RWE NPOWER TAX COMMENTARY 2012

28 June 2013

An RWE company

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TAXES ARE IMPORTANT

The UK government uses taxation to raise funds that can help our communities – providing law and order, educating our children, supporting the arts, offering health and welfare services, and sustaining our country's operational infrastructure.

At RWE npower, we benefit from our business in the UK and **we're committed to paying the right amount of tax in the UK at the right time**.

This commentary talks about the taxes we pay.

We report our accounts on a calendar year basis and, unless we've said otherwise, this commentary relates to the year that ended on 31 December 2012.

In it, we refer to parts of the UK tax system that are particularly relevant to us, such as capital allowances. It's quite a lengthy commentary because it explains items of relevance for the first time. Future commentaries are likely to be shorter, but they may refer back to this document.

Its publication marks the only change we've had to make to be in complete alignment with the Confederation of British Industry's (CBI's) tax principles, issued on 7 May 2013. We were the first CBI member to confirm it would embrace those principles, which encourage companies to explain why and how they pay certain taxes in narrative reports just like this one.

I hope you'll find it informative and be reassured that RWE npower is a company that acts with unambiguous integrity and transparency in the management of its tax affairs.

Paul Massara
Chief Executive Officer

npower
An RWE company

RWE npower means the group of legal entities encompassing both Generation and Retail business, headed by RWE Npower Holdings plc.

PART 1
THE TAXES WE PAY

OUR TAX POLICY

Our tax policy was set by the RWE npower board. The responsibility for implementing this policy rests with our Director of Tax, who reports to the Board on a regular basis and ad hoc basis.

We insist on involving our tax team in all significant business developments, so that any potential tax consequences can be fully assessed in advance. If we find a material tax uncertainty, then we seek proportionate external advice from reputable professional firms.

Each element of our tax policy is consistent with the CBI's tax principles:

- we take a responsible, transparent approach to the management of our tax affairs;
- we don't exploit or bend the rules, and we don't use contrived or artificial structures to reduce our tax liabilities;
- we take advantage of reliefs and incentives where applicable but at all times we show respect for the intention as well as the letter of the law;
- we are committed to maintaining a professional, constructive and 'Low Risk' relationship with Her Majesty's Revenue and Customs (HMRC).

All 10 elements of our tax policy are included in full at the back of this commentary.

'The Government expects all businesses and individuals to manage their tax affairs in a responsible way.' HMRC

'Our statement of principles is intended to promote and affirm responsible business tax management by UK businesses.' CBI

ATTRIBUTES OF A LOW RISK BUSINESS

For a large business or group of businesses to be classified as Low Risk, it has to fulfil all aspects of HMRC's criteria in three areas. HMRC publishes these criteria; we've listed them here for reference. RWE npower has been classified as a Low Risk business by HMRC since 2008.

HM Revenue & Customs

Governance

- Be open with HMRC in real time about how it manages tax compliance risk across all relevant taxes and duties;
- Raise significant compliance issues, uncertainties and/or irregularities with HMRC in real time;
- Promptly provide full, accurate and helpful answers to HMRC queries;
- Be aware of its obligations across all taxes and duties, seek assistance as necessary and provide appropriate resources to deal with those obligations;
- Have clear accountabilities up to and including the Board for the management of tax compliance risk and tax planning.

Delivery

- Have a history of accurate and timely returns, declarations, claims and payments across all relevant taxes and duties;
- Have appropriate tax accounting arrangements in place.

Tax Strategy

- Not be involved in tax planning other than that which arises from genuine commercial activity;
- Not structure transactions in a way which gives a tax result contrary to the intentions of Parliament;
- Tell us about significant transactions involving innovative interpretation of tax law and fully disclose any legal uncertainty;
- Ensure that the business is not involved with illicit trades.

OUR GOOD RELATIONSHIP WITH TAX AUTHORITIES

All of RWE npower's business is taxed in the UK. Most of our tax affairs are therefore dealt with solely by the UK tax authorities, rather than overseas bodies.

We do, however, own and manage some combined heat and power (CHP) plant in the Republic of Ireland, but this is taxed through Irish incorporated, UK tax resident entities: the amounts involved are insignificant to the RWE npower group as a whole.

We are classified as a Low Risk business

HMRC classifies large business tax payers as being Low Risk, or not. To be classified as Low Risk, they have to meet HMRC's criteria in three distinct areas: governance, delivery and tax strategy. We understand that less than half do so.

We were first classified as having a 'Low Risk' status by HMRC in 2008. This was refreshed in 2012, following HMRC's satisfactory on-site review of the systems and procedures that are the foundation for our tax returns. Our status is next due for review at the end of 2015.

In line with HMRC's criteria for that Low Risk rating, we disclose and discuss tax issues in real time. We have regular update meetings, maintain an open dialogue and include extensive, additional, voluntary disclosures when we file our annual Corporate Tax returns.

Our tax affairs are as up to date as they can be

UK Corporation Tax returns must be filed within 12 months after the year end. HMRC have a further 12 months to ask us questions about those returns.

Our Corporate Tax returns have been approved up to 2010. We are not expecting significant enquiries to be raised about our 2011 returns, which were filed on time in 2012, because we discussed our tax position with HMRC in advance. With that in mind, we therefore have no need for tax provisions for 'uncertain transactions'.

OUR PROFIT AND TAX NUMBERS FOR 2012

Taxation is a complex part of any business's operation. The combination of legislative obligations and differing accounting standards can make it challenging for companies to clarify how their taxes do or don't relate to accounting profits or losses.

This can be an even more demanding exercise for large groups like RWE npower. Our annual results have to be published in three different ways, at different times:

- RWE AG group accounts show our 'operating profit' in €m under International Accounting Standards;
- our industry's regulator, OFGEM, demands Consolidated Segmental Statements that show EBIT (earnings before interest and tax) for regulated supply and generation businesses;
- UK legal entity accounts are prepared using UK accounting standards rather than International Accounting Standards. They are then filed at Companies House.

The figure that's quoted most often in press and parliamentary coverage is our 'operating profit'. We use International Accounting Standards to define this and quote the figure before interest, amortization and any non-operating items are taken off.

£7bn
UK sales

£390m
Operating profit

£277m
UK statutory profit

"We want to provide our shareholders not only with profitable returns, but also with an efficient, ethical commercial business in which they can have the utmost confidence.

To our customers we will deliver not only high quality, continuously improving products and services, but also a sense of integrity and transparency in their relationship with us and the way we conduct our business to fulfil their expectations of us as their energy provider."

Jens Madrian, CFO, npower

UK TAX IS PAYABLE ON UK TAXABLE PROFITS

To calculate how much UK tax we need to pay, we start with the statutory profit (the amount before tax for each individual entity) that's shown in the accounts filed at Companies House.

At the end of this commentary we've included a two-part reconciliation that shows:

- the relationships between our operating profit of £390m and the sum of all UK statutory profits before tax of £277m;
- the relationships between our expected Corporation Tax Charge on that statutory profit – a figure of £68m, representing 24.5% of £277m – and the actual Corporation Tax charge of £18m.

The first part of the reconciliation links our 'headline' reported profit to the actual starting point from which we calculate UK tax – the statutory profit before tax.

The second part is a required disclosure under UK accounting standards. It represents an aggregate figure that's calculated using the individual tax reconciliations we submit in around 25 sets of statutory accounts.

From this reconciliation, we can see that RWE Npower was tax profitable in 2012.

We can also see that the actual charge of £18m Corporation Tax is £50m lower than the expected figure of £68m. The main reason for this is that the capital allowances claimed were higher than the equivalent accounting depreciation. This is a temporary effect arising from our substantial recent investment programme, and is explained further at the back of this document.

CORPORATION TAX

Usually, the amount of Corporation Tax that's paid during a year and the amount of tax charged for a year are slightly different figures. This is because UK Corporation Tax is payable in instalments, half of which are due after the end of the year to which the tax relates.

Because those instalments are based on estimates of the expected tax liability for the full year, it's quite normal for them to vary from the eventual liability.

An example of this can be seen in the reconciliation in Part 3, where adjustments to our previous estimates of Corporation Tax are identified as 'adjustments to tax computed for prior periods'.

In 2012 this prior period adjustment was £3m adverse, which meant our 2012 tax charge was £15m. All things being equal, and assuming our forecast was perfect, we would have paid one half of that sum (£7.5m) during 2012 and the other half (£7.5m) in 2013. However, subject to the finalization of our accounts, we believe the £15m liability will probably be discharged by 2012 tax losses that were incurred by RWE's renewable energy division in the UK.

That business unit comprises a separately managed sub-group of UK companies, the RWE Innogy UK group. Those surplus tax losses have arisen due to Innogy's ongoing programme of significant investment into renewable energy, including significant amounts that have qualified for capital allowances.

"Tax avoidance means going against the spirit, and the intention, although not the letter of the law. We've not done that.

Responsible tax management includes making efficient use of reliefs and incentives that are designed to recognise not only productive business but also committed, strategic investment that contributes positively to a country's economic and social welfare or growth.

We take great pride in the integrity and transparency with which RWE npower manages its tax affairs."

Brian Harris, Director of Tax, npower

Group relief

Within the UK tax system, companies with a qualifying group relationship can choose to offset certain losses, including trading losses, against other group members' profits instead of carrying them forwards or back. This happens through a process known as 'group relief'.

HMRC permits group relief, because it makes sure that different business structures are taxed on a level playing field. Under group relief, the same amount of Corporation Tax is paid regardless of whether a business chooses to operate as just one company or by using several companies formed into a group.

Assuming that full group relief is available in 2012, RWE npower will settle its £15m liability by paying that sum to RWE Innogy for the surrender of their tax losses, instead of HM Revenue and Customs.

Other taxes

We recognise there's a growing interest in taxes paid by multinational companies. Our group's total tax contribution to the UK economy includes other forms of taxation. During 2012, through our operations and economic activity in the UK, we paid property and payroll taxes in excess of £140 million. This included:

- £27m of business rates paid to local authorities,
- £33m of employer's National Insurance Contributions

- which were a direct cost to our group, deducted before calculating our profit. We also accounted for £82m of tax and employees' NIC through PAYE.

PART 2
NPOWER AND THE UK TAX SYSTEM

CAPITAL ALLOWANCES

The cost of a capital asset, when it's being used in a business over a period of time, can be spread over the expected period of its use before it wears out. This is known as depreciation. Capital allowances give businesses a type of tax relief that's broadly equivalent to depreciation, because depreciation itself is not an allowable UK tax deduction.

Capital allowances are available on some but not all of a business's assets. The assets that do or don't qualify have changed over time, but recently we've seen moves towards removing tax relief for assets and/or reducing the rates of relief altogether.

Nevertheless, for some capital intensive businesses (those that need to invest heavily to operate effectively), capital allowances can provide a temporary benefit when the tax relief on an investment starts out being larger than the accounting depreciation.

The result is that taxable profits can initially be lower than 'expected'. Npower saw this happen in 2009-2011. This example shows how timing can impact on the differences between taxable profits and accounting profits (the figures are simplified).

Example

An existing energy company builds a new power station costing £1 billion. It is depreciated in the company's accounts over a 20 year period (£50m each year, for 20 years, equals £1 billion).

We'll assume that the capital allowance rate is 15%, which is the simple average of two rates that were available (10% and 20%) up to March 2012.

This percentage is applied to what's known as the unrelieved balance of expenditure each year. As an example, in year 6, capital allowances are (15% x Year 5 closing tax value of £444m) £67m.

This shows how taxable profits are initially lower than reported accounting profits, with the result that less tax is payable than expected.

But something that isn't usually as widely reported perhaps, is that in Year 8 onwards (as shown in this example) the difference then reverses so that more tax is payable than expected.

Over the life of the asset then, the total capital allowances will equal the total depreciation. Claiming capital allowances doesn't avoid tax - it just delays it.

Year	1	2	3	4	5	6	7	8	9	10	15	20
Accounts value of power station (start of year)	0	950	900	850	800	750	700	650	600	550	300	50
Expenditure in year	1000	0	0	0	0	0	0	0	0	0	0	0
Depreciation in year	-50	-50	-50	-50	-50	-50	-50	-50	-50	-50	-50	-50
Accounts value (end of year)	950	900	850	800	750	700	650	600	550	500	250	0
Capital allowances	150	128	108	92	78	67	57	48	41	35	15	7
Tax value (end of year)	850	723	614	522	444	377	321	272	232	197	87	39
Tax profit (lower)/higher than accounts profit by:	-100	-78	-58	-42	-28	-17	-7	2	9	15	35	43

POLITICIANS' VIEWS

Cross-party support exists for the role capital allowances can play to encourage real investment in the UK.

Conservative - May 2013

"Let me make one point clear. When we bring in a tax relief we want companies to use those tax reliefs. They are entirely legitimate, they are entirely legal, and they shouldn't – as is sometimes the case – be confused with tax avoidance."

Exchequer Sec to the Treasury, David Gauke MP

Oxford Centre for Business Taxation and Centre for Corporate Reputation Conference in London.

Labour - May 2013

"Sometimes there will be good reasons why companies pay little tax - some companies invest large sums in research and development, assets and infrastructure. We want that real investment here in Britain and we should encourage it, even when it temporarily reduces the tax those companies pay."

Corporate Tax Transparency and Reform

Liberal Democrats - May 2013

"The capital allowances are there to give tax advantages to companies who are making that investment. So I think it is important, whilst I completely agree with you we need transparency, we need to make sure that all companies - not just energy companies - pay the tax they should pay, if we also want to promote investment and encourage investment, when a company uses capital allowances, as Parliament wanted them to do, I don't think they should be criticised for that."

Ed Davey, MP

Evidence given to the Energy and Climate Change Committee.

DIVIDENDS

We're sometimes asked to provide more details about dividends that are paid to RWE AG in Germany.

RWE npower Holdings plc, our 'top' UK legal entity, paid a similar amount in 2012 as it has done in previous years (£125m).

No dividends have been paid so far in 2013 and none are currently planned.

Dividends paid are not deductible for UK tax purposes.

EFFICIENT FUNDING

We borrow internally, rather than externally, because it's cheaper for the RWE AG group to raise equity and loan capital centrally, rather than doing so in each and every territory. The funds that are raised in this way are then distributed around the group.

Most importantly, it makes no difference where we borrow money from. It could be a UK or foreign bank, or an RWE company in Malta, Germany or Netherlands but the source of funds makes no difference at all to our UK taxable profits. What does make a difference to our taxable profits, is the interest expense.

RWE npower plc's statutory accounts show that, in 2012:

- £600m was newly borrowed from RWE Finance BV;
- RWE AG in Germany replaced the group finance company in Malta as the main source of lending (without cancelling or changing the loans in place).

The RWE group raised £600m of debt finance from the market in early 2012 by issuing a bond through its finance company, RWE Finance BV. This is a Dutch company, subject to the rules and regulations regarding Dutch Corporate Income Tax based in the Netherlands. The bond matures in 2034.

RWE Finance BV has been the established group issuer of debt instruments to the capital markets for many years, giving the group an opportunity to raise relatively cheap funds directly, rather than using traditional routes – loans from banks.

Those sterling funds were borrowed for use in the UK. They were lent to RWE npower plc. As a result, the interest on that loan is payable by npower to RWE in the Netherlands, and from there, directly, to the external bondholders.

A small profit margin for RWE Finance BV was required by, and agreed with, the Dutch tax authorities, but the interest rate payable was still competitive. And in essence, RWE npower has – ultimately – borrowed that money from the markets: there is no question of any tricks or interposition of a company in a 'tax haven'.

INTEREST EXPENSE

In the previous section we talked about where our borrowing came from and why. The natural consequence of a loan is an interest expense, which reduces our statutory profit and taxable profits.

Presumably because of its impact on UK tax payable, the interest expense incurred by UK groups on inter-company borrowing from overseas affiliates has been questioned by the public and the media.

This is a complex subject, but these facts should explain our borrowing position clearly:

- Our business has always been financed with a mixture of equity and loan capital, even before RWE AG bought the UK business. This is common business practice.
- As Innogy Holdings plc (the independent FTSE listed group that was bought by RWE), on 31st March 2002 we had external debt of £2,562m.
- Our level of net debt due from RWE affiliates at the end of 2012 was slightly lower, at £2,475m. This comprised borrowings of £2,655m less cash of £180m, as per RWE Npower plc's statutory accounts.
- Taking our large investment programme into consideration, our level of borrowing would have been much higher if RWE hadn't contributed funding in the form of £1,050m equity in 2009.
- The amount we borrow in comparison to our value is annually reviewed by HMRC. This is known as our 'gearing' and, at the end of 2012, it was around 55%.

We don't borrow money to avoid tax. We do borrow money to help fund our investment in the UK business, to help keep the lights on and provide energy to homes and businesses across the UK. This is something that we've done before and after we became part of the RWE group.

The terms of our loans are fully disclosed in RWE Npower plc's UK statutory accounts. Over recent years the interest rates have averaged around 4% across a mix of our longer and shorter term borrowings. We don't think that our borrowing levels are excessive and neither does HMRC.

PENSION CONTRIBUTIONS

As a responsible employer, RWE npower sponsors a very large occupational pension scheme, with around 35,000 members including ex-employees and dependants. We monitor the funding position of our pension scheme closely and, on 31 March 2010, we confirmed that our Defined Benefit fund was carrying a deficit of £746.8 million.

Because we want to support the employees who've worked with us and be sure of meeting our liabilities in respect of their pension expectations, we agreed a ten-year repair plan with the pension Trustees – contributing increasing payments, annually, between 2011 and 2020.

The UK tax system allows us to make a deduction for company payments to the scheme, not only for ongoing employee service but also for reducing any deficit in respect of past service.

Due to those deficit payments, in recent years there's been a significant difference between the pension charge used to calculate our Operating Profit in the RWE group accounts, and the UK tax deductible payment amounts. The latter amount was £256m higher for the three years 2009-2011.

TRANSFER PRICING

Transactions between RWE group companies have to be conducted at 'arms length', as defined by the OECD principles. In particular:

- the sale or purchase of electricity and gas by RWE npower, with third parties or with other RWE companies, takes place entirely within the UK;
- no RWE npower trading profits or losses are accounted for or 'shifted' outside the UK;
- no royalties are ever paid to RWE in Germany or elsewhere;
- lending by RWE to RWE npower is at market related rates.

CAPITAL INVESTMENT

This commentary talks about the taxes we pay. In it, we've referred to some of the UK tax system features that are most relevant to our tax position and how they work.

To appreciate why those tax reliefs have such an impact on our corporation tax position, and such a disproportionate impact on us compared to the other large energy suppliers, it's important to take the relative levels of our capital investment over recent years into account.

RWE npower: the biggest spender

Over the 5 years to 2011, according to a 2012 report by Bloomberg New Energy Finance, we were one of the smallest of the Big Six energy suppliers, with one of the lowest profit margins, but we had the highest ratio of capital expenditure to operating income.

Or in other words, of the Big Six energy suppliers delivering fuel to homes in the UK, we, relative to our size, were the biggest spender.

For the 5 years to 2012, our figures were (in £m)

	Capital Expenditure	Operating Profit
2008	489	429
2009	862	220
2010	769	233
2011	522	313
2012	248	390
Total	**2890**	**1585**

On average npower spent 1.8 times our operating profit on capital investment. This does not include money that was invested in UK renewable generation by our sister company, Innogy.

In the last two years, RWE npower has commissioned two new state-of-the-art gas-fired power stations at Pembroke and Staythorpe, Nottinghamshire, as well as upgrading our existing plant. In the same period, RWE Innogy invested a similar amount into new renewable technologies. Together, RWE now operates both the largest renewable energy portfolio and the largest, most efficient gas-fired power station fleet in the UK.

In some ways then, it is fair to describe our investments as being disproportionately large. As a result, the relative impact of tax relief was much greater for us than that experienced by other companies that form the Big Six.

Our absolute level of investment in 2007-2011 for example, as reported by Bloomberg, was £2,761m compared to £2,897m by Centrica. But Centrica's operating profit for the same period was £9,499m compared to ours - which was £1,685m.

Any tax timing benefit that arises from similar investment amounts (both firms invested around £2.8 billion), will clearly make a bigger difference to the amount of tax that should be paid if the profits of one company are roughly 5 times smaller than the other.

PART 3
OUR FIGURES IN 2012

GROUP PROFIT AND TAX RECONCILIATION

		£m	2012 £m
Operating profit under IAS (EBITA) reported in RWE AG accounts			390
Less UK amortisation			(71)
Less UK interest expense			(114)
Adjust for non-operating profit (loss) not included above			
Profit on disposal (50%) of Horizon Nuclear Power Ltd. (HNP)			76
Restructuring and reorganisation costs			(28)
Differences between IAS and UK accounting treatments			
Pensions			10
Other			6
Exclude 50% share of HNP loss for year			8
RWE npower group UK statutory profit before tax			**277**
Excludes income from shares in npower subsidiaries	Split as:		
	Retail	138	
	Generation	139	
Expected current tax on UK statutory profit		at 24.5%	68
Adjustments			
Capital allowances in excess of accounts depreciation			(51)
Expenses not deductible for tax purposes (mostly goodwill amortisation)			24
Profit on sale of Horizon shares not taxable (substantial shareholding exemption)			(19)
Adjustment to tax computed for prior periods			3
Utilisation of brought forward tax losses (domestic gas business)			(7)
Actual current tax charge			**18**

RWE NPOWER STATEMENT OF TAX POLICY

Our tax policy was set by the RWE npower board. The responsibility for implementing it rests with our Director of Tax, who reports to the Board on a regular basis and ad hoc if the need arises.

- We manage our tax affairs responsibly and transparently.
- We don't bend or exploit the rules, and we don't use contrived or artificial structures to reduce our tax liabilities.
- We take advantage of the reliefs and incentives that exist but show respect for the intention, as well as the letter, of the law at all times.
- We actively seek open dialogue with Her Majesty's Revenue and Customs (HMRC) in pursuit of a professional and constructive working relationship.
- We are committed to conducting our affairs in a way that maintains our Low Risk tax classification, first awarded to us by HMRC in 2008.
- Our tax team is involved in all significant business developments so that we can fully assess any potential tax consequences of our actions in advance.
- If we find a material tax uncertainty, we seek proportionate external advice from reputable professional firms.
- We never deliberately conceal or knowingly misrepresent issues to HMRC. If we discover errors, then we disclose them.
- We take an active role in contributing to the UK tax policy-making process, where relevant, including by taking part in formal and informal consultations.
- We expect our UK Tax Team to maintain enough skilled resources so that we can adhere to the principles stated above – without exception.

By responsibly managing our tax affairs in line with all 10 elements of our tax policy, we are also fully adhering to the Confederation of British Industry's seven tax principles.

Paul Massara

Jens Madrian

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