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FAO Elinor Mathieson

Water Services Regulation Authority
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31 October 2017

Dear Elinor,

Additional advice in relation to setting tax allowances at PR19

Further to our discussions, and as requested via Ofwat work Order No: SER/ 0710 dated 3 October 2017, we are pleased to provide our advice below.

Background / Scope

This work is being undertaken as a follow up to our report entitled "Ofwat PR 19 Taxation" (our "Report") which was delivered on 14 March 2017.

The scope of that report was set out in Ofwat's "Invitation to Tender for: PR19 – Taxation" which was dated 2 November 2016. The final report aimed 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 collective mechanism for ex post adjustments; and

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

The recommendations of the report were incorporated into Ofwat's consultation document entitled "Delivering Water 2020: Consulting on our methodology for the 2019 price review" which was published on 11 July 2017. The "Risk and Return" section of the consultation document included the following questions relating to tax:

Q4. Do you agree with our approach to setting tax allowances at PR19, including the proposed true up mechanism?

Q4a. Should the true up mechanism be limited to change in corporate tax rates and capital tax allowances or should we extend that true-up mechanism so we can also make adjustments for other changes in tax legislation or accounting regulations which have a material impact on the amount of tax companies are liable to pay?

Ofwat have requested that we review and provide high level comments from a corporation tax perspective on the water companies' responses to Consultation Question 4 (noting that there were no relevant comments relating to the tax methodology received from other responders). Specifically, we should comment on:

- The technical accuracy of the responses;
- The impact on the water companies' and the consumer of any proposals put forward by the water companies;
- Whether any proposals put forward by the water companies comply with Ofwat's policy objectives as set out in Section 4 of our "Ofwat PR 19 Taxation"; and
- Any issues that we consider require further technical consideration.

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Executive Summary

In responding to Question 4, the water companies had comments relating to:

- The basis of allocating the tax allowance across price controls;
- How the new interest restriction legislation should be incorporated into the tax allowance;
- The approach to capital allowances;
- The approach to group relief;
- The mechanics of the proposed tax true-up;
- What information should be collected from companies and refinements to tax reconciliation processes to assist transparency; and
- Other specific aspects of the tax allowance calculations.

There were no suggestions from the companies for changes to the approach to setting tax allowances at PR19 which were not considered as part of our Report or that have changed our initial recommendations. In our view, the significant issues raised which Ofwat should be aware of when finalising their proposed PR19 methodology are:

- Tax allowance allocation across price controls

  Thames suggested that a simplified approach to tax could be available to companies whose overall wholesale business is not forecast to make taxable profits.

- Capital allowances / Group relief

  A number of companies (Anglian Water, Southern, Thames and South East Water) commented on Ofwat's proposed approach to capital allowances and the interaction between capital allowances and group relief. The principal point raised by companies was that customers may benefit more than once if a tax allowance for one price control is calculated assuming companies claim the maximum level of capital allowances in each period, and then in subsequent price control periods any capital allowance disclaimers made by companies are not taken into account.

  Severn Trent broached an alternative approach to apportioning / allocating new capital expenditure across price control capital allowance pools based on historic information.

  Northumbrian Water raised a point relating to payment for group relief in a scenario where a company's actual tax charge exceeds the tax allowance (not being due to tax or capital allowances rate changes), proposing that Ofwat limit the clawback of tax allowance relating to group relief not paid for in this situation. This could be achieved in a simple way by restricting any such clawback to the amount of the tax allowance given to the company.

  Generally, companies appear to welcome a return to an "actual" (as opposed to simplified) basis of analysing forecast capex and allocating the capex to specific price control capital allowance pools.

  The responses received suggest an element of uncertainty exists as to Ofwat's exact proposed approach to capital allowances for PR19. We recommend that the final methodology be clearly set out (ideally with examples) in the final price methodology document.

- Interest deductibility

  Severn Trent, Affinity Water and Bristol Water proposed variant approaches to an "actual" basis of modelling corporate interest deductibility.

- Mechanics of the proposed true-up

  Northumbrian Water suggested the introduction of a true up within the price review period as opposed to at the end of the period.

  Bristol Water and Yorkshire Water requested further clarity as to how the true-up adjustment will be made. Yorkshire Water also requested that companies' have the choice as to whether to make the adjustment through RCV or revenue

- Transparency, Reporting and Monitoring

  Severn Trent included a suggestion that the tax reconciliation report for each price control resemble a tax computation, in order to aid transparency.

- Other aspects of the tax allowance calculations

  Severn Trent requested that Ofwat's tax allowance model be refined to allow for the accurate modelling of the tax treatment of deferred revenue expenditure.

  Portsmouth suggested that companies be able to retain the tax benefits of any Research & Development Tax Credits, given Ofwat's challenge to companies to increase innovation.

Technical commentary

Anglian Water (ANH)

Water company response	**Deloitte Comments**
In general, we agree with the majority of the proposed approach but have a number of specific comments which we set out below. References to section headings relate to Appendix 13 of the methodology.	No comment required
Basis of tax calculations (s6.1) The draft methodology proposes that companies calculate a separate tax allowance for each of the four wholesale controls and then limit the total allowance to the total of the four controls combined. This approach is not consistent with tax computations for submission to HMRC which are prepared on a "whole company" basis and we see little benefit in requiring four separate computations of tax allowance considering both the likely level of tax allowance arising for companies and the level of estimation that will be required to calculate these separate allowances by price controls. For example, to calculate separate allowances requires opening capital allowance pools, capital additions in the year and other items to be split between the four controls. The opening pool balances and some other computational adjustments will most likely be split using RCV and the capital additions will be allocated on an estimation of the assets likely to be built in the period. We consider a better alternative would be to calculate the total tax allowance for the four wholesale controls combined and then allocate this between the individual controls on an appropriate basis (probably RCV). This approach is both proportionate and would also make it easier to provide the reconciliation required annually between the tax figures in the annual regulated accounts and those in the company's final determination.	ANH are correct that the company's tax computation/return submitted to HMRC will be prepared in respect of its entire business and will not be split into different wholesale controls. We raised (Para 6.22 of our Report) this possibility of taking the tax position of the entire appointed business and apportioning, on the basis of the overall tax position, the tax allowance across all price controls. Whilst this approach may have some merits (for example, reduced burden on the companies), we believe there are several difficulties with such an approach (Para 6.23 of our Report). We concluded that a move away from calculating a separate tax allowance for each price control was not consistent with Ofwat's overall objectives – in particular, fairness and the stand-alone approach.
Treatment of interest (s6.2) We agree with continuation of the policy adopted in previous determinations that the tax allowance should be calculated on the basis of the company's actual capital structure if gearing is higher than the notional structure. We can also agree that the impact of the new Base Erosion and Profit Shifting (BEPS) legislation should have little impact on the regulated companies either because	No comment required

<table>
<tr><td>of the public benefit exemption or the group relief ratio, and so full deduction should be assumed for tax purposes.</td><td></td></tr>
<tr><td>Approach to capital allowances (s6.3)

Whilst we are pleased to see that the "simplified" methodology adopted at PR14 has been abandoned, we disagree with the proposed treatment of capital allowances in cases where disclaimers have been made in earlier years to utilise group relief in other group companies. We believe that the requirement for PR19 capital allowances to be calculated using the higher opening pool balances rather than the notional pool balances is fundamentally flawed. This is for the following reasons:

This approach is inconsistent with the proposed tax computation for all four wholesale price controls to be calculated as if they were stand-alone entities. This cannot be achieved if you take any account of tax planning made for group purposes. The methodology states that "In our calculation of tax allowances, we will assume that companies make full use of all the capital allowances available to them". This is contradictory to an approach that does not recognise the impact of previous disclaimers. In PR14 we calculated our tax allowance on the assumption that we claimed all available capital allowances. We have made disclaimers during AMP6 but these are for Group purposes and not for the regulated business. If we now use the higher opening pools that arise from these disclaimers as our opening position for PR19, customers will be benefitting twice from those disclaimed capital allowances. They will have reduced the tax allowance in PR14 and again in PR19. This is inequitable.

The approach that Ofwat proposes is contrary to the independent opinion given by Deloitte that a notional pool approach was the more appropriate methodology.

We would also point out that the notional pool approach was favoured by the Competition Commission in its considerations over Northern Ireland Electricity Transmission and Distribution as discussed in Deloitte's report at section 5.47 to 5.57.

We do not see any difficulties in calculating the "notional" pool as all companies will have copies of their submitted tax computation and it is a simple procedure to calculate the effect of the disclaimers made.</td><td>Our provisional view, which has not changed, for PR19 was that:
• the opening capital allowance pool balances for each price control should be taken from the latest available company tax return, 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;
• the tax allowance should be calculated assuming that full capital allowances are claimed;
• the capital allowance pool values carried forward to the next price review period should also assume that full capital allowances have been claimed (i.e. if a company were to disclaim capital allowances then the opening pool values for the next price control would become a 'notional' value).

We recognise however that some companies might not find it simple to calculate notional pool opening balances for PR19 – i.e. taking pool values per the latest submitted computations but reversing the impact of any capital allowance disclaimers – as disclaimers may go back several price control periods and historical records may not always be available. It would also be difficult, given the differing methodologies applied by the water companies historically, for Ofwat to review whether the reversal of all historical disclaimers is appropriate for each company.

In our view, what is important is that the approach to calculating the opening capital allowance pools for PR19 and future price control periods be consistent across all the water companies.

We recommend that the final methodology be clearly set out (ideally with examples) in the final price control methodology document.

If Ofwat choose, for the purpose of setting the companies' tax allowances for AMP7, to use companies' "actual" capital allowance pool opening balances at 1 April 2020, the impact of that may differ for each company depending on how they have computed their opening capital allowance pool balances historically. For example:

• If a company has never disclaimed capital allowances and/or its tax allowance has always been calculated based on "actual" capital allowance</td></tr>
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	pool values, then there will be no change to its tax allowance calculation methodology. • If a company has historically disclaimed capital allowances in order to claim group relief which it has not paid for and used "notional" capital allowance pool values for subsequent price control tax allowance calculations then the use of actual capital allowance pool opening balances for AMP7 will effectively claw back over time the benefit, on a stand-alone entity basis, of the group relief that was claimed for no payment. For future AMPs, from a tax technical perspective, ANH are correct that customers may benefit more than once if a tax allowance for one price control period is calculated assuming companies claim the maximum level of capital allowances in each period, and then in subsequent price control periods any capital allowance disclaimers made by companies are not taken into account.
Approach to group relief (s6.4) We agree that when calculating the tax allowance the assumption should be that regulated companies will pay for group relief surrendered from other group companies based on the headline corporation tax rate for the year in which the surrender is made. This upholds the principle of treating the regulated company on a stand-alone basis and charging the headline rate of tax on all of its taxable profits (i.e. ignoring any group relief). We also agree that a company should incur a liability to pay for that group relief at the headline rate of tax, noting however there may be valid reasons why the regulated company does not settle those liabilities within the control period. We agree with the principle of recovering a proportion of the tax allowance corresponding to the proportion of group relief not paid for but we believe it is important that this proportion should be based upon the amount for which no liability has been accrued rather than the actual amount paid. The company will then have been funded for its future liability.	ANH's concern is that a tax allowance may be clawed back in a situation where the company has yet to pay for losses claimed from other group companies even though a liability for the payment for losses has been accrued in its accounts. We believe it would be fair for both companies and customers if the claw back of any tax allowance were based on the accounting liability accrued in the company's financial statements. This methodology should take into account any accounting prior year adjustments for group relief not paid for or indeed additional amounts paid. We also do not believe it would place an undue burden on either the companies or Ofwat to monitor the position.

Northumbrian (NES)

Water company response	Deloitte Comments
We broadly agree with the proposed approach to setting tax allowances at PR19. In particular, we agree with the principles relating to the treatment of interest, capital allowances and group relief as they represent a clear, standard approach for companies to follow.	No comment required
Capital allowances – no mention is made of the status of brought forward pool balances; that is, are the balances subject to any significant potential amendment in order to be agreed with HMRC? It might be useful for companies to briefly state whether there is any uncertainty reflected in the starting position.	Our provisional view re approach to capital allowances is included above in response to ANH's query. We acknowledge that a) companies may need to apply a degree of estimation to opening capital allowance pool values, b) the allocation of capital expenditure across the price control period will also be subjective to some extent, and c) that pool values may be amended during a price control period as a result of challenges from HMRC. We would expect companies to apply their best estimates to capital allowance claims with the risk of HMRC requiring amendments to their tax computations resting with the companies unless Ofwat chooses to introduce a tax trigger which gives effect to changes other than those resulting from changes to the headline tax rate or capital allowance rate. That said, we cannot see any downside of companies giving Ofwat an overview of the status of their corporation tax compliance including any uncertain tax positions (including capital allowance assumptions) included in submitted computations.
Group relief – it is proposed that any group relief not paid for will be recovered as part of a tax true up mechanism. This would be acceptable where actual tax charges do not exceed the tax allowance. However, if a company's actual tax charge exceeds the tax allowance (not being due to tax or capital allowances rate changes) and was therefore unfunded, customers would not be disadvantaged where a company does not make a payment for group relief to the extent the 'free' or 'discounted' group relief covers the taxable profits giving rise to the excess charge.	We agree technically with NES's conclusions. In the interest of fairness to the water companies, Ofwat might consider limiting any clawback of tax allowance relating to group relief not paid for in this situation. This could be achieved in a simple way by restricting any such clawback to the amount of the tax allowance given to the company.
The proposal for a true up mechanism is welcome as it ensures that customers pay no more than is implied by prevailing corporation tax rates. However, we do have a slight concern that the suggested timing of the true up (at the end of the price control period) could lead to counter-intuitive outcomes. We would therefore suggest the introduction of a true up within the price review period.	NES's comments are technically reasonable. As stated in our report, one of the considerations for Ofwat in respect of the tax trigger mechanism should be the frequency of the adjustments. Whilst we agree with NES that annual adjustments may be fairer for all parties,

Depending on the political persuasion of the UK government, tax rates could rise during one review period (and therefore require the extra tax cost to be met by customers under the next true up) while rate reductions could be anticipated in the following review period (which customers might expect to lead to price decreases). A possible solution to this would be to adjust prices as contemporaneously as possible with tax rate changes, say in the year after new rates are enacted, at a suitable time to allow capture for tariff setting purposes. In cases where companies could be facing higher tax costs, this would also allow better matching from a revenue perspective.	these would impose a greater burden on both companies and Ofwat than a single end-of-period adjustment.

Southern (SRN)

Water company response	**Deloitte Comments**
The proposed approach to capital allowances and the proposed approach to group relief and true-up may adversely affect future customer bills and should be either/or, and not both. We believe that there is an inconsistency in the statement that 'we will assume that companies make full use of all the capital allowances available to them' and the statement 'where companies have chosen to disclaim capital allowances resulting in a higher opening capital allowances pool balances, we will use the higher opening allowance pool balance'. However, we have, in the past, adopted the approach of using our actual higher opening capital allowance pool balances which has been the most beneficial of the two approaches to customer bills. This approach resulted in there being a £nil wholesale tax allowance in our customer charges for PR14. Higher actual opening capital allowance pool balances benefit from the utilisation of group relief, and other factors, regardless of the amount paid for those reliefs. A recovery of a proportion of the tax allowance given to companies, equivalent to that for unpaid group relief, will likely discourage the use of available reliefs and lead to a reduction of actual future opening capital allowance pools. We suggest that the utilisation of available group reliefs should be encouraged as this results in a benefit to customers. This benefit should be shared between company and customer (50/50) rather than an approach that may discourage the use of available reliefs.	SRN's approach to capital allowances, i.e. using their actual opening capital allowance pool balances, is consistent with Ofwat's proposed approach in the recent consultation document. We believe SRN's concern is that Ofwat's proposals to use actual capital allowance pools per companies' latest submitted computations as opposed to notional pools and to require companies to pay for group relief will result in lower capital allowance pools than would otherwise be the case. We noted in our Report that in situations where companies claim group relief 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. In addition, as noted above (in response to ANH's query on capital allowances), if actual capital allowance pool balances are used at the beginning of each price control period – i.e. capital allowance disclaimers are not reversed – this is arguably unfair to the water companies as tax allowances are lower. SRN's proposal, we believe, is essentially that the future benefit of capital allowance disclaimers is shared with customers and is a potential option for Ofwat to consider.

Severn Trent (SVT)

Water company response	Deloitte Comments
In summary, we agree with the approach to setting tax allowances at PR19 including the proposal for a true-up mechanism. However, we think the true-up should also include other forms of tax, notably cumulo rates, which is now our largest tax.	No comment.
The apportionment of new capital expenditure between capital allowance pools is inherently subjective as we are being asked to consider the correct tax categorisation of expenditure before it has been incurred. OFWAT may want to consider an approach whereby new capital expenditure is allocated to pools based on, for example, the average capital allowance pool split per a company's last 3 submitted tax returns (i.e. a trend based allocation). Such an approach would provide a standard methodology for allocating new expenditure between pools with a clear audit trail back to previously submitted HMRC returns. It would also provide a transparent basis for identifying non-qualifying and deferred revenue expenditure (see further below). For significant projects that would be expected to have a capital allowance profile which differs from the trend based approach (e.g. a new impounding reservoir construction which would be large non-qualifying), the trend based approach could be set aside in favour of a project specific analysis.	We agree that a return to an "actual" (as opposed to simplified) basis of analysing forecast capex and allocating the expenditure to appropriate capital allowance pools is inherently subjective. It is unclear however as to how much SVT's proposed approach would reduce the compliance burden for companies, particularly given the negative feedback we received from the majority of water companies in respect of the PR14 simplified methodology.
Deferred Revenue Expenditure ("DRE") – Appendix 29 does not appear to contain an input line for DRE. This is expenditure which although capitalised for accounting purposes, is revenue for tax purposes giving rise to a deductible amount of 'eligible depreciation.' STW's brought forward DRE pool balance is c.£300m which gives to a typical per annum deduction of between £15m and £20m. We would recommend that additional input lines are added to Appendix 29 (i) to identify brought forward DRE pools and (ii) to capture the proportion of new capital expenditure which would be expected to be revenue for tax purposes (e.g. based on the above trend analysis). A blended rate of depreciation would then need to be calculated to convert the DRE inputs into a tax deduction. Again, this can be drawn from allocation schedules included in our HMRC tax returns.	Tax relief for capitalised/deferred revenue expenditure should follow the accounting treatment – i.e. tax relief available for the accounting depreciation. We assume SVT's issue is that the Ofwat model does not have the functionality currently to allow this expenditure to be treated in line with tax legislation. If the inclusion of additional lines within the tax allowance model is required to ensure tax relief is obtained for the depreciation of deferred revenue expenditure and this would also assist transparency, disclosure and monitoring of the tax relief for this expenditure then we believe SVT's proposal is sensible.
Interest deductibility – Deloitte note in their review that where it appears in principle that water companies could qualify for the Public Benefit	

Infrastructure Exemption ("PBIE"), it may be that a certain amount of restructuring will be required in order to satisfy the conditions for the PBIE. In effect, a conclusion that a standalone water company should not be impacted by the revised rules on interest deductibility is reasonable albeit not certain. On that basis, and given the introduction of what in effect will be a tax effected interest true-up on new debt at the end of the price control period, we would suggest that OFWAT calculates the tax allowance for companies with an actual gearing of less than the assumed notional gearing level on the basis of actual gearing. With the comfort of the end of period true-up for new debt, this should better align the treatment of interest in the calculation of the tax allowance with the statutory tax environment whilst protecting customers in the event that actual interest costs exceed that assumed in the business plan (i.e. via the cost of new debt true-up). It would also remove a reconciliation difference between the tax allowance and the subsequent actual tax charge as well as mirroring the approach we understand OFGEM take.	SVT's approach is a variant approach to an "actual" basis of modelling corporate interest deductibility which was an option for PR19 put forward in our Report. As noted in our Report, this approach would be arguably fairer for companies however, it would not incentivise companies to maximise the tax deductibility of debt and therefore arguably would not be in the best interest of customers.
Bad debts and retail controls – The aligning risk and return chapter notes that the retail control will receive a margin on profits to include an allowance for corporation tax. We have traditionally treated our annual bad debt provision as being part specific and part general for tax purposes. Although we anticipate revisiting this treatment with HMRC prior to the completion of the business planning process, to the extent that HMRC require us to continue treating part of the bad debt provision as general, this could be material in the context of the tax allowance for household retail control and, hence, may require a computational adjustment.	Whilst we are not familiar with the specifics of SVT's corporation tax computations, we can confirm that movements in a general bad debt provision may give rise to fluctuations in the current tax effective tax rate.
Tax Reconciliation Report – Deloitte's report notes the need to ensure that the approach to tax is clear and transparent. As any reconciliation will require a comparison back to the calculation of the tax allowance in the business plan, it would help if the tax reconciliation report for each price control resembled a tax computation. This would enable us to more easily identify how the Appendix 29 inputs have translated into amounts actually taken into account in calculating the tax allowance for each price control. At an aggregate level, this would make it easier to prepare those tax reconciliations required in the APR as well as to more readily respond to NAO/ other targeted reviews.	SVT's suggestion seems reasonable to us with the proposal consistent with Ofwat's overall objectives.

South West (SWT)

Water company response	**Deloitte Comments**
We support that the underlying approach to setting tax allowances at PR19 has remained largely consistent with previous reviews, with companies providing specific information relating to capital allowances and that the overall tax position is considered at both the appointee and individual control levels.	No comment required
We recognise that both before and during a regulatory period core assumptions, such as the headline corporation tax rate can change and would in term impact the level of revenue recovered from customers. However this arises across a number of areas within the business plan and true-up mechanisms focused on individual elements may not reflect the overall position in the round. As part of South West Water's WaterShare mechanism changes in the headline corporation tax rate are already shared with customers, however such impacts are considered alongside other cost variations (including the cost of debt) and therefore reflect a 'basket' of variations which inevitably arise during delivery of the business plan. In addition our customers are consulted on how any net outperformance should be shared with them. As engagement with customers is an integral part of WaterShare, we would like to continue to have flexibility on how we share this outperformance, based on what our customers want.	No comments.

Thames (TMS)

Water company response	**Deloitte Comments**
We reiterate our support for Ofwat adopting a notional approach when setting the WACC and capital structure and when assessing finance ability (which also ensures that companies bear the risk associated with their financing choices). However, to be fully consistent and symmetrical, an approach to fund tax on a notional basis would also need to be adopted for PR19 as set out in our response to the debt indexation consultation.	No comments.

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<tr><td>Price controls

We agree with the proposal to calculate the tax allowance for each of the wholesale price controls as if they were standalone entities, with an overall cap to ensure the tax allowances for the wholesale controls in total are no greater than the tax charge for the combined wholesale business.

We note that in circumstances where the overall wholesale business is not forecast to make taxable profits, performing a separate tax allowance calculation for each of the wholesale price controls appears to be of limited benefit. In such a scenario, the regulatory burden on companies and Ofwat may be reduced by using a simplified approach, particularly regarding the calculation of capital allowances and the overall tax loss by price control.

We consider that following a simplified approach in one price control period would not generate additional work in a subsequent period when a company becomes tax paying, as the capital allowances pools are calculated at the beginning of each price review period, based on the latest tax computations.</td><td>If a company is not seeking a tax allowance from Ofwat for any year within a price control period, then it would appear reasonable for a company to not have to produce the information ordinarily required to calculate the tax allowance.

However, were Ofwat to introduce an exemption from producing this information, we would recommend Ofwat set out the information that the relevant company would be expected to produce as part of the subsequent price review if the company is seeking a tax allowance for that control period.</td></tr>
<tr><td>Capital allowances

Ofwat indicates that it will assume that companies will make full use of all the capital allowances available to them. Our analysis indicates that, in certain circumstances, claiming all available capital allowances could result in companies paying tax earlier (due to the new tax losses rules), which could therefore affect customer bills prematurely. It would be helpful if Ofwat could confirm that companies would not be penalised for optimising the tax position, even if it meant not maximising claims for allowances in the short-term.

Regarding the impact of capital allowance disclaimers in AMP6, Ofwat has indicated that the calculation of tax allowances in subsequent AMPs will reflect the resulting higher opening pool balances. We welcome the clarity Ofwat has given, particularly the consistency that this will achieve across the sector.

We note that the company's actual capital allowances pools include amounts related to expenditure incurred at the company's expense and on non-appointed fixed assets. As in previous price reviews, we would expect that the actual capital allowance pools would be adjusted to remove such items, before calculating the tax allowances. It would be helpful if Ofwat could confirm that this approach remains.</td><td>TMS are technically correct that there may be circumstances post 1 April 2017 (when the new loss relief rules are expected to apply from) when disclaiming capital allowances may be the most efficient approach, on a stand-alone entity basis, from a tax perspective.

The proposal to use actual capital allowance pool balances at the beginning of each price control period – i.e. capital allowance disclaimers are not reversed – is arguably unfair to a water company in this scenario raised by TMS.

We assume that it is Ofwat's intention that the companies' opening capital allowance pools should be adjusted to remove the tax written down value of any non-appointed fixed assets. We recommend this point is clarified as part of the final methodology.</td></tr>
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United Utilities (UU)

Water company response	Deloitte Comments
We agree with Ofwat's approach to setting tax allowances and we support Ofwat's preferred option for the proposed true-up mechanism.	No comment required

Welsh Water (WSH)

Water company response	Deloitte Comments
In principle we are comfortable with the proposed approach to calculating corporation tax allowances for PR19. However, the assumption that all companies will receive full tax relief for their interest expenses via the Public Benefit Infrastructure Exemption (PBIE) may be problematic for some companies. We believe that the availability of the PBIE remains uncertain at this time as the exemption in the draft legislation is narrowly drawn. Interest deductibility may therefore be an issue for companies if they cannot utilise the PBIE and are unable to obtain full relief for their interest costs under the other rules (Fixed Ratio or Group Ratio). We are unlikely to be able to benefit from the PBIE in its current form, however should still be able to obtain full tax relief for our interest via the Group Ratio Rule.	This supports Ofwat's current intended approach of assuming the water companies' should be able to obtain full relief for financing costs.

Wessex Water (WSX)

Water company response	Deloitte Comments
While our Board recognises the issues raised in recent reports it considers that the proposals on tax and debt will encourage a rate of return culture by attracting passive, risk-averse investors. Our view is that the sector requires more challenging and risk-taking investors to deliver innovatively against the long-term challenges we face. We do not therefore support these changes and recommend they are removed so that these risks remain with equity, as it is best placed to manage them, rather than being passed onto customers.	We assume this response is largely in response to the proposed true up mechanism. The advantages and disadvantages, in our opinion, of introducing a formal tax trigger – as opposed to retaining the current system – were set out in our Report in Section 8 and our views have not changed.

It will also encourage company management to be more focused on negotiating the increasingly complex regulation that surrounds this.	

Yorkshire Water (YKY)

Water company response	**Deloitte Comments**
We agree with the principles that you have outlined in the approach to setting tax allowances at PR19.	No comment required
We agree with the principle of the proposed true up mechanism, subject to further clarity on the items to be included and the mechanism for applying the true-up adjustment. We agree that an end of period adjustment is the best approach, to ensure stability of customer's bills throughout the period. We would prefer to have the choice as to whether to make the adjustment through RCV or revenue.	No comments.

Affinity Water (AFW)

Water company response	**Deloitte Comments**
We broadly agree with the proposed approach, including the true-up mechanism.	No comment required
One area of concern is the proposed treatment of interest within corporation tax computations, and the assumption that all companies will be qualifying infrastructure companies for the purpose of the Public Benefit Infrastructure Exemption ("PBIE"). In theory, all companies should qualify for the exemption, however this is not certain. The Corporate Interest Restriction legislation is still in draft, and further guidance on what constitutes "insignificant" non-qualifying income and assets is needed. It has also been assumed that companies will be able to restructure their groups to take advantage of the PBIE, however this might not be possible for some groups. The draft methodology recognises the strong link between tax and interest costs, and proposes to make the tax true-up adjustment at the same time as adjusting for cost of debt. We would	AFW's approach is an ex-post basis for achieving an "actual" basis of modelling corporate interest deductibility which was an option for PR19 put forward in our Report. Whilst this approach would be arguably fairer for companies, it would not incentivise companies to maximise the tax deductibility of debt and therefore arguably would not be in the best interest of customers.

suggest including an adjustment for disallowed interest, to compensate those companies that are unable to benefit from the PBIE.	

Bristol Water (BRL)

Water company response	**Deloitte Comments**
We welcome the approach to revert back to individual tax pools for capital allowances. For the opening capital allowance pools, we use the pools per the latest submitted tax computation which are updated to reflect the expected expenditure to the end of the current AMP. Disclaiming capital allowances, where appropriate should continue, as this can minimise tax bills which is beneficial to customers in keeping the overall tax charges lower. The position of the opening capital allowance used should be confirmed in the methodology to ensure a consistent approach for the opening capital allowance pools across all companies.	As noted above, we agree that whatever approach to capital allowances Ofwat conclude is appropriate, that the methodology is clearly set out (ideally with examples) in the final price control methodology document.
We agree with the consistent approach from PR14 regarding the level of gearing and interest deductions. With regards to BEPS, although Water Companies should be able to qualify for the Public Benefit Infrastructure exemption, it is not guaranteed. If Ofwat deem that this exemption should apply to all Companies, they should recognise that there will be an element of related party debt which will be disallowable and make an allowance for this in the calculations.	BRL's suggested approach is an "actual" basis of modelling corporate interest deductibility which was an option for PR19 put forward in our Report (Page 60). As noted in our Report, this approach would be arguably fairer for companies however, it would not incentivise companies to maximise the tax deductibility of debt and therefore arguably would not be in the best interest of customers
We agree with the proposed approach as Group Relief has been paid for at the main tax rate and it provides consistency across the industry. The Group Relief should have symmetrical treatment to whether it is purchased or sold by the Water Company.	No comment required
We agree in principal with the true up mechanism. The mechanism should be symmetrical, so that both reductions and increases in tax rates are passed on to the customer. The proposed mechanism and timing of the recalculation of the tax allowance at the end of the period appears easy to manage and would not cause undue burden on either the Water Company or Ofwat. However, we do ask for further clarity over how the adjustment will be made is required; i.e. will future revenues be adjusted?	No comments.

Portsmouth (PRT)

Water company response	**Deloitte Comments**
Yes, we broadly agree with the principles of setting tax allowances in a way that encourages companies to set an efficient tax strategy and pass the benefit of this to their customers.	No comment required
We are supportive of Option 2 as a true up mechanism as it appears to balance the challenges of reflecting any significant tax changes but being relatively straightforward. One corollary to this is that companies must be in a position to have clarity/understanding of how the tax in the Ofwat Model/FD is calculated in a simple and transparent measure. Previous models have been very complex in relation to taxation and it has been very difficult and challenging to unpick these to understand how the tax charge has been built up. Without this it is impossible for companies to adequately understand and explain how and why tax has out turned differently to the FD.	We agree that any refinements to the tax allowance methodology and reconciliation process which may increase transparency should be adopted.
However, we have one specific point for further comment. Where Ofwat is challenging companies to increase innovation it is important that this is aligned to the ability for a company to retain the tax benefits of any associated R&D tax credits.	In order to develop our recommendations in our Report, we took Ofwat's policy objectives and applied them to taxation, leading to seven criteria against which any tax-related proposals for the PR19 tax methodology should be evaluated (see Section 3.2 of the Report). One of those criteria is that 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. Allowing the companies to retain the tax benefits of R&D tax credits, which are difficult to forecast and quantify ahead of an AMP, would seem to comply with Ofwat's policy objectives.

Sutton & East Surrey (SES)

Water company response	**Deloitte Comments**
We support the targeted introduction of an uncertainty mechanism related to changes in liabilities that our outside of our control.	No comment required

South East Water (SEW)

Water company response	Deloitte Comments
We agree with the approach to setting tax allowances at PR19 and the proposed true up mechanism - with the exception to the proposal to use the higher opening pool values as opposed to the notional pool value as used in previous price reviews. We wish to highlight an inconsistency within section 6.3 that if unchanged, will result in a considerable under funding for companies in respect of taxation. The issue concerns the current and historical disclaiming of capital allowances and how this impacts the opening capital pool balances disclosed in table APP29 – Wholesale tax. The methodology states: In our calculation of tax allowances, we will assume that companies make full use of all the capital allowances available to them. Therefore, where companies have chosen to disclaim capital allowances resulting in a higher opening capital allowances pool balances, we will use the higher opening pool balances in our calculation of tax allowances. We will also assume that full use is made of all capital allowances available as a result of any capital expenditure in each year. While we accept that like previous price reviews it is reasonable that we make full use of all capital allowances available to us, it should then follow that this principle also be used when calculating the opening pool balances. For this principle to be consistent then the opening pool values for table APP29 should also assume that we make full capital allowance claims, rather than on a pool value after capital allowances have been disclaimed. This notional pool balance would be consistent with the approach suggested in the Deloitte report. By using the higher opening pool balances, which include allowances that were previously disclaimed in the calculation of tax allowances, it creates a situation whereby customers are benefiting twice from the disclaimed capital allowances and companies are underfunded to that degree. The allowances are used once when they are assumed to be fully utilised in the previous price control period and again when they are included in the opening balances and utilised again in the new price control period. In order to correct this inconsistency the opening pool balance disclosed should be a notional pool balance that reflects the full use of capital allowances and ignores any deferral and therefore mirrors the standard allowance calculation and is consistent with the "stand alone" basis proposed. We believe that this is	See comments above in reply to ANH's very similar response on this issue.

also consistent with the preferred method set out in the Deloitte report on tax accompanying the consultation.	

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