revenue; or (ii) an ex post pass through of actual incurred tax liabilities.

5.26. Although an ex post pass-through of actual tax costs would have brought certainty of recovery of costs, the concern was that it would not have incentivised companies to maximise tax more efficiently by out-performing Ofgem's assumptions. After extensive consultation, Ofgem decided not to introduce a tax risk-sharing scheme.

5.27. However, Ofgem considered that the net effect of tax regime changes introduced in April 2008 (such as the fall in the corporation tax rate) resulted in a windfall gain for DNOs for the last two years of DPCR4, estimated to be equivalent to a 60 basis point increase in the return on regulatory equity for each year of the DPCR4 period. As a result, again after detailed consultation, Ofgem introduced a "tax trigger" for DPCR5, with effect from 1 April 2010. Key objectives of "tax trigger" were as follows[41]:

a. It should be unambiguously clear when a trigger event has occurred;

[41] "Strategy decision for the RIIO-ED1 electricity distribution price control – Financial issues – Supplementary annex to RIIO-ED1 overview paper", p.73

b. The effect of the trigger should be measurable by Ofgem with minimal recourse to DNOs, (subject to ex post adjustments for those that cannot be determined until tax returns are agreed by HMRC);

c. The trigger should be simple and transparent to apply;

d. The mechanism is "symmetrical" such that, whilst the downside risk of adverse legislative changes were removed from the DNOs, customers would retain the upside benefit of beneficial legislative changes;

e. It was intended that this approach would continue to incentivise the DNOs to manage their tax affairs responsibly within the existing tax regime; and

f. There is a materiality threshold (called the "deadband") in order to avoid adjusting for relatively small changes; the deadband was set at the greater of 0.33% of the total base revenue of an individual DNO or a 1% change in the corporation tax rate.

5.28. Following DPCR5, the price regulation for Electricity DNOs changed to an eight-year price review period, referred to as RIIO-ED1 (running from 1 April 2015 to 31 March 2023). The tax trigger mechanism was retained for RIIO-ED1. The tax trigger, as currently defined, applies as follows:

a. The primary adjustment mechanism is designed to be measurable by Ofgem and is calculated by re-running Ofgem's financial model. This is restricted to legislative changes in the rate of corporation tax applicable to large companies or the rate of tax relief for capital expenditure (called "Type A" events).[42]

b. Adjustments are also possible in relation to changes of other areas of legislation, HMRC interpretation, case law or accounting standards (called a "Type B" event).[43] However, any such adjustments are dealt with on a case-by-case basis.[44]

c. In the case of a "Type B event", Ofgem will receive a submission from a company, as part of which company is required to set out all its calculations and provide backing sources for how it has reached its estimated impact of the submitted numbers. Although the intention is to minimise the resource requirement for Ofgem, some scrutiny of the submitted information is required.

d. Type B events are only taken into account where the licensee has demonstrably used reasonable endeavours to minimise any increase in its tax liabilities

5.29. We understand that the mechanism has begun clawing back tax allowances for the consumer in the recent years and is expected to continue clawing back allowances for DNOs as the Corporation Tax rate continues to fall. The tax trigger can be run annually every November, as part of the Annual Iteration process (AIP). Further details on the tax trigger are set out in section 8 as part of our outline of a potential tax trigger for Ofwat.

[42] The latest ED1 Price Control Financial Handbook (March 2016) outlines the two types of tax trigger event at paragraph 4.15

[43] Taken together, Type A and Type B events are "Tax Trigger Events" or "TTEs".

[44] We understand that as at December 2016 there had been some pre-emptive notifications by companies that Type B events may occur, but that in practice no such events had in fact occurred.

5.30. The tax trigger applies where a relevant change exceeds a threshold set as the greater of a one per cent change in the corporation tax rate and a change of 0.33 per cent in base demand revenues. These amounts are fixed at the start of a price control period and are not updated.

5.31. A change to tax liability allowances for a particular year is only applied where one or more trigger events result in a change to the licensee's tax liabilities for that year whose absolute value is greater than the threshold; and any change to the tax allowance (upward or downward) is limited to excess above the threshold.

5.32. Where the change to the licensee's tax liabilities for a particular year is below the threshold, subsequent tax trigger events, relating back to that year could cause the threshold amount to be exceeded. In that case, a change to the licensee's tax liability allowance for the year concerned (a revised TTE value) would be determined once the threshold has been exceeded.

5.33. The trigger mechanism protects DNOs from material effects on their cashflows of legislative changes and is symmetrical for both DNOs and consumers, so that consumers will derive a benefit when tax liability costs fall materially, and the DNO will be appropriately reimbursed when they rise. The mechanism fulfils the following key criteria, in that it:

a. is unambiguously clear when a trigger event has occurred

b. is measurable by Ofgem with minimal recourse to DNOs, (subject to ex post adjustment for those that cannot be determined until tax returns are agreed by HMRC)

c. is simple and transparent to apply.

5.34. Changes are calculated by running the financial model, looking at the effect over the remainder of the price control period of changes in relevant legislation, whether introduced in a Finance Act, other Act of Parliament, Statutory Instrument or other legislative instrument.

5.35. There are two types of tax trigger event ("TTE"):

a. Type A tax trigger events: changes to corporation tax rates applicable to one or more years, changes to capital allowance rates applicable to one or more years.

b. Type B tax trigger events: other factors which cause a change to the licensee's notional tax liabilities for one or more years including: changes to applicable legislation the setting of legal precedents through case law changes to HMRC interpretation of legislation changes in accounting standards.

5.36. The following additional points are relevant to Type A events:

a. Ofgem notifies licensee by 30 September if it consider that it proposes to take account of a Type A event for use in the Annual Iteration Process, which takes place by 30 November each year. The notification specifies the changes in tax rates and capital allowances (as relevant).

b. The licensee then has 14 days in which to contact Ofgem if it consider that a Type A trigger event has occurred, but has not been included in the notification. If so, Ofgem notifies the licensee by 31 October if it agrees.

c. In the event that a Type A event has occurred, but this is not recognised until a later year, then an adjustment can be made in a later year, with an adjustment for the time value of money.

5.37. In relation to Type B events, the process is:

a. Licensees must notify Ofgem by 30 September of all new Type B events, whether they increase or decrease tax allowances. A failure to notify may be treated as a breach of licence (and this is to be decided on a case-by-case basis). The notification should contain full details of the event, the tax effect, supporting calculations and (if relevant) HMRC correspondence, evidence of mitigating actions and details of whether the licensee agrees with the event or intends to contest it.

b. Ofgem will review the information and may ask for additional information or actions in relation to it; in any case, Ofgem will notify the licensee by 31 October stating whether it agrees with the Type B tax adjustment, or whether Ofgem proposes a different adjustment; and also notify the licensee of any additional Type B events which Ofgem proposes.

c. The final quantification for any Type B event takes place when the amounts are finally agreed with HMRC, which will typically relate to an earlier year's adjustment.

Office of Gas and Electricity Markets (Ofgem) – Gas Distribution Network Operators

5.38. The price regulation for Gas DNOs has also been changed to an eight-year period, referred to as RIIO-GD1 (running from 1 April 2013 to 31 March 2021). Under RIIO-GD1, the gas DNOs are subject to the same tax trigger as electricity DNOs, described above.[45]

Office of Rail Regulation (ORR) – Network Rail

5.39. Prior to 2009, the ORR set prices for Network Rail on a pre-tax basis by providing a tax wedge to the post-tax cost of equity.[46] However, in PR08 the ORR changed its approach and started using a post-tax cost of equity, as a result of which a specific allowance for tax cost had to be provided in the company's costs.

5.40. In moving from a pre-tax to a post-tax cost of capital, the ORR took the view that by providing Network Rail with a tax wedge in the previous price regulation period (referred to as CP3[47]), whilst Network Rail had in fact paid very little tax, there had been a significant over-funding of tax. As a result, the ORR decided to calculate the amount of the over-funding and claw this back from Network Rail. This adjustment was supported by the Department for Transport, Transport Scotland and the

[45] GD1 Price Control Financial Handbook (September 2014), paragraph 4.15
[46] Details are taken from "Determination of Network Rail's outputs and funding for 2009-14" (ORR publication)
[47] From 1 April 2004 to 31 March 2009

Competition Commission[48], while Network Rail opposed it. In particular, Network Rail noted that when Ofgem moved from a pre-tax to a post-tax cost of capital, it did not make such an adjustment.

5.41. The mechanism chosen by the ORR to make the adjustment was to calculate the estimated over-funding of corporation tax and to reduce it every year by the amount of corporation tax that it estimated would be payable by Network Rail, until the balance on the account would reach zero. During that period, Network Rail would not be funded for estimated corporation tax payments, i.e. its return would be lower by this amount. Once the balance reached zero, the ORR would fund Network Rail's subsequent corporation tax payments through the regulatory tax allowance.

5.42. The amount of the over-funding was estimated by the ORR[49] to be £1.3 billion at 1 April 2009 (the start of CP4). The ORR set tax allowances on an ex ante basis and stated that "the CP4 corporation tax allowance will not be adjusted if Network Rail's actual position during CP4 is different to that forecast"[50], apart from some specific exceptions such as Research & Development claims, where Network Rail had not provided an estimate of the potential benefit; in such cases, the ORR assumed no benefit in the CP4 tax allowances, but stated that an adjustment to the "CP5 roll forward" would be made for any actual benefits obtained.

5.43. In the next price review, PR13 (for CP5), the ORR decided to deduct the amount of the over-funding from Network Rail's Regulatory Asset Base at the start of CP5, i.e. 1 April 2014.[51] This effectively brought the treatment of tax (on an ongoing basis) into line with the "normal" approach for post-tax WACC regulation, i.e. a calculated tax allowance is included in the assessment of costs when determining prices. The ORR stated that Network Rail "welcomes the 'cleaning up' of the RAB to resolve this issue once and for all".[52]

5.44. The actual levels of corporation tax currently paid by Network Rail are very low in the context of its overall financial position, e.g. only £7m of tax is forecast to be paid from 1 April 2014 to 31 March 2019 (largely owing to Network Rail's corporation tax losses).[53] As such, the ORR notes that its decision on the treatment of corporation tax "is unlikely to have significant financial implications for Network Rail in CP5".[54]

Northern Ireland Authority for Utility Regulation (NIAUR) - Northern Ireland Water (NI Water)

5.45. Whilst the NIAUR sets prices on a post-tax basis, NI Water has not been taxpaying prior to the PR15 price review, and at the time of the PR15 price review it did not include any tax in its business plan. However, NI Water did notify the regulator of a risk relating to cash tax, as the company's tax computations were resubmitted to HMRC around the end of 2014. As such, it was not clear whether any tax allowance would be appropriate or not. Therefore, the regulator stated in its final determination:

[48] "BAA Ltd – A report on economic regulation of the London Airport companies (Heathrow and Gatwick Airport Ltd)", Competition Commission, September 2007
[49] On the basis of a report from First Economics
[50] Paragraph 14.107
[51] "Periodic Review 2013: Final determination of Network Rail's outputs and funding for 2014-19" (October 2013) (referred to as "NR Final Determination")
[52] NR Final Determination, Para 12.358 (page 477)
[53] NR Final Determination, Table 13.4 (page 501)
[54] NR Final Determination, Para 12.353 (page 476)

"We agree with NI Water that the magnitude, liability and timing of any cash tax becoming payable are too uncertain at the time of writing and we have therefore excluded it from revenue considerations. NI Water have committed to providing updates on the current taxation status and any changes which may have an impact on the taxation status of NI Water.

"We will continue to monitor NI Water's taxation profile, particularly in the event of any cash tax becoming payable. In addition, we will consider this aspect at the mid-term review."[55]

5.46. The regulator has therefore stated that one of the explicit purposes of the mid-term review is to provide an opportunity to re-open the final determination to take account of "any material change in costs which cannot be defined with any certainty in the business plan – for example, the cash tax position of the company."[56] This is similar in some ways to Ofwat's concept of a "notified item".

NIAUR – Northern Ireland Electricity Transmission and Distribution (NIE)

5.47. The period running from 1 January 2013 to 30 September 2017 (referred to as RP5) uses a post-tax cost of capital. The RP4 period also used a post-tax cost of capital, however prior to this (i.e. periods up to RP3, which ended in March 2007), a pre-tax basis was used.

5.48. In the draft determination for RP5, the NIAUR proposed an assumed 24% tax rate up to 31 March 2013, but the regulator proposed that "the tax return that is sent to HMRC is also made available during RP5" and that the regulator would "alter the return and tax allowance each year in RP5 to reflect the relevant corporation tax rate".[57]

5.49. The NIAUR issued a final price control for NIE in October 2012 in respect of its transmission and distribution business, together with proposed draft Licence modifications to implement the price control was for RP5. NIE rejected the licence modifications and in April 2013 referred the matter to the Competition Commission (CC), which issued its final determination in March 2014.[58]

5.50. One of the issues at dispute between NIE and the NIAUR was the treatment of capital allowances. In summary, NIE had been disclaiming capital allowances as part of its group tax planning, in order to enable it to claim group relief from other (non-regulated) entities in the same group. NIE then paid for group relief at the full tax value, which was then 28%.[59] NIE state that this payment for group relief was "as permitted by condition 9(5)(b)(vi) of NIE's licence"[60], which reads as follows:

"[…] the Licensee shall not […] (b) transfer, lease, license or lend any sum or sums, asset, right or benefit to any affiliate or related undertaking of the Licensee otherwise than by way of […] (vi) payments for group corporation tax relief or for the intra-

[55] "Final Determination – Annex A, Financing Investment" dated December 2014, Paragraphs 6.1.2 to 6.1.4
[56] Para 7.4.7, "Water & Sewerage Services Price Control 2015-21, Final Determination – Main Report December 2014"
[57] "Northern Ireland Electricity Transmission and Distribution Price Controls 2012-2017 – Draft Determination" dated 19 April 2012.
[58] "Northern Ireland Electricity Limited price determination – A reference under Article 15 of the Electricity (Northern Ireland) Order 1992 – Final determination" (referred to as "NIE Final Determination") issued on 26 March 2014 by the Competition Commission to the NIAUR
[59] "Northern Ireland Electricity Limited – Transmission and Distribution – RP5 Price Control – Statement of Case to the Competition Commission" (referred to as "Statement of Case") dated 10 May 2013, para 4.2
[60] Statement of Case, Para 4.2

group allocation of Shadow Surplus ACT calculated on a basis not exceeding the value of the benefit received".

5.51. This provides a specific rule and basis on which NIE is required to pay for group relief, measured by reference to "the value of the benefit received". We note that arguably the value of the group relief to NIE is the discounted value of the future capital allowances which have been disclaimed, rather than the tax payable as a result of the capital allowance disclaimed. (We also note that is not necessarily the case that this is the value of the group relief to the company which surrenders the losses to NIE, as that company might have no other use for the losses, so that their value could be effectively zero from that company's perspective.)

5.52. The point of contention arose because the licence conditions required that the tax allowance be calculated by reference to the actual capital allowances (i.e. the out-turn), but it was not clear whether this should be the amount actually claimed, or the amount available to be claimed.[61]

5.53. NIE initially proposed that only the actual capital allowance claim be included in the tax allowance.[62] The effect would have been to increase the tax charge, and thereby increase the revenues allowed to NIE (and consequently disadvantaging customers).

5.54. On the other hand, the NIAUR's view was that the maximum capital allowance claim should be assumed, regardless of the actual claim. The effect would have been to reduce the tax charge, and thereby reduce the revenues to NIE (and consequently advantaging customers).[63]

5.55. NIE's revised proposal[64], which was accepted by the Competition Commission[65], was broadly in line with the NIAUR's, as follows:

a. The maximum capital allowance claim should be assumed. This would benefit customers as it would reduce the tax allowance, for NIE, thereby reducing revenues and, ultimately, reducing prices for customers.

b. Consistent with the assumed capital allowances claim, a set of "notional" capital allowance pools should be calculated. These notional pools would be used to calculate future assumed capital allowance claims.

c. As part of the annual reporting to the NIAUR, NIE would provide a reconciliation between its actual capital allowances position and the "notional" position (where the latter would be used to calculate the tax allowance when determining revenues).

5.56. This approach was favoured by the Competition Commission for various reasons, the main ones being:

a. It appears to be in the public interest, as it results in lower electricity prices.

b. It removes an element of ambiguity in the previous licence arrangements.

[61] NIE Final Determination, Para 14.14
[62] NIE Final Determination, Paras 14.14 and 14.15
[63] NIE Final Determination, Para 14.16
[64] NIE Final Determination, Para 16.21
[65] NIE Final Determination, Para 16.31

c. It avoids the risk of double counting which would have arisen if the tax allowance had been based on the maximum capital allowances claim, but if no "notional" pools had been kept and the maximum claim had always been based on the actual pool value.

d. It allows NIE to plan its tax affairs in the most beneficial way for itself, and the group of which it forms part, without prejudicing its customers.

e. It should be relatively simple to monitor and therefore should not place an undue burden on either NIE or the NIAUR.

5.57. The above is interesting in the context of water companies in England & Wales regulated by Ofwat, some of which are in similar positions to that of NIE, i.e. disclaiming capital allowances and claiming group relief. If one were to apply the principles set out by the Competition Commission and the terms of NIE's licence, the treatment would be:

a. Tax allowances should be calculated assuming a full capital allowances claim.

b. If the full claim is not made, then a "notional" pool should be calculated on the assumption that a full claim had been made and this "notional" pool should be used for future tax allowance calculations.

c. The fact that there is clarity over approach avoids the risk of inconsistent application. (This is clearly only relevant when there is more than one regulated entity.)

NIAUR – Gas Distribution Networks

5.58. NIAUR is responsible for regulating three gas DNOs in Northern Ireland: Phoenix Natural Gas Limited (PNGL), Firmus Energy (FE) and SGN Natural Gas Limited (SGN). Of these three, a pre-tax cost of capital is used for PGNL and FE, whilst a post–tax cost of capital is used for SGN.

5.59. Pre-tax costs of capital are used for PGNL and FE as this "reflects [NIAUR's] historical practice of settling pre-tax rates of return in all previous price control determinations and the difficulties that there would be in switching to an alternative approach at this point in the companies' licence periods.".[66]

5.60. By contrast, NIAUR states that "SGN is in a different position to the other GDN's as it is at the start of its life." As a result, NIAUR has decided to calculate a stand-alone tax allowance for SGN, as this is the approach adopted by the majority of regulated companies in the UK. NIAUR notes that "Ofwat was the first regulator to make company specific, period specific tax allowances in the 1990s. Since then, Ofgem, ORR and the Utility Regulator (with NIEN) have switched to modelled tax allowances and the CAA (with NATS), the Utility Regulator (with NI Water) and the WICS have all opted for this approach when regulating companies for the first time."[67]

5.61. NIAUR also noted that a post-tax cost of capital generates "clear advantages in terms of the annual match that it brings between the costs that a company incurs and the revenue entitlement that the company accrues".[68]

[66] "Price Control for Northern Irelands Gas Distribution Networks GD17" (referenced further as "Price Control"), p.289
[67] Price control p.289
[68] Price control p.289

5.62. However, on the basis that SGN is expected to have significant upfront capital investment which will shelter any taxable profits (as with Northern Ireland Water), the NIAUR have set the tax allowances at zero for the purposes of the current price control period. Although the tax allowances are set at zero for this price control period, the financial model used to calculate the allowances is available; the calculation used to reach the tax allowance is outlined in more detail below.

5.63. The NIAUR established an 'uncertainty mechanism' adjustment at the start of each subsequent period to deal with changes to statutory corporation tax rate. Rate changes appear to be the only tax item which can be adjusted for under this uncertainty mechanism. Whilst the NIAUR does not expect it to be relevant for the first price control period given that the tax allowance is zero, it considered it important to establish the principle of the mechanism.[69] Whilst no commentary appears to be provided on the rationale for including a specific tax uncertainty mechanism, NIAUR does note that the uncertainty mechanism as a whole was included "to reduce the risk to [Gas Distribution Networks] or to incentivise them to deliver outputs consistently."[70]

5.64. The uncertainty mechanism will be implemented at the start of the GD23 price control period by adjusting the determined allowances for differences between actual and allowed costs. The various adjustments made under the uncertainty mechanism fall into six categories. Tax will be treated as an 'output' item, as follows[71]:

a. The original tax allowance is calculated as the taxable profits multiplied by the statutory corporate tax rate (the "forecast driver");

b. Any difference in the driver (i.e. the tax rate) between the time of determination and the end of period will result in an adjustment at the time of GD23;

c. This adjustment will be calculated by applying the difference between the forecast tax rate and the actual tax rate to the taxable profits submitted as part of the original business plan.

5.65. The calculations will be adjusted only to reflect the updated statutory tax rate, i.e. it will not be updated for other changes.

Review of modelling of tax

5.66. In this section we consider the exact information and calculation used in determining tax allowances. On the basis that this only applies in the case of post-tax cost of capital approaches, we have only considered this for the ORR, Ofgem and the NIAUR. Of these, the financial models used to calculate the tax allowances were only available for those entities shown below.

5.67. Our overall conclusion from the review below is that Ofwat's approach to calculating tax allowances is broadly similar to that of other post-tax regulators and there are no specific points for which any change appears necessary, other than those separately discussed in this report.

[69] Price control p.272
[70] Price control, p.262
[71] Price control p.262, 263

NIAUR – Northern Ireland Water

5.68. NIAUR's calculation for Northern Ireland Water uses the following adjustments to PBT:

a. Items added back to Operating profit
- Depreciation
- Infrastructure renewals charge
- Amortisation of asset/grants
- Grants and contributions taxable on receipt
- Other additions
- Items deducted from PBT

b. Capitalised revenue expenditure (both infrastructure and non-infrastructure)
- Total interest paid
- Capital allowances
- Industrial building allowances utilised
- Other deductions

NIAUR – Gas Distribution (SGN only)

5.69. NIAUR's calculation is as follows:

a. Items deducted from revenue (i.e. no need to add back depreciation):
- Opex
- Interest
- Capital allowances
- Regulatory tax losses brought forward

Ofgem

5.70. Ofgem's calculation for electricity DNOs is as follows:

a. Items added to recalculated base revenue:
- Revenue adjustment from previous price controls, and other adjustment

b. Items deducted from recalculated base revenue:
- Net interest paid
- Capital allowances
- Revenue pool additions
- Taxable losses brought forward

Other approach

WICS

5.71. WICS adopted a fundamentally different approach in its 2015-21 price review for Scottish Water from that used by other regulators. The approach involves setting an acceptable range for the cash financial strength that Scottish Water requires; the upper and lower limits of this range are called the 'financial tramlines'. The items measured are cash interest cover, the ratio of funds flow from operations to debt, and gearing. None of these requires any specific calculation of a tax allowance, although we note that tax costs could still affect interest cover and the amount of funds flows.

5.72. In any case, we note that the forecast financial statements for Scottish Water for the period 2015-21, calculated using WICS's financial model, show zero current tax

payable.[72] Therefore, we would not expect current tax to be a relevant consideration in the price controls for this period.

Approach to Corporation Tax - provisional view for PR19

A post-tax approach enables forecast tax liabilities to be closer to actual tax liabilities, as tax-adjusting items can be taken account of. This generates clear advantages in cases where the tax cost may be different from the headline rate, because it enables the company's forecast tax costs to be factored into the revenue entitlement which it derives from customers. Reflective of this, the majority of regulators in the United Kingdom and Ireland adopt this approach.

Water companies regulated by Ofwat have a wide range of tax profiles. In order to ensure that each company receives a fair tax allowance, the varying tax profiles need to be taken account of by the tax allowance methodology. A post-tax approach enables this flexibility by requiring each company to forecast its tax charge.

The post-tax approach adopted by Ofwat is fundamentally correct: it is fair, incentivises responsible tax management, does not place an undue burden on the relevant parties and is consistent with the stand alone approach. Amendments may be required in specific areas, which are discussed later in the report.

[72] "Strategic Review of Charges 2015-21: The draft determination", Appendix 6 (page 88) published by WICS

6 Interaction of tax and Ofwat's business model

Introduction

6.1. As part of our review of taxation, we have been asked to consider[73]:

a. How the introduction of legislation on interest deductibility should be included within the PR19 methodology;

b. How the tax allowance methodology should interact with the separate price controls of the different business areas; and

c. How taxation should interact with the incentive mechanism.

6.2 This section sets out:

a. The current approach to gearing, in order to facilitate the consideration of interest restriction in section 7;

b. The current approach to price controls and our provisional view for PR19; and

c. The current tax treatment of incentives and true-ups and whether they are operating as intended.[74]

Current approach to gearing

6.3 At PR14, Ofwat assumed a notional gearing of 62.5% (subject to small adjustments) for computing WACC, but tax allowances are calculated on the higher of notional gearing and actual gearing.[75]

6.4 The cost of debt is one component in the real vanilla WACC (as discussed above), which was set by Ofwat at PR14 for the wholesale business of all companies as follows[76]:

a. South West Water and Affinity Water – 3.70% given the enhanced status awarded to these companies in the PR14 process[77]

b. All other water companies – 3.60% except for Portsmouth Water and Bournemouth Water, which get a 0.15% uplift (i.e. total cost of capital is 3.75%).

[73] As outlined in questions 3 and 6 of "Overall approach to corporation tax" and question 1 of "Implementation of Policy" in the ITT
[74] See question 6 under "Overall approach to corporation tax" in the ITT
[75] "Setting price controls for 2015-20 – final methodology and expectations for companies' business plans", section 9.4.2
[76] "Final price control determination notice: policy chapter A7 – risk and reward" (Ofwat report, December 2014), pages 2-3
[77] This is the real WACC based on RPI

6.5 Debt itself is split into "embedded debt" (i.e. already existing debt) and "new debt", the cost of which is specified by Ofwat as, respectively, 2.65% and 2.0%[78], based on a report by PwC prepared for PR14.[79]

6.6 Underlying this is the use by Ofwat of a single industry-wide cost of capital, the objective of which is to allow companies an appropriate return on investment; where companies can finance their debt efficiently, they can benefit if their cost of debt is lower than Ofwat's assumption. This also benefits customers, as such reductions are taken into account in subsequence price reviews.

6.7 At PR14, Ofwat also recognised that small water-only companies can face a higher cost of debt in practice. In order for Ofwat to allow such companies a higher cost of debt for price control purposes, Ofwat required such companies to demonstrate both (a) that they do in have a higher cost of debt and (b) that there is an offsetting benefit to customers.[80] Only Portsmouth Water and Bournemouth Water were able to demonstrate this at PR14.

6.8 We illustrate the current approach with three simple examples. In each case PBIT is assumed to be 100; gearing is assumed to be (i) less than 62.5%, (ii) equal to 62.5%, or (iii) greater than 62.5%. Corresponding interest costs are (i) 10, (ii) 15 or (iii) 20.

Example	(i)	(ii)	(iii)
Gearing	< 62.5%	62.50%	> 62.5%
Assumed interest cost	10	15	20
PBIT	100	100	100
Allowed interest cost	(15)	(15)	(20)
PBT	85	85	80
Tax allowance @ 20%	17	17	16
Actual tax	18	17	16

6.9 We comment on the above example as follows:

a. In case (i), customers do not bear the addition tax cost of 1 (i.e. actual cost of 18 versus tax allowance of 17) which arises from the company's gearing being less than 62.5%.

b. In case (ii), the actual tax cost is equal to the tax allowance.

c. In case (iii), the company obtains a tax benefit from gearing up above 62.5%, compared to the tax charge if gearing were equal to 62.5%. The tax benefit is passed on to customers as the tax allowance is correspondingly lower than in cases (i) and (ii).

[78] "Final price control determination notice: policy chapter A7 – risk and reward" (Ofwat report, December 2014), page 38
[79] "Updated evidence on the WACC for PR14 – A report prepared for Ofwat" (PwC report, December 2014)
[80] "Setting price controls for 2015-20 – risk and reward guidance" (Ofwat report, January 2014), page 23

6.10 The tax deductions associated with interest, including how the new interest deductibility legislation will interact with the gearing assumptions, is discussed in section 7.

Current approach to price controls

6.11 A change introduced in PR14 was the use of price controls for different parts of a water company's business, as follows[81]:

a. There are price controls for (1) wholesale water and (2) wholesale wastewater services[82]; a separate tax allowance is calculated separately for each part of the business.

b. There are also separate price controls for the household and non-household retail businesses; these are broadly calculated as the sum of (1) the wholesale water (or wastewater) cost plus (2) an allowance or EBIT margin to cover additional costs; no separate tax allowance is calculated for these.

6.12 Any brought forward tax losses and brought forward capital allowances at the start of AMP6 were wholly allocated to the wholesale business. This required a notional division of the brought forward balances between the two wholesale price controls.

6.13 As a result of the PR14 approach, the following important tax points arise:

a. There is no explicit tax allowance for any tax payable in respect of the retail part of the business – however there is an allowance for tax factored into the EBIT margin.

b. While the wholesale and retail businesses remain part of the same legal entity, the tax position of the entire legal entity will almost certainly be different from the tax allowances given for the wholesale business. This will mean in practice that, to some extent, the tax allowances are "notional", as they relate to only part of the entity's business; in turn, this may make it more difficult for a third party to understand the relationship between the tax paid by the entity and the business's tax allowances. Nonetheless, we note that a reconciliation of the tax allowances per the price controls and the "actual" tax paid is provided in the APRs (see section 9).

c. In addition, an allocation of total expenditure ("totex"), needs to be made to each element of the wholesale business in order to determine its tax allowance, as set out in RAG 2.05 'Guideline for the classification of costs across the price controls'. However, RAG 2.05 does not refer to tax; instead, guidance in the Business Model inputs (specifically Table A3[83]) specifies how losses and capital allowance pools should be allocated to each price control.

6.14 The above position would be simplified if companies were to transfer the different parts of their businesses into separate legal entities, as there would then be an exact

[81] Details of Ofwat's proposals for price controls are set out in "Water 2020: our regulatory approach for water
and wastewater services in England and Wales" (May 2016)
[82] In addition, a separate wholesale wastewater price control was included in PR14 specifically for the Thames Tideway Tunnel project in Thames Water. This is being retained for PR19.
[83] Guidance to lines 24 and 25 of Table A3 (References A3024 and A3025) state that brought forward losses should be wholly allocated to the wholesale water and/or wastewater businesses

correlation between the business in respect of which the control is determined, and the legal entity which owns that business.

6.15 Ofwat is not proposing that there should be a legal separation of the wholesale controls. However, with the opening of the non-household retail market to competition in April 2017 a number of companies have restructured their non-household retail businesses and in some cases they have sold their non-household business to a third party (for example, Thames Water transferred its non-household retail business to Castle Water[84]) or have transferred it to a separate company; and we understand that other companies are also considering similar transactions. Companies are not currently able to exit the residential retail market. However, until there is a complete separation of all such parts, the above position will to some extent remain.[85]

6.16 For PR19, there are to be up to 4 price controls across the wholesale business, being i) wholesale water resources, ii) wholesale water network plus[86], iii) wholesale bioresources, and iv) wholesale wastewater network plus.

6.17 This will require the brought forward capital allowance balances and the brought forward tax loss pools to be notionally divided between the four wholesale price controls. Ofwat should prescribe a methodology for doing so. Going forwards, this will require separate capital allowance claims (or disclaimers) to be made for each separate price control.

Stand-alone approach

6.18 As discussed earlier, the "stand alone" basis for tax allowance purposes is an important aspect of Ofwat's approach.

6.19 In the case of companies with tax losses[87], this means that there will likely be a "notional" tax loss or losses which represents the tax position of each element of the wholesale business, but which is different from the tax loss (if any) of the legal entity which houses the wholesale business (as well as other activities). In addition, as capital expenditure is incurred in respect of the retail business (assuming that it remains in the same legal entity as the wholesale business), a divergence may arise between the capital allowance pools within each price control and those of the entity which houses it. As a result, it may in due course become difficult to provide a simple and clear explanation of the difference between the tax actually paid by a water company and the tax allowance which is incorporated into water prices. This issue is partially addressed by the APR disclosures; it is further considered in section 9.

6.20 We have reviewed the current disclosures in companies' APRs and note that the reporting framework requires a reconciliation between the tax allowance per the final

[84] Thames Water Utilities Ltd announcement of 18 July 2016: "Thames Water is today announcing that Castle Water is to provide billing and associated services for its business customers."
[85] In most (possibly all) companies there has also been, and continues to be, a relatively small "non-appointed" business (e.g. discharges to sewage treatment works, gravel sales, property searches and treatment of waste from private receptacles not linked to the network). Therefore, in such cases there has historically been a divergence between statutory (or regulatory) accounts and the tax allowance of the appointed business; however, in our experience and review of various water companies, the scale of the non-appointed businesses is typically small in comparison with the appointed business.
[86] Those parts of the value chain that remain after excluding the activities that fall within the separate price controls for bioresources and water resources.
[87] We note that the final PR14 business plans for Thames Water, Portsmouth Water, Dŵr Cymru and Southern Water all show tax losses arising during some or all of AMP6; all other companies show profits.

determination and actual current tax charge, which in almost all cases is provided, although there is some variation in the level of disclosures given by the companies. This is discussed in section 9.

6.21 If "unbundling" of the different parts of the business (wholesale, non-wholesale, retail, etc.[88]) were to be required in the future as a result of the approach to competition in the water sector, this may in due course result in the legal separation of the businesses. In such a case, there could in the future be a close (possibly exact) correlation between legal entities and individual businesses, which would aid transparency of reporting.

Alternative approach

6.22 A possible alternative approach would be to take the tax position of the entire appointed business (of which the wholesale business is part) and to apportion, on the basis of the overall tax position, the tax allowance across all the price controls – i.e. to both the wholesale and non-wholesale businesses. For example, if the appointed business as a whole were not taxpaying, then no tax allowance would be apportioned to the wholesale business.

6.23 However, there are several difficulties with such an approach, including:

a. There is no explicit modelling of the tax position of the non-wholesale business. Therefore, ex ante it would not (under the current approach) be possible to determine the overall tax position. Instead, it would be necessary either (1) to model the tax position of the non-wholesale business, or (2) make an ex post adjustment to the tax allowance, once the actual position of the entire appointed business is known.

b. This approach could result in a higher tax allowance being apportioned to one price control if, for whatever reason, the effective tax rate of another price control was higher. This would not seem to be a fair outcome, as some customers would pay more.

c. On the other hand, if the effective tax rate of one price control were lower than that of another, then there would be a form of cross-subsidy, whereby one's tax allowance is reduced by virtue of the tax position of another part of the business.

6.24 Therefore, for the above reasons, we do not consider it consistent with Ofwat's overall objectives – in particular, fairness and the stand alone approach – to use such an "apportionment". We have therefore assumed that the strict "stand-alone" approach (outlined above) would continue to be used.

Profitable and loss-making controls

6.25 Assuming that the stand alone approach is used, there is one adjustment to this which we understand Ofwat has adopted. In the event that not all the wholesale price controls are profitable, the profitable price control is awarded a tax allowance based on the net position across the wholesale business and then there is a true-up in future periods when the loss making price control becomes profitable. The objective is that a wholesale customer should not pay more simply because Ofwat has

[88] For Water and Sewerage companies, there will be four wholesale and up to two retail price controls; for Water Only companies, there will be two wholesale and one retail price controls.

separated the water and wastewater controls. As a result, customers may obtain a favourable timing difference in the price they pay.

6.26 We consider this to be a sensible and fair departure from the stand-alone approach.

Price controls – provisional view for PR19

The use of separate price controls for different parts of a water company's business which are modelled on a notional single entity basis is in line with the standalone approach.

Ofwat currently make one adjustment to the strict single entity basis: the aggregate of the tax allowances for individual price controls cannot exceed the total forecast tax charge for the company. We consider that this is fair both to customers and companies, as it ensures that customers only fund tax allowances to the extent that the company is forecasting overall taxable profits.

The tax reconciliation in the APR will be an important mechanism to ensure that the forecast tax charge for each price control is monitored against the actual tax charge.

Taxation of incentives and true-ups

6.27 Ofwat's regulatory approach sets out a number of incentive mechanisms in which adjustments are made ex post to revenues and Regulatory Capital Value (RCV[89]). As part of our review of taxation, we have been asked to consider:

b. The principles which should be applied in determining whether to make an allowance for tax as part of any true up; and

c. Whether the impact of tax means that the incentives as proposed for PR19 are (or are not) operating in the way that they were designed to operate.

6.28 Three of the adjustments are in the following areas:

a. Outcome delivery incentives (ODIs), which provide companies with rewards for achieving performance targets and compensate customers if performance is below performance targets. In addition, there is a "cap and collar" structure to limit the rewards or penalties which can arise under the ODIs. There are also water trading incentives, in relation to both imports and exports.

b. Wholesale revenue forecasting incentive mechanism (WRFIM), which provides financial incentives for companies to provide accurate forecasts, and ensures under- and over-recovery is reconciled. This also includes a prior AMP adjustment (referred to as the "blind year adjustment").

c. Adjustment in respect of household retail customers.

6.29 The treatment adopted by Ofwat for PR14, following consultation[90] and external advice[91], is set out in the "PR14 reconciliation rulebook" issued in July 2015. The

[89] Note also that apart from adjustments such as this, RCV does not itself include any explicit tax balances.
[90] "Consultation on the PR14 reconciliation rulebook" (Ofwat document, March 2015)
[91] "PR14 Reconciliation Rulebook - Updated recommendations for implementing PR14 reconciliation mechanisms" (PwC Report, July 2015)

current approach to tax for each of these is summarised in the table below and further explained in the following text.

Area	Tax treatment	Comment
ODIs / Trading incentives	Tax allowance	Adjustment to revenues; essentially treated like any other allowed revenue
WRFIM	No tax allowance	True-up to revenues for which a tax allowance has already been given.
Retail incentives	No tax allowance	No specific tax allowance is provided for retail revenues

6.30 We have considered the current approach to the above areas of incentives and adjustments by reference to the criteria set out in section 4. We consider that the current approach is fair, incentivises responsible tax management, does not place an undue burden on the relevant parties and is consistent with the stand-alone concept. For these reasons, we do not propose any changes to the above treatment. Further details are provided in the text below.

6.31 In addition, there is a fourth area of adjustments, in relation to wholesale total expenditure (totex) sharing, where a company's outperformance, or underperformance, is shared with customers. We comment on the current treatment of this below.

Taxation of ODIs and Trading Incentives

6.32 The PR14 final determinations included performance commitments and financial ODIs; financial ODIs are taken by the companies as either adjustments to revenue or RCV[92], the main difference being that the former are recovered over a shorter period (i.e. one AMP) than the latter (i.e. several AMPs). For most companies, ODIs relating to AMP6 will be taken into account in PR19, although in a few cases some in-period ODIs are possible.[93]

6.33 In addition, there is an aggregate cap and collar on the financial impact of ODIs, in order to provide a safeguard for customers and companies by placing limits on the financial impacts of outcome incentives during AMP6 to a maximum of +/-2% of notional regulated equity.

6.34 The key policy issue considered by Ofwat in relation to taxation was whether they should be pre-tax or post-tax. After consultation and advice, Ofwat's approach is to calculate financial ODIs on a post-tax basis, but not to adjust ODI rewards and penalties for taxation when comparing with the cap or collar.

6.35 The post-tax basis is straightforward when applied to end of period ODIs and end of period RAV adjustments. This is because both give rise to adjustments to revenue in the next AMP, which automatically lead to higher (or, for penalties, lower) tax

[92] In two cases (United Utilities and Yorkshire Water), the ODI rewards and penalties affect either RCV or revenue, depending on whether there are net rewards or penalties.
[93] At PR14, only Anglian Water, Severn Trent Water and South West Water could have in-period ODIs. We understand from Ofwat that at PR19 more companies may have in-period ODIs.

allowances. For in-period ODIs, Ofwat states that these can be adjusted for the relevant companies' marginal rates of tax.[94]

6.36 Ofwat's approach is also that no adjustment be made to the cap and collar when comparing with the ODIs. This is on the basis that companies are compensated for tax through the for tax allowance, so that a straightforward comparison can be made between the ODIs and the cap or collar.

6.37 PR14 included incentives for new exports and new imports during the price control period. The export incentive applies to all new "qualifying exports" starting during AMP6; this allows exporters to retain 50% of the profits from such exports, above the normal return on capital invested. In relation to imports, "qualifying imports" benefit from an import incentive of 5% of the costs of water imported.

6.38 In relation to tax, Ofwat's approach is to provide a tax allowance on these incentives; this is consistent with the approach taken for ODIs and the overall post-tax framework. We do not see any reason to change this approach.

6.39 We do not consider that any further adjustment is required or that the ODI mechanism (and tax treatment thereof) affects, or is affected by, any of the matters addressed in this report.

WRFIM

6.40 The WRFIM framework allows for an over-recovery or under-recovery of allowed revenue in one AMP to be taken into account through a true-up mechanism, either in-period or in the following AMP. Ofwat's approach is not to include any taxation adjustment for this. This can be best explained through an example:

a. Suppose that revenues of 100 and a tax allowance of 20 are assumed in one AMP, but that in fact revenues of only 80 (and therefore tax of 16) arise. In the next period, additional revenues of 20 will be allowed (with no additional tax allowance); if revenues of 20 do actually arise, then tax of 4 will be due.[95]

b. The total revenues actually received will therefore be 100 (80 in one period, 20 in the next period) on which tax of 20 will be paid; and this is equal to the original intention, albeit the revenues (and tax) span two periods rather than one.

6.41 The above mechanism only works if the tax rate is unchanged in different AMPs. Under the PR14 methodology, companies bear the cost (and benefit) of any unexpected changes in the tax rate which occur during the AMP; as such, it would be consistent with current framework to ignore rate changes in respect of WRFIM adjustments.[96]

6.42 However, if a mechanism were to be introduced to pass the effect of any rate change on to customers, then – in order to be consistent – an adjustment to the tax allowance would be needed. For example, using the figures in the above example:

a. Suppose that the 20% rate in the first AMP fell to 15% in the second AMP. Bills will have been set on the basis of revenues of 100 and tax of 20. However, the

[94] "PR14 Reconciliation rulebook policy document", page 21
[95] We note that if adjustments are made during the AMP then the overall effect is the same as set out in the text of the report
[96] "PR14 Reconciliation rulebook policy document", page 59

actual tax charge will be 16 (in the first AMP, assuming actual revenues of 80) and 3 (in the second AMP, assuming actual revenues of 20).

b. In this case, a clawback of 1 in the second AMP would be needed in order to pass the benefit of the rate reduction to customers.

6.43 The above only applies where the true-up is in the following AMP; any true-ups in the original AMP should not be affected.

6.44 The "blind year adjustment" refers to the revenue adjustment made at the end of one AMP, in relation to the last year of the previous AMP. For example, at the time of PR14, the figures for the final year of PR09 were not available. As a result, at the end of PR14 (by which time final figures for PR09 would be available), an additional adjustment in respect of that year would be made, subject to a materiality threshold of £10,000. The taxation of such adjustments follows that of the main WRFIM adjustment, as above.

Household retail

6.45 The household retail control sets total allowed revenue based on forecast customer numbers at the beginning of the AMP, although out-turn may be different, for various reasons. A mechanism is in place to provide for an adjustment, at the end of the AMP, to take account of certain differences in retail revenues.

6.46 No specific tax allowance is given in respect of retail revenues and therefore no tax allowance should be given in respect of any retail incentives. Instead, an EBIT margin is given in respect of retail revenues; this is intended to cover tax. Therefore, if the same approach is adopted at PR19 then no adjustment for tax is required.

Totex sharing

6.47 PR14 has a cost sharing approach where companies out-perform, or under-perform; this is shared between the company and its customers, based on the company's menu sharing rate. Any out-performance or under-performance during AMP6 is only shared with customers in the following AMP(s). Totex is split into the amount recovered directly as revenue in the next AMP and amount that is added to RCV and therefore recovered over several AMPs.

6.48 The revenue and RCV adjustments could be made net or gross of taxation. A tax adjustment would increase the customer impact of any totex overspending (as an additional allowance for tax would be required) and reduce the impact of any totex underspending (as the reduction in revenue will reduce the amount required for tax). The approach recommended in the PwC report[97] and in the final policy is to make no tax adjustment totex recovered through revenue (PAYG), but to include an adjustment for totex recovered through changes to RCV.

6.49 In a simple case, if a company incurs additional revenue costs of (say) 100, then the post-tax cost to the company is 80. If the company is then compensated by receiving additional revenues of 100, then the post-tax benefit to the company 80, i.e. exactly matching the original cost. It is this concept which is discussed in the "PR14

[97] PR14 Reconciliation Rulebook - Updated recommendations for implementing PR14 reconciliation mechanisms" (PwC Report, July 2015), page 20

Reconciliation Rulebook Policy Document"[98] and in the "PR14 Reconciliation Rulebook".[99]

6.50 Overall, this approach has the benefit of being simple to understand and implement. It also provides a fair outcome in respect of adjustments which are revenue (for tax purposes) and which are recovered through PAYG, owing to the "symmetry" of the tax benefit/cost from the original over/under-spend, which is matched with the tax cost/benefit of the revenue adjustment.

6.51 However, the position is not symmetrical for adjustments which are recovered through RCV. The position is slightly different depending on whether the original expenditure is revenue or capital for tax purposes. For illustrative purposes we assume an overspend, although the principles should similarly apply to an underspend. We assume a constant tax rate of 20%.

a. If there is a revenue overspend of 100 then the company obtains a tax deduction of 20, so that the post-tax cost to the company is 80. The overspend is assumed to give an increase in RCV of 100, which will in turn give increased revenues of 100 in future AMPs, which will in turn generate their own tax allowance (of 20 ignoring NPV effects). Thus, the post-tax revenues would be 100, so that the company is over-compensated by 20.

b. If there is a capital overspend of 100 then the company will claim capital allowances during that AMP (of say 20, giving a tax deduction of 4); at the end of the AMP there will be a capital allowance pool (of 80, using the assumed figures). Provided that the capital allowance pools for the next AMP are increased by 80, future tax allowances will incorporate tax deductions of 80, i.e. tax allowances will be 16 lower than otherwise. The post-tax cost to the company will therefore be 96 (representing the 4 of tax deductions which are assumed during the AMP in which the overspend occurs). The post-tax revenues would, as before, be 100. The company is still overcompensated, but (using these figures and assumptions) only by 4, i.e. a much smaller amount that in the earlier example.

6.52 We note that in assessing the current approach, Ofwat made a simplifying assumption that "the PAYG element of totex is broadly equal to the accounting opex" and "for the RCV element, we have assumed this is accounted for as capex".[100]

Totex – detailed analysis

6.53 We have analysed this further by considering two hypothetical situation, one involving an opex overspend, the other involving a capex overspend. We show that, under certain simplifying assumptions, there is a difference in the net cost to the company between the opex and capex overspend; and that with a specific adjustment, this cost could be eliminated. The benefit would be that companies and customers could share the post-tax cost in the agreed proportions, regardless of the composition of the overspend. The full analysis is set out in Appendix 2. The effect of this mismatch is that the overall post-tax effect of the incentive is that customers and companies may not – depending on the composition of the overspend or underspend – share the cost in the expected proportion. This does not, however, prevent the mechanism from incentivising companies; it is simply that the sharing ratio may differ from what is intended. We also note that the overall approach to

[98] "PR14 Reconciliation rulebook policy document", pages 45-46
[99] "PR14 Reconciliation rulebook", Section 2.3.4
[100] "PR14 Reconciliation rulebook policy document", page 45

totex can lead to similar outcomes, e.g. if the composition of a company's totex expenditure is different from what is assumed for price control purposes, then the post-tax cost will differ from what had been assumed – even if the totex figure itself is as expected. Therefore, in some respects, the tax issue noted here is already present in the existing approach to totex. On this basis, we consider that it is reasonable to continue with the current approach to totex incentives.

Taxation of incentives – provisional view for PR19

We consider that the tax treatment of the Outcome Delivery Incentives, Export and Import Trading Incentives, the Wholesale Revenue Forecasting Incentive Mechanism and Retail Incentives are in accordance with Ofwat's objectives and appears to be fair.

We consider that the mechanism related to totex incentives can lead in some cases to mismatches between the tax effects of any underspend or overspend, and the tax effect of the consequent totex adjustment. Whilst it is theoretically possible to eliminate such mismatches, we acknowledge that in practice this may lead to an undue level of complexity and regulatory burden; as such, it is unlikely to be workable in practice.

7 Areas of Complexity

Introduction

7.1 As part of our review of taxation, we have been asked to consider the following[101]:

a. How the introduction of legislation on interest deductibility should be included within the PR19 methodology;

b. How the issue of group relief should be addressed, particularly with regards to whether regulated companies should be allowed to surrender losses for group relief and, if they are, the price that companies should receive/pay for the use of group relief;

c. How capital allowances should be taken account of, and whether the simplified approach adopted at PR14 is still appropriate; and

d. Other areas of corporation tax which are expected to change over the next price review period or which merit further review.

Tax deductibility of interest expense

7.2 As part of an international effort to reduce tax avoidance, the G20/OECD's Base Erosion and Profit Shifting ('BEPS') project was developed in July 2013, with 15 specific 'Actions', of which Action 4 relates to profit shifting via financing arrangements.

7.3 In October 2015, the G20/OECD issued their recommendations for 'Limiting Base Erosion Involving Interest Deductions and Other Financial Payments'. At Budget 2016 the Chancellor announced that the Government would introduce new rules adopting these recommendations. Following a consultation on the detailed design and implementation of the new rules, the Government published its reply to the consultation on 6 December 2016, together with draft legislation for inclusion in Finance Bill 2017; the draft legislation was expanded on 26 January 2017. The legislation may be further refined before it becomes law with the draft Finance Bill expected in March 2017, and enactment around June or July 2017.

Overview of the draft legislation

7.4 A broad overview of the proposed legislation is as follows:

a. The interest restriction rules will apply on a group, rather than company, basis. The group will comprise the ultimate parent and all entities that are consolidated on a line-by-line basis in the parent's consolidated financial statements, based on IFRS concepts.

b. A group will be subject to interest restrictions if its "aggregate net tax-interest expense" is greater than its "interest capacity".

[101] As outlined in questions 2, 3, 4 and 7 of "Overall approach to corporation tax"

c. A group's interest capacity is calculated as being its current year "interest allowance" plus any brought forward interest allowance amounts. The interest allowance is calculated either under the Fixed Ratio Method or (by election) under the Group Ratio Method.

d. Under the Fixed Ratio Method, a group may obtain net interest deductions of up to 30% of its aggregate tax-EBITDA. "Tax-EBITDA" is broadly defined as a company's profits chargeable to corporation tax excluding interest income/expenditure, capital allowances and (optionally) fair value movements on derivatives.

e. The fixed ratio has been drafted to include a modified debt cap meaning that the UK group should not deduct more interest than is suffered by its worldwide group. This will replace the existing "Worldwide Debt Cap Rules"[102].

f. The Group Ratio considers the net interest to EBITDA ratio on an accounting basis for all companies in the worldwide group (again, using an IFRS consolidation test), i.e. not just the UK companies. Applying this ratio (the "group ratio" which cannot exceed 100%) may allow a greater proportion of third party interest to be deducted for highly geared groups. However, the amount of interest deductions available under the group ratio is capped at the amount of net qualifying group-interest expense. Net qualifying group-interest expense does not include 'related-party' interest.

g. The main definition of a related party states that a person is a related party where (i) they are part of the same consolidated group, (ii) there is common participation in the management, control or capital of the parties, or (iii) one party holds a 25% (or greater) investment in the other. The rules however are extended to consider parties to be related where a number of loan investors also hold equity in the entity concerned in the same or similar proportions; albeit there is an exemption from these 'acting together' rules where at least 50% of debt with the same rights is held by unrelated parties (i.e. those with no equity stake). These rules are likely to restrict deductions for shareholder debt in more highly geared entities.

h. There is a £2 million de minimis amount of interest which is deductible regardless of the overall cap.

i. As noted above, interest restrictions are calculated on a UK group basis. This requires a group to sum the tax-EBITDA of each UK resident member company and UK Permanent Establishment, and to the extent the group's aggregated net tax-interest expense exceeds its interest capacity (calculated using the fixed or group ratio methods), there is an interest restriction equal to the excess. A group may decide how an interest disallowance should be allocated between group members subject to the amount allocated not exceeding each company's net interest expense.

j. Groups that are subject to an interest restriction may carry forward the disallowance for offset in any future period provided there is sufficient interest capacity in those periods. Conversely, where a group has spare tax-EBITDA capacity for a period it can carry this forward and use it as additional interest capacity in subsequent periods for 5 years.

[102] The Worldwide Debt Cap rules are not currently modelled (or otherwise taken account of) by Ofwat.

k. A provision to protect investment in infrastructure that has a public benefit - a Public Benefit Infrastructure Exemption ("PBIE") (described below) – has been included within the rules. As this report is being issued [in February 2017] prior to the issuance of final draft legislation or indeed the enactment of Finance Bill 2017, our comments on this exemption should be taken as provisional and should be confirmed in due course by reference to the actual legislation.

Public Benefit Infrastructure Exemption (PBIE)[103]

7.5 As mentioned above, the draft legislation contains provisions intended to protect investment in public infrastructure, the PBIE. The effect will be that "qualifying interest expense" of "qualifying infrastructure companies" will be fully excluded from their group's interest restriction calculations – i.e. there will be no restriction on the deductibility of qualifying interest even if that interest exceeds 30% of tax-EBITDA. There are three important definitions when determining whether, and how, the exemption can apply:

a. Qualifying infrastructure company

b. Qualifying infrastructure activity

c. Qualifying interest expense

7.6 "Qualifying infrastructure companies" are those which:

- do not generate operating income other than from "qualifying infrastructure activities";
- have no financial income, such as interest and distributions, other than from qualifying companies;
- do not hold any tangible or intangible fixed assets other than those representing public benefit infrastructure and ancillary fixed assets; and
- do not hold financial assets other than those representing public benefit infrastructure, or loans to or shares in other qualifying companies.

In addition, the total level of indebtedness of qualifying infrastructure companies must not exceed that of comparable group entities who carry on similar activities with similar assets.

Qualifying infrastructure companies must also be within the charge to corporation tax on all their activities and are required to make an election (see further below).

Immaterial amounts of non-qualifying income or assets will not prevent a company from qualifying.

7.7 "Qualifying infrastructure activities" are the provision of "public infrastructure assets" or the carrying on of any other activity that is ancillary to, or facilitates the provision of a public infrastructure asset. "Provision" for these purposes includes acquisition, design, construction, conversion, improvement, operation and repair.

7.8 Any tangible asset may be a "public infrastructure asset" if it meets a "public benefit test". That is the asset is procured by a relevant public body or its use is or would be regulated by an "infrastructure authority". A public infrastructure asset must have

[103] The legislation relating to Public Infrastructure is contained in Chapter 8 of the draft legislation which is to be included as a New Part 10 in TOPA 2010.

had, has or be likely to have an expected economic life at inception exceeding 10 years.

7.9 The draft legislation includes examples of what "infrastructure" might include and also what would be considered an "infrastructure authority". Water, electricity, gas, telecommunications or sewerage facilities are included as examples of "infrastructure". The treatment of bioresources is not specifically referenced. The Water Services Regulation Authority is included in the list of "infrastructure authorities".

7.10 "Qualifying interest expense" must be paid by a qualifying company to lenders which are not related parties and which only have recourse to the income or assets of qualifying companies (including via security over shares in those companies). Interest will also qualify if it is paid to public bodies or other qualifying companies. However, interest will not qualify if paid on loans for which guarantees are provided, unless by qualifying companies or public bodies.

7.11 The tax-EBITDA and interest income of companies that have elected into the PBIE will always be excluded from the group's interest restriction calculation.

7.12 As a result, the PBIE will not exempt interest except on loans that are used in their entirety to fund taxable public benefit infrastructure and which arise from a commercial decision by the owners of the infrastructure to obtain debt finance.

7.13 A limited grandfathering provision for "qualifying old loan relationships" is to be introduced where a loan was agreed prior to 12 May 2016. Grandfathering will be limited to cases where 80% of the qualifying company's expected income has been materially fixed for 10 years or more by long-term contracts with, or procured by, relevant public bodies. The only relaxation of the PBIE conditions is that the interest may be payable to related parties. All the other conditions must still be met, including electing for the PBIE to apply.

7.14 An election to be a qualifying infrastructure company must be made in advance of an accounting period if it is to have effect. It can be revoked after a period of five years, but will continue to have effect until the accounting period after a revocation. If a revocation is made, a subsequent election cannot be made for five years from the revocation.

Potential application of new interest deductibility rules for water companies

7.15 The water companies will be subject to the proposed rules like any other industry. As such, the companies' starting point will be to restrict the deductibility of their UK group's net interest expense to 30% of the UK group's tax-EBITDA.

7.16 Whether the companies might qualify for the PBIE will need careful consideration on a company by company basis.

7.17 As a starting point, given the inclusion in the draft legislation of water and sewerage facilities as an infrastructure asset and The Water Services Regulation Authority as an infrastructure authority, the provision of water services by water companies should be a "qualifying infrastructure activity".

7.18 Assuming that the water companies are carrying on qualifying infrastructure activities, the next question is whether they will be "qualifying infrastructure companies". In broad terms, it appears that they could be, but that a certain amount

of restructuring may be required in order to satisfy the conditions set out in the current proposals. Specific areas where companies may currently fail the conditions include the following, with the proviso that "immaterial" amounts of non-qualifying income or assets will not prevent a company from qualifying.

a. They must not generate operating income other than from "qualifying infrastructure activities". Most (possibly all) companies carry on some "non-appointed activities" which generate revenues; in principle, these would not appear to be "qualifying infrastructure activities". Therefore, these activities can only be ignored if they are immaterial.

b. They must have no financial income, such as interest and distributions, other than from qualifying infrastructure companies. Some companies have interest income from loans to other group companies (which might, or might not, be "qualifying infrastructure companies").

c. They may not hold any tangible or intangible fixed assets other than those representing public infrastructure assets and ancillary fixed assets. Any assets held for non-appointed activities might fail this condition, unless they can be treated as "ancillary" or are immaterial.

d. They may not hold financial assets other than those representing public infrastructure assets, or loans to or shares in other qualifying infrastructure companies. Many companies do have loans to other group companies. Whilst we would expect financing companies to be "qualifying infrastructure companies" for the purpose of these rules, equity or loan investments in other companies (e.g. trading subsidiaries) may prevent a company from qualifying for the PBIE. Upstream loans to parent companies or other group companies may also prevent a company from qualifying.

e. They must not hold any shares in non-qualifying companies. A number of companies hold shares in other group companies, which could be problematical (although not in the case of holdings in finance company if they are themselves "qualifying infrastructure companies").

7.19 It does not appear that the water companies could benefit from the grandfathering provision, as their expected income will not be materially fixed for 10 years or more by long-term contracts with, or procured by, public bodies or their wholly owned subsidiaries

Financial estimate based on business plans

7.20 In order to obtain an initial view of how the provisions could affect water companies, we have carried out a high-level analysis of the figures provided for the PR14 final business plans and calculated the potential additional tax exposure for the companies on the basis that the rules apply from 1 April 2017 and for the remainder of the PR14 period, assuming a restriction on interest deductibility to 30% of tax-EBITDA.

7.21 Our high-level analysis (the methodology for which is set out below) indicates that the impact on companies may be quite varied with the total estimated additional tax for the three year period ranging from £nil to £77m. The table gives the estimated interest disallowance (shown as a negative number) and the tax cost (at 20%, shown as a positive number). We have also calculated the potential tax effect of a disallowance of interest as a percentage of the companies' total revenue for the periods to give an idea of the materiality of the adjustment for each company.

Company	Year					
	2017-18 £m	2018-19 £m	2019-20 £m	**Total £m**	Tax cost @20% £m	**% of total revenue**
Affinity Water	(9)	(8)	(6)	**(23)**	5	**0.3%**
Anglian Water	(76)	(78)	(80)	**(233)**	47	**0.7%**
Bournemouth Water	(1)	(1)	(1)	**(4)**	1	**0.3%**
Bristol Water	(4)	(5)	(7)	**(16)**	3	**0.6%**
Dee Valley Water	-	-	-	**-**	-	**-**
Dwr Cymru (Welsh Water)	(80)	(83)	(87)	**(250)**	50	**1.3%**
Northumbrian Water	-	6	13	**19**	-	**-**
Portsmouth Water	(2)	(2)	(2)	**(5)**	1	**0.5%**
Severn Trent Water	(57)	(63)	(67)	**(188)**	38	**0.5%**
South East Water	(11)	(11)	(11)	**(33)**	7	**0.6%**
South Staffordshire Water	-	-	-	**-**	-	**-**
South West Water	(27)	(27)	(26)	**(80)**	16	**0.6%**
Southern Water	(14)	(12)	(9)	**(34)**	7	**0.2%**
Sutton & East Surrey Water	(1)	(1)	-	**(2)**	-	**0.0%**
Thames Water	(124)	(131)	(132)	**(387)**	77	**0.7%**
United Utilities	(46)	(35)	(23)	**(104)**	21	**0.2%**
Wessex Water	(13)	(15)	(15)	**(43)**	9	**0.3%**
Yorkshire Water	(41)	(36)	(29)	**(106)**	21	**0.4%**

7.22 In the case of companies which have no taxable profits in the above periods (e.g. because capital allowance claims exceed tax-EBITDA or because of brought forward losses), this disallowance may not result in actual cash tax liabilities (and therefore should have no effect on prices) but will reduce the companies' trading losses carried forward.

7.23 The figures are calculated using figures from the PR14 final business plans, taking 30% of PBT plus depreciation and comparing this to interest expense (adding together interest on both non-indexed and indexed loans), in all cases assuming a de minimis allowance of £2m. We have also ignored the potential benefit of the PBIE. A more sophisticated analysis could model taxable profits more accurately; however, we consider that the modelling is for indicative purposes only and is therefore sufficient for the purposes of this report.

Practical issues and application methodology for PR19

7.24 Two points follow from the above analysis:

a. Whilst the estimated tax effect of the new rules (absent the PBIE) appears to be significant for a number of companies, when considered as a proportion of total revenue the effect modelled is a relatively small amount. However, the absolute tax cost of the restriction will still have an important impact on a number of companies.

b. Whilst the PBIE may be available to certain companies, it is not easy to determine from publicly available information whether this exemption will ultimately benefit those companies, as the rules apply on a group basis (for which we do not have full details) and the exemption does not extend to related party debt interest.

7.25 As a result, we expect that (absent any major changes), the interest restriction will be an important issue for PR19. As may be seen from the outline of the proposals above, the group position may have a significant effect on a company's tax-deductible interest expense. This may be positive (e.g. if the group ratio is above 30%, or if the group has additional tax-EBITDA which can increase the deductions for a company); or it may be negative (e.g. if the wider group has negative tax-EBITDA).

7.26 It would be consistent with the approach on many other issues to treat the appointed business as if it were a stand-alone entity. However, even applying the new rules to each regulated entity on a stand-alone entity basis could be undertaken in different ways with significantly different results. In order to illustrate this, we have set out below three examples. In all cases, the company has EBITDA (assumed to be equal to tax-EBITDA) of 150 and interest expense of 50, but the disallowance is variously 0, 5 or 50.

Example 1

The company has tax-EBITDA of 150, interest expense of 50 from third parties and does not elect for the PBIE. As a result, the 30% limit is 45 (=30% of 150), leading to a disallowance of 5.

	Water Co
EBITDA	150
Depreciation	-50
Interest - Bank	-10
Interest - Finco	-40
PBT	50
Tax-EBITDA	150
Interest limit (at 30%)	45
Restriction of 5	

Example 2

The same facts, but the company borrows from a Finco. The Finco has itself borrowed from a third party. Both the company and Finco are "qualifying infrastructure companies" and elect for the PBIE. The disallowance is therefore zero.

Water Co		Finco	
EBITDA	150	Income	40
Depreciation	-50	Expense - Third party	-40
Interest - Bank	-10		
Interest - Finco	-40		
PBT	50	PBT	0

Example 3

The same facts, but Finco has itself borrowed from a related party. Both companies elect for the PBIE, but the related party expense is disallowed. The total disallowance is 40.

Water Co		Finco	
EBITDA	150	Income	40
Depreciation	-50	Expense - Related party	-40
Interest - Bank	-10		
Interest - Finco	-40		
PBT	50	PBT	0

7.27 An added complexity for price review purposes will be the interaction between these new rules and Ofwat's approach to gearing assumptions. In the event a company's gearing level exceeds 62.5%, Ofwat ordinarily reduce the company's tax allowance accordingly to reflect the additional tax relief available for the greater interest payable. However, this would not appear to be fair on the companies post the introduction of these new rules if the company concerned does not actually obtain tax relief for the additional interest cost.

Application methodology for PR19

7.28 One approach to dealing with this law change within the tax allowance process for PR19 would be to assume that the PBIE is available to the water companies and all interest expense should be assumed to be paid to third parties or qualifying companies and therefore tax deductible.

7.29 This approach could be justified on the basis that it is a company's choice as to how to structure its financing arrangements and whether it should elect into the PBIE, but that Ofwat may reasonably expect a company to maximise its interest deductions, noting that it is required to undertake all transactions (including financing) on arm's length terms. The water companies will have a three year window (with PR19 not applying until 1 April 2020) to review their financing arrangements to minimise any tax inefficiencies.

7.30 A refinement to this simple methodology may be necessary in situations where water companies' gearing levels exceed the 62.5% optimal level set by Ofwat. To the extent a company suffers an interest disallowance in respect of debt in excess of the 62.5% level, it would appear unfair to reduce a company's tax allowance. A variant of this option therefore would be to assume the PBIE applies, but to take account of any related party interest, which would be non-deductible. This would arguably provide a fairer outcome for companies but would need to be monitored and contain provision for Ofwat to clawback allowances if companies subsequently restructured to increase their tax deductions for interest expense.

7.31 The alternative approach would be to model the "actual" impact of the new rules on each company – i.e. the company would provide the figure for tax-deductible interest expense along with supporting calculations. Under this approach, companies could choose to elect into the PBIE or not, and this would accordingly be taken into account in the forecast tax costs.

7.32 If an "actual" basis is used, a refinement of the tax allowance modelling method and tracking of certain figures would be required, either as part of the Ofwat financial model or via calculations by the companies with only the result input into the financial model. An outline of such an approach is as follows:

a. The tax-deductible maximum interest amount would be calculated as 30% of tax-EBITDA; there would be no way of knowing what the group ratio might be, and in any case the group position is irrelevant under the "single-entity" approach.

b. Tax-EBITDA: can be estimated using figures from the existing financial model template.

c. Interest expense: can be taken from the financial model.

d. Disallowed interest: the difference between interest expense and 30% of tax-EBITDA; this figure also contributes to either the "excess interest" figure or the "excess capacity" figure (see next two items).

e. Brought forward / carried forward excess interest: needs to be tracked separately. Interest disallowed in earlier periods can be carried forward indefinitely.

f. Brought forward / carried forward excess capacity: also needs to be tracked separately; excess capacity can be carried forward for five years.

Alternatively, companies would notify Ofwat that the PBIE is to be assumed; and the figure for tax-deductible interest expense (which might not be the same as the actual interest expense) would need to be provided by the companies along with support.

7.33 Additional complexity may arise in relation to the alternative "actual" approach as the Ofwat tax allowance is calculated using Ofwat's specific approach to gearing assumptions which means the actual interest payable by companies may be different to that assumed for tax allowance purposes.

7.34 The effect of modelling the interest restriction in this way for business plans will likely result in a "notional" position for the different price controls for which the out-turn in the legal entity is different. As a result, there may be a need to reconcile the modelled position compared to the out-turn.

Interest restriction – provisional view for PR19

It appears likely that some water companies could face a significant interest restriction unless the Public Benefit Infrastructure Exemption (PBIE) is available. In most cases (possibly all) it appears likely that it could apply; albeit some companies may need to restructure in order to benefit from it.

The simplest approach for Ofwat to dealing with this law change within the tax allowance process for PR19 would be to prescribe that the companies should assume that the PBIE is available and to be applied by them when calculating their tax allowances – i.e. all interest expense should be assumed to be paid to third parties. A refinement to this simple methodology may be necessary in situations where water companies' gearing levels exceed the 62.5% level set by Ofwat.

Alternatively, the "actual" basis could be modelled:

a) If the PBIE is not expected to apply then it may be necessary to calculate the allowable interest expense on a notional stand-alone basis, using the 30% rule and "tracking" figures such as carried forward excess capacity, or carried forward interest deductions. This will involve additional complexity beyond the current modelling of tax.

b) If the PBIE does apply then a company could notify Ofwat and provide the forecast interest deduction as part of the business plan, although this may not be as simple as just assuming full deductibility of all interest expense, particularly given Ofwat's specific approach to gearing assumptions which means the actual interest payable by companies may be different to that assumed for tax allowance purposes.

Even if the PBIE does apply, Ofwat may still wish to "track" the interest expense which would have been deductible without the PBIE, to ensure that customers are not disadvantaged.

Group relief

Overview of taxation and accounting considerations

7.35 UK resident companies under common 75% ownership are generally able to surrender current year tax losses to each other, using the mechanism of group relief. In certain cases, lower percentage holdings can also enable tax losses to be surrendered, using the mechanism of consortium relief.

7.36 Any such surrender is not automatic, but must be agreed to by means of a formal procedure by both the surrendering and claiming companies, although in practice many groups use a simplified procedure in which a group relief matrix is submitted to HMRC by a nominated group company.

7.37 Payments or receipts for tax losses are not brought within the charge to UK corporation tax provided that any payment is not more than the gross amount of the loss, e.g. a payment of up to £100 could be made for a loss of £100, notwithstanding that the tax value of the loss would (at a headline corporation tax rate of 20%) be only £20. In practice in the general UK corporate environment, the approach to payments for group relief is typically:

a. There is normally a group policy governing payments for group relief, i.e. it is not typically left to individual group companies to make their own decision;

b. The policies generally adopted are either to pay nothing for group relief, or to pay the full tax value;

c. Two other policies which could be adopted, although in our experience this is in practice less common, are:

- A payment calculated on the basis of the expected NPV of the tax loss
- A payment of an amount somewhere between zero and the full tax value of the loss.

7.38 A group's chosen policy for paying for group relief has a direct impact on its entities' financial statements. Any payments for group relief will be accounted for as part of a company's Income Statement tax charge – i.e. in the same way as a company's expected tax liability payable to HMRC. If no payment is made for group relief then a company's tax charge (and effective tax rate) will be lower than expected.

Current approach to group relief adopted by water companies

7.39 It is common for a regulated entity which has taxable profits to claim group relief from its wider group.

7.40 As highlighted by the NAO and A&M in their reports, the water companies do not take a consistent approach to the payment for group relief. We have reviewed disclosures relating to group relief in the 2016 APRs and note that there is also no common approach to the disclosure of group relief. In particular:

a. Only six companies clearly state what their policy is for paying for group relief.

b. Only one states that group relief is not paid for; it appears that the benefit of this is a material reduction in the company's tax charge.

c. Three companies state that some payments for tax losses are at less than full tax value, but the actual benefit is not disclosed.

d. Two companies include payments for group relief in the tax reconciliation. Without further explanation, it is not clear why group relief would be a reconciling item unless the company pays less than tax value for group relief

7.41 As part of the overall understanding of group relief, further clarity would be helpful. We comment further on this and set out specific recommendations in section 9.

Treatment of group relief – payments at full value

7.42 An important point of principle is whether to consider a payment for group relief as essentially the same as a payment of corporation tax.

7.43 A payment for group relief at full rate, i.e. where the amount paid is exactly the same as the amount that would have been paid in corporation tax to HMRC, is conceptually almost identical to a payment made to HMRC. Both payments are made in respect of the company's taxable profits: if group relief is not available, then the company would pay a certain amount in corporation tax to HMRC; if, however, group relief is available and is paid for at full value, then the company will pay exactly the same amount to a group company for the losses surrendered.

7.44 It is not clear why the recipient of the payment should make a difference, provided that the payment is on arm's length terms. For example, it is acceptable under the price control regulations for the regulated entity to make a payment for services or assets provided by group companies, provided that the payment is on arm's length terms.

7.45 On this basis, there does not appear to be any conceptual reason why a payment for group relief should be treated differently to a payment of corporation tax to HMRC, provided that the payment is at the full tax value. This is consistent with the stand-alone concept; it also aids transparency and eliminates an aspect of inconsistency of approach amongst the companies.

Treatment of group relief – payments at an undervalue

7.46 The A&M report identifies a difference of £480m between the tax value of losses surrendered to companies and the amount which could have been paid for such losses. Whilst the A&M report does comment on the interaction between group relief and capital allowances, it provides no material comment on the question of payments for group relief at an undervalue.

7.47 A concern raised in the PAC and NAO report is that prices were set for PR09 on the assumption that tax of £480m (or a similar amount) would be paid; but that as this tax has not been paid, as it was sheltered by group relief surrendered for no payment or for undervalue, the companies have enjoyed a substantial benefit which could have been passed on to customers.

7.48 However, were a mechanism to be put in place which put groups at a disadvantage if they paid less than full value for group relief, then it is reasonable to assume that groups would respond by charging full value for group relief.

7.49 Given the overall requirement for transactions to be on an arm's length basis, it would appear to be necessary for groups to justify the price that they pay for group relief. This is considered next.

Transfer pricing considerations

7.50 It is a regulatory requirement that all transactions, including the transfers of assets and/or liabilities, between the regulated entities and related parties should be undertaken on an arm's length basis. Although RAG5 does not explicitly refer to tax (or tax losses), we would expect this requirement to extend to the payment for group relief. Indeed, it would be helpful for RAG5 to be amended to cover tax issues so that there is clarity and consistency of approach. We set out recommendations below.

7.51 In practice, the application of transfer pricing concepts to the payment for group relief is not straight forward, in that an arm's length price can be defined as a market price that would be paid between unrelated parties, but there is no market for group relief as losses can only be surrendered between group companies.

7.52 In the case of losses, their value to the two parties to the transaction (i.e. the surrendering company and the claiming company) may be different, with the recipient in principle willing to pay any amount up to the full tax value of those losses as it will otherwise have to pay the full tax liability to HMRC, whilst the surrendering company may be willing to accept a lower value for its losses if it has no other use for them.

7.53 The surrender of tax losses generated by a UK group company is outside the scope of UK transfer pricing regulations as the right to utilise such losses is itself granted by UK tax law. Accordingly, purely from a UK tax perspective, HMRC does not require that the losses be "traded" at arm's length between related parties.

7.54 However, from an economic point of view, there is clearly a commercial value associated with a transfer of losses if the transfer generates a financial advantage for the company utilising the losses (i.e. a reduction in its tax liability). Accordingly, it is possible to consider what the arm's length price for the transfer of losses could be.

7.55 Paragraph 1.34 of the OECD Transfer Pricing Guidelines indicates that independent parties, when evaluating the terms of a potential transaction, will compare the transaction to the other options realistically available to them and will enter into the transaction if they see no alternative that is clearly more attractive to them. This aspect should be analysed from the perspective of each party to the transaction, i.e. the transferor (surrendering its loss) and the transferee (claiming the loss).

7.56 From the transferor's perspective there are two possible scenarios:

a. The transferor could either use the losses itself or surrender them to another group company. In the case of a surrender of losses, the arm's length price would most likely be the current tax value of the losses, i.e. the gross loss multiplied by the headline corporate tax rate. This represents the highest price the recipient of the losses would be willing to pay for the losses given that this is the economic value they will receive as a result of the losses. This is also the best option available for the transferor if it could also use the loss itself (e.g. in a future or prior period) and derive an equivalent tax saving.

b. However, if the transferor has no other use for the losses, those losses could essentially have no value to that company, whereas the value to the company claiming the losses is still the tax value. In this case, the arm's length price could be any amount between zero and the tax value.

7.57 The OECD Transfer Pricing Guidelines recognise that associated enterprises sometimes have a considerable amount of autonomy and can often bargain with each other as though they were independent enterprises. It seems appropriate to assume that such autonomy would be exercised by the transferor and transferee when negotiating the price for the transfer of losses.

7.58 Attempting to replicate the outcome of bargaining between independent enterprises may involve the following steps:

a. In the first stage, the initial remuneration would be the lowest price an independent seller would reasonably accept in equivalent circumstances and the highest price an independent buyer would be reasonably willing to pay, i.e. in this case, at least £1 per £100 of losses for the transferor and at most £20 per £100 of losses for the transferee (assuming a 20% corporation tax rate);

b. Any discrepancy between these two figures (i.e. the difference between £20 and £1) represents the residual value over which independent enterprises would bargain. In the second stage of bargaining, the residual value could be divided between the related parties based on an analysis of any relevant factors that independent enterprises might use to split the difference between the seller's minimum price and the buyer's maximum price (see Paragraphs 1.5 and 2.122 of the OECD Transfer Pricing Guidelines).

7.59 However, case law has also emphasised the importance of considering the relative bargaining positions of parties when considering the arm's length nature of transactions (e.g. DSG Retail Ltd and others v HMRC (2009)). The importance of bargaining power between independent parties was underlined in the DSG Retail case, and it was accepted that the availability of alternatives in the market (i.e. the competitiveness of the market) was key in determining the extent to which the bargaining power would remain with the party that held an attribute or asset that created economic profit over and above a normal market rate of return. While the transactions considered in the DSG Retail case are significantly different from the transactions under review here, the judgement from the DSG Retail case emphasises that the underlying economic reality, and specifically the relative bargaining power of parties, is paramount when considering the arm's length nature of the pricing of a transaction.

7.60 Economic theory suggests that bargaining power is determined by various specific factors characterising each party in the deal, such as the availability of alternatives, information, commitment, patience, risk aversion.

7.61 In the case of a water company and another group company it is arguable that the water company is in the position of deriving a known benefit from claiming or surrendering the losses, i.e. the tax value of the losses or, in the case of a capital allowance disclaimer, the discounted value of future capital allowances. Indeed, from a regulatory perspective these are matters which can be determined and monitored. On the other hand, the position of the other company depends on many factors outside the regulatory boundary (e.g. the wider group position).

7.62 On this basis, there is a good argument that the correct transfer price for losses should be the benefit to the water company, i.e. typically the headline tax rate multiplied by the gross value of the losses. Such an approach would be fair, transparent and accord with the "stand alone" concept.

7.63 We are aware that in some cases it might be difficult for companies to pay full tax value for group relief (e.g. in certain securitisation structures). In such a case, a fair outcome for customers may be to claw back the difference between the tax allowance and the price paid for the group relief.

7.64 The regulated companies have typically not included group relief claimed in their business plans due to the inherent uncertainty associated with it. However, in the event that a company does forecast group relief in its business plan, and this forecast shows that the company will pay less than full tax value for these losses, then the tax allowance should be reduced accordingly (rather than operating a clawback, as in the scenario outlined above).

Treatment of group relief – interaction with capital allowances disclaimers

7.65 The case where capital allowances are disclaimed is noted in the A&M report[104] and analysed at a high level. The situation typically arises where the wider group has more losses to surrender than the regulated entity would be able to utilise if it were to make a full capital allowances claim. In this case, the regulated entity disclaims some or all of its potential capital allowances, thereby increasing its taxable profits; it then claims a higher amount of losses as group relief, for which it may (or may not) make a payment.

[104] A&M Report, p.43

7.66 From the company's perspective, there is an immediate payment for group relief, balanced by the future ability to claim capital allowances. The gross amounts (i.e. not tax effected) should be exactly offsetting, i.e. an increased taxable profit of £100 would be offset by an ability to claim future capital allowances of £100. However, in practice the tax effected values and the economic effect may not match:

a. If the tax rate reduces in the future, then the tax effect of an additional £100 of taxable income now will be greater than the future tax saving from £100 of deductions in a later period

b. The cost of a cash payment now is greater than the benefit of a future tax saving, even if it is of an equal amount, owing to the time value of money.

7.67 The above considerations suggest that arguably water companies should pay less than the current tax value of losses, at least to the extent that capital allowances have been disclaimed. However, as capital allowance disclaimers are not funded in the tax allowance, it is arguable of less concern to Ofwat what price a company pays for group relief which is used to shelter profits arising from a disclaimer.

Treatment of group relief – surrenders by regulated entities

7.68 The discussion above focusses on regulated entities claiming group relief; another possibility is that the regulated entity itself has losses, which can either be carried forward or surrendered to other group companies, although in practice this is less common.

7.69 As a point of principle, transactions with related parties must be on arm's length terms. Any group relief surrender for no consideration would clearly not be an arm's length transaction, because the regulated entity is giving up an asset (the tax loss) for which it could expect to obtain a future benefit. Provided that the pricing is arm's length, there does not appear to be any economic objection to the notion of surrendering tax losses.

7.70 It is not necessarily straightforward to determine what the arm's length price for the losses is. The value to the regulated entity depends on the period in which the entity will be able to utilise the losses, as that will determine the applicable tax rate (noting that the headline corporation tax rate is due to fall in coming years) and any discount to take account of the time value of money; an additional discount might also apply in respect of uncertainty in the regulated entity's forecasts, compared to the benefit of receiving value for the losses today. In other words, it is not necessarily a matter of simply applying the current period tax rate to the losses. It is important to note that company would never surrender losses for less than the economic value of the losses that it could itself enjoy.

7.71 Overall, a policy of requiring that losses be paid for (whether claimed or surrendered) at full tax value would be simple, transparent and impose little additional burden on Ofwat or the companies. It would likely be close to the actual economic value, without requiring any complex or subjective valuations or forecasts.

Group relief – provisional view for PR19

Payment for group relief is conceptually reasonable.

Water companies have a variety of approaches to the price paid for group relief. This results in a lack of transparency for customers and is arguable unfair where a company has been given a tax allowance but does not pay full tax value for group relief.

Arm's length is a difficult concept to apply to group relief with no market, but payment at full tax value appears to be practical and simple; this deals with the situation of both claims and surrenders of tax losses. This should be specifically mentioned in RAG5.

In cases where a company nonetheless pays less than full tax value for group relief, a fair outcome for customers may be to claw back the difference between the allowance and the price paid for group relief. However, in a scenario whereby group relief is claimed to shelter profits as a result of a capital allowance disclaimer, it may be of less concern to Ofwat what price is paid for group relief as capital allowance disclaimers are not funded in the tax allowance.

Capital allowances

7.72 One of the specific areas which Ofwat has requested that we review is how capital allowances should be taken account of and, in particular, whether the simplified approach adopted at PR14 is still appropriate.

7.73 Several issues arise in relation to capital allowances, including (i) the simplified approach adopted at PR14, (ii) the use of actual versus "notional" pool figures and the interaction with group relief, (iii) the existence of 100% allowances such as Enhanced Capital Allowances ("ECAs") and Research and Development Allowances ("RDAs") and (iv) the fact that an estimated capital allowances claim is typically used for accounts purposes, with a final claim resulting in adjustments later. Each of these is considered in more detail below.

7.74 As part of our work, we have sought the views of all the companies on various aspects of their approach to capital allowances. 14 companies have replied although one – Tideway – stated that it was not able to claim capital allowances and therefore the questions were not relevant; we have used the responses from the remaining 13 companies who did reply to inform our comments below.

Simplified approach adopted at PR14

7.75 At PR14, Ofwat adopted a simplified approach to capital allowances, under which average writing down rates were used for tax forecasts rather than using separate forecasts for each capital allowance pool, in line with the then policy of minimising the time required.

7.76 In the final PR14 methodology Ofwat stated that the majority of respondents supported the simplified approach, although some considered that it would not reduce the burden on them. Indeed, the A&M report[105] notes that in fact the six

[105] A&M Report, page 44

companies that they spoke to still prepare detailed forecasts. Of the companies surveyed:

a. Six said that the simplified approach increased the time required;

b. Five said that it had no impact or minimal impact; and

c. One said that it reduced the time required[106].

7.77 10 of the companies also stated that they continued to prepare more detailed models of their capital allowance position, in order to support and determine the appropriate pool balances and average writing down rates. A common theme with these companies was that it was necessary to "reverse engineer" the average writing down allowances, due to the fact that the capital profile of the projects varies across the five years of the price control period.

Actual/notional capital allowance pools and the interaction with group relief

7.78 For regulated companies which are members of larger groups, it is not uncommon for the regulated company to disclaim capital allowances in order to realise taxable profits against which losses from elsewhere in the group can be group relieved. This disclaimer is made for the benefit of the group, typically to prevent losses being trapped in other group companies which might not be able to utilise them in future.

7.79 Whilst capital allowances claimed throughout the period are included within the business plans, group relief claims are not included due to (1) their inherent uncertainty and (2) the fact that companies are assumed to be taxed on a stand-alone basis. Indeed, if capital allowance disclaimers were to be modelled in business plans then this would result in consumers funding a matter which is properly one of the group tax planning, as shown in the simple example below.

Scenario	**1**	**2**
	Capital allowances claimed in full	*Capital allowances disclaimed*
Taxable profits	100	100
Capital allowances	(100)	-
Profits chargeable to tax	-	100
Tax charge @ 20%	-	20

7.80 As part of our survey, we asked companies whether they used actual or "notional" pool balances (e.g. to reverse the effect of capital allowance disclaimers) and how they calculated them:

a. Five make capital allowance disclaimers but reverse the effect when computing pool balances for their business plans;

b. Six do not make capital allowance disclaimers (although one company said that it made full claims in all but "exceptional circumstances");

[106] The remaining company did not comment.

c. Two companies disclaim but do not (apparently) reverse the effect; and

d. One company had not made such disclaimers prior to PR14, but has done so since then.

7.81 The "single entity approach" requires each business to be treated on a notional "stand alone" basis, with its tax computed as if it were a separate entity. Applying the single entity approach would require companies to reverse all capital allowance disclaimers for the purpose of completing the business plan and calculating the tax allowance i.e. using a 'notional' capital allowance pool.

7.82 Several companies (Yorkshire Water, United Utilities) noted that no clear methodology was provided by Ofwat to clarify how capital allowances should be calculated, which perhaps accounts for the variety of approaches outlined above.

7.83 When considering the implications of the above, it is also relevant to consider the recent dispute between NIAUR and NIE on whether NIE's tax allowance should be calculated by reference to notional or actual capital allowances, which was ultimately referred to the CC. The details of the case are discussed in greater detail in section 5 of this report; the proposal accepted by the CC was that:

a. The maximum capital allowance claim should be assumed.

b. Consistent with the assumed capital allowances claim, a set of 'notional' capital allowance pools should be calculated, which would be used to calculate future assumed capital allowance claims.

c. As part of the annual reporting, a reconciliation between the actual capital allowance position and the notional capital allowance position would be disclosed.

7.84 This proposal was accepted because it was a clear and simple approach, and it appeared to be in the best interest of the consumer (as it lowered water prices) whilst allowing the water company to plan its tax affairs in the best way for the group.

7.85 We consider that similar considerations apply in the present case and that water companies should assume full capital allowance claims when calculating capital allowance pools for business plan purposes.

Inclusion of 100% allowances

7.86 In addition to the writing down allowances available in the main pool at a rate of 18% and the special rate pool at a rate of 8%, there are alternative allowances available which may accelerate the tax relief on certain types of capital expenditure.

7.87 ECAs are designed to provide 100% allowances for energy saving plant and machinery. Of the 13 companies which have responded and for which the questions were relevant:

a. 6 companies said that they included ECAs in their business plan;

b. 3 companies said that they did not include ECAs due to the inherent uncertainty involved with claiming them;

c. 3 companies said that they did not include ECAs as they had been immaterial in previous years; and

d. 1 company said they did not include ECAs as they had not claimed any in the past.

7.88 RDAs give 100% relief for capital expenditure on research and development. Of the 13 companies which have responded and for which the questions were relevant:

a. Two companies said that they included RDAs in their business plan;

b. Three companies said that they did not include RDAs due to the inherent uncertainty involved with claiming them;

c. Four companies said that they did not include RDAs as they had been immaterial in previous years;

d. Three companies said they did not include RDAs as they had not claimed any in the past; and

e. One company did not mention RDAs in their response.

7.89 As the effect of the ECAs and RDAs is included in business plans where reasonably certain, but not where the effect is uncertain or immaterial, we do not consider that any change to the existing approach is required.

Opening pool value

7.90 Typically, an estimate of the final capital allowance claim is typically used for accounts purposes. Once the final capital allowance claim has been made in the submitted tax return, an adjustment will be made in the next set of accounts.

7.91 The submitted business plans for each water company will have followed this process, and will include an estimate of the capital allowances which are to be claimed over the five year period. As a result, the actual pools at the start of an AMP may differ from pools computed in the previous AMP's business plans, independent of the issue regarding capital allowance disclaimers discuss above. For example:

a. The timing of capital expenditure may be different from that assumed in the previous business plan for the previous AMP. As WDAs are computed on a reducing balance basis, a change in the timing of expenditure will change the pool value at a given date.

b. The nature of the expenditure, and in particular its classification for capital allowance purposes, may change. As there are different WDA rates, this can also affect pool values.

c. Actual pools may include items which relate either to a non-appointed business or to expenditure which is not funded by customers.

7.92 Limited information was provided by the water companies regarding whether they perform "true ups", i.e. whether capital allowance pools at the start of an AMP are adjusted to reflect the actual pools (as far as possible, given that business plans need to be prepared before the relevant tax computations will have been finalised).

7.93 We also asked companies to clarify their approach to determining the opening pools for AMP6 (i.e. at 1 April 2015). The various approaches adopted were as follows:

a. Use actual March 2013 balances (adjusted to remove effect of CA disclaimers) and forecast expenditure to March 2015

b. Use "forecast March 2015" balances (no reference to "actuals" at any date)

c. "Actual pools" used

d. "Actual pools" at March 2014 (including effect of previous CA disclaimers), although subsequent years assume no disclaimer

e. Consistent notional basis (apparently no estimate to "true up", for various reasons mentioned in the response)

7.94 We consider that in order for the approach to tax to be fair to customers of different companies and to be transparent, it is important that companies interpret and apply the approach in consistent ways. As there are currently different approaches to calculating the opening pools, outlined above, it is therefore important to specify a single approach. An approach which seems reasonable and fair, is:

a. Take the latest available pools per draft or submitted tax computations, excluding any amounts relating to a non-appointed business or which have not been funded by customers[107];

b. Add any estimated expenditure to reach the position at the start of the next AMP; and

c. Eliminate the effect of any capital allowance disclaimers (so that full capital allowance claims are assumed).

7.95 A slight modification of this approach would be for step (c) (the elimination of capital allowance disclaimers) to eliminate only the capital allowance claims which had been assumed when computing tax allowances (e.g. in the business plan for the previous AMP).

7.96 Another computational point to consider is how far back such an approach should go in order to compute the pools. An obvious approach would be to eliminate the effect of disclaimers in AMP6. However, companies may have other views on what would be fair and reasonable.

Conclusions

7.97 The following conclusions can be drawn from the above analysis:

a. The simplified capital allowance approach adopted for PR14 did not materially reduce the time burden on water companies, with the majority of water companies confirming that they were still preparing detailed capital allowance forecasts to support the figures provided to Ofwat.

[107] We are aware of at least one company which has incurred significant capital expenditure which was not funded by customers

b. A variety of approaches were adopted by water companies with regards to calculating their capital allowance pools: whilst some reversed all capital allowance disclaimers in order to align with the single entity approach (thereby creating notional capital allowance pools), other companies used the actual capital allowance pools, including all disclaimers which may have been made.

c. Whilst ECAs or RDAs are available to water companies, most companies do not include these allowances in their business plans either due to inherent uncertainty over these claims, or the immaterial nature of past claims.

d. Actual capital allowance pools at the start of a price control period may differ from the capital allowance pools computed during the previous price control period, irrespective of the position adopted with regards to capital allowance disclaimers.

7.98 It is clear that the treatment of capital allowances is a material issue for PR19 which can have a significant effect on the tax allowance a company receives and, by extension, the price incurred by consumers.

7.99 In order to be consistent with the approach on many other issues, the regulated entities should be treated as if they were a stand-alone entity. Of equal importance is the need for all water companies to follow the same approach, in order to ensure consistency and transparency.

7.100 We have outlined our provisional view for the methodology to be adopted as part of PR19 below.

Capital allowances – provisional view for PR19

The simplified capital allowance approach should be removed for PR19. Our research has found that the majority of companies did not feel that it reduced the time they spent on their capital allowance calculations with most continuing to produce detailed capital allowance workings.

The methodology for PR19 should stipulate the capital allowances pools into which expenditure is to be allocated. This will help to increase the transparency associated with capital allowance claims. With regards to ECAs and RDAs, should Ofwat chose to include these in the tax allowance calculation, then these should be stipulated as additional pool categories. However, given the immateriality of these claims, an alternative approach would be to stipulate that these two pools should not be included in the tax allowance calculation, with any timing benefit derived from the submission of ECA and RDA claims to be retained by the company. This alternative approach would be in line with Ofwat's stated objective to provide effective incentives to companies to manage their tax affairs responsibly.

In line with the stand alone concept, the tax allowance for PR19 should be calculated assuming that full capital allowances are claimed. The capital allowances carried forward to the next price review period should also assume that full capital allowances have been claimed (i.e. if a water company chooses to disclaim its allowances, the tax effect is a matter for the company rather than the customer).

The approach to calculating the opening pools should be applied by the companies in a consistent way in order to be fair and transparent. We recommend that for PR19 companies should take the latest available capital allowance pools per the tax returns, add any estimated expenditure to reach the position at the start of the next price control period, and eliminate the effect of any capital allowance disclaimers, as shown in the table below:

Actual capital allowance pool					
AMP 1					
Year	*1*	*2*	*3*	*4*	*5*
Brought forward balance	10,000	12,500	14,500	17,250	19,750
Additions	2,500	2,000	2,750	2,500	2,000
WDAs @ 18%	-	-	-	-	-
Carried forward balance	12,500	14,500	17,250	19,750	21,750
Assuming full capital allowances claimed					
Brought forward balance	10,000	10,250	10,045	10,492	10,653
Additions	2,500	2,000	2,750	2,500	2,000
WDAs @ 18%	(2,250)	(2,205)	(2,303)	(2,339)	(2,278)
Carried forward balance	10,250	10,045	10,492	10,653	10,376
Capital allowance pool to be taken forward into AMP2					**10,376**

The methodology for PR19 should clarify whether companies should reverse all historical disclaimers when computing the opening balances for PR19. Whilst reversing all disclaimers is the most complete approach, this also represents an increased burden on the companies, particularly if historical records are not readily available. Ofwat will need to consider this matter further prior to finalising the PR19 methodology.

Other areas of complexity

7.101 This section covers the following areas which are, or are likely to be, relevant to the taxation of water companies for PR19:

a. Rate reductions
b. Prior period adjustments;
c. Loss relief;
d. Other timing differences;
e. Changes to taxation of leasing; and
f. Timing of corporation tax payments.

7.102 In each case, the objective of the analysis will be to consider the following points:

a. Whether the issue is one which is suitable for inclusion in a tax clawback mechanism;
b. Whether the issue can be dealt with on a stand-alone basis, or whether group effects are relevant (and, if so, how to take into account such group effects);
c. In each case, how any tax effects could be quantified;
d. Information that would be required for the quantification; and
e. How Ofwat can ensure consistent treatment by different companies.

7.103 We note that the A&M report also identified other adjustments, specifically (i) the treatment of expenditure previously qualifying for IBAs, (ii) infrastructure receipts and (iii) transition to new UK GAAP. On the basis that these are of historical relevance only and are not considered likely to reoccur in AMP6, we do not propose covering these points in any detail in this report.

Headline corporation tax rate

7.104 The headline corporation tax rate at the date of this report (Q1 2017) is currently 20%, although it is due to fall to 19% on 1 April 2017 and 17% on 1 April 2020.[108] Both of these rate reductions have been legislated; neither was anticipated in PR14, which uses a rate of 20% for 2015-16 to 2019-20.

7.105 As a result of the rate reduction, companies which are forecast to be taxpaying in AMP6 may have been overfunded to a certain extent – ignoring any other differences which could affect taxable profits and actual tax paid, and also ignoring any actions which companies may have taken to compensate customers unilaterally.

7.106 Assuming that there are no further rate reductions, and ignoring any other differences, the impact of the overfunding is shown in the table below:

Company	Forecast total tax charge for AMP6 (£m)	Revised total tax charge for AMP6 (£m)	Overfunding (£m)	Overfunding as a % of revenue
Affinity Water	7.5	7.05	0.45	0.03%
Anglian Water	45.62	44.03	1.59	0.03%
Bournemouth Water	2.86	2.69	0.17	0.08%

[108] Finance Act 2015, s7(1) and 7(2)

Bristol Water	5.44	5.32	0.12	0.02%
Dee Valley Water	1.59	1.52	0.06	0.05%
Northumbrian Water	235.43	225.45	9.98	0.24%
Severn Trent Water	120.79	116.77	4.02	0.05%
South East Water	10.76	10.23	0.53	0.05%
South Staffordshire Water	11.95	11.45	0.5	0.08%
South West Water	31.01	29.01	2.0	0.13%
Sutton and East Surrey Water	2.66	2.53	0.13	0.04%
United Utilities	241.53	227.02	14.51	0.16%
Wessex Water	67.36	64.36	3.0	0.11%
Yorkshire Water	31.01	29.01	2.0	0.04%

7.107 Southern Water, Thames Water, Dŵr Cymru (Welsh Water) are forecast to be loss making for the entirety of AMP 6, whilst Portsmouth Water is forecast to be loss making from 2017/18 and therefore the change in tax rate does not impact the tax charge forecast in the business plan.

7.108 The Government has stated on several occasions that it may consider reducing the rate further to 15%, although it is not currently clear whether, or when, any such reduction could happen. It is certainly possible that such a change could arise during AMP7 and might not have been enacted at the time of PR19, so that it would not be included in the PR19 price determinations. For this reason, it may (depending on the timing of any announcement or enactment of a rate change) be important to decide, in advance, how to treat any such rate change – in other words, whether to claw back any benefit, or whether to allow companies to keep the benefit.

7.109 We note that the financial model, and final business plans (at least as set out for PR14) contain the headline corporation tax rate; and this rate is used to calculate the tax allowance. Therefore, it would be relatively simple to re-run the models using a different headline rate. In addition, no group effects should be relevant.

Prior period adjustments

7.110 We have included "Prior period adjustments" in our review because such items can have a material effect on the tax charge of a company. One reason for this is that the tax provision is calculated shortly after a period end and is based on estimated tax figures, but the corresponding tax returns may not be agreed until, at the earliest, one year later – and in practice many not be agreed for several further years. Adjustments between the estimated and final figures are typically shown as a "prior period adjustment".

7.111 As such adjustments cannot be estimated in advance (for if they could, then they would form part of the original estimated tax charge), they cannot in practice form part of the forecast tax charge in companies' business plans. As a result, the tax charge shown in the financial statements – either statutory accounts, or regulatory accounts, or the tax charge of the appointed business (as shown in a company's APR) – may differ from the tax allowance per price determinations as a result of such prior period adjustments.

7.112 Given that a prior year adjustment can arise in for numerous different causes, e.g. payment for group relief, agreement of capital allowance claims, treatment of GAAP

adjustments, the only reasonable approach to them would seem to by reference to the underlying items. For example, if the item in question is one for which a clawback is considered appropriate (see section 8), then the clawback mechanism is the correct means by which to make any adjustment to the tax allowance.

7.113 An important point, therefore, is that any material prior year adjustments which are disclosed (e.g. in the tax reconciliations in the APRs) should also explain the nature of the underlying item. For example, in our review of the 2016 APRs, we found the following prior year adjustments disclosed in the tax reconciliations with no further explanation:

Company	Prior year adjustment at APR6 (£m)	Prior year adjustment as proportion of current tax charge
Affinity Water	(0.76)	47%
Anglian Water	(7.7)	60%
Bournemouth	0.2	12%
Bristol Water	(0.6)	40%
Dŵr Cymru (Welsh Water)	(0.5)	2%
Northumbrian Water	(0.5)[109]	2%
Portsmouth Water	0.06	5%
Severn Trent Water	(2.8)	5%
South East Water	0.1	3%
South Staffordshire Water	(0.16)	44%
Southern Water	8.8	44%
Sutton and East Surrey Water	(0.01)	0.3%
United Utilities	(5.7)	12%
Wessex Water	(0.7)	3%

7.114 Dee Valley Water and Thames Water disclosed prior year adjustments in AMP6, but the disclosure included an explanation of what the prior year adjustment related to. Yorkshire Water did not have a prior year adjustment in AMP6.

Other timing differences

7.115 Other timing differences represents items which, whilst accrued for accounting purposes, are taxable or deductible for tax purposes in a different period.

7.116 The point at which the items become taxable or allowable for tax purposes varies depending on the nature of the other timing differences: for example, general provisions are tax deductible when the provision is utilised, pension costs are tax deductible in the accounting period in which the cash is paid, whilst salaries and bonuses are tax deductible provided that they are paid within nine months of the end of the relevant accounting period.

[109] A prior year charge of £1.2m relates to group relief, however no further explanation is given for the prior year credit of £1.7m.

7.117 "Other timing differences" are included as separate reconciling items in the business plan provided to the water companies by Ofwat. The estimated movement on the underlying item for each price control period will be included within the business plan, thereby forming part of the forecast tax charge. The following timing differences are discussed below:

a. Change in general provisions;

b. Grants and contributions taxable on receipt; and

c. Other adjustments to taxable profits (presumably intended to act as a 'catch all' for other timing differences).

7.118 Also relevant to this discussion is a consideration of the relative materiality of the other timing differences included within the submitted business plans for PR14. We have considered this below.

Change in general provisions

7.119 Based on the submitted business plans, only four companies' forecasted movements on the general provisions (Welsh Water, United Utilities, Thames Water, and Severn Trent Water) and these are all likely to be considered to be immaterial in the context of the business plan, as shown in the table below.

Company	Forecast change in general provision for PR14 (£m)	Associated tax impact (£m)	Associated tax impact as a % of revenue
Dŵr Cymru (Welsh Water)	0.46	0.09	0.0%
Severn Trent Water	0.86	0.17	0.0%
Thames Water	0.04	0.01	0.0%
United Utilities	(3.24)	(0.65)	0.0%

Grants and contributions taxable on receipt

7.120 Based on the submitted business plans, all but three companies forecasted movements on timing differences associated with grants and contributions. As with the general provisions, most of these are likely to be considered to be immaterial in the context of the business plan, as shown in the table below.

Company	Forecast change in grants and contributions for PR14 (£m)	Associated tax impact (£m)	Associated tax impact as a % of revenue
Affinity Water	38.9	7.8	0.5%
Anglian Water	80.5	16.1	0.3%

Bournemouth Water	1.3	0.3	0.1%
Dee Valley Water	1.2	0.2	0.2%
Dŵr Cymru (Welsh Water)	1.4	0.3	0.0%
Northumbrian Water	11.9	2.4	0.1%
Severn Trent Water	32.6	6.5	0.1%
South East Water	14.3	2.9	0.2%
South Staffordshire Water	1.8	0.4	0.1%
South West Water	26.1	5.2	0.2%
Southern Water	36.0	7.2	0.2%
Sutton & East Surrey Water	2.2	0.4	0.1%
Thames Water	77.0	15.4	0.1%
United Utilities	68.8	13.8	0.1%
Wessex Water	0.6	0.1	0.0%

Other adjustments

7.121 Based on the submitted business plans, all but two companies forecasted movements on other timing differences. These are the most material of all timing differences submitted in the business plan. No further disclosure is provided as to what these timing differences relate to.

Company	Forecast change in other adjustments for PR14 (£m)	Associated tax impact (£m)	Associated tax impact as a % of revenue
Affinity Water	(42.9)	(8.6)	(0.5%)
Anglian Water	(763.6)	(152.7)	(2.4%)
Bournemouth Water	0.4	0.1	0.0%
Bristol Water	(27.9)	(5.6)	(1.0%)
Dee Valley Water	(12.5)	(2.5)	(1.9%)
Northumbrian Water	302.4	60.5	1.5%
Portsmouth Water	(23.6)	(4.7)	(2.3%)
Severn Trent Water	186.6	37.3	0.5%
South East Water	(182.4)	(36.5)	(3.1%)
South Staffordshire Water	(43.7)	(8.7)	(1.4%)
Southern Water	(557.2)	(111.4)	(2.7%)
Sutton & East Surrey Water	(38.1)	(7.6)	(2.4%)
Thames Water	(1,075.9)	(215.2)	(2.0%)
United Utilities	(292.7)	(58.5)	(0.6%)
Wessex Water	(50.5)	(10.1)	(0.4%)

Yorkshire Water	(134.1)	(26.8)	(0.5%)

7.122 Timing differences have an inherent 'true up' mechanism i.e. a higher tax charge in the period of the disallowance is compensated for by a lower tax charge in the period of the utilisation. No separate clawback mechanism should therefore be needed for this. However, this does not extend to cover any change to the timing difference which is not included in the original forecast tax charge and which has not reversed at the end of the AMP.

7.123 Overall we do not consider that there is any reason to assume that actual timing differences will be materially different from forecast differences; and the inherent "true up" feature of them means that many differences will reverse during an AMP. For this reason, we do not propose any specific measure to deal with such items.

Loss relief[110]

7.124 From 1 April 2017, the tax treatment of brought forward tax losses will change, and in some respects, there will be greater use possible amongst group members. However, an important restriction will be introduced, whereby companies will be able only to use the losses against up to 50% of profits, subject to a £5m annual allowance.

7.125 The aspects relevant for water companies are:

a. In cases where companies are forecasting tax losses which are used to shelter future income, that shelter will only be available for 50% of subsequent years' profits (subject to the £5m allowance).

b. There is a £5m allowance available to a stand-alone company or, if the company is part of a group, then it is available to the entire group. In the latter case, the group is able to allocate the £5m allowance broadly as it wishes.

7.126 In particular, unlike, for example, the new interest restriction, there is no exemption for public benefit infrastructure companies (such as water companies). We note that the final business plans for PR14 only showed four companies with losses during AMP6:

a. Southern Water, Welsh Water and Thames Water all show losses arising in each of the AMP6 years; therefore, for AMP6 at least, the loss carry-forward restrictions would not have any effect.

b. Portsmouth Water shows profits in 2015-7, but losses in 2017-19, which are carried forward to offset profits in 2019-20. However, the profits of 2019-20 are shown as £49k, i.e. well within the £5m limit.

7.127 The effect for PR19 will therefore be as follows:

a. Ofwat's financial model will need to have sufficient flexibility to deal with the £5m allowance and the 50% restriction (where relevant).

[110] "Reforms to corporation tax loss relief: response to the consultation" published by HM Treasury and HMRC, December 2016

b. It will be necessary to decide what assumption to make regarding the £5m allowance. For example, if each company is assumed to be a stand-alone entity, then it would be consistent to assume that each has its own £5m allowance.

Leasing

7.128 During the current AMP, it is expected that there will be changes to both the accounting standards and tax legislation relating to asset leasing.

7.129 From an accounting perspective, there is a proposed new IFRS 16 leasing accounting standard which is intended to have effect from 1 January 2019. The changes to leasing accounting will be particularly significant for lessees as many more plant and machinery leases (including leases currently accounted for as operating leases) within scope will come on balance sheet for lessees with a 'Right of Use Asset' which is depreciated, and a balance sheet liability obligation together with "interest" expense. The changes will be less significant for lessors who will continue to apply finance lease and/or operating lease treatment.

7.130 The expectation is that the leasing standards within FRS 101 and FRS 102 will eventually fall in line with IFRS 16.

7.131 Currently, HMRC are considering how to address these changes to the accounting standards for tax purposes. UK tax legislation includes many references to finance lease and operating lease principles which will not be relevant for IFRS 16 lessees. HMRC have indicated they favour a single approach for tax purposes, whether the taxpayer is applying UK GAAP or IFRS principles.

7.132 In August 2016, HMRC produced a Discussion Document setting out four Options for the taxation of plant or machinery leases (which we understand includes plant/machinery assets which are fixtures). The tax treatment of non plant and machinery (e.g. property) leases are not currently within the scope of this exercise.

a. Option 1: Retain the status quo for lessor and lessee, i.e. in the majority of plant and machinery leasing scenarios, the lessor claims capital allowances in respect of any qualifying assets and the lessee follows its accounting treatment claiming tax relief for expenditure (depreciation, interest or operating lease rentals) as the cost is recognised in its income statement. Noting however that as lessee accounting may change (as noted above), even if the lessee is currently following the accounts for tax purposes this may mean following the accounts on a different basis.

b. Option 2: Change to an accounts basis of tax for the lessor and lessee. This may be a particularly significant change for a lessor who currently claims capital allowances.

c. Option 3: Change to an accounts basis of tax for the lessor and the lessee, with a lessee option to accelerate tax depreciation by applying a factor of, for example, 1.1 to accounting depreciation.

d. Option 4: Change to an accounts basis of tax for the lessor and lessee, with a lessee option to claim capital allowances.

(Note 1: If there is a change to the tax treatment of plant and machinery leases then there is likely to be some form of grandfathering/transitional rules to move to a new approach.)

(Note 2: The lessee options for accelerated depreciation/capital allowances would only be available to the end-lessee in a chain of leases.)

(Note 3: We do not yet know how the new category of IFRS 16 lessee "interest" expense may be treated for tax purposes including whether this will be treated as interest for the purposes of the reformed interest deductibility rules.)

7.133 A Consultation Document from HMRC, setting out one option for formal consultation, is expected in Q1 of 2017.

7.134 It is our understanding that a number of the water companies are plant and machinery lessees (under either finance or operating leases). The potential impact of any of the proposed options on the companies will depend on the current accounting and tax treatment for each company.

7.135 For a lessee currently following the accounts for tax purposes (i.e. not a hire purchase lessee or a lessee claiming long funding lease tax treatment), provided the amount of tax deductible lease rentals is not restricted, one might expect the effect of any changes to the tax legislation to simply result in a difference in timing of tax deductions.

7.136 For a lessee currently claiming capital allowances (as a hire purchase lessee or a lessee claiming long funding lease tax treatment) then, unless applicable grandfathering rules are introduced, one might expect a more significant difference in treatment, albeit again likely only a difference in timing of tax deductions.

7.137 We note that there may also be a knock-on impact on the quantum of lease rentals payable as a result of new tax rules if they have an adverse impact on the tax treatment of the lessor.

7.138 These preliminary high level conclusions are however subject to any changes to the taxation of property leases and/or leases involving capital payments; and also subject to the outcome of how the new IFRS 16 lessee "interest" expense may be treated for tax purposes.

7.139 Given IFRS16 is to apply from 1 January 2019, it would seem reasonable to expect any changes to the tax legislation in respect of leasing arrangements to have been announced (or even enacted) prior to then. As such, the impact of the legislation should be known ahead of the water companies' preparation of PR19 business cases.

Timing of corporation tax payments

7.140 The Ofwat financial model does not take account of actual corporation tax payment dates (e.g. quarterly payments), but instead corporation tax is assumed to be a cashflow cost of the year following that in which the revenues and profits arise.

7.141 In practice, corporation tax payments fall in the following year only for those companies which are outside the quarterly instalment regime. For companies within the quarterly instalment regime, corporation tax payments are 50% in-year and 50% in the following year.

7.142 In Autumn Statement 2016, it was announced that the dates on which quarterly payments are made would be accelerated for companies with taxable profits of £20m or more; and the figure of £20m is divided by the number of companies in the group,

so that for large groups a company may be under the new rules even if its stand-alone taxable profits are less than £20m.

7.143 The effect of the change, for companies affected, will be that from 1 April 2017 the entire amount of quarterly payments will be due in the year to which they relate. There will thus be a transitional period – 1 April 2017 to 31 March 2018 – when 50% of the previous year's payments are due, plus 100% of the current year's payments.

7.144 Following the change, there will be three different sets of rules for payments of corporation tax (noting that in all cases the figures of £1.5m or £20m are divided by the number of entities in the group):

a. The above rule for companies with taxable profits of £20m or more (noting that the £20m figure is adjusted for groups);

b. The "old" rule for companies with taxable profits of between £1.5m and £20m (i.e. 50% in-year and 50% in the following year; and the £1.5m and £20m are also adjusted for the group); and

c. Companies with taxable profits of up to £1.5m will continue to pay nine months after the year end

7.145 As these effects simply represent timing differences and Ofwat's current financial model does not currently attempt to model the timing of tax payments, there does not seem any reason to change the current approach.

Other areas of complexity – provisional view for PR19

Unanticipated changes to the headline rate of corporation tax in previous years has resulted in tax paying companies being overfunded. A change in the headline corporation tax rate lies outside the control of the water companies; they should therefore bear neither the associated risk nor reward. This should therefore be included in any clawback mechanism that is introduced (see section 8).

The financial model used by Ofwat will require updating to reflect the changes to the loss restriction rules which apply from 1 April 2017.

No other changes to the financial model are proposed in relation to the remaining items discussed in this section.

8 Alternative Models for Consideration

Introduction

8.1 We have been asked to consider whether Ofwat should allow for the reset of any tax allowance owing to changes in tax legislation; and, if so, which changes should be taken into account.[111] In order to address this, we consider how tax risk can be allocated between companies and customers and we outline two possible approaches to this.

General considerations in relation to the sharing of tax risk

8.2 Tax risk for companies arises from the potential for future tax costs to differ from the expected levels, due to changes in tax rates and rules rather than variations in the financial performance of the business. Tax risk falls within a broad category of "political" or "legislative" risk and gives rise to unexpected changes in taxation costs, which may be positive or negative. The approach to tax risk taken in previous price reviews has been to allocate it entirely to the companies. As has been noted by the PAC and NAO reports, this has led to benefits arising to the companies from various changes in tax legislation which had not been taken into account at PR09, because they were not known at the time that prices were set. In some cases, companies may have voluntarily adjusted prices to pass on some of this benefit to customers, but this has not been part of a formal price adjustment mechanism.

8.3 A possible change would be for taxation costs to be dealt with on a "pass through" basis. The use of cost pass-through allows the regulator to reduce a company's risk by allowing it to recover the full cost (or a percentage of the cost) from customers via the price mechanism. Cost pass-through involves a transfer of risk from the company to its customers; typically the costs that a regulator might allow to be passed through would be those items which the company has little or no control over.

8.4 An advantage of such an approach is that it reduces uncertainty for the company; a disadvantage is that it may reduce a company's incentive for efficiency if cost pass-through is allowed for items over which the regulated company does have some degree of control.

8.5 The tax charge does depend, to some extent, on choices made by the company and the way in which it manages its tax affairs, so that tax risk is partly within a company's control. For example, a company may seek to maximise the claims which it makes (e.g. capital allowances) or to seek the most beneficial solutions to newly arising situations (e.g. the treatment of IBA claims[112] or GAAP adjustments).

8.6 A broad approach to the allocation of tax risk to take account of the above comments would be to allocate the risk of legislative change (being outside the company's control) to customers, while risks arising from the management of tax (being in the

[111] Question 5 of "Approach to corporation tax" in the ITT
[112] This is discussed in some detail in the A&M report on pages 11, 12 and 25

company's control) would be allocated to the company itself, although in practice it may be difficult to determine the boundary between the former and the latter.

8.7 Another aspect of the interaction between the price control mechanism and the nature of the UK tax regime is the fact that changes to tax legislation occur on an annual basis, but only those changes enacted at the time of the price review are taken into account. This can lead to odd results, particularly as rate changes are sometimes (but not always) enacted well in advance. For example:

a. At the time of PR09, the headline corporation tax rate was 28% and this rate was used in the final determinations. The intention to reduce rates was announced in the June 2010 Budget, but as prices had already been determined, there was no mechanism to take this into account. If the announcement had been made earlier, adjustments (or a mechanism to allow for adjustments) could have been included.

b. At the time of PR14, the headline rate was 21%, but the reduction to 20% from 1 April 2015 had already been enacted, so that the rate of 20% was used for the final determinations.

c. During AMP6, reductions to 19% (from 2017) and 17% (from 2020) have been enacted, so that they can be taken into account for AMP7, but not AMP6.

8.8 There does not appear to be any good reason why some rate changes should be taken into account (e.g. the reduction to 17%), but not others (e.g. the reduction to 19%), simply owing to the date on which the rate changes are announced or enacted.

8.9 The above considerations suggest a general approach that tax allowances be calculated by applying the actual tax regime in force during each year of an AMP, rather than the tax regime in force at the time of the final determinations. This is on the basis that the tax regime is outside the company's control and the arbitrary timing of regime changes should not determine whether they are taken into account or not. We consider this further below.

Examples of different approaches to tax risk

8.10 In our review of approaches to tax by other regulators, we have identified the following examples where tax risk has not been entirely allocated to the regulated businesses:

a. Ofgem: We discuss the Ofgem tax trigger in detail below.

b. NIAUR, in relation to Northern Ireland Water: owing to uncertainty over the company's tax position (as it recently refiled tax computations with HMRC), it was not clear whether any tax allowances would be appropriate. There is therefore a mechanism to review the tax allowance at an interim point of the price control period.

c. NIAUR, in relation to Northern Ireland Electricity: The tax allowance is calculated by reference to "actual" capital allowance claims (or, where amounts are disclaimed, by reference to the amount which could have been claimed). In other words, capital allowances are dealt with on a "pass through" basis.

d. NIAUR, in relation to SGN: There is an "Uncertainty Mechanism" which covers a wide range of areas, one of which is the headline corporation tax rate. The mechanism applies to tax by calculating a new tax allowance using revised rates and including any resulting adjustment in the next period's price control (i.e. the adjustment is computed at the end of a price control period). No other tax adjustments are made, but in fact the tax allowance for gas distributors at GD17 was zero, so in practice this mechanism is currently theoretical only.[113]

8.11 It is therefore clear that some other regulators have, to a greater or lesser extent, taken into account these issues, with the most complex approach being that of Ofgem.

Two possible options for dealing with tax risk

8.12 The two options which we have considered are as follows:

a. No change from the current system, in which tax risk (both positive and negative) lies entirely with the companies; in certain cases, Ofwat may encourage companies to share any unexpected tax benefits with customers; and the companies may choose to do so.

b. A formal "tax trigger" mechanism, of which the Ofgem example is an obvious model to refer to, although some adjustments may be needed for the water sector.

8.13 The main advantages and disadvantages of the first option are broadly as follows:

a. It is a very simple system, involves no change to the regulatory system and puts no increased burden on either the companies or Ofwat. It enables any tax differences to be addressed on a case-by-case basis and therefore provides full flexibility to both Ofwat and the companies. It also encourages companies to practice responsible management of tax, as any tax savings remain with them (unless they voluntarily return them to customers).

b. However, it does not provide any formal mechanism other than encouragement (on the part of Ofwat) and voluntary price adjustments (on the part of the companies). It may lead to uncertainty as to what tax differences Ofwat may ask the companies to pass on to customers; there is no formal mechanism for determining how any such items have been passed on; and it may be difficulty in practice to be transparent about actual tax charges compared to tax allowances per the price determination – particularly if there are voluntary, ad hoc price adjustments arising from such differences. It is also asymmetric, as it does not allow companies to recover any additional costs; it is therefore arguably unfair on companies.

8.14 Under this option (i.e. the current regulatory regime), there have been some examples of Ofwat requesting that tax benefits be passed on to customers; and there have been some cases where companies have disclosed that they have done so.

8.15 The main advantages and disadvantages of the second option are broadly:

a. It should provide certainty to companies and customers; and it should be transparent, as any adjustments would be clearly disclosed – this should make it

[113] From 1 January 2017 to 31 December 2023

simpler to compare actual tax charges (as amended by any such adjustments) and those assumed for price allowances.

b. However, it will impose an increased regulatory burden on both Ofwat and the companies, as both will need to understand, monitor and implement any such change. Depending on how it works, it may reduce or remove an incentive for the companies to out-perform Ofwat's financial model (as regards tax), as some or all of such savings may go directly to customers; it also protects companies from unexpected tax costs such as rate rises.

c. This option also directly addresses the concerns raised by the PAC and the NAO in relation to the difference between assumed and actual tax charges.

Outline of how Ofwat's tax trigger could be structured

8.16 We now consider the main features of a tax trigger for Ofwat.

a. Symmetry. It would seem fair and reasonable for any mechanism to apply equally to both tax savings and tax costs. We note that the PR09 reviews showed tax savings which could have been passed on to customers. It is important to be aware that in the future there could be additional tax costs which, under a risk-sharing mechanism, could be passed to customers.

b. Frequency. The Ofgem tax trigger can be applied during any year of the 8-year price control.[114] As Ofwat has a 5-year price control period, there are fewer years within the AMP when the tax trigger could be implemented. It is arguably fairer for customers for an adjustment to be made in the period to which it relates, rather than at the end of a period; otherwise there could be a mismatch between customers whose bills are based on the assumed tax position, and those whose bills are adjusted for the actual position. However, an adjustment every year would impose a greater burden on both companies and Ofwat than an end-of-period adjustment. As such, it might be more appropriate to adjust only once, at the end of an AMP, rather than every year. In addition, most other true-up or adjustment mechanisms are currently end-of-period rather than in-period.[115]

c. Materiality threshold. Ofgem's tax trigger uses a threshold calculated as the higher of 0.33% of base demand revenues and the effect of a 1% change in corporation tax rate. In addition, once the Ofgem threshold has been reached, it is only the excess (over the threshold) that is adjusted. However, if Ofwat were to operate the clawback mechanism at the end of an AMP, and include any resulting tax adjustment in the following AMP, there does not appear to be any reason why a materiality threshold would be needed.

d. Areas covered by the tax trigger. In theory a tax trigger could apply to all differences between assumed and actual tax costs. However, this would mean that there is a total pass-through of tax costs from the companies to customers. As discussed above, this would remove any incentive from companies to be tax efficient; and it would make customers bear tax risks which, arguably, they should not bear – i.e. those which are properly in the control of the companies. It would also be inconsistent with Ofwat's overall approach in other areas, where

[114] RIIO-ED1 runs from 1 April 2015 to 31 March 2023

[115] We also understand that a change to existing licences could be required if in-period changes to tax allowances were to be made. An end of period adjustment could be made at the same time as any adjustment to the cost of new debt.

companies are incentivised to outperform the business plan assumptions; although if pass-through were only to apply to the tax rate, then the efficiency incentive would largely remain. Therefore, in the absence of a total pass-through of tax costs, it would be necessary to determine the cases where adjustments would be made. This report examines various areas of taxation; we also have the examples of the 2016 APR tax reconciliations to see what sorts of adjustments arise in the first year of AMP6; and we also have the PAC, NAO and A&M reports, which examine differences in AMP5.

8.17 Our overall view is as follows:

a. The most material aspects of companies' tax computations are the treatment of capital allowances and the headline tax rate. In addition, the current modelling of tax specifically takes account of these; as such, it should be relatively simple for Ofwat to re-run its model at the end of an AMP to determine the effect of any changes in these specific areas. It therefore seems that, as a minimum, the effect of any changes to these areas should be included in a clawback mechanism.

b. The other changes identified in this report (such as interest restriction) can be specifically modelled for PR19; if any further changes to the legislation arise, they can be taken account of at the next price review.

8.18 We note that at PR14, four companies forecast tax losses during some or all of AMP6, so that they receive zero tax allowance for some or all of the period. The effect of the tax trigger would be to adjust the amount of tax losses assumed for price control purposes. These losses would be carried forward to the next AMP and in due course may be expected to be relevant in computing actual tax charges.

Tax trigger – provisional view for PR19

The introduction of a formal tax trigger mechanism in specific areas would be a fairer allocation of tax risk between companies and customers. However, the mechanism would increase the regulatory burden on Ofwat and the water companies; it may also reduce the incentive for companies to out-perform Ofwat's financial model as regards tax, as part of such savings may go to customers.

Other regulators (in particular Ofgem) have introduced mechanisms which share tax risk with customers to varying degrees.

As a minimum, we consider that the effect of any changes to the headline tax rate and the capital allowance rate should be included in a clawback mechanism. Any other changes identified in this report can be specifically modelled for PR19; if further changes to the legislation arise, they can be taken account of at the next price review.

9 Transparency, Reporting and Monitoring

Introduction

9.1 In this section we consider what information Ofwat would need to collect in order to action and monitor the issues and proposals set out in this report, as well as what tests and assessments should be carried out by Ofwat. Our comments are divided into the following areas:

a. General approach
b. Price controls
c. Interest deductibility
d. Group relief
e. Capital allowances
f. Tax trigger
g. Tax losses
h. Disclosure issues

General approach

9.2 This report examines various areas of corporate tax and sets out recommendations for their treatment at PR19, with the overall objective of satisfying the seven tax principles set out in section 4; amongst these, one of the most important is that companies should receive a fair tax allowance to cover their forecast tax cost.

9.3 It is therefore important for Ofwat to continue to monitor changes in the tax regime applicable to companies, including tax effects caused by changes in accounting rules. If any changes are known by the time of PR19 and are expected to have a material effect, they can be included in the tax allowance methodology; if any changes arise during AMP7, then they can be taken into account (on a prospective basis) in the following price review. Such monitoring should be done regularly, e.g. every quarter or half year, and in particular prior to the finalisation of the PR19 methodology.

9.4 In addition, we consider that during the course of an AMP it is important for Ofwat to monitor the reconciliations of tax allowances to actual tax charge, for the following reasons:

a. Any differences which arise from changes in corporation tax rates or rules relating to capital allowances will give an advance indication of the likely amount of any adjustment in these areas (if the proposed "tax trigger" is implemented at the end of an AMP, rather than during it).

b. Any material differences arising from other areas will highlight potential further areas for change at the next AMP (if the proposed "tax trigger" does not incorporate a mechanism to deal with such items) and allow early planning and/or consultation.

Price controls

9.5 We have not proposed any change to Ofwat's overall approach to price controls as we believe the existing approach, which treats price control units on a stand-alone basis subject to an overall principle that the aggregate of tax allowances for price controls should not exceed the total tax payable by the appointed business, is fit for purpose. Therefore, we do not consider that any additional monitoring is required.

Interest deductibility

9.6 We set out in this report three options for dealing with the proposed limitation on interest deductibility. The requirements for transparency, reporting and monitoring are very different for the three options.

a. If the PBIE is assumed to apply and all interest payable (regardless of lender) is assumed to be deductible, then companies would simply include deductions for interest expense in their business plans as they currently do.

b. If the PBIE is assumed to apply, but a concession is included to acknowledge that related-party interest might not be deductible, then an adjustment would be needed to reduce the tax-deductible interest expense.

c. Finally, if the "actual" position is adopted, then accurate calculations / modelling of the amount of deductible interest would be required. This is the most complex of the options, as this modelling would be required for each price control unit on a notional stand-alone basis. Companies would need to track brought forward/carried forward excess capacity and excess interest, etc., for each price control unit.

9.7 The modelling of options (b) and (c) above could either be done as part of Ofwat's financial model itself, or "offline" by the companies; in the latter case, sufficient disclosure would be required to enable Ofwat to monitor compliance with the approach.

Group relief

9.8 We have proposed that tax losses be paid for at the value that they have to the water company, which in most cases we would expect to be the tax value of the loss; or, in the case of losses claimed following capital allowance disclaimers, the discounted tax value of the expected future capital allowance claims.

9.9 Any differences subsequently in the amounts paid for group relief and the tax allowance granted should not affect the business plans or financial model (which would not normally include any group relief). Instead, these can be monitored via the tax reconciliations in the APRs. Indeed, most (although not all) companies already include specific comments on group relief in their APRs.

9.10 We have suggested that, in the event that a company pays less than tax value for group relief, the difference between the tax allowance and the price paid for the group relief may be clawed back from companies (subject to an exception where a claim to shelter profits arises as a result of a capital allowance disclaimer). If Ofwat choose to implement this change, then it will be necessary for Ofwat to monitor, with reference to companies' APRs, the difference between the tax allowance and a company's actual tax charge arising as a result of group relief paid for at under value.

9.11 As part of any changes to the treatment of group relief, we believe an amendment to the text of RAG 5.06 should be considered, in order to specify the general policy for payments for tax losses. For example, Ofwat might consider including the following wording within RAG5.06:

"Consistent with the general guideline principles of RAG5.06, tax losses claimed/surrendered by way of group relief from/to associated companies should be paid for at market value. The rebuttable presumption is that market value in this case should be the full tax value (i.e. the gross loss multiplied by the prevailing corporation tax rate for the period) of the loss to the company making the claim."

Disclosure requirements in relation to group relief

9.12 Paragraph 3 of the Appendix to Condition F states that undertakers must report on "the transfer of any asset or liability to or by the Appointee by or to an Associated Company." Paragraph 2.3 of condition F states:

"For the purposes of this Condition:

1) all forms of property shall be assets, whether situated in the UK or not, including:

   a. options, debts and incorporeal property generally; and

   b. any currency, including sterling;

2) …

3) References to a transfer of an asset or liability include references to a part transfer of an asset or liability and, without limitation, there is a part transfer of an asset where an interest or right in or over the asset is created."

9.13 For accounting purposes, there is no doubt that tax losses are assets. International Accounting Standard (IAS) 12 contains extensive rules regarding the criteria for determining whether a deferred tax asset can be recognised in respect of tax losses. The typical situation is where a loss arises in one period and can be carried forward to future periods – this accords with the normal accounting concept of an asset, which is a present right to future economic benefits (i.e. a company has the right to carry the loss forward for offset against future taxable profits.

9.14 As such, we consider that group relief surrenders and claims should fall within the provisions of Paragraph 3 of the Appendix to Condition F and that companies should therefore comply with the associated disclosure requirements.

Capital allowances

9.15 Two changes to the treatment of capital allowances are discussed in this report:

a. A reversion to the PR09 method of calculating capital allowances on the basis of separate pools for different writing down allowance rates. This simply requires that companies model each pool individually (split across the different price control units). This is in line with the PR09 methodology.

b. A proposed revised methodology for calculating opening capital allowance pools for PR19. Once the details of this have been determined, the methodology simply needs to be specified to companies.

9.16 In both cases, Ofwat may wish to consider a mechanism for checking compliance with the proposed methodology; this could be on a sample basis, or carried out during the AMP (with any corrections made in the following AMP).

Tax trigger

9.17 The proposed tax trigger, to be implemented at the end of an AMP, would require Ofwat to have details of any changes to the tax rate and capital allowances; the financial model would then need to be amended to take account of these; finally, the model would be re-run (with no other changes).

Tax losses

9.18 The proposed changes to the utilisation of tax losses from 1 April 2017 will require a change to the Ofwat financial model, as set out in section 7. This is essentially a minor amendment to the method by which the financial model deals with carried forward tax losses.

Review of 2016 disclosures

9.19 The APRs contain a specific reconciliation of tax allowances per the final determination and the current tax charge for the appointed business. As previously noted, this figure is likely to differ from that of the legal entity which owns the appointed business, for several reasons, including:

a. The legal entity (typically) also owns some non-appointed business;

b. The appointed business in the entity (currently) contains both wholesale and retail activities, whilst the tax allowances are only given for wholesale activities; and

c. "Notional" tax balances for the wholesale businesses, e.g. tax losses and capital allowance pools, being used for tax allowance purposes.

9.20 We have reviewed the disclosure of tax in the 2015-16 APRs with the specific objective of seeing how the tax allowances per price controls, and per the accounts, is disclosed. In almost all APRs, there is a reconciliation of the tax allowed in the PR14 final determination and the "actual" current tax charge for 2015-16. (We put "actual" in inverted commas, because the tax charge in question is for the wholesale business and therefore is, as discussed above, based on various assumptions and apportionments).We have set out below a summary of the reconciliation (after certain minor simplifying assumptions[116]).

[116] The difference for Sutton and East Surrey Water (£2.7m) has been categorised as "Other"; there appears to be no difference for Welsh Water; and the difference for Dee Valley Water (£0.1m) has been categorised as a prior year adjustment.

		£m
Current tax allowance per price limits		**239**
Effects of		
Changes in profits	50	
Differences in capital allowances/depreciation	(23)	
Yorkshire Water - capital allowance disclaimer	36	
Yorkshire Water - group relief	(38)	
United Utilities - financing adjsutment	15	
Yorkshire Water - financing adjustment	7	
Northumbrian Water - GAAP adjustment	(49)	
Bristol Water - GAAP adjustment	(4)	
Yorkshire Water - GAAP adjustment	(5)	
Southern Water - group relief	11	
Other	(2)	
Total		(3)
Actual tax charge per APRs		**236**

9.21 Our comments on the above table are as follows:

a. Whilst the aggregated charge is close to the aggregated tax allowances, there are significant differences in individual companies. This is reviewed further below.

b. Some of the differences (e.g. GAAP adjustments) are ones which we would expect to have been factored in to the business plans if the relevant information had been available at the time. Please refer to section 8 for a discussion of how an ex post adjustment could be made.

c. In principle the reconciliations in the APRs are extremely helpful in providing an important check between the actual and expected tax charges. However, it does not appear to be completed consistently across different companies and it does not necessarily show all of the information which may be needed by Ofwat for PR19. Further guidance has however been provided in the updated RAG5 for 2016/17 which will hopefully improve the quality of disclosures.

d. The disclosure of the impact of group relief is not consistent. Only six companies[117] clearly state what their policy is for paying for group relief. Of these, only Yorkshire Water states that group relief is not paid for; it appears that the benefit of this is a £38m reduction in the tax charge. Northumbrian Water, Southern Water and Thames Water state that some payments for tax losses are at less than full tax value, but the actual benefit is not disclosed. As part of the overall understanding of the impact of group relief, further clarity would be helpful. We highlight and address the issues that group relief presents further in a separate section.

[117] Bristol Water, Northumbrian, South West Water, Southern Water, Thames Water and Yorkshire Water

e. Some companies – Southern Water (£11m shown in the table) and Wessex Water (£1.2m included in "Other") include payments for group relief in their tax reconciliations. Without further explanation, it is not clear why group relief would be a reconciling item unless the company pays less than tax value for group relief (e.g. Yorkshire Water).

f. With one exception (Yorkshire Water), the effect of capital allowance disclaimers is not clearly shown. This is important, because the effect of capital allowance disclaimers is relevant in calculating "notional" capital allowance pools.

9.22 We have set out below the total difference for each company (listed alphabetically); whilst the total across the companies is small (£3m, as noted above), there are some large individual differences.

	£m	**% of total revenue**
Affinity Water	(3)	**(0.2%)**
Anglian Water	(9)	**(0.1%)**
Bournemouth Water	1	**0.5%**
Bristol Water	(2)	**(0.4%)**
Dee Valley Water	-	**0.0%**
Dwr Cymru (Welsh Water)	-	**0.0%**
Northumbrian Water	(29)	**(0.7%)**
Portsmouth Water	1	**0.5%**
Severn Trent Water	9	**0.1%**
South East Water	-	**0.0%**
South Staffordshire Water	1	**0.2%**
South West Water	(2)	**(0.1%)**
Southern Water	19	**0.5%**
Sutton & East Surrey Water	-	**0.0%**
Thames Water	21	**0.2%**
United Utilities	6	**0.1%**
Wessex Water	11	**0.4%**
Yorkshire Water	(4)	**(0.1%)**

9.23 We note that the main explanations for the large differences are as follows:

a. Thames Water – Prior year adjustment (£15m) and "Other" (£6m)

b. Southern Water – Group relief (£11m) and Prior year adjustment (£9m)

c. Wessex Water – increase in profits (£9m)

d. Severn Trent Water – increase in profits (£15m) less capital allowances (£4m)

e. Northumbrian Water – GAAP adjustment (£49m)

9.24 In conclusion, we recommend Ofwat request the following from companies as part of the APR tax disclosures:

a. A clear statement in respect of the company's policy for payment for group relief (i.e. the value at which losses are paid for) and disclosure of any benefit received by the company if group relief is not paid for at full tax value;

b. Detail of any capital allowance disclaimers made and their impact on the tax charge for the period when compared to the tax allowance;

c. Additional detail or explanations in respect of any "prior year adjustments" impacting the current tax charge for the appointed business; and

d. Additional detail or explanations for any "other" significant reconciling items (i.e. differences between the tax allowance per the final determination and the current tax charge for the appointed business).

Transparency, reporting and monitoring – provisional view for PR19

Ofwat should clarify the information required of companies in preparing their APR tax disclosures and reconciliations – as set out above at 9.24.

Ofwat should monitor the reconciliation of tax allowances to actual tax charge during an AMP.

Ofwat should provide clear instructions to companies regarding their reporting requirements.

The wording of RAG5.06 should be amended in order to include the policy for payment of tax losses.

Ofwat should consider introducing a mechanism for checking that companies are calculating their capital allowances in accordance with the revised capital allowance methodology for PR19.

The financial model employed by Ofwat should be amended to reflect the new loss utilisation rules.

10 Appendix 1

Glossary

A&M	Alvarez & Marsal
AIP	Annual Iteration process
APR	Annual Performance Report
BEPS	Base Erosion and Profit Shifting
CAA	Civil Aviation Authority
CC	Competition Commission
CER	Commission for energy regulation
DNO	Distribution Network Operators
ECA	Enhanced Capital Allowances
FE	Firmus Energy
IAS	International Accounting Standard
LLU	Local Loop Unbundling
NAO	National Audit Office
NIAUR	Northern Ireland Authority for Utility Regulation
NIE	Northern Ireland Electricity Transmission and Distribution
ODI	Outcome Delivery Incentive
Ofcom	Office of Communications
Ofgem	Office of Gas and Electricity Markets
ORR	Office For Rail Regulation
PAC	Public Accounts Committee
PBIE	Public Benefit Infrastructure Exemption
PBT	Profit Before Tax
PNGL	Phoenix Natural Gas Limited
RAG	Regulatory Asset Guideline
RCV	Regulatory Capital Value

RDAs	Research and Development Allowances
SGN	SGN Natural Gas Limited
Totex	Total expenditure
TTE	Tax Trigger Event
WICS	Water Industry Commission for Scotland
WLR	Wholesale Line Rental
WRIFM	Wholesale Revenue Forecasting Incentive Mechanism

11 Appendix 2

Detailed totex analysis

In this Appendix we analyse totex adjustments in using algebra in order to assess the underlying tax position. We understand that Ofwat's overall objectives in relation to the tax treatment of totex adjustments are:

a. There should not be a difference in the treatment of capex or opex (i.e. the tax position should be consistent with the overall approach to totex).

b. The adjustment should enable a 50:50 sharing between customers and companies, on a post-tax basis.

Opex overspend

Let the opex overspend be O, and let the amount to recover from customers be split into an amount P to recover through PAYG and an adjustment Q to RCV. We ignore the time value of money and assume that the tax rate remains unchanged across the relevant AMPs.

We assume that the entire amount of overspend is tax-deductible, so that the post-tax cost of the overspend is O(1-t), where t is the tax rate.

As the adjustment to RCV will generate its own future tax allowance, the amount of revenue from customers arising from RCV will be Q / (1-t).

The total revenues from customers will therefore be R = P + Q/(1-t).

The post-tax cost to the company from the original overspend and the additional revenues will therefore be:

$$O(1-t) - [P + Q/(1-t)] + t[P + Q/(1-t)] = (1-t)[O - [P + Q/(1-t)]]$$
$$= (1-t)[O - R]$$

Example: If O=1,000, t = 20%, P = 375 and Q = 200 then the amount paid by the customers is 625 and the total cost to the company is 300.

Capex overspend

Let the capex overspend by C; define P and Q as before. We assume that 70% of C is qualifying expenditure for capital allowances and that the balance is non-deductible.

Assume further that a proportion x is tax-deductible in the AMP during which the overspend arises, and a proportion y is tax-deductible in later AMPs, where x + y = 1.

Finally, assume that at the start of the next AMP, the company's capital allowance pools are adjusted to take account of the future deductions from the overspend; these will total 0.7Cy.

The post-tax cost of the overspend to the company is C – 0.7Ct.

The adjustment to RCV will generate its own future tax allowances, so the amount of revenue from customers arising from RCV will be Q/(1-t).

However, there will also be a reduction in tax allowances owing to the increased capital allowance pool. The reduction will be 0.7Cyt/(1-t).

The total revenues from customers will therefore be R = P + Q/(1-t) – 0.7Cyt/(1-t).

The post-tax cost to the company from the original overspend and the additional revenues will therefore be:

C – 0.7Ct – (1-t)R = C – Ct + 0.3Ct – (1-t)R = (1-t)[C-R] + 0.3Ct
Example: If C=1,000, t = 20%, P = 375, Q = 200 and y=46% then the amount paid by the customers is 545 and the total cost to the company is 424

Now compare the cost to the company in each case:

Opex overspend: (1-t)[O-R]

Capex overspend: (1-t)[C-R] + 0.3Ct

And compare the cost to the customer in each case:

Opex overspend: R = P + Q/(1-t)

Capex overspend: R = P + Q/(1-t) – 0.7Cyt/(1-t)

Potential adjustment

In order to make both cases equal for both company and customer, a one-off adjustment at the start of the next AMP could be made to the opex and/or the capex case so that it is equal to the other case. One way to do this would be to take half the difference. For example, the revised formulae could be:

Cost to the company in each case:

Opex overspend: (1-t)[O-R] + 0.15Ct

Capex overspend: (1-t)[C-R] + 0.15Ct

And the cost to the customer in each case:

Opex overspend: R = P + Q/(1-t) – 0.35Cyt/(1-t)

Capex overspend: R = P + Q/(1-t) – 0.35Cyt/(1-t)

However, crucial to the analysis is knowledge of "y", which depends on the amount of capex overspend, the timing of the capex overspend (split by year), the nature of the overspend (i.e. whether tax-deductible or not, and – if deductible – which capital allowance pool the amount relates to). In practice, obtaining any analysing such information would impose a significant additional burden on both Ofwat and the companies.

Conclusion

We now return to the objectives set out at the start of this Appendix and consider to what extent they can be achieved:

Objective	Taxation
There should not be a difference in the treatment of capex or opex (i.e. the tax position should be consistent with the overall approach to totex)	As shown above, this is in theory possible, but depends on knowing the value of "y" above.
The adjustment should enable a 50:50 sharing between customers and companies, on a post-tax basis.	This could in theory be achieved through appropriate setting of P and Q. However, the ratio P : Q would need to be adjusted according to "y" above.

The overall conclusion is therefore that Ofwat's objectives could be achieved, but that the information requirement and resulting burden on both companies and Ofwat make this impractical.

Deloitte.