Civil Aviation Authority

H7 Price Control Model – approach to corporation tax

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1 Executive summary

1.1 The Civil Aviation Authority ('CAA') has engaged Grant Thornton UK LLP to support on the design and development of a Price Control Model ('PCM'). The PCM will ultimately be used as the analytical tool to calculate the appropriate price per passenger that Heathrow Airport Limited ('HAL') can charge to its customers for the H7 regulatory period.

1.2 The intention is for the model to provide a calculation for tax which provides a reasonable estimate of the actual tax expected to be incurred by HAL. The calculation of tax costs should reflect the input assumptions in the PCM and be sufficiently flexible to respond to changes in these inputs.

1.3 In order, to assist the CAA's consideration in it's approach to taxation for the H7 regulatory period, Grant Thornton UK LLP has been specifically asked to review the approach of the following UK regulators in order to compare against the existing CAA approach and inform decision making on the CAA approach to tax for H7:

i. Office of Communications ('Ofcom')

ii. Office of Gas and Electricity Markets ('Ofgem')

iii. The Water Services Regulation Authority ('Ofwat')

1.4 It is proposed that the model includes flexibility to calculate an allowed tax charge within the calculation of allowed aeronautical charges. This approach would be similar to the approach adopted by Ofgem and Ofwat.

1.5 For the H7 regulatory period, the CAA intends to include three possible approaches to modelling the allowed notional tax charge within the model for which HAL can recover through aeronautical charges. The PCM will include the ability to select between these options. These are outlined below:

i) Adjustment to the Allowed Cost of Capital applied to Regulatory Asset Base ('RAB')

ii) A specific cash adjustment for tax based on high level tax calculations

iii) Profiled input

1.6 At present the CAA's approach is consistent with (ii) above. A post tax cost of equity approach seeks to calculate a specific tax allowance in an attempt to provide a reasonable estimate for the actual cost of tax to the business. This is to ensure that the significant capital expenditure associated with the third runway can be accounted for under the capital allowances regime using data from the H7 financial model along with any other key tax adjusting items.

1.7 The PCM will calculate a notional tax charge based on a modelled profit before tax (PBT) figure, which is calculated based on specific assumptions and forecasts provided in respect of the regulated aspects of the HAL business (i.e. used to calculate aeronautical charges).

1.8 The tax calculation of the PCM will adjust this notional PBT for specified items in order to calculate an appropriate corporation tax charge.

1.9 The key factors taken into consideration in determining the approach and methodology of the tax calculation are:

i. The materiality of the specified tax adjusting items

ii. The ability to forecast the specified tax adjusting items

iii. The frequency of the specified tax adjusting items (i.e. whether they are exceptional or recurring items)

Specified tax adjusting items - capital in nature

1.10 An adjustment for capital allowances will be made on the basis they can be reliably modelled and are material to the calculation. The PCM will track individual capital allowance pools (namely the main pool, the special rate pool and structural and buildings allowance pool) based on forecasted spend in order to calculate yearly capital allowance figures, which will be deducted from the PBT figure.

1.11 An adjustment for depreciation will be added to the PBT figure. This amount will be based on the accounting depreciation charge calculated as part of the wider PCM workings. This is in line with the decision to calculate and deduct capital allowances.

1.12 An adjustment for depreciation on capitalised revenue expenditure will be made to the extent forecasts can support this value. The PCM will incorporate forecasted figures and will incorporate the unwind of historically capitalised amounts, which will be deducted from the PBT figure.

1.13 An adjustment for amortisation will be included in the PCM based on the depreciation amount calculated as relating to software as part of the wider PCM. This amortisation amount will be added back to the PBT figure, on the basis capital allowances are claimed on qualifying software.

1.14 An adjustment will be made in respect of the corporate loss restriction rules to the extent brought forward losses are crystallised in excess of the £5m de minimis and where losses exceed this amount any utilisation will be restricted to 50% of remaining taxable profits (as prescribed by the relevant legalisation).

Specified tax adjusting items - revenue in nature

1.15 Various recurring items which are treated as disallowable on a yearly basis will be added back to PBT, to the extent appropriate supporting forecast information is provided by HAL. These may include third party entertaining costs, capital related legal and professional fees, preference share dividends, leased cars and exceptional expenditure. Where reliable forecasts are not available an amount will be treated as non-deductible in respect of recurring disallowable expenditure, calculated as a percentage of operating expenditure. This amount will cover all possible non-deductible expenses (i.e. third party entertaining, capital related consultancy fees etc.) We understand HAL use a figure of 1% for the purpose of forecasting.

1.16 To the extent the relevant expenditure can be forecast, the PCM will adjust for disallowable exceptional expenditure by adding an appropriate figure back to PBT.

1.17 In accordance with the new corporate tax loss reforms introduced as of 1 April 2017, the PCM will restrict the utilisation of losses brought forward to £5m. To the extent losses brought forward exceed £5m, 50% of remaining in year profits will be able to be relieved by brought forward losses.

Items not adjusted for as part of the H7 PCM

1.18 Items not currently adjusted for in the PCM (based on current conclusions) are considered to be either immaterial or cannot be reasonably forecast. However, should any items arise in HAL's business plan that are material to the tax calculation it will be necessary to reconsider their exclusion and will be included as appropriate.

1.19 No adjustments are proposed in respect of gains/losses on fixed assets, on the basis no material disposals of assets not qualifying for capital allowances are expected during the period, and any other adjustments would feed into the wider capital allowance calculations.

1.20 No adjustments are proposed in respect of fair value gains/losses on investment properties or financial instruments, on the basis these cannot be reasonably forecast.

1.21 No adjustments are proposed in respect of late paid wages, salaries and pensions, on the basis that such expenditure is allowable once paid and typically adjustments are merely timing differences between years.

1.22 No adjustments are proposed for capitalised interest on the basis all interest contained within the PCM will be revenue in nature as opposed to capital. As such, any deduction for capitalised interest may result in excessive relief within the PCM.

1.23 No adjustments are proposed in respect of Research and Development expenditure, on the basis this is expected to be an immaterial amount. This relates to the Research and Development Expenditure Credit

('RDEC') only. Any Research and Development Allowances available under the capital allowances regime would be calculated as part of the capital allowances adjustment.

1.24 Intragroup lending and charges are not being included within the PCM, and the PCM is prepared on the basis that all transactions are undertaken on an arm's length basis. No further adjustments for transfer pricing will be included within the model.

1.25 No restrictions are to be modelled under the Corporate Interest Restriction provisions, on the basis it is expected that the Public Benefit Infrastructure Exemption will continue to be available.

1.26 No adjustments are proposed in respect of group relief, on the basis HAL pays for any group relief it receives, meaning the overall cost of tax remains the same.

1.27 No adjustments are proposed in respect of deferred tax, on the basis this is not considered a relevant cost as tax is remunerated on a cash basis for the purposes of the PCM.

Gearing clawback

1.28 The PCM will calculate the tax cost based on the notional level of gearing in the PCM. However, where a higher level of gearing is adopted, HAL could receive a benefit in the form of additional tax-deductible interest.

1.29 The CAA applies a gearing based clawback to its regulatory model for the license granted to NATS (En Route) plc in respect of air traffic control services within the UK.

1.30 Ofcom do not currently appear to model any gearing based clawback.

1.31 Ofwat assume a notional gearing of 62.5% but use the higher of the notional or actual gearing when calculating the tax allowance. This process acts a simple clawback mechanism where the company only obtains the tax benefit of gearing up to 62.5% and any benefits associated with gearing in excess of the notional level is passed onto consumers. Conversely, consumers don't bear the costs should gearing be below the notional level.

1.32 Ofgem specifically adjusts for a clawback of tax benefit due to excess gearing, as set out in an open letter dated 31 July 2009[1]. This clawback is triggered in the following circumstances;

i. where actual gearing exceeds notional gearing; and

ii. where interest costs exceed those modelled at the relevant price control

1.33 Where both of these conditions are satisfied, Ofgem will claw back the tax benefit which results from the difference between actual and modelled interest costs in that year.

1.34 While the decision to pursue any clawback mechanism is ultimately a policy decision, we consider that since there is precedent for the utilisation of such a clawback, both by other regulators and by the CAA, this area should be given further consideration by the CAA in advance of any final decisions on the overall tax policy for H7.

1.35 Whilst the functionality for a gearing clawback is not yet included in the PCM, we would recommend the CAA consider adding this in future if it adopts this approach.

Tax uncertainty mechanism

1.36 In any regulatory modelling exercise, there is a likelihood that the forecast information does not accurately represent the final tax charge, due to changes in tax adjusting items, actual performance, as well as any changes in the overall tax landscape.

1.37 To the extent these relate to variations in financial performance, our understanding is that any additional tax charge or benefit is expected to fall upon the regulated entity, on the basis these are items which are within the control of the entity, and as such this encourages the regulated entity to manage its business in an efficient manner.

[1] https://www.ofgem.gov.uk/sites/default/files/docs/2009/07/tax_clawback_open_letter-july09.pdf

1.38 However, to the extent that the differences relate to changes in tax rates and rules, there is an argument that the regulated entity should not bear these risks, as they are not able to forecast for or control against these.

1.39 There are several approaches which could be taken in respect of modelling and adjusting for any tax risk (e.g. changes to statutory corporate tax rates, changes to writing down allowance rates and changes to existing legalisation or the introduction of new legislation).

iii. No adjustment

iv. Cost pass-through approach

v. Tax risk sharing mechanism

1.40 While the decision to pursue any uncertainty mechanism is ultimately a policy decision, we consider that since there is precedent for the utilisation of such an uncertainty mechanism by other regulators, this area should be given further consideration by the CAA in advance of any final decisions on the overall tax policy for H7.

1.41 The functionality for a tax uncertainty mechanism is not yet included in the PCM but we would recommend the CAA consider adding this in future if it adopts this approach.

2 Background

The Price Control Model ('PCM')

2.1 The Civil Aviation Authority ('CAA') has engaged Grant Thornton UK LLP to support on the design and development of a Price Control Model ('PCM'). The PCM will ultimately be used as the analytical tool to calculate the appropriate price per passenger that Heathrow Airport Limited ('HAL') can charge to its customers for the H7 regulatory period.

2.2 The PCM is intended to calculate a tax liability which takes account of:

- i) Legislated and announced (to the extent not yet written into the tax legislation) corporation tax rates
- ii) Legislated and announced (to the extent not yet written into the tax legislation) writing down allowance rates
- iii) Existing legislation, case law, accounting standards and HM Revenue & Customs (HMRC) policy
- iv) Projected levels of capital expenditure
- v) Projected levels of corporate debt interest payments

2.3 It is intended that the model provides a calculation for tax which is reasonably straightforward but maintains the ability to take into account relevant material considerations in order to estimate the tax costs in the H7 regulatory period. It is desired that the inputs will have sufficient relevant flexibility in terms of any changes to input assumptions in the PCM, which could include the following:

- i) Changes in capital expenditure profile
- ii) Changes in depreciation policies
- iii) Changes in gearing levels

2.4 In undertaking our review and the subsequent determination of the modelling approach designed to meet the above requirements, we have used the below approach:

- i. A review of the historic tax computations for HAL to identify specific material tax adjustments made in order to calculate profits chargeable to corporation tax
- ii. Consideration of the different possible modelling options for these material tax issues in the PCM
- iii. Review of other regulators approach to this material tax issues
- iv. Interim conclusions selected for implementation in the PCM for HAL to use for its initial business plan based on the quantum of the adjustments and the information available

2.5 The PCM may include an ability to adjust for tax clawbacks, to the extent tax liabilities are significantly different to those forecast as a result of any alterations to the Heathrow Airport Limited ('HAL') debt structure or gearing levels. This could be implemented dependent on CAA policy.

2.6 The tax assumptions applied in the model will inform the price which HAL can set. This will ensure that HAL is able to receive an appropriate level of return when taking into account its expected level of tax on profits and the revenues required to offset this expense.

2.7 This exercise is undertaken in the context of the proposed expansion in capacity at Heathrow airport, which is expected to give rise to significantly elevated capital expenditure.

2.8 Please note, all figures quoted in this report are in nominal terms unless otherwise stated.

Approach to corporation tax

2.9 As part of our review we have been asked to consider the approaches in determining how companies can be compensated for expected corporation tax expenses, both in terms of the CAA's historic approaches and in terms of how other regulators have approached this issue. We have specifically been asked to review the approach of the following UK regulators:

i) Office of Communications ('Ofcom')

ii) Office of Gas and Electricity Markets ('Ofgem')

iii) The Water Services Regulation Authority ('Ofwat')

2.10 We understand that two methodologies have been considered by the CAA and the above regulators in their approach to corporation tax:

i) A post-tax cost of equity; i.e. where specific tax allowances are calculated separately to the allowed cost of capital. This approach allows for forecast tax liabilities to be closer to the actual tax charges, as the impact of various tax sensitive items can be taken into consideration

ii) A pre-tax cost of equity; i.e. where a generic headline tax rate is used to calculate the pre-tax cost of equity in the allowed cost of capital, equivalent to applying the headline tax rate to profit before tax ('PBT')

2.11 The CAA's approach to taxation at Q6 was to use an appropriate headline rate of tax to convert the post-tax cost of equity to a pre-tax cost of equity (method (ii) above). No adjustments were made to take into account any items which might reduce the actual effective corporate tax rate incurred. We understand that in previous periods a set rate of tax was applied for the whole period. When the tax rate was reduced during the period, this led to a mismatch between the modelled rate and the actual rate.

2.12 This gave rise to a pre-tax WACC calculated as below:

$$WACC_{pre-tax} = (g \times CoD) + \frac{(1-g) \times CoE}{(1-t)}$$

2.13 Where g is the gearing of the operator, CoD is the pre-tax cost of debt, CoE is the post-tax cost of equity and t is the tax rate applied.

2.14 For Q6, the expected average tax rate utilised was 20.2%.[2]

2.15 However, given the historic discrepancies between utilisation of a headline rate versus actual tax incurred, as well as the significant expected capital spend anticipated due to potential Heathrow expansion activities, a need was identified by the CAA and its advisors to revisit this approach in order to more accurately model corporation tax costs for setting aeronautical charges.[3]

2.16 In undertaking our review, a comparison exercise between the headline rate of tax and effective rate was performed. It was evident that the variance between the current headline rate and the effective tax rate was large. This would indicate that there is a significant rationale for adopting a post-tax cost of equity approach where consideration is given to specific tax allowances.

2.17 The proposed tax rates announced by the government for the relevant period are as follows:

i) 31 December 2022 - 17%

ii) 31 December 2023 - 17%

iii) 31 December 2024 - 17%

iv) 31 December 2025 - 17%

2 Detailed in 'Estimating the cost of capital: a technical appendix to the CAA's Final Proposal for economic regulation of Heathrow and Gatwick after April 2014'
3 Detailed in section 7 of 'Estimating the cost of capital for H7: A report prepared for the Civil Aviation Authority)' as prepared by PwC in November 2017

v) 31 December 2026 - 17%

2.18 We understand that Ofcom does not apply any adjustments for tax purposes, and its model includes a tax adjustment based on the headline rate of tax.

2.19 Ofwat undertakes a more detailed calculation to give a post-tax cost of equity.

2.20 Ofgem includes some detail in its calculation but to a lesser extent than included by Ofwat. Ofgem's calculation is designed to consider corporate tax rates, writing down allowances, modelled gearing and debt interest payments and existing HMRC policy.

2.21 It is proposed that the PCM includes flexibility to calculate an allowed tax charge within the calculation of allowed airport charges. This approach would be comparable with the approach adopted by the other regulatory bodies considered in this report (namely Ofgem and Ofwat).

2.22 The PCM will consider current tax only (the basis for not amending for deferred tax is discussed later in this document). The PCM will then include three approaches to this calculation, which have been previously considered:

i) Adjustment to the Allowed Cost of Capital applied to Regulatory Asset Base ('RAB')

ii) A specific cash adjustment for tax based on high level tax calculations

iii) Profiled input

2.23 We understand that the model will calculate a notional tax charge based on a modelled profit before tax figure. While this will not be identical to the PBT of HAL as a corporate entity, we understand that this should represent a reasonable estimate for the current tax cost for the regulated entity.

2.24 The tax aspects of the PCM will adjust this notional PBT for the various items considered in this report, in order to calculate an appropriate corporate tax charge, which will be used for the purposes of calculating an allowance for tax costs.

2.25 The report structure is outlined below:

i Section 3 – summary of the items considered and agreed modelling approach

ii Section 4 – consideration of tax treatment of capital expenditure (i.e. capital allowances, depreciation, amortisation and profits on disposal of fixed assets)

iii Section 5 – consideration of the tax treatment for the various tax sensitive revenue expenditures

iv Section 6 – consideration of appropriateness of modelling R&D expenditure and relief

v Section 7 – consideration of transfer pricing rules and implications for H7 PCM

vi Section 8 – consideration of interest deductibility and gearing clawback mechanisms

vii Section 9 – consideration of scope for group relief and implications within the H7 PCM

viii Section 10 – consideration of corporate loss restriction rules

ix Section 11 – consideration of deferred tax

x Consideration of tax uncertainty sharing mechanisms

3 Summary of options

3.1 We have reviewed the historic tax computations for Heathrow Airport Limited to determine potentially material adjustments made in order to determine profits chargeable to corporation tax.

3.2 The below table summarises the items considered and the proposed modelling approach along with references to the relevant subsections of this report which details all possible modelling methodologies considered. The proposed approach will be kept under review depending on the tax modelling within HALs business plan.

Adjustments considered	***Modelling approach***	***Chapter reference***
Capital allowances	Included in PCM – capital expenditure allocated across capital allowance pools	4.2 – 4.51
Depreciation /amortisation	Included in PCM – added back using figure calculated in PCM	4.52-4.85
Profit or loss on disposal of fixed assets	Not included in PCM – on the basis no material disposals are anticipated and it is not possible to accurately estimate these amounts.	4.86-4.94
Exceptional / 'one off' disallowable expenditure	Included in PCM – amounts included base on available forecast and entered into PCM through a single input line.	5.1 - 5.16
Third party entertaining	Included in PCM – treated as recurring non-deductible expenditure and added back in a single line within the PCM as a percentage of operating expenditure	5.17 - 5.28
Commercial disallowance	Included in PCM – treated as a specific disallowance which can be accounted for through the single input line for exceptional items.	5.29 - 5.34
Consultancy costs in respect of capital projects	Included in PCM – treated as recurring non-deductible expenditure and added back in a single line within the PCM as a percentage of operating expenditure	5.35 – 5.47
Preference share dividends	Included in PCM – treated as recurring non-deductible expenditure and added back in a single line within the PCM as a percentage of operating expenditure	5.48 – 5.57
Fair value gain/loss on investment properties/financial instruments	Not included in PCM – on the basis it is not possible to accurately estimate these amounts.	5.58 – 5.92
Leased car costs	Included in PCM – treated as recurring non-deductible expenditure and added back in a single line within the PCM as a percentage of operating expenditure	5.93 – 5.103

Adjustment for pension contributions and late paid bonuses	Not included in PCM – on the basis these adjustments are a timing difference and are deductible when paid.	5.104 – 5.116
Capitalised interest	Not included in PCM – on the basis all loans within the PCM are revenue in nature (i.e. no capitalised interest exists within the PCM).	5.117 – 5.125
Research and development	Not included in PCM – R&D claims immaterial and the level of expected R&D qualifying expenditure expected to continue	6.1 – 6.20
Transfer pricing	Not included in PCM – on the basis no intragroup lending included within the PCM and the PCM assumes all transactions occur on an arm's length basis. Therefore, no adjustment is necessary.	7.1 – 7.5
Finance costs ("CIR")	Not included in PCM – CIR out of scope on basis Public Benefit Infrastructure Exemption in point throughout the modelling period	8.1 – 8.37
Group relief	Not included in PCM – it is our understanding HAL pay for group relief at full tax value and therefore already incur the tax cost. However, the tax cost is paid to group companies rather than HMRC.	9.1 – 9.13
Corporate loss restricon	Included in PCM - A maximum of £5m of brought forward losses will be available for use with no restriction. Any amounts in excess of this will only be able to shelter 50% of remaining taxable profits (ie profits in excess of £5m) arising in a given period.	10.1 – 10.16
Deferred tax	Not included in PCM – on the basis all current tax implications are appropriately and reflect the true cash tax cost.	11.1 – 11.25

3.3 Each of these items are discussed in turn in the following pages, or in the relevant sub section of this report, to identify potential methodologies for including these adjustments within the PCM.

4 Tax treatment of anticipated capital expenditure

4.1 There are numerous points to consider in respect of the treatment of items which are capital in nature. This is an area which sees a wide variety of interpretations across the various regulatory frameworks, and there does not appear to be a 'one size fits all' approach which is universally accepted.

Capital allowances

4.2 Given the substantial capital expenditure expected to be incurred during the regulatory period, a key area of consideration for the purposes of calculating any tax allowance or high-level tax calculation for the model will be the impact of capital allowances.

4.3 Various issues can arise, including but not limited to:

i) Differences between forecast and actual spends

ii) Changes in capital allowance regimes (i.e. Finance Act 2019 announced the introduction of the Structures and Buildings Allowance, a temporary increase in the Annual Investment Allowance threshold, a reduction in the special rate writing down allowance and the abolition of certain enhanced capital allowances ('ECAs'))

iii) The various capital allowance pools and adjustments between them

Potential approaches

4.4 Based on other regulators, we are aware of various approaches to capital allowances which have been undertaken.

No adjustment for capital allowances – depreciation method

4.5 In such an approach, the depreciation expense is treated as deductible, on the assumption this is broadly equal to the capital allowance deduction which would be available. This method is ineffective when there is a significant proportion of fixed assets ineligible for capital allowances, or where the rate of depreciation is significantly different from the effective rate of writing down allowance in the period.

4.6 We would not recommend that such an approach be undertaken in calculating the tax for the PCM, as this would likely give rise to significant discrepancies between forecast and actual tax. Using such an approach would likely result in significantly lower tax charges, meaning HAL would be exposed to the difference between these amounts.

4.7 Further, within the UK tax jurisdiction depreciation is not allowable as a deduction in UK tax computations and returns submitted to HMRC. A recent Office of Tax Simplification (OTS) review into the simplification of tax relief on fixed assets concluded in June 2018 that whilst the capital allowances regime could be simplified, it could not be feasibly replaced by accounting depreciation as a deduction. Any model adopting a depreciation method would therefore be inconsistent with both UK taxation practice and these recent OTS findings.

Simple approach

4.8 In such an approach, average writing down rates are applied to tax forecasts. This negates the requirement to track individual pools but can give rise to significant deviations between the actual and notional pools as tracked in the model.

4.9 It can also be difficult to determine an appropriate average writing down rate, as to do so requires a level of forecasting of expected tax treatments.

4.10 The potential approach to calculating an average writing down rate could be as follows:

i) Calculating the average historic rate of capital allowances by reference to HALs entire asset base for a period of 3-5 years

ii) Using a forecast effective capital allowance rate as prepared by HAL

4.11 Ofwat have historically undertaken such an approach. The capital allowances claimed by HAL typically represents between 5-7% of the tax asset base in the year. However, as discussed later in this report, upcoming changes to the capital allowance regime (in particular the introduction of the Structures and Buildings Allowance) could potentially increase the capital allowances available in future periods that would not be reflected in the averaging of HAL's previous capital allowances claims.

4.12 Further, on the basis significant expenditure is anticipated during the H7 period as part of the Heathrow expansion project, a review of the historic position may not be appropriate on a prospective basis.

4.13 It could be possible to rework the historic position based on future rules, but there would need to be consideration given as to how to undertake any such calculation, and different approaches may not give an accurate representation of the future position.

Detailed approach

4.14 In order to minimise differences between forecasts and actuals, the methodology could require that expenditure is allocated into capital allowance pools based on expected levels of spend.

4.15 A possible approach to this would be to calculate percentages to apply to any forecast capital expenditure and to allocate the spend into notional capital allowance pools. These percentages could be calculated in various ways. Some potential options could include:

i) Calculation of average ratios / percentages based on level of qualifying spend as a proportion of total spend over a period of 3-5 years

ii) Detailed forecasts of anticipated spend and related capital allowances claims to be prepared by HAL

iii) Appropriate proportions calculated based on anticipated spend and a benchmarking exercises undertaken based on available industry data. This would require provision of forecasting capital expenditure by HAL, a schedule delineating different types of projects and asset class (i.e. fit outs of lounges, acquisition of plant and machinery, construction of hotels etc) for analysis and benchmarking against completed capital allowances claims.

4.16 The same approach will need to be considered in respect of any disposals.

4.17 There will be a requirement to calculate an appropriate 'starting point' in terms of the brought forward tax pools to which the forecast additions can be applied. Ideally, this will be in the form of available actual data.

4.18 It may be necessary to review the approach on an ongoing basis if significant discrepancies arise.

4.19 In any instance, there are further complexities which could be considered, such as:

i) Whether it is possible to model any 'disclaim' of capital allowances in a given period

ii) Whether to model enhanced capital allowances ('ECAs') and any research and development allowances ('RDAs')

4.20 However, we understand from HAL that RDA expenditure is expected to remain constant throughout future periods, in line with previous RDA claims. RDA claims are made on 'just and reasonable' basis, with various claim methodologies agreed with HMRC.

4.21 We have not inspected the basis of the RDA methodology utilised by HAL and their advisors, however this could be reviewed to ensure RDAs claims are optimised in comparison with the results of alternative claim methodologies. A balancing charge will be applicable on the disposal of assets upon which RDA have been claimed. We understand that there are no forecasted disposals within future periods applicable to the model. Based on the information provided, we understand that HAL has historically claimed significant capital allowances as at the following rates:

i) Main pool assets at 18%

ii) Short Life Assets ('SLA') at 18%

iii) Integral features assets at 8%

iv) Long life assets at 8%

4.22 It has also historically claimed the full AIA allowance. As noted on the next slide, the AIA was temporarily increased from £200k to £1m in Finance Act 2019.

4.23 Historically, RDAs and ECAs have been claimed where applicable, however we note these represent an immaterial percentage of total capital allowances claimed each period.

4.24 Another factor to consider is the impact of revenue expenditure which is considered capital in nature. No corporation tax deduction in respect of any such capital expenditure is available. Capital allowances may be available on any such costs. It should be appropriate to adjust for this in the high-level tax calculation. The CAA may wish to consider an appropriate quantum of adjustment for the purposes of any such calculation.

4.25 If it is expected that the nature of spend will change significantly, it may be more appropriate to request that HAL undertakes a more detailed forecast of anticipated spend.

Legislative uncertainty and changes

4.26 The proposed changes as per Finance Act 2019 may have considerable impact on the tax position and may need to be considered within the model.

Enhanced Capital Allowances

4.27 ECAs are not expected to be available due to legislative changes, with the majority of assets qualifying for ECA taken off the criteria list from April 2020. In FY2017 ECA relief amounted to c£1.5m.

4.28 On that basis, no adjustment for ECAs should be included in the PCM.

Structures and Buildings Allowance

4.29 The new Structures and Buildings Allowance (SBA) potentially will significantly increase the total amount of capital allowances available. SBA is a new form of capital allowance claimed on qualifying structure and building construction projects commencing post 28 October 2018 at 2% over a 50-year period.

4.30 The draft SBA legislation has been issued for consultation and we are waiting HMRC's response to consultation comments. There are a number of outstanding factors with relation to SBA including a definition of assets that qualify under the relief. However, the vast majority of previously non-qualifying expenditure on buildings and structures is expected to qualify for this relief.

4.31 As at 30 November 2017, there are £6.74b of assets allocated to non-qualifying capital expenditure, including a residual Industrial Building Allowances ('IBA') pool. Any additions that would otherwise be treated as non-qualifying could be allocated to SBA in future periods, subject to the provisions of the final SBA legislation.

4.32 The model could include an additional capital allowance forecast for expected SBA assets. We would expect that this would be modelled in any detailed forecasts prepared by HAL.

Change in Special Rate WDA rates

4.33 Further, the rate of WDAs on special rate pool assets has recently decreased from 8% to 6% from April 2019. This could impact on the relevant rates and proportions used for the purposes of any capital allowance calculation.

4.34 We would recommend that the forecasts take this 6% rate into account.

Annual Investment Allowance

4.35 Furthermore, the Annual Investment Allowance (‘AIA’) has been temporarily increased for periods from 1 January 2019 to 31 December 2020 to £1m, from the previous £200,000 threshold. This could significantly increase the rate at which qualifying expenditure is realised, if factored into the model.

4.36 It is not expected based on the currently enacted legislation that this increased AIA will be available during the H7 regulatory period. Therefore, we would not recommend that this is included in the forecast. It may be appropriate to provide some flexibility in the model to allow for changes in the AIA, should any such changes be enacted in the period.

Other regulator approaches

4.37 Ofwat concluded that the simplified approach to capital allowances did not work, as the majority of companies felt that this did not reduce their required workload with reference to a continued requirement to produce detailed capital allowance forecasts. A more detailed forecasting exercise is as such being undertaken by the regulated entities to identify the nature of their forecast spend. For their ‘PR19’ regulatory period, the methodology stipulated the capital allowance pools into which expenditure is allocated. It is not apparent whether ECAs and RDAs were included as potential pools. It is also assumed that full capital allowances have been claimed for any given period.

4.38 Ofgem are also tracking capital allowance pools. Based on the price control model for the period, the so-called ‘Totex’ expenditure is allocated between the various capital allowance pools based on a forecast apportionment. This apportionment appears consistent year on year. It has not been confirmed how this apportionment has been calculated.

4.39 Ofcom do not appear to calculate any tax liabilities, and merely use the relevant tax rate for the period in the calculation of their pre-tax WACC.

Information provided by HAL to date

4.40 HAL have confirmed that they have not yet undertaken detailed capital allowance forecasts for the regulatory period but would expect to have such information available at the time at which the PCM is to be populated.

4.41 Further to this, HAL are awaiting detailed guidance on which assets will be eligible for the new SBA and would expect to make use of any such guidance at the point at which they are preparing forecast capital allowance allocations.

Current conclusion

4.42 We would recommend adjusting for capital allowances given its quantum and relative predictability.

4.43 However, we do note that there is still uncertainty regarding the application of the new Structures and Buildings Allowance, and the legislation is still in draft. HAL have stated this is the reason they have been unable to prepare any estimates in respect of this to date.

4.44 On the basis HAL expect that they will have detailed forecasted capital expenditure at the point at which the PCM is populated, we would advise the CAA to require HAL to pool such expenditure on a reasonable basis into the below pools:

i) Main pool

ii) Special rate pool

iii) Structures and building allowance

4.45 As part of this process, we would recommend that the CAA requires that HAL provide sufficient assurance to validate such apportionment, in the form of detailed workings or formal advice.

4.46 We understand that the forecasts may be undertaken on a high-level basis for the purposes of the HAL business plan, but that more detailed forecasts will be available closer to the final population of the PCM.

4.47 Draft legislation is expected later this year, and we recommend consideration is given to this once available.

Depreciation

4.48 In the first instance, depreciation is not an allowable deduction for the purposes of calculating profits chargeable to corporation tax. There are specific circumstances where this treatment does not apply, but, with the exception of depreciation of deferred revenue expenditure discussed elsewhere, we are not aware of any such circumstances applicable to HAL.

4.49 In order to include such an adjustment, it will be necessary to forecast the depreciation expense. Depreciation is purely an accounting driven concept, so we have considered how this will be modelled in the underlying forecast workings and PCM.

Possible approaches - depreciation

4.50 The historic nominal depreciation charge which has been added back in the tax computations is as follows:

	£
FY2013	446,378,493
FY2014	571.827,128
FY2015	647,556,177
FY2016	631,626,531
FY2017	650,802,636

4.51 A potential approach would be to not adjust for depreciation, but this does not appear reasonable as this is a material tax adjustment.

4.52 We understand that two approaches are currently planned in respect of forecasting depreciation as part of the wider PCM, as follows:

i) Accounting depreciation will be calculated using the straight-line basis method. The relevant input sheet will include an input for the annual % depreciation applied.

ii) Choice of accounting depreciation or a user-defined profiled input to be used for regulatory depreciation.

4.53 We would expect that the PCM should include an adjustment for the purposes of calculating the relevant tax based on any such accounting forecast.

4.54 Our understanding is that it will be possible for the depreciation amount included within the wider PCM calculation to be added back as part of the tax calculation.

Possible approaches – deferred revenue expenditure

4.55 We understand that an amount of depreciation charged each year is in fact considered deductible, on the basis this is ‘depreciation’ of deferred revenue expenditure on which a deduction is available in accordance with BIM42215.

4.56 Given the quantum of deferred revenue expenditure, an adjustment for this could be included (to the extent it is possible to forecast such amounts). In the absence of such an amendment, the tax forecast would include an excessive disallowance in respect of depreciation. This would mean that HAL would receive a windfall in respect of any depreciation on deferred revenue expenditure.

4.57 It may be possible to forecast any such deduction. A number of options could be available in respect of this, such as:

i) Applying the appropriate depreciation rate per HAL's accounting policies to the brought forward carrying value of the relevant assets combined with appropriate forecast additions

ii) Calculate an average historic deferred revenue depreciation amount based on the corporation tax returns for the last 3-5 years

iii) Include an adjustment based on HAL forecasts

Other regulator approaches

4.58 Ofwat includes in its calculation of the tax allowance an add back for depreciation. We are not aware of any adjustment for deferred revenue expenditure.

4.59 Ofgem calculates a tax liability allowance which is modelled at the outset of the relevant Price Control Period. This is based on a notional tax calculation which includes an adjustment for the depreciation of the regulatory asset value. We are not aware of any adjustment for deferred revenue expenditure.

4.60 Ofcom do not appear to calculate any tax liabilities, and merely use the relevant tax rate for the period in the calculation of their pre-tax WACC.

Information provided by HAL to date

4.61 We understand that the model will include an amount in respect of depreciation, based on HAL's accounting policies.

4.62 On the basis HAL expect that they will have detailed forecasted capital expenditure, which would likely include deferred revenue expenditure, at the point at which the PCM is populated, we would advise the CAA to require HAL to forecast such costs.

4.63 As part of this process, we would recommend that the CAA requires that HAL provide sufficient assurance to validate such apportionment, likely in the form of a working paper which shows the relevant assets and the forecast depreciation thereon.

4.64 We understand that the forecasts may be undertaken on a high-level basis for the purposes of the initial business plan (IBP), but that more detailed forecasts will be available closer to the final population of the PCM.

Current conclusion

4.65 On the basis capital allowances are expected to be modelled in the PCM, it would not be appropriate to leave the depreciation charge unadjusted, as this would represent a double deduction.

4.66 We would recommend that the accounting depreciation expense included within the wider PCM is added back, as this appears consistent with the wider approach to modelling.

4.67 To the extent HAL are able to model forecast deferred revenue expenditure, and to the extent such assets are appropriate and relevant to the regulated entity, we would recommend including these amounts as deductions in the tax model.

Amortisation

4.68 In the first instance, where amortisation is charged on an intangible asset created on or after 1 April 2002, the amount charged in a given period is considered a deductible expense in calculating profits chargeable to corporation tax.

4.69 Under old UK GAAP, capitalised software costs were categorised as tangible fixed assets. This is because under FRS 10, software costs which met the definition criteria of an asset were capitalised as tangible fixed assets. However, under FRS 102, the decision relating to whether to treat the capitalised item as a tangible or an intangible fixed asset is based on the commercial reality, i.e. where the software constitutes an asset in its own right it is generally treated as an intangible asset. On transition to FRS 102, some historic software amounts recognised as tangible fixed assets were then reflected as intangible fixed assets.

4.70 This can give rise to a mismatch, where historical software costs were originally treated as tangible fixed assets and attracted tax relief under the capital allowances regime, while new assets which were capitalised as intangible fixed assets would, in the first instance, be eligible for tax relief on an amortisation basis.

4.71 In order to minimise complexity, a company may elect under s815 CTA 2009 to exclude capital expenditure on software from these rules, and instead claim capital allowances on these assets. This means there is no requirement to track the assets which gain relief under the capital allowance regime and under the amortisation regime as separate ‘pools.’ To the extent this is the case no deduction shall be available for any amortisation charged in respect of these assets. We understand that HAL has historically made such an election.

4.72 The relevant amortisation expense for FY2013 – FY2017 were as follows:

	£
FY2013	nil
FY2014	nil
FY2015	34,673,399
FY2016	36,308,613
FY2017	40,183,720

Potential approaches

4.73 In order to include an adjustment, it will be necessary to forecast the amortisation expense.

4.74 To the extent the amortisation expense is forecast within the wider PCM, we would expect that the PCM could include an adjustment to ‘add back’ any amortisation expense included within the forecast model.

4.75 Should this not be the case, any amortisation adjustment could be calculated in a number of ways. Some potential options are calculated below:

i) Applying the appropriate amortisation rate per HAL’s accounting policies to the brought forward carrying value of the relevant assets combined with appropriate forecast additions

ii) Calculate an average historic amortisation amount based on the corporation tax returns for the last 3-5 years

iii) Include an adjustment based on HAL forecasts

Other regulator approaches

4.76 Ofwat does not explicitly include any adjustments for amortisation in the model, with the exception of amortisation of deferred revenue expenditure, which is discussed above. However, on the basis the amortisation of software is broadly equal to depreciation and is considered non-deductible where capital allowances are taken on the underlying asset, we would expect that Ofwat would consider this in their calculation.

4.77 Ofgem calculates a tax liability allowance which is modelled at the outset of the relevant Price Control Period. It is not apparent whether this includes an adjustment for amortisation.

4.78 Ofcom do not appear to calculate any tax liabilities, and merely use the relevant tax rate for the period in the calculation of their pre-tax WACC.

Current conclusion

4.79 On the basis capital allowances are expected to be modelled in the PCM, it would not be appropriate to leave the amortisation charge in respect of software on which capital allowances are claimed as unadjusted, as this would represent a double deduction.

4.80 We would recommend that the amortisation expense included within the wider PCM is added back, as this appears consistent with the wider approach to modelling.

Gains / losses on disposal of fixed assets

4.81 No gains / losses on disposal of fixed assets are brought into account for calculating corporation tax for a given period (relief is available as part of the capital allowance calculations). The impact of these gains or losses are included by virtue of their impact to the capital allowance pools.

4.82 The historic amounts in respect of disposals of fixed assets are as follows:

	£
FY2013	235,153
FY2014	(52,821)
FY2015	44,910
FY2016	(533,798)
FY2017	123,287

Potential approaches

4.83 A potential approach could be not to adjust for any such gains or losses, on the basis it is very difficult to forecast, and the amounts involved are not considered material

4.84 Alternatively, a forecast amount could be adjusted for, based on one of the following methodologies:

i) Calculation of an expected adjustment using the average gain / loss over the past 3 – 5 years

ii) Preparation of forecast gains or losses as prepared by HAL

Other regulator approaches

4.85 Ofwat does not explicitly include any adjustments for gains or losses on disposals of fixed assets in their policy.

4.86 Ofgem calculates a tax liability allowance which is modelled at the outset of the relevant Price Control Period. Based on the published model, this does not appear to give consideration to any gains or losses on disposal of fixed assets.

4.87 Ofcom do not appear to calculate any tax liabilities, and merely use the relevant tax rate for the period in the calculation of their pre-tax WACC.

Information provided by HAL to date

4.88 HAL has confirmed that it does not anticipate any chargeable gains arising in the regulatory period.

Current conclusion

4.89 On the basis no material gains are expected, and in any instance, it would not be possible to forecast the accounting gains / losses arising, we do not propose to include any adjustment in respect of gains or losses arising on disposal of fixed assets.

5 Tax treatment of revenue expenditure costs

Exceptional / 'one-off' disallowable expenditure

Background

5.1 Due to their nature, one-off or exceptional items which could be included in the corporation tax computations are very difficult to forecast.

5.2 They are typically highly relevant for corporation tax purposes due to their typically large nature and likelihood they will contain capital related expenditure and/or costs not wholly and exclusively related to a company's trade.

5.3 To the extent it is possible to forecast any such one-off adjustments, including these in the PCM will ensure that there is minimal discrepancy between the forecast and actual tax charge. The absence of any such adjustments in the model would produce a lower tax charge, and the risk of any significant exceptional disallowance would be borne by HAL.

5.4 Based on HAL's tax computations for FY2017, costs of this nature included:

i) Lease variations payments

ii) Non-deductible accounting adjustments

iii) Releases of intercompany balances

5.5 Exceptional expenditure has been variable over the past 5 years, with it ranging between values of c£273m in 2015 to £13.7m in 2013.

Possible approaches

5.6 We note based on discussions with our modelling team that non-deductible accounting adjustments are not expected to be factored into the PCM.

5.7 One option is to ignore these items, on the basis that by their very nature they are difficult to predict. Based on our review of the corporation tax computations for FY13 to FY17, the disallowances for these items vary significantly.

5.8 To include a notional allowance for additional non-deductible expenditure, options for this calculation could be as follows:

i) Review of historic disallowable expenditure incurred and calculate an average over a 5-year period (the same period as the PCM will apply to).

ii) Estimates based on benchmarked level of disallowable revenue expenditure incurred by similar businesses. We consider that it is unlikely that information would be available to in sufficient detail to provide an accurate forecast and given the unpredictability of the expenditure it would not necessarily be any more accurate that a review of HAL's historic expenditure.

iii) Review of available forecasts and estimate potential specific disallowable items based on forecast expenditure. We note that it is unlikely that forecasts would contain information which would be specific enough to calculate an accurate estimate.

5.9 Another option would be for HAL to provide specific estimates in respect of spend of this nature. HAL would need to provide sufficient evidence to support any such amounts.

Regulatory precedent

5.10 Other regulators have remained silent on their treatment of exceptional items but have included adjustments for 'non-deductible expenditure.'

5.11 Ofwat does not explicitly include any adjustments for exceptional costs, but does adjust for non-deductible expenditure, which may include such items identified as being non-deductible for HAL.

5.12 Ofgem calculates a tax liability allowance which is modelled at the outset of the relevant Price Control Period. It is not apparent whether this includes an amount in respect of disallowable expenditure, as the Ofgem model recalculates base revenue for the regulated entity, and this may not include exceptional costs.

5.13 Ofcom do not appear to calculate any tax liabilities, and merely use the relevant tax rate for the period in the calculation of their pre-tax WACC.

Information provided by HAL to date

5.14 HAL have confirmed that they have not yet undertaken exceptional expenditure forecasting for the regulatory period but would expect to have such information available at the time at which the PCM is to be populated.

Current conclusion

5.15 We would recommend that an adjustment is included based on expected levels of disallowable exceptional expenditure along with supporting evidence for such adjustments.

5.16 To the extent HAL are able to forecast such disallowable costs, we would recommend including these amounts as adjustments through a single line in the PCM.

Third party entertaining

5.17 No corporation tax deduction is available in respect of third-party entertaining.

5.18 We note that client entertaining is potentially a sensitive issue and it may be perceived as discretionary. Non-deductible expenditure will increase the tax charge, and this will ultimately be borne by airlines if taken into account in the model. Airlines may therefore expect HAL to minimise client entertainment.

Possible approaches

5.19 In terms of including any such disallowance in the model, the following approaches could be taken:

i) No adjustment made in respect of third-party entertaining

ii) Calculate an adjustment based on average spend on third party entertainment over a historic 5-year period flexing for any one-off/unusual events that may be expected

iii) Calculate based on any forecast third party entertaining spend accounted for by HAL, taking into account any future expected exceptional events

Regulatory precedent

5.20 Other regulators have remained silent on their treatment of specific non-deductible items, but do refer to adjustments of this nature

5.21 Ofwat does not explicitly include any adjustments for third party entertaining, but does adjust for non-deductible expenditure, which may include such items identified as being non-deductible for HAL

5.22 Ofgem calculates a tax liability allowance which is modelled at the outset of the relevant Price Control Period. It is not apparent whether this includes an amount in respect of disallowable expenditure, as the Ofgem model recalculates base revenue for the regulated entity, and this may not include third party entertaining costs

5.23 Ofcom do not appear to calculate any tax liabilities, and merely use the relevant tax rate for the period in the calculation of their pre-tax WACC.

Information provided by HAL to date

5.24 HAL have confirmed that they have not yet undertaken non-deductible expenditure forecasting for the regulatory period but would expect to have such information available at the time at which the PCM is to be populated.

Current conclusion

5.25 We would recommend that an adjustment is included based on expected levels of third party entertaining expenditure.

5.26 To the extent HAL are able to forecast such disallowable costs, we would recommend including these amounts as deductions in the tax model.

5.27 In the absence of detailed forecasts, we would recommend an amount be treated as non-deductible in respect of recurring disallowable expenditure, calculated as a percentage of operating expenditure. This amount will be a single line item within the PCM and cover all possible non-deductible expenses (i.e. third party entertaining, capital related consultancy fees etc.) We understand HAL use a figure of 1% for the purpose of forecasting.

Commercial disallowance

5.28 We understand HAL have agreed a position with HMRC in respect of a particular contract that results in a fixed recurring disallowance. The details of the contract and associated agreement are commercially confidential.

Possible approaches

5.29 In terms of including any such disallowance in the model, the following approaches could be taken:

i) No adjustment made in respect of the disallowance

ii) Include an adjustment based on HAL’s agreed disallowance.

Regulatory precedent

5.30 Given this is a specific adjustment relevant to HAL’s business model, there are no directly comparable regulatory precedents.

Information provided by HAL to date

5.31 HAL have confirmed that this adjustment is expected to continue throughout the regulatory period.

Current conclusion

5.32 We would recommend that an adjustment is included based on HAL’s yearly payment.

Consultancy costs in respect of capital projects

5.33 Consultancy, legal and professional costs will not be allowable under general principles where they are either capital in nature or not wholly and exclusively for the purposes of the trade of the business.

5.34 HAL incurs significant expenditure on consultancy costs and hence it would seem appropriate to model this expenditure within the PCM.

Possible approaches

5.35 Potential approaches in modelling the impact of capital related fees could include:

i) No adjustment made in respect of consultancy costs

ii) Include an adjustment based on historical capital related consultancy costs incurred.

iii) Include an adjustment based on forecast figures as prepared by HAL

5.36 Given the exceptional nature of consultancy and legal expenditure on capital projects (typically incurred on project by project basis) the use of historic data could be particularly inaccurate. Based on a review of the tax computations above, historic expenditure does not give a consistent basis for estimating the proportion of spend to be disallowed.

Regulatory precedent

5.37 Other regulators have remained silent on their treatment of specific non-deductible items but do refer to adjustments of this nature.

5.38 Ofwat does not explicitly include any adjustments for capital related legal and consultancy fees, but does adjust for non-deductible expenditure, which may include such items identified as being non-deductible for HAL.

5.39 Ofgem calculates a tax liability allowance which is modelled at the outset of the relevant Price Control Period. It is not apparent whether this includes an amount in respect of disallowable expenditure, as the Ofgem model recalculates base revenue for the regulated entity, and this may not include specific legal and professional fees.

5.40 Ofcom do not appear to calculate any tax liabilities, and merely use the relevant tax rate for the period in the calculation of their pre-tax WACC.

Information provided by HAL to date

5.41 HAL have confirmed that they have not yet undertaken non-deductible expenditure forecasting for the regulatory period but would expect to have such information available at the time at which the PCM is to be populated.

5.42 From a forecasting perspective, HAL assume that 1% of costs are considered non-deductible.

Current conclusion

5.43 We would recommend that an adjustment is included based on expected levels of disallowable capital related consultancy expenditure.

5.44 To the extent HAL are able to forecast such disallowable costs, we would recommend including these amounts as deductions in the tax model.

5.45 In the absence of detailed forecasts, we would recommend an amount be treated as non-deductible in respect of recurring disallowable expenditure, calculated as a percentage of operating expenditure. This amount will be a single line item within the PCM and cover all possible non-deductible expenses (i.e. third party entertaining, capital related consultancy fees etc.) We understand HAL use a figure of 1% for the purpose of forecasting.

Preference share dividends

5.46 Broadly, income and expenses arising on preference shares can be accounted for as liabilities rather than equity but for tax purposes they are considered to be a dividend and broadly are unlikely to be brought into account (i.e. preference share dividends paid are treated as non-deductible). It is worth noting the rules regarding the deductibility of returns on preference shares are complex.

5.47 Based on HAL's tax computations for past five years, preference share dividends paid were as follows.

	£
FY2013	999,730
FY2014	962,171
FY2015	985,649
FY2016	1,076,569
FY2017	947,678

Possible approaches

The ability to accurately model any future dividends will depend on whether the preference shares in question have a fixed coupon rate. On the basis the dividends appear similar each year, this may be the case.

Where this remains consistent, it should be possible and would be appropriate to include this expenditure in the PCM and high-level tax calculation.

Regulatory precedent

5.48 Ofwat explicitly includes an adjustment in respect of preference share dividends as part of its calculation of the tax allowance

5.49 Ofgem calculates a tax liability allowance which is modelled at the outset of the relevant Price Control Period. It is not apparent whether this includes an amount in respect of disallowable expenditure, as the Ofgem model recalculates base revenue for the regulated entity, and this may not include specific legal and professional fees

5.50 Ofcom do not appear to calculate any tax liabilities, and merely use the relevant tax rate for the period in the calculation of their pre-tax WACC.

Information provided by HAL to date

5.51 We are not aware of any forecasting in respect of preference share dividends to be paid.

Current conclusion

5.52 To the extent HAL are able to model such disallowable costs, we would recommend including these amounts as non-deductible in the tax model.

5.53 In the absence of detailed forecasts, we would recommend an amount be treated as non-deductible in respect of recurring disallowable expenditure, calculated as a percentage of operating expenditure. This amount will be a single line item within the PCM and cover all possible non-deductible expenses (i.e. third party entertaining, capital related consultancy fees etc.) We understand HAL use a figure of 1% for the purpose of forecasting.

5.54 It will also be necessary to confirm whether any preference share dividends would be included within the underlying forecast model, dependent on the financing structure modelled in the PCM.

5.55 However, given other regulators explicitly adjust for preference share dividends, it is likely appropriate to adjust for these.

Fair value gain / loss on investment properties

5.56 Where there is a fair value adjustment in respect of an investment property, this is added back (in the same way as depreciation) to PBT before calculating corporation tax. Therefore, fair value adjustments are disregarded for tax purposes and the adjustment is not brought into account for calculating corporation tax for a given period.

5.57 Based on HAL's tax computations for past five years, the fair value gain/(loss) on investment properties have been as follows.

	£
FY2013	n/a
FY2014	n/a
FY2015	94,989,494
FY2016	43,725,759
FY2017	149,110,957

5.58 Reviewing earlier periods, fair value gains and losses on investment properties varies significantly, due to the impact of external factors.

5.59 However, there is a question as to whether the relevant investment properties should be considered for the purposes of the PCM, on the basis these may fall outside the regulated aspect of HAL.

Possible approaches

5.60 We would not expect to see amounts in respect of fair value adjustments in forecast PBT in the PCM.

5.61 The historic adjustments do not give a very consistent guide and by their very nature, the scope for modelling fair value movements is limited.

5.62 Given their unpredictable quantum, using either historic information or forecasts is not likely to be an accurate or reliable method.

Regulatory precedent

5.63 Ofwat do not include any adjustment in respect of fair value movements.

5.64 Ofgem calculates a tax liability allowance which is modelled at the outset of the relevant Price Control Period. Based on the published model, it does not appear that fair value movements are included in the tax liability allowance, likely due to the fact that they cannot be accurately forecast.

5.65 Ofcom do not appear to calculate any tax liabilities, and merely use the relevant tax rate for the period in the calculation of their pre-tax WACC.

Information provided by HAL to date

5.66 HAL have not provided any forecasts in respect of potential fair value movements, which is to be expected given their nature.

5.67 HAL have confirmed that they do not expect any disposals of investment properties in the period.

Current conclusion

5.68 We would not recommend that an adjustment in respect of fair value adjustments relating to investment properties be included on the basis it is not possible to accurately estimate these amounts. The PCM will not forecast these numbers, so there is no requirement to adjust these movement out to get to a figure representative of the profits chargeable to corporation tax.

5.69 The historic adjustments do not give a very consistent guide and by their very nature, the scope for modelling fair value movements is limited. Given their unpredictable quantum, using either historic information or forecasts is not likely to be an accurate or reliable method.

Fair value gains / losses on financial instruments

5.70 Fair value adjustments in respect of financial instruments can have a tax impact. The loan relationship rules are complex and would need to be considered in detail to determine the tax impact of any adjustments.

5.71 There are various provisions in respect of fair value gains and losses in respect of financial instruments, and the tax treatment can include or exclude these from the charge to tax, dependent on various elections and specific tax rules.

5.72 The fair value adjustments on financial instruments varies significantly, although the amount taxable has generally been between £6-£10m.

5.73 Based on HAL's tax computations for past five years, the fair value gain/(loss) on financial instruments have been as follows.

	£
FY2013	n/a
FY2014	n/a
FY2015	84,237,044
FY2016	(474,058,643)
FY2017	48,409,047

5.74 However, there is a question as to whether these fair value adjustments should be included within the PCM.

5.75 Where an entity has elected to apply the Disregard Regulations, certain fair value adjustments relating to the hedging instrument in question are not brought into account for tax. Depending on the type of hedge and the Disregard Regulation that applies, the FV gains and losses are either deferred or brought into account via an alternative basis of calculation.

5.76 Regulations 7, 8 and 9 all require a hedging relationship (defined by Regulation 2(5)) between a derivative contract and a particular hedged item. A hedging relationship is defined as one where the company has:

- i) Designated a derivative contract as a hedge for accounting purposes; or
- ii) has an intention to hedge for tax purposes

5.77 It is our understanding HAL has made an election to apply Regulations 7, 8 and 9 of the Disregard Regulation on the basis that the hedging conditions are met and are relevant contracts for these purposes.

5.78 Regulation 7 applies to currency contracts for the forward purchase and sale of a currency other than the company's functional currency.

5.79 Regulation 8 covers commodity and debt contracts that are used to hedge forecast transactions and firm commitments.

5.80 However, Regulations 7 and 8 do not apply to a particular derivative contract where profit or losses on the hedged item are brought into account for tax on a fair value basis. This is because in such cases the fair value profits and losses arising on the contract should be offset by fair value losses or profits arising on the hedged item. Under Regulations 7 and 8, fair value gains or losses are brought into account on the maturity of the contract (or realisation).

5.81 Regulation 9 typically applies to an interest rate contract that is used to hedge an asset or liability, receipt or expense. The impact of applying Regulation 9 is that all fair value adjustments are disregarded for tax purposes, and instead replaced with an "appropriate accruals basis" for tax purposes per Regulation 9(2).

5.82 It is worth noting there are strict deadlines for making an election and we assume that HAL has made these elections within the required time limits.

Possible approaches

5.83 We would not expect to see amounts in respect of fair value adjustments in forecast PBT in the PCM.

5.84 The historic adjustments do not give a very consistent guide and by their very nature, the scope for modelling fair value movements is limited.

5.85 Given their unpredictable quantum, using either historic information or forecasts is not likely to be an accurate or reliable method

Regulatory precedent

5.86 Ofwat does not include any adjustment in respect of fair value movements.

5.87 Ofgem calculates a tax liability allowance which is modelled at the outset of the relevant Price Control Period. Based on the published model, it does not appear that fair value movements are included in the tax liability allowance, likely due to the fact that they cannot be accurately forecast.

5.88 Ofcom do not appear to calculate any tax liabilities, and merely use the relevant tax rate for the period in the calculation of their pre-tax WACC.

Information provided by HAL to date

5.89 HAL have not provided any forecasts in respect of potential fair value movements, which is to be expected given their nature.

5.90 HAL have confirmed that a Disregard election was made in respect of derivative contracts entered into on or after 1 January 2015. It is worth noting HAL have some historic swaps (pre 1 January 2015) which continue to be taxed in line with the underlying accounting treatment (i.e. FV accounting).

Current conclusion

5.91 We would not recommend that an adjustment in respect of fair value adjustments relating to financial instruments be included, on the basis it is not possible to accurately estimate these amounts. The PCM will not forecast these numbers, so there is no requirement to adjust these movement out to get to a figure representative of the profits chargeable to corporation tax.

5.92 The historic adjustments do not give a very consistent guide and by their very nature, the scope for modelling fair value movements is limited. Given their unpredictable quantum, using either historic information or forecasts is not likely to be an accurate or reliable method.

5.93 Additionally, as a Disregard election is in place, any amounts which arise would not be brought into account until such a time that the underlying item is settled.

Leased car expenditure

Background

5.94 For new leases taken out from 1 April 2009, relief is restricted for the leasing costs of high emission cars. The definition of a high emission car has changed multiple times, but for leases beginning on or after 1 April 2019 relief for the leasing costs is restricted for cars with CO2 emissions exceeding 110g/km.

5.95 HAL has historically suffered a restriction on its total car leasing costs based on an agreement with HMRC. The disallowance for the leasing costs is 15% of the lease charge recognised in the statement of profit and loss for the period. This arrangement has applied to all accounting periods we have reviewed (FY2013).

5.96 Based on HAL's tax computations for past five years, the disallowance for leased cars was:

	£
FY2013	75,103
FY2014	67,812
FY2015	56,250
FY2016	20,649
FY2017	27,047

Potential approaches

5.97 In terms of including any such disallowance in the model, the following approaches could be taken:

i) No adjustment made in respect of leased cars as the amount is immaterial

ii) Include an adjustment based on forecast car leasing costs

iii) Include an adjustment based on historic leased car costs

Regulatory precedent

5.98 Other regulators have remained silent on their treatment of specific non-deductible items, but do refer to adjustments of this nature

5.99 Ofwat does not explicitly include any adjustments for leased cars, but does adjust for non-deductible expenditure, which may include such items identified as being non-deductible for HAL

5.100 Ofgem calculates a tax liability allowance which is modelled at the outset of the relevant Price Control Period. It is not apparent whether this includes an amount in respect of disallowable expenditure, as the Ofgem model recalculates base revenue for the regulated entity, and this may not include car leasing costs

5.101 Ofcom do not appear to calculate any tax liabilities, and merely use the relevant tax rate for the period in the calculation of their pre-tax WACC.

Current conclusion

5.102 We would recommend that an adjustment is included based on expected levels of disallowable leased car expenditure.

5.103 To the extent HAL are able to forecast such disallowable costs, we would recommend including these amounts as deductions in the tax model.

5.104 In the absence of detailed forecasts, we would recommend an amount be treated as non-deductible in respect of recurring disallowable expenditure, calculated as a percentage of operating expenditure. This amount will be a single line item within the PCM and cover all possible non-deductible expenses (i.e. third party entertaining, capital related consultancy fees etc.) We understand HAL use a figure of 1% for the purpose of forecasting.

Adjustments for pension contributions and late paid remuneration

Background

5.105 Wages, salaries, and bonuses receive tax relief provided they are actually paid within nine months of the end of the accounting period. Accrued wages, salaries and bonuses that are not paid within nine months of the period end are treated as non-deductible and relief is given in the period which the wages are physically paid.

5.106 Pension contributions receive tax relief in the accounting period in which they are paid, not accrued. Any amounts unpaid at year end are treated as non-deductible and relief is given in the period in which the contributions are physically paid.

5.107 It is common for pension contributions to be paid one month in arrears and hence the tax computations have shown a yearly adjustment in respect of unpaid pension obligations.

5.108 With respect to defined benefit pension schemes, the amounts paid in a period are considered deductible, while any IAS 19 accounting adjustments are not brought into account.

5.109 Given the historic quantum of wages and salaries and pension costs, any adjustments could prove to be highly material.

Potential approaches

5.110 There are various approaches which could be taken in respect of employment related timing differences, including the following:

i) Historic – Calculate expected disallowance using average disallowance over the past 3-5 years

ii) Forecasted – subject to the availability of accurate forecasts, use budgeted data to calculate quantum of disallowance

iii) Payroll policy – apply percentages formulated from payroll policy to real time remuneration and pension contributions.

Regulatory precedent

5.111 Other regulators have remained silent on their treatment of specific non-deductible items but do refer to adjustments of this nature.

5.112 Ofwat does not explicitly include any adjustments for pension costs and late paid remuneration, but does have an adjustment for ‘other adjustments’, which may include such items identified.

5.113 Ofgem calculates a tax liability allowance which is modelled at the outset of the relevant Price Control Period. It is not apparent whether this includes an amount in respect late paid salaries and pension costs.

5.114 Ofcom do not appear to calculate any tax liabilities, and merely use the relevant tax rate for the period in the calculation of their pre-tax WACC.

Information provided to date by HAL

5.115 HAL have confirmed that there is an intention to clear the defined benefit deficit to £nil on an actuarial valuation basis. However, this will not necessarily result in the IAS 19 deficit being £nil, and as such IAS 19 adjustments will likely continue to be accounted for.

Current conclusion

5.116 Given this relates to a timing difference, and all amounts are ultimately deductible when paid, we do not propose to include an adjustment in respect of these costs.

Capitalised interest

Background

5.117 HAL has confirmed that where interest is capitalised, relief is taken at the point the interest is capitalised through the tax computations under the loan relationship provisions. In Finance Act (No 2) 2015, a new provision was introduced to allow a tax deduction to be taken for capitalised interest.

5.118 It is expected that the policy of capitalising interest will continue through the regulatory period. On that basis, there is an argument that an adjustment should be made to reflect this within the model.

5.119 Based on HAL's tax computations for past five years, the amount of capitalised interest was:

	£
FY2013	163,608,361
FY2014	83,344,119
FY2015	21,576,953
FY2016	35,077,908
FY2017	45,916,506

Potential approaches

5.120 Potential approaches to modelling this adjustment could include:

i) No adjustment made on the basis the model will assume that no interest amounts are capitalised

ii) Historic – Calculate expected level of capitalised interest using average figure over the past 3-5 years

iii) Forecasted – subject to the availability of accurate forecasts, use budgeted data to calculate quantum of expected interest

Regulatory precedent

5.121 Ofwat does not explicitly include any adjustments for capitalised interest amounts, but does adjust for other adjustments to PBT, which may include such items identified.

5.122 Ofgem calculates a tax liability allowance which is modelled at the outset of the relevant Price Control Period. It is not apparent whether this includes an amount in respect of disallowable expenditure, as the Ofgem model recalculates base revenue for the regulated entity which does not appear to consider any additional deductions for capitalised interest

5.123 Ofcom do not appear to calculate any tax liabilities, and merely use the relevant tax rate for the period in the calculation of their pre-tax WACC.

Current conclusion

5.124 It is our understanding all loan balances within the model are raised at a corporate level (as opposed to in respect of specific assets under creation) and as such all interest costs within the PCM will be revenue in nature rather than capital. It follows, therefore, that adjusting for an additional deduction related to capitalised interest may give rise to a double deduction for interest costs.

5.125 As such, we do not propose to include any adjustment in respect of capitalised interest.

6 Tax treatment of anticipated R&D expenditure

Research and development tax relief

6.1 We understand from the information provided that HAL is considered a large company as it does not meet the SME criteria by virtue of the fact that it has over 500 employees, and it exceeds the total balance sheet threshold of €86m and the turnover threshold of €100m.

6.2 Currently large companies can benefit from a research and development expenditure credit (RDEC) as outlined below:

i) A taxable credit of 12% is available in relation to qualifying expenditure. Based on a 17% corporation tax rate this will typically result in a 9.96% net benefit after tax.

ii) The RDEC operates like a government grant and is payable even if the company does not have sufficient tax liabilities.

iii) The credit can be allocated against R&D expenditure within the P&L; include the RDEC as “other income” or offset it against the ‘relevant expenditure’ such as wages and salaries costs within admin expenses.

6.3 Based on the R&D spend identified by EY in relation to the accounting periods ended 31 December 2015 and 2016, eligible R&D expenditure is minimal. For FY2016, the expenditure was £108,142. Information is not yet available for FY2017.

6.4 HAL have stated that they do not expect expenditure to increase significantly, therefore this does not appear to be a material item. However, we set out below for completeness a summary of the credit available and possible approaches to modelling

Potential approaches

6.5 A variety of methodologies may be adopted in order estimate future R&D spend, although it is important to note that HM Revenue & Customs agreement validates a claim. Complications arise in forecasting R&D claims in that they must be made retrospectively within the respective tax computation to which the expenditure relates. The definition of R&D is that a project must seek to resolve a scientific or technological uncertainty and in seeking to do so must obtain a scientific or technological advance. R&D assessments can therefore only be made retrospectively.

6.6 A company has 2 years from the end of the accounting period to which the expenditure relates to in order to file a valid R&D claim.

Simple approach – average method based on prior expenditure

6.7 In such an approach an estimation of qualifying R&D expenditure could be based on prior year eligibility. HAL has typically filed R&D claims in the region of 0.03% - 0.04% of total staff costs.

Detailed approach – technical review of forecast expenditure

6.8 Technical discussions could be undertaken with individuals within HAL, in order to ascertain the potential quantification of qualifying R&D activities based on forecast expenditure. Assessment could therefore be estimated in relation to the level of qualifying R&D undertaken as below:

i) A Project based approach – review and estimate the level of R&D within future projects

ii) Individual staff assessment / departmental review – review and estimate the level of R&D to be undertaken by a specific staff member or a specific department.

Regulatory precedent

6.9 Ofwat does not explicitly include any adjustments for RDEC amounts, although it does include the impact of Research and Development allowances as part of the capital allowance modelling.

6.10 Ofgem calculates a tax liability allowance which is modelled at the outset of the relevant Price Control Period. Based on the published model, this does not appear to give any consideration to RDEC.

6.11 Ofcom do not appear to calculate any tax liabilities, and merely use the relevant tax rate for the period in the calculation of their pre-tax WACC.

6.12 To the extent any forecast PBT figures include RDEC as an above-the-line credit, the additional tax charge is recognised thereon. However, no other regulators appear to consider the potential Step 1 or Step 7 offset as part of the RDEC mechanism (see appendix 3).

Information provided to date by HAL

6.13 HAL have confirmed that they do not anticipate significant additional RDEC eligible spend arising as due to the increased capital spend

6.14 Any additional spend qualifying for RDAs will be considered as part of the capital allowances calculation, although we note RDA's make up a immaterial percentage of total capital allowances claimed each year.

6.15 On the basis HAL expect that they will have detailed forecasted capital expenditure at the point at which the PCM is populated, we would advise the CAA to require HAL to pool such expenditure on a reasonable basis.

6.16 As part of this process, we would recommend that the CAA requires that HAL provide sufficient assurance to validate such apportionment, in the form of detailed workings or formal advice.

6.17 We understand that the forecasts may be undertaken on a high-level basis for the purposes of the IBP, but that more detailed forecasts will be available closer to the final population of the PCM.

Current conclusion

6.18 We understand that HAL undertakes significant spend to improve the functioning of the airports operations, underlying software and robotics systems.

6.19 Given the immaterial nature of the claims in question, and that the spend is not expected to increase, we would not recommend including an adjustment for RDEC in the PCM.

6.20 Any RDA relief will be considered as part of the wider capital allowances modelling. However, RDA claims make up an immaterial percentage of total capital allowances claimed each year and on this basis would be recommend not including these within the capital allowances calculations.

7 Tax treatment of Transfer Pricing adjustments

Transfer Pricing (TP) on intercompany services & intragroup lending

7.1 An area of consideration for the purposes of calculating any tax allowance or high-level tax calculation for the model will be the impact of intercompany Transfer Pricing adjustments.

7.2 Various issues can arise, including but not limited to:

i) Differences between forecast and actual adjustments

ii) Changes in regulatory environment, for example due to changes in OECD guidance or best practice

iii) Changes in the nature and activity of the intercompany group transactions which impact on the appropriate costing mechanism

Existing Transfer Pricing documentation

7.3 BAA Limited (the historic parent of HAL) has transfer pricing documentation for the year ended 31 December 2007, which outlines a cost plus model in respect of Centralised Airport Services and obligations.

7.4 Based on the historic corporation tax computations for FY2013 – FY2017, no Transfer Pricing adjustments have been imputed through the tax computations in respect of any intercompany services (i.e. these have all been booked in the relevant profit before tax figures).

Current conclusion

7.5 We understand intragroup lending and charges are not being included within the PCM, and the PCM is prepared on the basis all transactions are undertaken on an arm’s length basis. Further, our assumption is that the forecast figures would include any required Transfer Pricing adjustments, on the basis these should be posted as part of any accounting recharge mechanism rather than adjusted through the tax computation. Given this, no adjustment will be necessary.

8 Tax treatment of interest deductibility

Corporate Interest Restriction rules

8.1 The UK government has introduced new rules to restrict the tax deductibility of interest in line with Action 4 of the OECD Base Erosion and Profit Shifting ('BEPS') project.

8.2 The Corporate Interest Restriction ('CIR') rules apply on a group basis, so it may be necessary to consider the ultimate parent of the group and any entities which are consolidated on a line-by-line basis in the parent's consolidated financial statements, in accordance with IFRS accounting standards.

8.3 The group will be subject to an interest restriction to the extent that its UK aggregate net-tax interest expense exceeds its available interest capacity.

8.4 The interest capacity is calculated as the current year interest allowance plus any brought forward interest allowance.

8.5 The interest allowance is calculated in the first instance under the Fixed Ratio Method ('FRR'). There is an election available to calculate the allowance under the Group Ratio Method ('GRM').

8.6 In any instance, a group has a de minimis interest allowance of £2m a year.

8.7 Under the FRM, the interest allowance is calculated as the lower of the following:

- i) 30% of UK tax-EBITDA
- ii) The adjusted net group interest expense ('ANGIE')

8.8 Tax-EBITDA is broadly a company's profits EBITDA under tax principles (i.e. before capital allowances and any interest amounts).

8.9 The GRM considers the net interest to EBITDA ratio on an accounting basis for all companies in the worldwide group. The ratio calculated is applied to the relevant UK interest amounts. The GRM does not permit an allowance in excess of the net qualifying group interest expense, which is broadly the ANGIE adjusted to remove any related party interest.

8.10 There are specific provisions in place to protect investment in infrastructure which has a public benefit. This results in the qualifying interest expense of qualifying infrastructure companies not being brought into account in the calculation of the CIR.

8.11 The Interest Restriction Return for FY2017 shows that all entities within the worldwide group (with the exception of LHR Insurance Services and BMG Europe Limited) have made two Public Infrastructure Elections, as follows:

- i) An election for all other entities (including HAL) in the group to be Qualifying Infrastructure Companies under the PIE in accordance with Section 433, Part 10, TIOPA 2010
- ii) A grouping election, which operates to apply the PIE tests on a group basis in accordance with Section 435, Part 10, TIOPA 2010

8.12 Where the election applies, there will be no restriction to the deductibility of interest under the CIR principles. There may still be a restriction under other corporation tax principles which should be considered.

8.13 HAL has confirmed that the exemption is expected to apply on a prospective basis for the regulatory period. As such, it does not appear necessary to model any restriction under the CIR regulations in the PCM.

Regulatory precedent

8.14 This approach is in line with the documented approach taken by Ofwat, as the entities regulated by Ofwat are also considered eligible for the PBIE

8.15 For the purposes of the methodology set out by Ofgem, no adjustment is made in respect of any non-deductible interest payment, and specifically references any restrictions arising due to the historic worldwide debt cap regime, which has been superseded by the CIR regulations.

8.16 Ofcom do not appear to calculate any tax liabilities, and merely use the relevant tax rate for the period in the calculation of their pre-tax WACC.

Information provided to date by HAL

8.17 HAL have confirmed that they do not anticipated that the PBIE will cease to apply during the regulatory period

Current conclusion

8.18 We would recommend making no adjustments for interest deductibility under the Corporate Interest Restriction rules on the basis the PBIE is expected to continue to apply meaning no restrictions would in point.

8.19 We are not aware of any factors which would result in this exemption ceasing to be available.

Gearing clawback mechanism

8.20 As discussed above, it is expected that any interest expense incurred by HAL will be considered deductible for the purposes of the model.

8.21 The PCM will calculate a price based on an expected level of notional gearing. However, where a higher level of gearing is adopted, HAL could receive a benefit in the form of additional tax-deductible interest.

8.22 As such, it is proposed that a clawback could apply to such scenarios.

Regulatory precedent

8.23 We understand that CAA applies a similar methodology to its regulatory model for NATS.

8.24 The clawback calculation takes the following steps:

i) Step 1: Compare actual gearing to the target level of gearing of 60 percent. Gearing is defined and measured as set out in Condition 5 of the licence. If the simple average of actual gearing for the control period is lower or equal to the target gearing, then no clawback applies. If it is higher, then proceed to step 2.

ii) Step 2: Compare actual interest to modelled interest. If actual interest costs used in the calculation of actual tax are lower or equal to the costs used to estimate the tax charge in the price decision, then no clawback applies. If they are higher, then proceed to step 3.

iii) Step 3: The excess relief is calculated as actual interest less modelled interest. This is then multiplied by the statutory corporation tax rate used in the price determination and uplifted by the RP2 cost of capital to reflect the time value of money. The resulting clawback adjustment is to be included in the opening RP3 RAB. The tax clawback is then apportioned to the UKATS and Oceanic RABs in proportion to the estimated opening RAB values at the start of RP3 broadly to reflect the relative size of the two businesses.

8.25 Based on the above, it appears that the clawback mechanism for the regulatory period in question is reflected in the opening adjustment for the subsequent regulatory period.

8.26 While this does not give real time reactivity to changes in gearing levels, in the absence of a yearly recalculation of the PCM this appears a reasonable approach.

8.27 Other regulators also consider the impact of differences between notional and actual gearing.

8.28 Ofwat assume a notional gearing of 62.5% but use the higher of the notional or actual gearing when calculating the tax allowance. This process acts a simple clawback mechanism where the company only obtains the tax benefit of gearing up to 62.5% and any benefits associated with gearing in excess of the notional level is passed onto consumers. Conversely, consumers don't bear the costs should gearing be below the notional level.

8.29 Ofgem uses an Annual Iteration process, which adjusts the licensee's tax liability allowances.

8.30 Ofgem specifically adjusts for a clawback of tax benefit due to excess gearing, as set out in an open letter dated 31 July 2009[4]. This clawback is triggered where actual gearing exceeds notional gearing; and (ii) interest costs exceed those modelled at the relevant price control. When both of these conditions are satisfied, Ofgem will claw back the tax benefit which results from the difference between actual and modelled interest costs in that year.

8.31 At the outset of the relevant Price Control Period, Ofgem require that specific modelling assumptions are made in respect of financing. However, as part of the Annual Iteration process, the tax liability allowance calculated based on these assumptions can be amended for the prospective period in accordance with the higher level of gearing.

8.32 There is no provision to give additional tax allowances where the licensee chooses to operate at a lower level of gearing than the modelled one.

8.33 The relevant steps taken in this calculation are as below:

i) Step 1: Compare actual gearing to notional gearing. For this purpose, actual gearing is defined as yearend net debt/year end RAV. If actual gearing is lower or equal, then no clawback applies. Where actual gearing is higher, then proceed to step 2.

ii) Step 2: Compare actual interest to modelled interest. If actual deductible interest is lower or equal, then no clawback applies. Where this is higher, then proceed to step 3.

iii) Step 3: The excess relief is calculated as actual interest less modelled interest. This is then multiplied by the corporation tax rate applicable for that year to determine the clawback adjustment.

iv) Step 4: If the clawback adjustment is lower than the tax allowed in the financial model for that year, then the adjustment is present valued using the applicable cost of capital and deducted from revenue allowances in the subsequent price control. To the extent that it exceeds the tax allowed (as may be the case for some of the GDNs), then the excess is instead added to the assumed regulatory tax loss for the year and carried forward.

8.34 Ofcom does not adjust for gearing clawback mechanisms, on the basis Ofcom do not appear to calculate any tax liabilities, and merely use the relevant tax rate for the period in the calculation of their pre-tax WACC.

Current conclusion

8.35 While the decision to pursue any clawback mechanism is ultimately a policy decision, we consider that since other regulators have applied a gearing clawback mechanism, and since the CAA itself has applied a mechanism to the regulated entity NATS, it would be reasonable for the CAA to include a gearing based clawback mechanism.

8.36 We are not aware that the CAA intends to apply an Annual Iteration process as part of the H7 PCM process.

8.37 On that basis, the approach taken for the NATS calculation appears reasonable for the purposes of the H7 PCM. We would expect that the CAA would define an appropriate notional level of gearing in the PCM.

[4] https://www.ofgem.gov.uk/sites/default/files/docs/2009/07/tax_clawback_open_letter-july09.pdf

9 Tax treatment of group relief

Approach to group relief

Background

9.1 Group relief allows losses to be surrendered from loss making UK companies to profitable UK companies in the same 75% group. In certain circumstances, losses in non-UK subsidiaries in EEA territories can be surrendered to UK group companies.

9.2 There has been significant reform to corporate tax loss relief rules in FA 2017. These reforms introduced greater flexibility for the utilisation of losses carried forward and also the ability to group relief carried forward losses.

Group relief – complexities relating to payments

9.3 Complications can arise where Groups of companies implement payment policies for group relief. There is no legislative requirement for claiming companies to make payments to the surrendering company for the losses it has used. However, Groups can implement such policies for commercial reasons where they see fit.

9.4 Where payments for group relief are paid at the full tax value (i.e. where the amount paid matches the exact amount of tax that would have otherwise been paid to HMRC were it not for group relief), it is effectively a payment of tax but to the Group company as opposed to HMRC. It is not obvious why the recipient of the payment should make a difference. It is easily arguable that there should be no difference between payments made to HMRC and payments for group relief (so long as they are made at full value of the tax).

9.5 Where payments for group relief are paid at below the tax value (or no payment is made at all), the Group will benefit as the amount that would have been paid to HMRC were it not for group relief exceeds the amount paid to shelter that payment using group relief. The Group could be argued to have gained a cost saving that could be passed onto the consumer.

9.6 Transfer Pricing legislation require payments between companies be undertaken on an arm's length basis (i.e. market value). This is not easily applicable to the payment for group relief given it is exclusively between 75% related companies (i.e. there is no market between third parties) and the value of losses to each Group company are not necessarily equal (e.g. a company with losses it can't utilise may be willing to sell the losses for below full tax value and a company purchasing the losses would pay anything up to the full tax value.

9.7 Based on HAL's tax computations for past five years, the group relief profile of the company is detailed below:

	Status	£
FY2013	Claimant	244,542,827
FY2014	Claimant	238,294,575
FY2015	Claimant	268,606,908
FY2016	Claimant	269,092,130
FY2017	Claimant	257,156,116

Regulatory precedent

9.8 There is no consistent approach regarding the payment of group of relief.

9.9 Ofgem disregards group relief in the assessment of tax liabilities and allowances for price control purposes.

9.10 Ofwat does not appear to prescribe a specific treatment. The water companies under its purview adopt very different approaches to group relief including some:

i) who explicitly state their group relief policy

ii) who explicitly state no payments are made for group relief

iii) who explicitly state payments are made below the full tax value

9.11 It is recommended a policy is formulated to ensure transparency to customers.

Current conclusion

9.12 It is our understanding HAL make payments for the use of group losses at the full tax value. As a result, the overall tax cost incurred by HAL remains the same, but the recipient of tax payments group companies as opposed to HMRC.

9.13 Given this, we do not recommend that any adjustment is included for the impact of group relief.

10 Tax treatment of brought forward losses

Corporate loss restriction

Background

10.1 Finance (No 2) Act 2019 introduced new rules in respect of the utilisation of brought forward losses for periods after 1 April 2017.

10.2 These rules apply a restriction on the utilisation of brought forward losses in excess of a £5 million de minimis threshold. This £5m allowance is available on a group basis.

10.3 Broadly, to the extent profits have not been extinguished by the use of £5m brought forward losses, and further losses are available, 50% of remaining profits can be sheltered.

Potential approaches

10.4 The approach to calculating the actual remaining profits to which the 50% restriction applies is both complicated and involved. The steps are as below:

i) calculate ‘modified total profits’

ii) separate modified profits into ‘trade profits’ and ‘non-trade profits’

iii) allocate ‘current year’ group relief and other ‘in-year reliefs’ against trade profits and non-trade profits to determine ‘qualifying trading profits’ and ‘qualifying non-trading profits’

iv) apportion the £5m deductions allowance to the two pools and to the total to create ‘relevant trading profits’, ‘relevant non-trading profits’ and ‘relevant total profits’

v) apply the 50% restriction to the resulting figures

10.5 In order to calculate a restriction, the above steps could be calculated as part of the model. However, this would add significant complexity to the workings.

10.6 Alternatively, the 50% restriction could be applied on a more general basis to remaining taxable profits after the application of the £5m de minimis. This may give rise to a materially similar position.

10.7 The loss restriction could also be ignored. However, given the rules are in place, this would not appear appropriate.

10.8 There will also be a requirement to consider whether HAL will have a £5m allowance, or whether this should be shared with the wider Heathrow group.

Regulatory precedent

10.9 Ofwat have considered this as part of their modelling and require that the model can deal with the £5m allowance and 50% restriction. They have also commented that there will be a requirement to consider whether each regulated entity would have access to a £5m de minimis but has not concluded.

10.10 Ofgem do not appear to comment on the new corporate loss restriction rules, given these were introduced after the current Ofgem policy was set in 2013.

10.11 Ofcom do not adjust for any loss restrictions

Current conclusion

10.12 Given these rules are new, there is not significant precedent to consider when coming to a conclusion.

10.13 However, given the potential impact, it would seem appropriate to model some impact.

10.14 We would recommend that the loss restriction of 50% of remaining profits should be calculated based on remaining taxable profits, in order to maintain simplicity and ignore group relief in line with the wider proposals.

10.15 We would also recommend it be assumed that HAL have access to the full £5m de minimis, unless otherwise advised by HAL.

10.16 In any instance, it is not apparent that HAL is expected to make losses during the period, so this functionality may not be utilised.

11 Tax treatment of deferred tax

Approach to deferred tax items

11.1 From an account's disclosure perspective, the financial statements for HAL will include a total tax charge / credit consisting of both current and deferred tax.

11.2 The deferred tax charge or credit will as such impact on the profit after tax for HAL and will be included as part of its retained earnings.

11.3 If this accounting expense is considered a cost to HAL which it would expect to be able to 'cover' as part of the process of setting the relevant prices, then there may be a requirement to model this as part of the PCM.

11.4 Other regulators make no reference to any adjustments made in respect to deferred tax and as a result it is not possible to confirm whether any adjustments are made (albeit we consider it unlikely).

11.5 HAL has the follow deferred tax attributes as per its FY2017 accounts:

(asset) / liability	2017 £m	2016 £m
Excess of capital allowances over depreciation	319	307
Retirement benefit obligations	(28)	(21)
Other timing differences	(7)	(5)
Derivatives	(125)	(149)
Revaluation of investment property to fair value	197	187
Tax on rolled over gains	8	8
Operational land	23	25

11.6 Each of these items are considered in turn.

Excess of capital allowances over depreciation

11.7 The current tax impact of these items will be captured in the model through the capital allowance methodology applied, as outlined earlier in this report. On that basis, there should be no requirement to adjustment for any deferred tax movement, as the cash tax impact of the deferred tax adjustment will be capture by the PCM.

11.8 As such, we would not recommend that any deferred tax movement on this item is modelled in the PCM.

Retirement benefit obligations

11.9 The current tax impact of these items will be captured in the model to the extent any pension movements are modelled in the PCM. It would not be possible to forecast any actuarial gains or losses, and any attempts to do so could potentially give rise to significant discrepancies between the forecast and actual position.

11.10 The FY2017 financial statements suggest that LHR Airports Limited intend to eliminate the deficit on the defined benefit pension scheme by 2022. This would reduce the level of fluctuation on the deferred tax and should mean that any movements beyond the forecast current tax adjustments do not materially impact on the tax profile of HAL.

11.11 As such, we would not recommend that any deferred tax movement on this item is modelled in the PCM.

Other timing differences

11.12 We are not aware of the nature of these balances. However, to the extent the movement is not considered material, and may be recognised through various revenue related items recognised elsewhere in the model.

11.13 As such, we would not recommend that any deferred tax movement on this item is modelled in the PCM.

Derivatives

11.14 To the extent the derivative movements are recognised through the statement of profit or loss, HAL does not bring the majority of the relevant income or expense into account, due to historic disregard elections or other tax shelter. Where these amounts 'crystallise' and the underlying hedging instrument is closed out, the fair value gain or loss shall be brought into tax.

11.15 In terms of a forecasting exercise, as per the financial statements it would not be appropriate or indeed possible to forecast any fair value movements, as these are driven by external and uncontrollable factors.

11.16 As such, we would not recommend that any deferred tax movement on this item is modelled in the PCM.

Revaluation of investment property to fair value.

11.17 HAL have confirmed that they do not intend to dispose of any investment properties during the regulatory period, so this deferred tax liability should not crystallise.

11.18 In terms of a forecasting exercise, as per the financial statements it would not be appropriate or indeed possible to forecast any fair value movements, as these are driven by external and uncontrollable factors, and so it would not be possible to model any movement that is not a full disposal event.

11.19 As such, we would not recommend that any deferred tax movement on this item is modelled in the PCM.

Tax on rolled over gains

11.20 HAL have confirmed that they do not intend to make any disposals which would give rise to chargeable gains during the regulatory period, so this deferred tax liability should not crystallise.

11.21 As such, we would not recommend that any deferred tax movement on this item is modelled in the PCM.

Operational land

11.22 HAL have confirmed that they do not intend to make any disposals which would give rise to chargeable gains during the regulatory period, so this deferred tax liability should not crystallise.

11.23 As such, we would not recommend that any deferred tax movement on this item is modelled in the PCM.

Current conclusion

11.24 We would not recommend that any of the deferred tax movements are modelled in the PCM. This is because the current tax implications of any movements are appropriately modelled, and all other items do not appear feasible to model.

11.25 This is also in line with discussions with the CAA, who suggest that deferred tax is not considered a cost which would be included in the price control exercise.

12 Tax uncertainty mechanisms

Sharing of tax risk

12.1 In any regulatory modelling exercise, there is a likelihood that the forecast information does not accurately represent the final tax charge.

12.2 To the extent these relate to variations in financial performance, our understanding is that any additional tax charge or benefit is expected to fall upon the regulated entity, on the basis these are items which are within the control of the entity, and as such this encourages the regulated entity to manage its business in an efficient manner.

12.3 However, to the extent that the differences relate to changes in tax rates and rules, there is an argument that the regulated entity should not bear these risks, as they are not able to forecast for or control against these.

12.4 Potential areas where there may be an argument to share tax risk could be as follows:

i) Changes to existing and announced corporation tax rates

ii) Changes to existing and announced writing down allowance rates

iii) Changes to interpretation of existing legislation, accounting standards, or HMRC policy

iv) Introduction of new tax legislation

12.5 Any tax uncertainty mechanism would need to ensure that tax risks are effectively managed by HAL and that the effects of these tax risks are borne by HAL. However, tax risks that are outside the reasonable management control of HAL could be expected to passed onto users.

12.6 As the political and legal risks identified above can result in increased or decreased tax charges, it would seem fair and reasonable for any mechanism to apply to either scenario, i.e. that both tax benefits and increases can be adjusted for and passed on to customers in the pricing mechanism.

12.7 There are also questions over the frequency of any analysis, and to what period any adjustment would apply. There would need to be consideration over whether this was an annual process, or whether this could be triggered on an ad hoc basis as required.

12.8 With respect to the period of application, it may not be appropriate for the pricing to be adjusted during the regulatory period, in accordance with the license arrangements. However, this could lead to a mismatch between any tax benefit or expense and the time at which this is passed on to the customer, in the case that the adjustment is applied to a subsequent period.

12.9 There is also uncertainty over the required threshold for an adjustment to be required.

Potential approaches

12.10 There are a number of approaches which could be taken in respect of modelling and adjusting for any tax risks.

No adjustment

12.11 The CAA has not historically adjusted for any of the above tax risks. Historically, this has meant that where the corporation tax rate has fallen, the regulated entity has benefited from a tax windfall and vice versa where the corporate tax rate has risen.

12.12 Where regulated entities receive such windfalls in the absence of any mechanism to force this benefit to be passed on to customers, this can lead to excess profits in the regulated entity.

12.13 The CAA could choose to encourage HAL to share any unexpected tax benefits with customers. However, in the absence of any formal mechanism to force the regulated entities to pass on any savings to customers, there is no guarantee that this will happen.

12.14 There are various advantages of not adjusting, the main being that this does not introduce significant additional complexity into the regulatory price control environment.

12.15 This approach also encourages the regulated entity to efficiently manage its tax affairs in order to benefit from any tax savings.

12.16 As such, it would seem appropriate to model some degree of pass-through in respect of tax risks which the regulated entity may be exposed to due to changes in the legislative or political environment.

Cost pass-through approach

12.17 One potential approach would be for taxation costs to be dealt with on a pass-through basis, i.e. the company can recover either the full cost or a percentage of the cost from its customers.

12.18 Typically, the costs which can be recovered would be those identified above, i.e. those that are triggered by legal or political changes over which the regulated entity has no control.

12.19 While this approach reduces uncertainty for the regulated entity, as it has more visibility over its expected risk profile, this also removes the incentive for the company to effectively manage its tax affairs.

Tax risk sharing mechanism

12.20 As the prices are set at given point in time, any subsequent changes to the legal or political environment will not be included in the pricing.

12.21 However, on the basis changes to the tax legislation occur on a yearly basis, this can lead to significant discrepancy.

12.22 This has been seen in historic regulatory periods where the headline corporate tax rate has fallen during the relevant period.

12.23 Any changes enacted which are considered to meet a certain trigger threshold to be defined by the CAA could then give rise to an adjustment.

12.24 This could be brought into account through either an annual iteration process or by an adjustment to be included in the subsequent regulatory period.

12.25 This approach introduces certainty to companies and customers where the relevant triggers are clearly documented and agreed.

12.26 This would place some regulatory burden on both the CAA and HAL, as both would need to understand, monitor and implement any changes.

12.27 This could also reduce incentives for the regulated entity to effectively manage its tax affairs but should retain the incentive to manage tax costs unlike the cost pass-through approach.

Regulatory precedent

12.28 We understand that the CAA has not historically included any such adjustment but may consider the inclusion of a tax uncertainty mechanism for H7.

12.29 Other regulators have taken varied approaches on this.

12.30 As part of the PR19 tax analysis for Ofwat, Deloitte concluded that the introduction of a formal tax trigger mechanism in specific areas would provide a fairer allocation of tax risk between companies and customers. However, the mechanism would increase the regulatory burden on Ofwat and the water companies and may also reduce incentives for companies to out-perform Ofwat's financial model as regards tax, as part of such savings may go to customers.

12.31 In particular, Deloitte highlighted that the treatment of capital allowances and the headline tax rates were the most material aspects of the regulated entities' tax profiles, and as such at a minimum these should be included in any tax clawback / risk sharing mechanism.

12.32 It was proposed that any such amendments would be run at the end of a given regulatory period for application in a subsequent period.

12.33 Ofgem takes a similar approach. However, as Ofgem updates tax allowances annually to reflect changes in corporation tax and the market cost of debt, they are able to apply these adjustments on a more real-time basis.

12.34 Ofgem introduced a tax trigger mechanism which had effect from 1 April 2010.

12.35 The tax trigger applies when a relevant change exceeds a given threshold, being either a one percent change in the corporation tax rate or a change of 0.33 percent in base demand revenues, based on the fixed amounts at the start of the regulated period.

12.36 There are two types of tax trigger events

i) Type A tax trigger events: changes to corporation tax rates applicable to one or more years or changes to capital allowance writing down allowance rates applicable to one or more years.

ii) 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 impact of case law, changes to HMRC interpretation of legislation, and changes in accounting standards.

12.37 For Type A events, Ofgem will notify the licensee that they intend to take account of the event during the Annual Iteration Process. The licensee can notify Ofgem if they consider there are any further Type A events

12.38 For Type B events, licensees must notify Ofgem where these increases or decrease tax allowances. Ofgem will then consider whether there is a need to apply the tax trigger process.

12.39 Ofcom does not adjust for tax risk sharing mechanisms, on the basis Ofcom do not appear to calculate any tax liabilities, and merely use the relevant tax rate for the period in the calculation of their pre-tax WACC.

Current conclusion

12.40 While the decision to pursue any tax risk sharing mechanism is ultimately a policy decision, we consider that since certain other regulators have applied a tax risk sharing mechanism, it would be reasonable for the CAA to include a tax risk sharing mechanism. Appropriate risks would be as outlined below:

i) Changes to corporate tax rates

ii) Changes to capital allowance writing down allowances

iii) Changes to applicable legislation, interpretation of case law, HMRC guidance and accounting standards.

12.41 We are not aware that the CAA intends to apply an Annual Iteration process as part of the H7 PCM process.

12.42 On that basis, the approach taken by Ofwat may be an appropriate basis for any CAA policy relating to tax risk sharing.

13 Appendices

Appendix 1: Sources of information

13.1 We have prepared our report using the following information as provided by Heathrow Airports Limited:

- 6.2. BAA Limited - Transfer Pricing Report - Analysis of Airport Support Services - Sep 2008 – PWC.pdf
- corporate-interest-return HMRC online form submission.pdf
- FGP Topco Ltd Group - Statement of Group Relief Claimed and Surrendered and Summary of Group Tax Position - YE 31 December 2013.pdf
- Final submitted Simplified-Arrangements-Dec 2014 v4 16.12.pdf
- Group deductions allowance statement 2017.pdf
- Group relief - final claims and surrenders matrix 2017.pdf
- Heathrow - AP15 AP16 - RD Claim Report - FINAL Issued 06082018.pdf
- Heathrow - Group relief simplified arrangements matrix - Year ended 31 December 2015 - resubmission.pdf
- Heathrow - Group relief simplified arrangements matrix - Year ended 31 December 2016.pdf
- Heathrow - transfer pricing debt analysis_FINAL 26022015.pdf
- HEATHROW AIRPORT LIMITED 16 - Online filing computation and return.pdf
- Heathrow Airport Limited Dec 201313 - Online filing computation and return.pdf
- Heathrow Airport Limited Dec 201414 - Online filing computation and return.pdf
- Heathrow Airport Limited Dec 201515 - Online filing computation and return.pdf
- Heathrow Airport Limited TC and return 2017.pdf
- Heathrow CA Pack - FY2013.pdf
- Heathrow CA Pack - FY2014 15.12.2016 Final - Updated for ECA claim and restated 2014 BCS accounts.pdf
- Heathrow CA Pack - FY2015 - RESUBMITTED Dec 17.pdf
- Heathrow CA Pack - FY2016 - Final - Adjusted for resubmission.pdf
- Heathrow CA Pack - FY2017 - v5 FINAL.pdf
- Heathrow Group 2017 CIR Return for submission to HMRC.pdf

13.2 We have also considered the following policy documents as published by the relevant regulators

- Economic regulation at Heathrow from April 2014: final proposals
- Estimating the cost of capital: a technical appendix to the CAA's Final Proposal for economic regulation of Heathrow and Gatwick after April 2014
- Ofcom Wholesale Local Access Market Review: Statement – Annexes 17 - 27
- Ofwat PR 19 Taxation Report dated 14 March 2017
- Ofgem GT1 Price Control Financial Handbook version 2.1 dated 10 July 2018
- Estimating the cost of capital for H7 – A report prepared for the CAA dated November 2017
- NATS (En Route) plc Regulatory Accounting Guidelines 2017

13.3 We have also gathered information through regular calls and meetings with Stewart Carter and Daniel Rock at the CAA.

Appendix 2: Scope of works

Scope of work

13.4 Please find enclosed our report pursuant to our Change of Control Notice 2869 – Variation 2.

i We enclose our agreed scope as per the aforementioned Change of Control Notice as an Appendix to this report

ii We have been engaged to provide tax advice to the Civil Aviation Authority only.

iii This report does not offer any legal advice other than advice on the tax law. Where appropriate you should seek such advice from your legal advisers. We will not draft legal documentation as part of our engagement.

Confidentiality and disclaimer

13.5 This report is confidential and has been prepared exclusively for the Civil Aviation Authority. It should not be used, reproduced or circulated for any other purpose, in whole or in part, nor disclosed to third parties, without our prior written consent, except as required by law or regulation or if disclosure is required to HMRC. Such consent will only be given after full consideration of the circumstances at the time. For the avoidance of doubt, we accept no duty of care nor assume any responsibility to any third party.

Forms of report

13.6 For your convenience, this report may have been made available to you in electronic as well as hard copy format. Multiple copies and versions of this report may therefore exist in different media and in the case of any discrepancy the final signed hard copy should be regarded as definitive.

Reliance

13.7 This report is based on current tax rates, tax legislation and HMRC's practice as at the date of this report which may be subject to future change.

13.8 While we have prepared our advice based on our interpretation of the legislation and HMRC current practice, you should appreciate that there can be no guarantee that HMRC will accept this. As with all tax planning, there is a risk that HMRC could challenge the analysis and conduct an enquiry into the tax return.

The general anti-abuse rule

13.9 The general anti-abuse rule (GAAR) is aimed at preventing abusive tax arrangements which would not have been contemplated when the relevant tax legislation was formulated. We have taken the risk of the GAAR applying to this particular transaction into consideration as part of our advice to you. However, while we do not consider that the proposed transaction is of a nature targeted by the GAAR, we cannot preclude the possibility that HMRC may seek to argue that the GAAR applies. The legislation and guidance in this area is likely to evolve as cases are brought before the GAAR advisory panel, the Tribunals and higher courts. There is, therefore, a risk that the tax advice that forms the scope of this engagement may be challenged by HMRC using the GAAR. In this event, it may require time and costs in disputing its assessment, even if you are successful in establishing that the GAAR does not apply. If HMRC successfully counteracts the tax planning in reliance on the GAAR, the transaction will not achieve some or all of its expected tax consequences. Where additional tax is assessed, interest and penalties may apply.

Scope of work – Specification – Tax policy & modelling for H7

13.10 This report has been adapted from the report produced as part of Phase 1 of our work to be made suitable for publication.

13.11 The report will outline/include:

- Commentary on the various tax issues considered as part of the agreed scope outlined in Phase 1 along with possible suggested modelling options considered, namely:
    - Applicable tax rates
    - Treatment of lifecycle costs (e.g. capital expenditure and tax adjusting revenue items)
    - Relevance of appropriate reliefs and allowances (e.g. capital allowances, R&D etc)
    - Corporate Interest Restriction
    - UK transfer pricing
    - Impact of possible clawback mechanisms (e.g. gearing clawback and uncertainty sharing mechanisms)
- The agreed modelling approach for inclusion in the H7 Price Control Model and justifications for doing so (quantum, availability of accurate forecasts, practicality of inclusion etc)
- regulatory precedent in respect of the issues outlined. Specifically we will consider the approach to tax taken by:
    - Ofwat
    - Ofgem
    - Ofcom
- executive summary summarising modelling approach taken in respect of all issues considered

Appendix 3: R&D expenditure credit scheme

13.12 These sections set out a series of steps to determine how the credit claimed should be dealt with:

Step 1

13.13 The credit discharges any corporation tax liability of the claimant company for the accounting period. The liability is not reduced by the credit but is settled by it like any other payment made by the company.

13.14 The RDEC is considered in respect of the liability for the accounting period and not the liability outstanding at the end of the accounting period, which may be different say as a result of QIPs.

13.15 If the discharge results in a repayment of liabilities paid at an earlier date, interest will be calculated on a last in first out basis (LIFO), giving the expected result that generally RDEC will not attract interest. The amount of RDEC remaining after the discharge is then subject to the following steps.

Step 2

13.16 This step restricts the potential payable element and ensures that loss makers receive the same net benefit as profit makers (the credit being taxable). This is achieved by retaining a ‘notional’ tax such that the total cash benefit for all claimants is equal to the expenditure credit, net of tax at the main rate of corporation tax. The ‘notional’ tax retained under this step is carried forward and available to reduce the corporation tax liability of a later period of that company

13.17 In preference to carrying forward the tax retained, a group company can surrender the amount to another group company.

13.18 A restriction also applies if the amount remaining after step 1 is greater than the net value of the set-off amount. When (for example) because the RDEC exceeds the liability that amount is to be reduced to the net value of the set off amount. This lesser amount is the amount taken forward to step 3.

13.19 If the amount remaining after step 1 does not exceed the net value of the credit proceed to step 3.

13.20 The net value of the credit is calculated by assuming that the credit is taxable at the main rate of corporation tax for the accounting period even if the company is actually paying tax at the marginal or lower corporation tax rates (see example 1). If the accounting period straddles two financial years and subsequently two main rates of corporation tax, the main rate should be apportioned on a time basis

Step 3

13.21 This step further restricts any payable element to the company’s total expenditure on R&D workers’ PAYE and NIC for the accounting period.

13.22 The calculation of the capped credit for R&D workers’ PAYE and NIC.

13.23 The amount which exceeds the cap is carried forward and added to any expenditure credit for the following accounting period.

13.24 Where the amount (of excess) is treated as an amount of RDEC for the accounting period by virtue of this step, having been brought forward from the prior year, it will not be subject to any further restriction at step 2 of the following year’s calculation due to the sum having already been fully taxed.

Step 4

13.25 Any amount remaining after step 3 is used to discharge any outstanding corporation tax liabilities (due but not settled) of the company for any other accounting periods. The legislation does not prescribe a priority order here, so it is up to the company decide. In the absence of any offset specified by the company, HMRC may use their discretion to apply the offset

Step 5

13.26 If the company is a member of a group it may surrender the whole or any part remaining after step 4 to any other group member, see CIRD89810. A company can chose not to surrender any amount and it remains as a potentially payable credit but subject to steps 6 and 7. This contrasts with step 2 where the retained tax not surrendered is only available to discharge a future CT liability of the company.

Step 6

13.27 Any amount remaining after step 5 is used to discharge any other liability of the company to pay a sum to the Commissioners, for example VAT or liabilities under any contract settlement.

Step 7

13.28 The final amount remaining is payable to the company provided that the company is a going concern.

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