

Business Rates Liabilities of Airports

March 2024



Changes in Business Rates Liabilities Calculation

Businesses pay rates on non-domestic properties based on valuations conducted by the Valuation Office Agency (“VOA”). The VOA conducts business rates valuations on a three-year cycle, with the most recent cycle starting in 2023.

For the 2023 cycle, the VOA changed its guidance on valuation of major international and regional airports from the Contractor’s Basis to the Receipts and Expenditure (“R&E”) method. In this blog, we set out some of the technical details of this change in methodology, and the implications for airports.

Contractor’s Basis

Under the Contractor’s Basis, notional rent payable for an airport hereditament (a property liable for business rates) was valued based on the estimated cost of building a replacement hereditament

R&E Basis

Under the R&E method, the notional rent payable for an airport hereditament is now valued based on the expected profitability of a business making use of that hereditament.

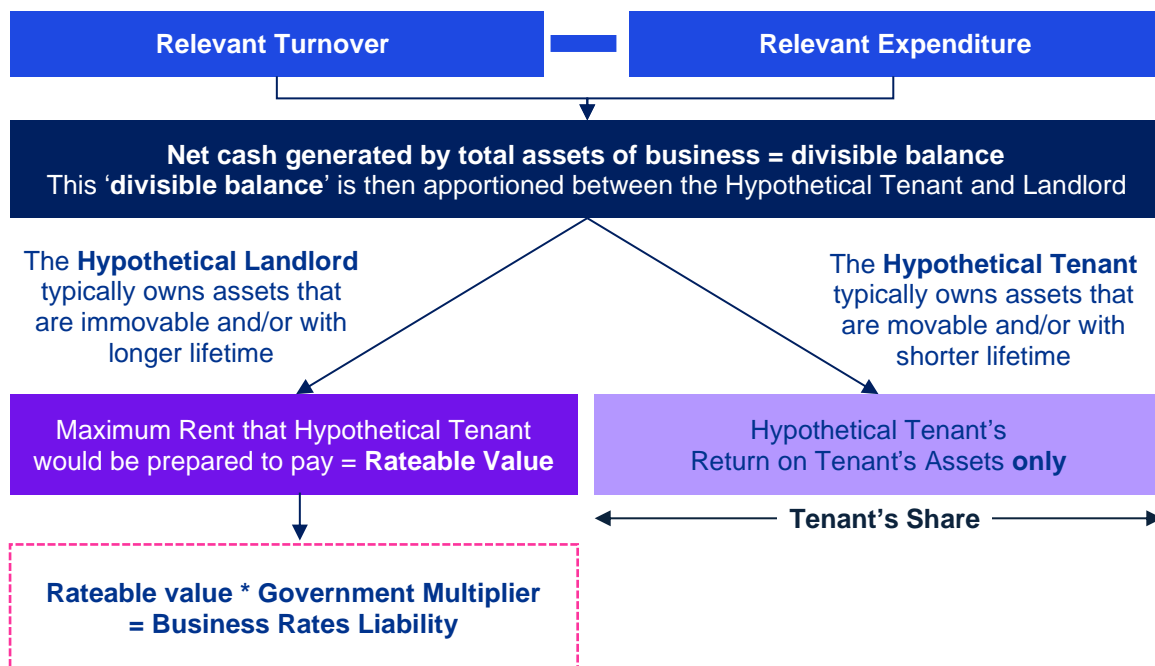
Receipts and Expenditure Method Overview – Estimating hypothetical market rent

The R&E method is typically used by the VOA in situations where there is minimal relevant rental evidence, and any rent payable would be likely to be dictated by the actual or anticipated profit of the business carried on at the hereditament. The method is intended to simulate a rent negotiation between a hypothetical landlord and hypothetical tenant.

The total profit generated by a business from the hereditament is referred to as the divisible balance, which consists of relevant turnover less relevant expenditure (turnover and expenditure are considered to be relevant if they are derived from, or attributable to the occupation of, the hereditament).

To arrive at the notional rent, the tenant’s share is deducted, which reflects the return a tenant would require to take on the tenancy at the agreed rent, considering the capital requirements and the level of risk to that capital.





The business rates liability is heavily dependent on the methodology used to calculate tenant's share, with a higher tenant's share corresponding to a lower liability.

In the airport industry, we are aware that the VOA have proposed two main approaches to calculating the tenant's share, with Option 1 being commonly used as the primary approach for the 2023 cycle:

Option 1 – Percentage of Divisible Balance

- The tenant's share is calculated as a percentage of the total divisible balance. The percentage used is typically based off an analysis of the split of fixed assets between the hypothetical tenant and hypothetical landlord.

Option 2 – Return on Tenant's Assets

- The tenant's share is calculated by applying an estimated weighted average cost of capital ("WACC") to the total value of the hypothetical tenant's assets, to work out the tenant's required return.

Based on our initial analysis, key considerations for the valuation of airports under the R&E method are likely to include:

- The approach taken to tenant's share calculation;
- Apportionment of assets between the hypothetical tenant and landlord;
- Identification of relevant intangible assets;
- Indexation of assets to a current-cost basis;
- Identification of allowable capitalised repairs; and
- The estimation of cost of capital.

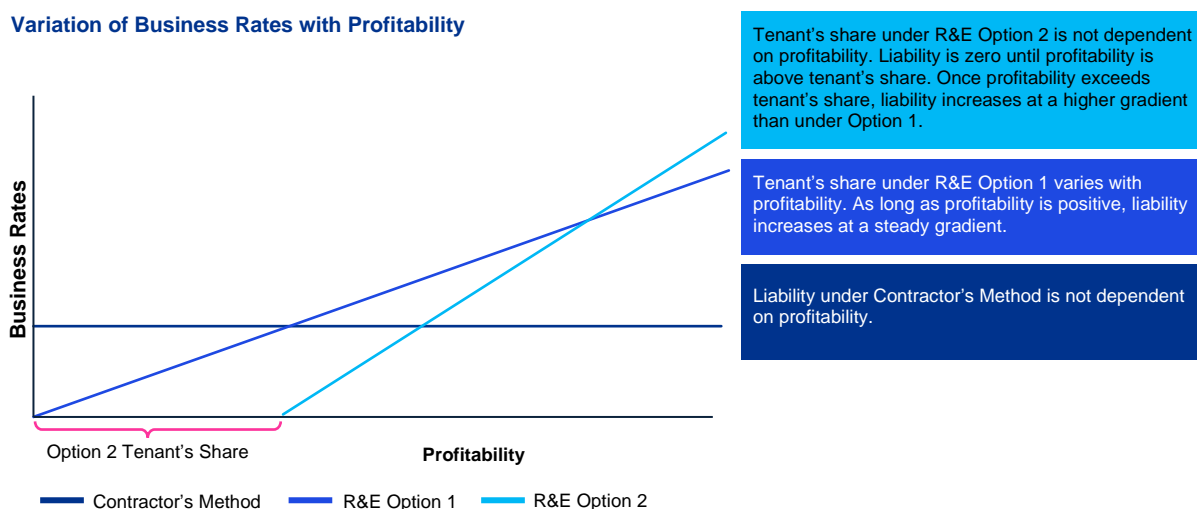
The Impact on Airports

The impact on individual airports is likely to vary significantly depending on their circumstances. Larger airports may have a greater value of land assets, and be able to operate more efficiently, leading to a comparatively higher liability. Variation in factors such as customer mix may also have an impact, with airports which attract a higher proportion of premium travellers also potentially seeing a higher liability under the R&E method.

If these differences in operating model have implications for the risk profile faced by the hypothetical tenant, this should be reflected in the R&E calculation, either through a risk uplift to Tenant's Assets, or through the WACC.

Airports should recognise that their business rates liability will vary with their profitability under the R&E method. The chart below compares how the business rates liability for airports varies with profitability under the Contractor's Method and both options for the R&E method.

Variation of Business Rates with Profitability



Tenant's share under R&E Option 2 is not dependent on profitability. Liability is zero until profitability is above tenant's share. Once profitability exceeds tenant's share, liability increases at a higher gradient than under Option 1.

Tenant's share under R&E Option 1 varies with profitability. As long as profitability is positive, liability increases at a steady gradient.

Liability under Contractor's Method is not dependent on profitability.

We understand that the VOA has typically provided significant allowances due to the impact of COVID-19 on expected profitability in the 2023 cycle.

As a result, the liability calculated for the 2023 cycle may not be an accurate reflection of the likely outturn in future cycles, with the removal of COVID-19 allowances likely to result in a substantial increase in liability in the 2026 cycle.

As this first post-Covid valuation is likely to start to establish precedent for future business rates cycles, we would strongly recommend that airports engage with the VOA well in advance of the next cycle to ensure accurate valuations under the new methodology.

KPMG Support

The business rates team at KPMG consists of experts in economics and regulatory finance. We have extensive experience of working alongside chartered surveyors to support companies across a range of industries, (including airports, water and telecoms), in reviewing valuations conducted under the R&E method.

Our recent experience has included helping multiple airports to understand the impact of the shift to the R&E method, identifying the key parameters of that R&E valuation, and ensuring that those parameters have been appropriately and robustly estimated. Outside of business rates, we have also worked with airports on wider regulatory finance issues including cost of capital estimation.

We have built a strong understanding of the R&E methodology and the issues that are likely to arise for airports and would be happy to discuss how we could support you in meeting those challenges.

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