3.1 Cost assessment: Business Rates

In the Draft Determination, Ofwat has assumed that Business Rates in 2020-2025 will be the same as the costs incurred in 2017/18. The implication is that Ofwat expects the revaluations in 2021 and 2024 will have no material impact on business rates.

In explaining why it assumes revaluations will have no material impact Ofwat has presented four lines of reasoning:

1. **Frequency -** It is less likely that companies will experience the large step changes in business rates compared to previous revaluations following the Autumn Budget 2017 which announced that the frequency of revaluations would be increased;
2. **Transition relief** - It is likely that transition relief will continue to apply to companies that experience a large change on revaluation of rateable values. This relief means any future large increase will be phased in over time rather than in one year.
3. **Degree of company control** - Companies have some control over the level of business rates they pay, for example as a result of efficiencies and by fully engaging with the Valuation Office Agency (VOA) in the revaluation process; and
4. **Forecasting difficulty** - There is no strong evidence with which to robustly forecast the impact of the 2021 and 2024 revaluations and therefore Ofwat have not taken them into account in our allowances.

We understand the reasons for Ofwat's position and in many areas, such as developer services, we support the emphasis on simplicity. However given the sensitive nature around tax we think there are strong reasons why a slightly different approach should be adopted for the final determination.

In this representation, we respond to each of Ofwat's arguments, demonstrating that the issues still arise. In particular we demonstrate that it is almost certain the revaluations will result in Business Rates expenditure being different to what Ofwat has assumed for PR19. This will mean some companies will spend significantly less on Business Rates than assumed and some more. Put another way, there will be winners and losers on this tax, and for some companies this will create windfall gains with the consequence that bills should have been lower.

The potential for windfall gains on this tax would be damaging to the sector. It would run contrary to:

- the overall approach Ofwat has applied to tax in PR19 whereby mechanisms were introduced to *pass through material changes in tax to customers* (see PR19 Draft Methodology).[1]
- the recommendations of the National Audit Office, which noted that Ofwat should look to increase the pass-through to customers of costs or benefits which are outside companies' control, such as general movements in taxation or borrowing rates;
- The views of stakeholders, many of whom have criticised the sector for not paying its fair share of tax, including Michael Gove who raised concerns about avoiding taxes and keeping chargers higher than they should be;[2]
- the views of our customers:
    - 59% of whom consider that Ofwat should correct at the end of the AMP for companies under or outperforming on business rates; and
    - 82% of whom consider that Ofwat should use the latest data available from the VOA to try to predict more accurately how business rates might change over the AMP.

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[1] Ofwat, PR19 Draft Methodology, p. 192, https://www.ofwat.gov.uk/wp-content/uploads/2017/07/Delivering-Water-2020-Consulting-on-our-PR19-draft-methodology-2.pdf

[2] Independent, https://www.independent.co.uk/news/uk/politics/michael-gove-water-company-bosses-speech-attack-audience-tax-executive-pay-a8235531.html

Our representation is structured as follows:

- Section 1 demonstrates that Business Rates will almost certainly change at the next revaluation and that the impact will be material despite the points raised in the Autumn Budget 2017;
- Section 2 explains how transitional relief works and why the assumption of gradual phasing is not appropriate;
- Section 3 provides details about how companies can reduce rates and the approach used, demonstrating the relatively limited scope for further changes; and
- Section 4 sets out our proposed solution, which prevents windfall gains on rates, incentivises reductions whilst utilises the best available information from the VOA.
- Appendix A sets out our customers' views on how business rates should be treated in the price review, reflecting a deliberative piece of research we undertook post DD.

1. The impact of revaluations on Business Rates

A key feature of the Draft Determinations is the assumption that there will be no material change in business rates at revaluation. In reaching this position, Ofwat cites the Government's decision published in the 2017 Autumn Budget to increase the frequency of revaluations, noting:

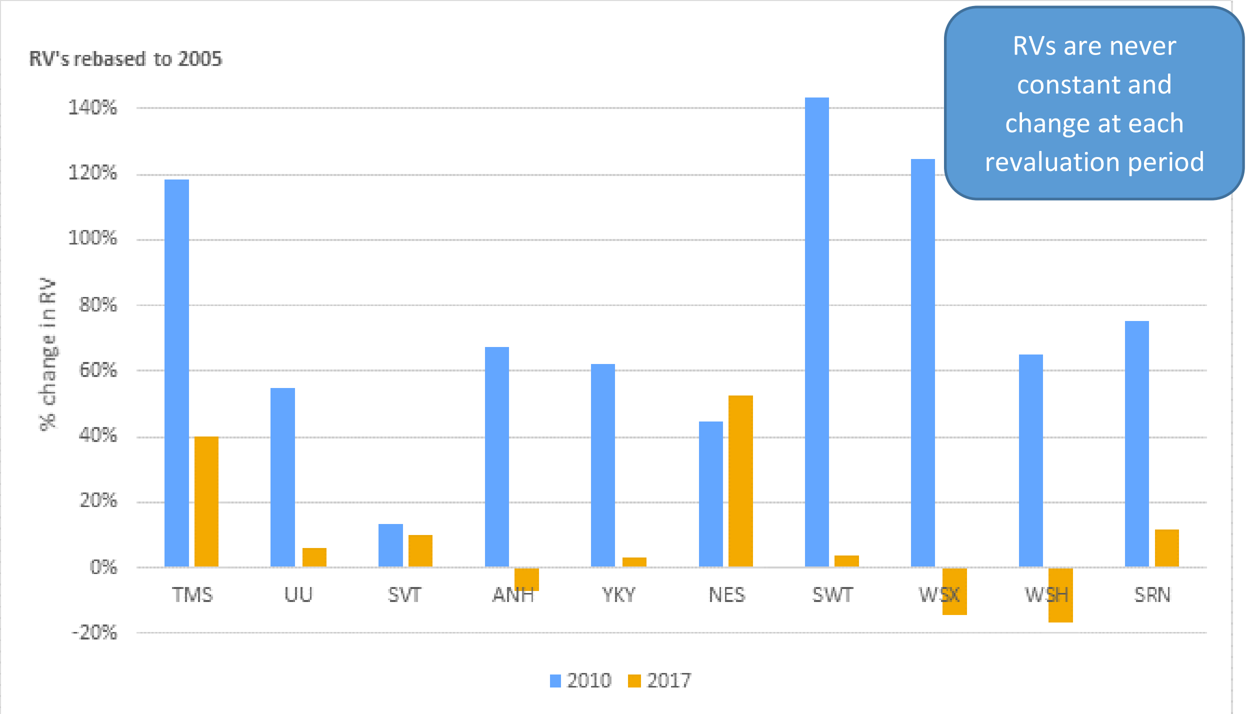
> *In the Autumn Budget 2017, the government announced that the frequency of revaluations would be increased to improve the fairness of the business rates system and to reduce significant changes to rateable values at revaluations. Therefore, it is less likely that companies will experience the large step changes in business rates that they have at previous revaluations. Equally, the range of impacts across the sector may not be as wide as it has been following revaluations historically.*

In this section we demonstrate that revaluations are likely to lead to a change in Business Rates and the shorter frequency would still mean the change is material. Furthermore, we highlight more recent Budget decisions that indicate more of the tax burden will be falling on immobile sectors like water.

1.1 Impact of revaluations

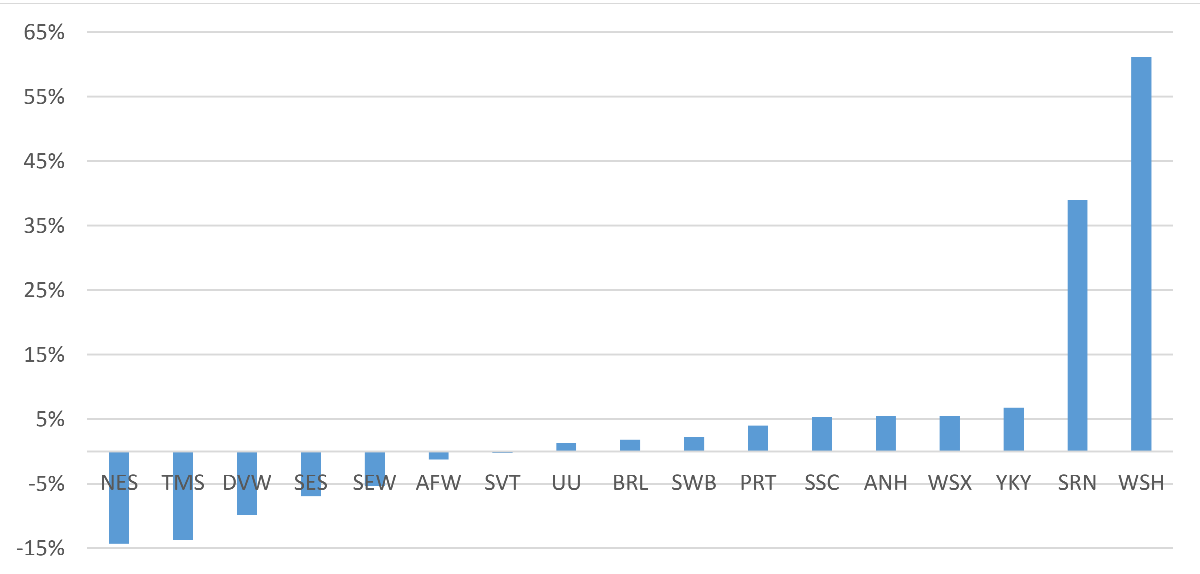
The one constant about Business Rates is that they are never constant. Historical precedent shows that RVs change at every revaluation. These changes can be either upwards or downwards and this will vary across companies. This point is illustrated in the figure below which shows the water RVs at each revaluation period.

Figure 1 – Percentage change in Rateable Values at each revaluation period



The impact of changing RVs at each revaluation ultimately means that there will winners and losers against Ofwat's allowance. This point is illustrated in the figure below where over AMP6 two companies have significantly outperformed Ofwat's allowance by more than 35% whereas five companies have underperformed by more than 5%.

Figure 2 – Business rates performance against Ofwat allowance - AMP6 to date



The key point to note is that the vast majority of companies have made windfall gains as a result of expenditure being different to what Ofwat has assumed. The impact on customer bills is significant.

For example:

- Welsh customers have on average paid £6.70 per year more than they should have;
- Whereas customers of Northumbrian Water have paid on average £3.30 per year less than they should have.

We do not think it is in customers' interests or the reputation of the sector that such gains should be earned from outperforming the assumptions on Business Rates.

1.2 Impact of more frequent revaluations

In the analysis presented in the previous sections, the revaluations were undertaken on a 5 and 7 year basis. We can appreciate that on first glance, a decision to shift revaluations to every 3 years might appear to reduce the volatility. However, we think that frequent revaluations do not remove revaluation uncertainty for AMP7, as it simply gives the Government more opportunities to change the tax base.

Water companies will now experience two revaluations over AMP7. Given the rapidly changing profile of the rates tax base and the pressure on the Government to reduce the burden of business rates on retailers and small companies, there is arguably more uncertainty rather than less for water companies. Recent Government policies to reform business rates will put further pressure on water and waste business rates (which will flow through the multiplier). In the 2018 Budget, the Government has committed to providing further Business Rates relief to small businesses. For example businesses with a rateable value of under £51,000 would receive a 1/3 discount on their rates bills. This is likely to be recovered from other tax payers such as sectors like the water sector which are immobile and considered more able to absorb taxes.

Our business rates take into account profits and capital investment, including engineering costs. These factors can be volatile due to changes in legislation, commodity prices and interest markets. This point can be best illustrated using the waste business rates, which are assessed using the formula set out below.

RV= (Capital Cost – Allowances) x Decap Rate

Uses asset detail from surveys & VO Cost guide

Uses VO allowance schedule

Set by Government

One of the key inputs into waste business rates are capital costs – reflecting the estimated replacement cost of a site. In calculating the capital cost the VOA examines how different inputs (ie, constructions costs) have changed since the last revaluation – this is done using the VO cost guide. On this subject, there is clear evidence that input costs and thereby capital have increased. For example the BCIS Tender Price Index, which was used by the VO in 2017, shows a 23% increase in costs. This underscores the pressure that business rates will face at the next revaluation.

Overall the evidence suggests that there will be pressure on business rates and that despite moving to a shorter timeframe the impact will be material.

2. Transitional relief work and why the assumption of "new relief" is not appropriate

In justifying the decision to hold the allowance for business rates constant Ofwat has also noted that *transition relief will continue to apply… This relief means any future large increase will be phased in over time rather than in one year.*

However as we show below it is wrong to assume that transitional relief would mean only small gradual increases in business rates.

Under the Government's rules on transitional relief, any water company would be eligible for transitional relief only if an increase in Business Rates exceeded 42%[3]. Even under this "relief" Business Rates would still increase by 42% in the first year, 32% in the second year and 49% in the third year, as illustrated below.

[3] HM Government, https://www.gov.uk/apply-for-business-rate-relief/transitional-relief

Figure 3 - Government transitional relief

If your bill is increasing

Rateable value	2017 to 2018	2018 to 2019	2019 to 2020
Over £100,000	42.0%	32.0%	49.0%

If your bill is decreasing

Rateable value	2017 to 2018	2018 to 2019	2019 to 2020
Over £100,000	4.1%	4.6%	5.9%

The clear implication on the Government's rules on transitional relief is that increases to rates will be felt quickly. As illustrated above, a company could be receiving transitional relief and still face a 123% increase in Business Rates over the period, while Ofwat's allowance assumes 0% change.

It is also interesting to note from the calibration of the transitional relief demonstrates that the Government is contemplating material movements in Business Rates and that increases are adjusted for far quicker than decreases.

3. Management control over Business Rates

In justifying the decision to hold the allowance for business rates flat, Ofwat also notes that companies *have some control over the level of business rates they pay, including as a result of efficiencies and by fully engaging with the Valuation Office Agency in the revaluation process*.

It is true that in prior years water companies have had some success in reducing business rates by engaging with the VOA to challenge either or both the methodology used and the accuracy of data.

At the 2017 revaluation the VOA spent considerable time developing a methodology that could be rolled forward, and which provides a prescribed basis for how Rateable Values for the sector should be updated at 2021:

- Water – rateable values will be updated for the PR19 financial model receipts and expenditure; and
- Waste – rateable values will be updated for AMP6 civil assets and changes to construction prices.

The VOA is now well established and supported by the outcome of the United Utilities Valuation Tribunal for their 2005 appeal. As a result we believe there is much less scope for businesses to reduce their business rates on the grounds of methodology.

This means the scope for influence comes down to ensuring the VO uses the most accurate data. We have worked closely with the VO helping them understand Ofwat's data tables and financial model as well as providing them with additional evidence to challenge their valuations where appropriate. There are diminishing returns from this activity, particularly for companies that were able to secure concessions in 2017 (as improved data is a one shot game). For example, we succeeded in moving the VO's assumptions on tenant assets from their out of date PR04 position to an updated list of tenant assets. Updating the tenant assets for the last three years of additions is unlikely to have as significant impact on the rateable value as it did at 2017.

4. Solutions and recommendations

The PR19 Draft Determination makes two assumptions that are unlikely to eventuate given historical experience – first that all companies will face similar movements in Business Rates; and second Rateable Values will be unchanged at 2021.

These assumptions also appear to be inconsistent with the VOA methodology, which could easily lead to a situation in which some companies significantly outperform on tax and others underperform. This outcome would run counter to the underlying message from the National Audit Office review of water regulation – which is to pass-through to customers of costs or benefits which are outside companies' control.

In other network industries regulators typically address this issue by allowing the cost of Business Rates to be passed through, treating it like other taxes such as Corporation Tax. For example the ORR allows a full pass through and so does Ofgem, provided companies can demonstrate that they have taken appropriate actions to minimise the cost to customers.

In the water sector, Ofwat has historically recognised that Business Rates are largely outside management control using sharing factors to provide companies *with a residual incentive to argue for reasonable treatment in the rating review on behalf of customers* (PR14 Final Determination). We believe this approach should continue for PR19.

We have identified a simple pragmatic solution that we believe should be introduced for the final determination.

Step 1 - Update the Rateable Values using the October VOA draft RVs

- Water – use the VOA's draft RVs published in October and update Business Rates in the final determination on this basis. This would be similar to the approach adopted at PR09 whereby Ofwat updated its Final Determination to reflect the new information from the VOA published in October 2009. This information could be used before the cost models and financial models are closed for the final determination.

Step 2 – Apply a Business Rates true-up mechanism at 2024/25

- Given the uncertainty in forecasting Business Rates, a simple solution would be to establish a true-up mechanism similar to Corporation Tax, but with a 75:25 sharing rate (customer:company)
- This asymmetric sharing rate would provide companies with a strong residual incentive to engage with the VOA and minimise business rates, whilst customers would get the majority of any upside, preventing perceptions of companies underpaying tax.

Appendix A

During August 2019, we conducted research with customers about how business rates could be accounted for in price setting. Using our online community panel, Tap Chat, we conducted an online focus group (11 participants comprising a mix of age, gender and location across the Severn Trent region) and an online survey (a representative sample of 500 customers).

In both elements of the project, we took customers on a journey, gradually introducing information about Ofwat, about Business Rates and about the potential impact of these on customers' water bills, before asking for their more informed view on two key issues. For each question, we provided the pros and cons of each answer option.

Our research found that:

- 82% of customers would prefer that Ofwat uses the latest data available from the VOA to try to predict more accurately how business rates might change over the AMP.

  "This seems a more accurate and fair way of estimating the future taxes"

  "Neither option will be 100% accurate according to you so you might as well have a stab at getting it as close as you can."

- 59% of customers felt that Ofwat should correct at the end of the AMP for any difference between estimates of business rates and the actual assessments. Of the 24% that did not believe a correction should be made, a number cited bill volatility as a potential concern.

  "If I, as a customer have been overcharged by a significant amount it seems fair and honest for me to be entitled to a refund of the excess. By similar logic it is only right that I should pay my share of a supplier's loss in the case of undercharging"

  "I think most people would prefer accurate bills, even if this meant less stability."