May 2021

Proposed treatment of tax impacts for green recovery expenditure

Ofwat

About this document

This document outlines our proposed treatment of tax impacts for green recovery expenditure and invites responses on those proposals.

Responding to this consultation

We would welcome any comments on this document. Please email them to greenrecovery@ofwat.gov.uk.

The closing date for this consultation is **midday on Wednesday 9 June 2021**.

We will publish responses to this consultation on our website at www.ofwat.gov.uk, unless you indicate that you would like your response to remain unpublished. Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with access to information legislation – primarily the Freedom of Information Act 2000 (FoIA), the General Data Protection Regulation 2016, the Data Protection Act 2018, and the Environmental Information Regulations 2004. For further information on how we process personal data please see our privacy policy.

If you would like the information that you provide to be treated as confidential, please be aware that under the FoIA there is a statutory Code of practice which deals, among other things, with obligations of confidence. In view of this, it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information, we will take full account of your explanation, but we cannot give an assurance that we can maintain confidentiality in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on Ofwat.

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In our draft green recovery determinations we stated that we are still considering our approach to tax and that we are concerned that companies might receive an unwarranted tax benefit from expenditure. We also stated that we may account for this when making the RCV adjustment at PR24.

1.1 PR 19 wholesale tax

In PR19 companies received a wholesale revenue allowance based on expected future tax liabilities in the period 2020-21 to 2024-25. We also introduced a tax reconciliation tool that would reconcile for changes to capital allowance rates and changes to the headline corporation tax rate only. Variances in the amount of expenditure compared to that included in the PR19 determinations are outside of the scope of the reconciliation. The reconciliation will be applied at PR24.

1.2 2021 Budget

In the 2021 budget the Chancellor announced changes to capital allowance rates and the rate of corporation tax to stimulate business investment and support recovery from Covid 19 pandemic. Key changes are:

1. Corporation tax increase to 25% from 1 April 2023. This is an increase from 19%.
2. The budget introduces revised capital allowances for additions in 2021-22 and 2022-23:

   - a super-deduction providing allowances of 130% on most new plant and machinery investments that ordinarily qualify for 18% main rate writing down allowances
   - a first year allowance of 50% on most new plant and machinery investments that ordinarily qualify for 6% special rate writing down allowances

1.3 Corporation tax and green recovery expenditure

We anticipate that most green recovery expenditure will be classed as capital expenditure for tax purposes, but it is possible that some will be classed as operating expenditure.

Capital expenditure will attract capital allowances that can be used to reduce company tax liabilities. These capital allowances will be over and above those included in the PR19 price determinations.

All other things being equal, these capital allowances will reduce the tax charge paid by companies in the period 2020-21 to 2024-25. Companies may also pay less tax in the period 2020-21 to 2024-25 due to higher interest costs because of borrowing to fund green recovery investment. Any additional operating expenditure due to green recovery not recovered in-period will also reduce taxable profits in the period 2020-21 to 2024-25.

The additional capital allowances arising from green recovery will also result in higher opening capital allowance pools, impacting the tax calculations at PR24. The additional tax deductions generated would be captured in the tax allowance calculated at PR24.

We propose adjusting RCV at PR24 for green recovery expenditure. Our proposal is to adjust the value of the RCV for the incremental value of tax saved during the 2020-21 to 2024-25 period due to the green recovery investment. We will apply the latest corporation tax rate when doing this. The tax impacts arising from the variance in expenditure will not be captured by the PR19 tax reconciliation.

An illustrative example is shown in the table below.

Table 1.1 Illustration of RCV adjustment

Description	£m
Green recovery Expenditure (GRE)	10
Tax saving due to GRE	(2)
Addition to RCV*	8

* The addition to RCV will be made in an NPV neutral way with discounting applied to reflect the time value of money.

1.4 Ex ante or ex post adjustment

At PR19 we gave companies a wholesale revenue allowance to fund their anticipated level of wholesale corporation tax. We have identified two options for the treatment of corporation tax for green recovery expenditure:

- **An ex ante adjustment based on forecasts of efficient levels of corporation tax.** The pros of this approach are that it matches the PR19 approach to wholesale tax and incentivises companies to be efficient on tax. The cons of this approach are that it is reliant on forecasts based on imperfect information and companies bear the risk of forecast errors.
- **An ex post adjustment to reflect actual tax savings of the green recovery expenditure.** The pros of this approach are that any adjustment will be based on actual data, and that the risk to companies from forecasts based on imperfect information are removed. The cons are that it reduces the financial incentive for companies to maximise tax savings from green recovery expenditure.

Our current preferred option is to use an ex post adjustment, as we believe the risks of making ex ante forecasts based on imperfect information outweigh the risks associated with companies not having financial incentives to maximise tax savings.

1.5 Incentives

As set out in our draft decision document, we propose that companies can retain 10% of any underspend, passing 90% on to customers. We have given some thought to whether there should be an incentive for companies to make their tax arrangements for the green recovery efficient. We are considering two options:

- **Not creating a separate efficiency incentive for green recovery tax impacts.** Companies would experience an adjustment to RCV equal to the saving in tax they experienced in the 2020-21 to 2024-25 period.
- **Having a separate efficiency incentive for green recovery tax impacts.** In a similar way to costs, companies would be allowed to keep a percentage of tax savings (for example 10% consistent with cost efficiency incentives) to incentive them to maximise tax savings.

Our current preferred option is not to have a separate efficiency incentive for green recovery tax impacts. This is because we do not believe incentives work well with calculating the tax adjustment on an ex post basis. Companies would always benefit from such an adjustment, which would not be in the best interests of customers.

1.6 Request for company views

There are two key areas where we would welcome company views on as part of their response to the draft green recovery proposals:

- Do you agree our proposed approach?
- Do you consider that you can reliably forecast tax impacts of green recovery expenditure, and if so, how much tax do you consider you would save from green recovery expenditure?

We are open to other suggestions that companies may have in this area.

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales.

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