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Appendix 8.1

OUR APPROACH TO TAXATION

September 2018

APPENDIX 8.1
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Taxation

The approach we have taken for tax in the Business Plan is in line with Ofwat's final methodology and fully reflects the final position taken in the specific areas where Ofwat has provided further clarity.

The appointed business publishes a transparent tax strategy in the Annual Performance Report (APR). In the directors' opinion, the strategy meets legislative requirements (contained in Schedule 19 Finance Act 2016) and will continue to be applied in the management of the appointed business' tax affairs. The quality of tax reporting in the APR is continually monitored which has helped promote Ofwat's ranking of the appointed business to 'self-assured'.

The tax allowance required by the appointed business in 2020-25 has been modelled on a standalone basis and uses a corporation tax rate of 17% throughout the five year period, being the rate to be introduced on 1 April 2020 (Section 46 Finance Act 2016). The rates for capital allowances are those currently in force as, unlike the headline tax rate, the Government has not given any indication of future changes. The main rates are 18% for the main plant pool and 8% for the special rate (or 'long life') pool.

Capital allowances pool balances relate solely to the appointed business and reflect the latest position submitted to HMRC (i.e. in the tax return for year ended 31 March 2017). They have not been adjusted for any previously disclaimed capital allowances. The Appointed business uses an independent industry expert to give advice on the allocation of capital expenditure for tax purposes. The same advisor has been used in the preparation of the tax table (App29) in the Business Plan. Capital allowances pool balances have been allocated across the four wholesale price controls in proportion to RCVs as suggested by Ofwat. This approach has also been used selectively in other areas.

Interest charged on the appointed business' borrowings is expected to be fully allowable for tax purposes, with no restrictions under the Base Erosion Profit Shifting (BEPS) legislation. Longer-term funds are generally raised in the bond market via a wholly owned UK-based finance subsidiary (Northumbrian Water Finance plc) and also, historically, with the European Investment Bank (EIB). We are currently uncertain whether the EIB will remain a strong supporter of the UK Water Sector post Brexit. Short-term funding is provided by a small group of key relationship banks. The appointed business does not use any overseas-based finance structures for the purpose of raising debt finance.

The tax allowance reflects the tax liabilities for the appointed business which, in reality, will include a mix of amounts payable to HMRC and amounts payable to related companies for the benefit of claiming group relief. For periods beginning on or after 1 April 2020, all tax instalment are due to HMRC within the financial year (Section 5, The Corporation Tax (Instalment Payments) (Amendment) Regulations 2017) while payments to related parties will reflect the prevailing rate of corporation tax.

With such a long planning period, there are clearly areas of tax uncertainty which could crystallise between now and 2025. For example the Office of Tax Simplification (OTS) began a new review in 2017 to look at the possible replacement of capital allowances by depreciation, and the last Labour Party manifesto included a proposal to raise corporation tax rates to 26%. Although the OTS effectively ruled out the 'accounts depreciation' option in its final June 2018 report, amendments to the existing capital allowances regime are likely. This, and potential tax rate changes should be catered for by Ofwat's new true-up mechanism for tax which will pass through the impact of changes of this type to customers at the end of the PR19 planning period.

Another potential area of uncertainty is changes in accounting standards. The accounting and tax impacts of adopting IFRS15 (revenue recognition) and IFRS16 (leasing), which have effective dates of 1 April 2018 and 2019 respectively, have been taken into account in preparing the Business Plan. IFRS16 is not expected to have a material impact on the company's tax position. We are not aware of any other major changes in standards that are planned.