Heathrow
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Dear Dan,

We have reviewed the Grant Thornton tax paper (CAP1876A "H7 Price Control Model – approach to corporation tax"), and information requests from you. In doing this we have considered the rational for moving away from the current method in the context of the overall purpose of the pricing model.

1. Rational for moving away from the current method

Grant Thornton's paper notes that the two key drivers for moving away from the current method are (i) significant expected capital spend anticipated due to potential Heathrow expansion activities, and (ii) large historic discrepancies between the Q6 allowance for tax and the actual tax liability in Q6.

Taking these drivers in turn, Heathrow expansion has been paused for at least a few years, meaning this driver falls away at this time. With regards to the second driver, we believe the Q6 methodology has produced a reasonable tax allowance compared to the actual tax liability over Q6.

To undertake a proper comparison of the Q6 allowance and the actual tax liability, following our initial conversation with you, for the actual tax liability, we believe you need to look at the SP group companies' ("SP group") position as a whole (the SP group being Heathrow (SP) Limited and its subsidiaries, which includes Heathrow Airport Limited ('HAL'), the main trading company). We view the actual tax liability for the SP group as being the total of all the taxable profits and losses for all these companies, multiplied by the tax rate applicable for the year in question.

We have provided you with the actual tax payable for the SP group for each of FY15-FY19. The difference between these tax payable numbers and the tax allowance for those years in the PCM is in our view not material, particularly in FY18 and FY19.

Our capital allowance claims have reduced over these 5 years, which is one key reason why our actual tax liability increased over this time. This reflects the lower level of capital expenditure in Q6 compared to previous Qs working its way through the allowances. Our capital allowance claims should continue at these more reduced levels of recent years, as our annual capex spend

forecast for H7 is unlikely to be higher than FY19 levels. Therefore, this should contribute to the tax difference in H7 being more typical of the difference we saw in 2019, rather than 2015.

We can also confirm that every year during Q6, total EBITDA for the SP group companies was very similar to SP group companies' taxable profits before deductions for capital allowances and finance costs. This should give you reassurance that there isn't any unusual specific tax relief being claimed.

Given this analysis of our historic tax position and the current status of Heathrow expansion, we believe that the reasons set out by Grant Thornton for moving away from the current 'pre-tax' method don't make the case for changing policy; such a change would be complicated to implement for all parties and may remove the incentive for Heathrow to run its tax affairs efficiently We'd therefore welcome your detailed views on the suitability of the current method prior to considering the practicalities of any alternative method.

2. <u>Benefits of the pre-tax method</u>

A key advantage of a pre-tax approach is that it provides a time consistent approach to taxation, in that although the pattern of actual tax paid may vary, over time the allowance will be appropriate. This was a point emphasized by the Competition Commission in their assessment of the correct approach to taxation for Heathrow in 2007.

Incentivising efficiency

While a post-tax approach could reduce uncertainty for HAL, it could remove the incentive for HAL to manage its tax affairs efficiently (for example properly making use of available reliefs), which would not be in the interest of passengers and airlines.

Carry forward losses

The interaction of a post-tax approach and losses carried forward leads to an inconsistent approach between taxation and other elements of the regulatory risk allocation. Tax losses are incurred as a result of revenue being significantly lower than anticipated in the Settlement. Such tax losses would be incurred irrespective of whether a pre-tax or post-tax regulatory approach was used and the mitigation they supply is an important aspect of the risk allocation implicit in the WACC.

With a pre-tax approach no account is taken of these losses in subsequent years. This ensures that the mitigation works as intended and the appropriate post-tax returns obtained. However, a post-tax regulatory approach that takes account of such losses would in effect remove this mitigation. It would create a time inconsistency in the approach to tax as losses incurred in one period would be carried into a subsequent period and thereby not supply the intended mitigation. In addition, the restrictions on applying losses to no more than 50% of taxable profit means that losses are likely to be applied over more years thereby increasing the risk of inappropriate transfers across regulatory periods.

Given the impact of Covid, issues arising from tax losses are material, for the CAA to change from a pre-tax to post-tax WACC approach at this time would lead to a very large time inconsistency and would not be consistent with good regulatory practice.

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3. Challenges with a post-tax method

Our overall observation is that Grant Thornton is essentially proposing that a five year mini tax computation forecast is prepared at the outset, but our concern is that the detail that would be needed simply won't be available at the forecast stage (especially the detailed breakdown needed for capital allowances). Tax returns are submitted 12 months after year end, when actual numbers and the detail behind them are known. Attempting to prepare a tax computation using forecast data for so many years in advance would inevitably be materially inaccurate.

Capital allowances

Capital allowances is a key number in our tax computations, and we need to consider what estimate is possible and proportionate for H7. The capex forecast for H7 is not designed for detailed tax work, and there is flexibility within the envelope of spend for the business to react to capital and investment requirements which may all have a very different tax treatment.

Currently, the detailed spend breakdown needed for the capital allowance analysis is first made available by the Forecasting team to the Tax team shortly before the year in question (for example November 2020 for FY21). The level of detail needed by the Tax team can't be provided any earlier than this because the Development team spend the prior year finalising the bottom-up detail of their envelope of spend for the coming year, including engagement with the CAA and airlines on what exactly is going to be spent.

The opening balance for H7 also won't be known until circa December 2022 when the FY21 tax return has been prepared. It will be hard to estimate what this will be before this time, as we may have decisions to make as to whether to disclaim allowances, depending on what the tax profile of that year actually looks like.

Capital allowance rules allow a taxpayer to disclaim allowances in any given year (i.e. chose not to claim any or all of your entitlement). A taxpayer can, if it's beneficial, claim allowances even if loss making thereby increasing the loss amount. Losses can then be carried forward or backward to different years (subject to various rules). It is an important point for 2020 and potentially 2021 if these are loss making years and we chose to disclaim capital allowances (thereby increasing the pool going forward) or we claim allowances and carry forward losses to future profitable years. And decisions on losses can therefore mean revisiting computations and subsequent adjusting to tax liabilities. Practically, it is very hard to anticipate what HAL will choose to do, as our tax position for future years simply isn't known and we have only filed tax returns up to FY2019.

With regards to structures and buildings allowance (SBAs), we have not estimated any forecast for what our SBA claims will be for H7. As explained above, the data available as part of the capex forecast isn't detailed enough. We don't yet have any historical data for SBAs, as we haven't made any SBA claim yet.

Materiality of other amendments

Many adjustments needed for tax returns are not material in the context of the PCM. AIA is in our view immaterial (£1m) and ECAs have been abolished. The super deduction is unlikely to be of any material benefit to us, due to the small timescale in which spend on new contracts needs to be incurred and our reduced capex profile for FY21 and FY22.

In terms of (i) disallowing revenue spend that is capital in nature for tax and (ii) claiming tax relief on depreciation for capitalised revenue expenditure, again we don't see these as material, and they would be difficult to estimate with the upfront forecast data.

Forecast one off adjustments

As Grant Thornton note, these are hard to predict, as by their nature they are one offs. Their paper comments that there is a wide range in disallowances for prior years, unfortunately we can't see where their numbers have come from in paragraph 5.5.

Amortisation

We don't view this adjustment as particularly material in the context of the overall revenue requirement, and in any event the difference in relief is only one of timing, not one of amount. As discussed in the capital allowance section, detailed software costs won't be available for the H7 period at this time.

Claw-backs/ later adjustments

Subsequently adjusting the allowance for tax to reflect actual liabilities would remove the incentive from HAL to manage its tax affairs efficiently (for example claiming all properly available reliefs). Further, the main reason for actual tax being different from forecast amounts is likely to be profit levels, and it wouldn't make sense to adjust for any actual tax if the underlying number to which it relates isn't also being amended. In terms of the practicalities of how an adjustment mechanism could work, aside from change in law adjustments, any other changes could only realistically be made once the tax computation for the relevant year has been submitted (12 months after the end of year in question).

4. Conclusions

Overall, we consider that the CAA has not made a compelling enough case for changing to a post-tax approach to the price control. The approach would add significant complexity for no additional benefit and risk introducing significant time inconsistency. We therefore consider that a pre-tax approach is still appropriate for H7 and that it should therefore continue to be used.

Yours sincerely,

Mike King

Chief Economist