



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 its 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 legislation).

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 2009¹. 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.

<i>Adjustments considered</i>	<i>Modelling approach</i>	<i>Chapter reference</i>
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.