

# Transport Perspectives



This edition contains two articles on highly topical issues with significant implications on the transport sector.

In the first article, Richard Lenthall examines the impact of the macro-economic slowdown on freight transport companies, and identifies possible actions they can take to boost their financial resilience, and improve their chances of surviving the downturn.

In the second, David Prestwich and Michael Everett look at recent developments in UK tax legislation that impact on the transport sector, and outline key future changes to the tax code which all transport companies should be aware of.

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# Financial Resilience in the economic slowdown - Freight

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## Introduction

This article examines the impact of the macro-economic slowdown on air, sea, and road cargo haulage from a Euro-centric perspective, but elements will apply globally: What is happening and what may be done to address it?

### A Gathering Storm

Three features are affecting the performance of many industry players and creating the conditions for a perfect storm:

#### Output, GDP and consumer demand

are all measures of activity in the world economy. The growth in all of these measures points in one direction; firmly decreasing. A consensus view is beginning to emerge: GDP growth is slowing and slowing fast. This is compounded by uncertainty in the Eurozone and the knock-on to exchange rates globally.

**Transport capacity.** Take, as an example, shipping's Baltic Dry index<sup>1</sup>. Through 2010 the rates averaged around 3,230; they bottomed in February 2011 at 1,386 and have recovered slightly to 1,500. The February number is of interest because it is a benchmark at which rates barely cover the operating costs, crew costs and fuel. Witness too, the number of laid up vessels, especially tankers, outside major ports or circling close to refineries waiting to unload. The position is likely to be compounded, in the short term. For example, new orders for container ships are expected to break previous records in 2012, with growth of 9.5% concentrated in the ultra-large sector and on Asia-Europe trade lanes. Most of the capacity growth is from Korea, China and Japan.

By September 2010, capacity for air freight (tafk<sup>2</sup>) had begun to exceed demand (tfk<sup>2</sup>) – a position not seen since July 2009 - and rates started to suffer. Recent figures from IATA disclose that air freight volumes have shown consecutive deteriorations since April 2011.

In road haulage, the market is characterised by pricing transparency between customers and hauliers, limited ability to distinguish service features between providers and contract lock-ins. Couple this to significant over-capacity and the rate consequences are obvious.

**Fuel price.** The price of Brent Crude has been highly volatile. Back in 2008 the average price was around US\$75 p/b. Recently, the Brent price has peaked at \$140 p/d, troughed at \$40 p/b and return to a peak of \$130+ p/b – against possible planning assumptions of \$75 p/b. A general industry view prevails that OPEC members will seek to balance their budgets within the range \$95-100 p/b, though going to press the price was stubbornly high at \$113.70. However, great uncertainty exists in terms of the balance between weaker demand driven by economic slowdown and the possible compensating effects of the US credit downgrade hitting the dollar and pushing oil futures upwards.

### Effect on Transport Groups

Some of the common effects of this situation which differ in severity across the main cargo/freight segments and across companies are:

- a) Over-capacity in the face of falling demand;
- b) Inflexible asset bases (long lead times for construction/order) which vary in the degree of efficiency and future relevance (regulation/technology/size); and
- c) Rising operating costs (driven by fuel, taxation and regulation).

The outcomes of this, for companies who fail to adapt, are a mixture of laying up aircraft in deserts, running ships at breakeven and potentially loss-making rates, ship yards and marine facilities under pressure (through lack of marine demand) and failing and uneconomic hauliers.

Transport groups have three options. First, they can continue to run assets and attempt to cover marginal costs or 'make a contribution' to overheads. This often is a perilous route, particularly where the operational gearing is high and the true variable costs are unclear or not fully understood and where there may be complex inter-relationships with associated revenue streams (for example for airlines under-wing versus over-wing). The problem with operating

<sup>1</sup> A wide-based index issued daily by the Baltic Exchange giving an assessment of the average rates for moving dry raw materials and commodities.

<sup>2</sup> tfk is a measure of demand for air freight, being tonnes in flown kilometres and tafk is a measure of supply, being tonnes available in flown kilometres.



all of a portfolio of assets at the marginal cost is that losses inevitably follow, since overheads and finance costs are not covered.

Second, they can lay up the assets. For aircraft, this may be easier than for a bulk marine carrier: dry storage in the desert is relatively cheap versus the marine options of idling in or out of port, stacking or taking the vessel out of class (incurring variously crew costs, port charges and insurance). For hauliers, the critical issue is labour costs. The amount of flexibility available here pivots around the terms and conditions, regulation and consequent labour exit costs. A major judgement here, apart from the cost of operations and potential to generate losses if rates further deteriorate, is the assessment of the duration for which the over-capacity or demand/supply imbalance will endure for. History suggests that many operators take this capacity/lay-up decision too late and under-estimate the duration.

Third, operators can sell out or scrap their worst performing assets. Clearly many assets will be uneconomic in the short term. Taking a wider perspective, many may ultimately prove to be obsolete and marginal given the new operating metrics around rates and costs (for example, fuel-inefficient aircraft). If rock-bottom buyers cannot be found, these assets should be the

first to be scrapped as capacity seeks to rebalance with demand. Whilst painful on the profit and loss account, such assets should be considered for sale to balance the efficiency of a more optimised fleet and to generate cash.

#### **Possible Actions - how to survive a downturn**

In order to survive, operators should take key steps to strengthen their business. Those that fail to do so are unlikely to survive in this prolonged downturn. The stronger players should be looking to buy relevant assets at highly discounted rates, or to buy whole operations and strip costs out to rebalance the rate/cost equation.

These key steps include:

**Get cash and liquidity sorted – and do it now:** Focus on cash generation and preservation. Revisit sanctioning levels and batten down the controls over who can spend and *commit* cash. The perfect storm is looming and it is likely to take time to ride out. Many companies risk short term liquidity difficulties, before they can get to longer term financial restructuring, as the fundamentals of the industries change over the mid-term. The position for many may be exacerbated by operators which are backed by sovereign wealth, where the operator enjoys either a strong balance sheet, or investors with deep pockets.

Such investors may capitalise on the prevailing conditions to achieve strategic gains in various markets.

**Review the fleet planning:** conduct objective scenario planning for a range of downside possibilities. Conduct these against several truly pessimistic cases – not just tinkering around the edges. Fully cost revenue streams, routes and assets and understand the step-cost base between fixed, semi-fixed and variable and evaluate the marginal profitability of the same at various stepped levels of volume. Develop new models for the business and economically evaluate them fully, free from emotion and politics.

**Contingency planning:** ensure that the red-lines are understood, at which point actions regarding fleet reduction (and associated cost mitigations) are to be taken. Ensure the supporting plans are *actionable*, not just wishful thinking or to be developed downstream.

**Cost reduction:** ensure that cost reduction plans are underway and delivering expected benefits. Remember that many organisations try to cut out layers of fat that have accumulated over years. Often, this approach leads to 'deaths by a thousand cuts' as layers are peeled off and new plans are constantly overlaid on the predecessor plan(s). The result of this

is all too often corporate fatigue, loss of critical staff and a failure to see where game-changing actions could be taken. Successful cost reduction plans aim to *cut hard and cut once*, looking to change the game early on – they match new fleet configurations to ‘must-have’ costs, not desirable costs.

**Operational governance:** Set up appropriate measures to ensure that actions are being taken as planned and milestones are being reached. Monitor performance of key metrics regularly and develop a series of forward, lead indicators. Put risk management at the forefront of meetings and develop indicators that trip actions.

Finally, create resilience and focus on *value protection*<sup>3</sup>. Value will be eroded from a number of angles as we have seen: declining, pro-longed weakening of demand and input cost (fuel) inflation and volatility. Even less predictable are disruptive events: the impact of the Australian flooding on the shipping demand, the Icelandic ash cloud incident for air freight, the Japanese tsunami or terrorism to name but a few. It is evident that value can be eroded much quicker than it can be generated in most scenarios – far-sighted boards will have recognised this and already taken some or all of the above actions.

Value protection is the value driver associated to stakeholders’ confidence in a management team to deliver cash flow and, ultimately, stay afloat. It provides a different focus to shorter term value realisation and mid-term value creation. Value is best protected when plans are proactively introduced without delay and free from reactionary panic. The aim is to create a well structured, resilient balance sheet and implement robust risk management around it, in the form of contingency plans, asset profiling and cash management. Cash may be king, but a resilient balance sheet is the fortress that protects it.

<sup>3</sup>The *value driver framework and value protection* are concepts used by KPMG firms that are explored in more detail in the article: *Stress in the Airline Sector*, dated August by this author.





# Trends and Developments in UK Tax

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At present, European economic crisis looms and the real impact this will have on individuals, on businesses and on nations is uncertain. However fiscal austerity, especially regarding public sector finances, is likely to feature on the landscape for several years to come, with potentially significant impacts on the tax system which will affect all transport companies.

This article looks at how the UK tax system is responding to the crisis, and developments which we might see over the next few years. While the focus is the UK, clearly this would be relevant for many countries across Europe.

Whilst the temptation arising from this economic situation may be to raise taxes, with corporate Britain being an obvious target, it would appear that the UK government has recognised that the approach of the last decade or so has been increasingly perceived as anti-business, culminating in some high-profile corporate migrations. Consequently it has introduced a number of regimes (some of which are still in consultation phase), aimed at making Britain a more tax efficient place for corporates to do business.

In this article we examine how the changing attitude of the UK tax authorities, as well as the impact of economic upheavals, has played out on the Transport sector. We then look at Government initiatives to reduce the tax burden on companies. The challenge for government will be how to make this reality, whilst dealing with the fallout from the current, arguably unprecedented, economic crisis.

## Trends in Taxation

When a large or cross-border business seeks to plan its affairs in a tax efficient way, there is no “right” answer. They should examine multiple choices with different tax analyses and consequences, from which they can choose.

Changes in UK tax in recent years have mostly been in one direction- increasing. For example higher income tax, higher VAT, higher National Insurance and 62% tax for North Sea oil producers. Corporation tax may be lower at 25% and a planned 23% by 2014 - in line with global trends - but Industrial Buildings Allowances have gone and the value of capital allowances on plant is reducing. From 1 April 2012 it will be 18% ( or 8% on long life assets) compared with 25% for most assets four years ago.

Ships and trains are no longer protected from this 8% “special” rate. Expenditure on ships and trains incurred from 1 January 2011 counts as long life. The air industry has retained a better deal as they can treat half of each plane as a long life asset and half as a standard rate asset. (However the BATA Agreement permitting this expires at the end of 2013 and aeroplanes are likely to follow ships and trains in losing this concessionary treatment).

In November 1996 when the long life asset rules came in, existing assets were “grandfathered” so that they would continue to attract allowances at the standard rate even if they changed hands. One might expect trains and ships acquired in the 1996-2010 period now to benefit from similar grandfathering but this is not the case. The seller can retain the right to main rate writing down allowances but, unfortunately, this cannot be passed on to a purchaser.



From 2000 the UK tonnage tax regime combined with the UK lease regime provided increase incentive for overseas groups to enter the UK. But over the years it seemed to get harder to enter tonnage tax. And when in 2009 HMRC changed their published guidance, to make it impossible for certain groups to enter tonnage tax, the shipping industry was highly disappointed. This guidance has recently been restored to its original state, which is welcome news for the industry. Difficulty remains in another 2009 change of policy which created a one-sided tax charge for tonnage tax companies which have intra-group loans (a regular commercial arrangement).

UK leasing was very attractive before 2006: lessors were given 25% capital allowances, meaning 95% of the tax deduction occurred over the first 10 years, whereas rental income might be taxed over 25 years. This was particularly valuable to those seeking lease finance for major assets like ships, aircraft and oil rigs. Banking profits were sheltered by the losses of the banks' leasing subsidiaries. This was often followed by a sale of the leasing company to a group with losses, such that the deferred tax liability never crystallised. Lessees shared some of the benefits.

The Finance Act 2006 saw tax leases stripped of much of their splendour. Most UK lessors of major items lost

capital allowances on new leases. A tax charge, ("the Schedule 10 Charge"), was brought in to tax the seller of a "burnt out" leasing company (i.e. one which has a deferred tax liability as a result of claiming capital allowances faster than accounts depreciation). This Schedule 10 charge is a major feature – and in our experience a potential deal-breaker – in transactions to buy and sell portfolios of leased transport assets. (Tonnage tax companies escaped many aspects of the 2006 changes as lessors into tonnage tax could usually retain capital allowances).

On 6 December 2011 we saw proposals to extend the capital allowances anti-avoidance rules. This will introduce a purpose test and will mean that from 1 April 2012 many types of capital allowances planning will no longer be permissible.

Planning ideas to accelerate or enhance capital allowances have been very popular with the transport sector in common with other users of large value pieces of plant or machinery. Turn the clock back only to 2004 and we saw the *Barclays Mercantile Business Finance Ltd v Mawson* case, where the House of Lords accepted that capital allowances were available to Barclays as a result of a complex tax scheme. In this case, the bank bought an undersea gas pipe from the Irish gas board and leased

it back under arrangements where the bank assumed little risk. Some saw the decision as confirmation that the "Ramsay Principle" (which states that where a transaction has pre-arranged steps that serve no commercial purpose other than to save tax, the correct approach is to tax the effect of the transaction as a whole) was no longer to be feared by the taxpayer wishing to indulge in "inventive" planning.

How do such schemes fare now? We have had the Code of Practice on Taxation, which seeks to prevent banks from facilitating tax structures. We have had the developing Disclosure of Tax Avoidance Schemes rules which HMRC uses to gather timely intelligence. And we have the attitude of the courts. Recently, in the *Samarkand* case, the First Tier Tribunal ruled that a sale and leaseback was not trading commercially. This will be of concern for organisations whose business is the sale and leaseback of assets such as ships and aircraft. The courts are definitely tightening the net on tax avoidance structures.

On top of all this, Graham Aaronson QC has now reported back on the feasibility of a statutory general anti-avoidance rule ("GAAR"). A GAAR has challenging aspects and it remains to be seen whether it will actually be introduced.



### Hope for the future?

We have seen that there have been many developments and the tax opportunities now are very different from those five or even two years ago. However all is not “doom and gloom”; given the government’s desire to encourage corporates to do business in Britain.

A series of major proposed changes include:

- the phased reduction in headline corporation tax rates from 28% in 2010 to 23% by 2014;
- the Corporation Tax Reform package, which includes the introduction of the foreign branch tax exemption regime; as well as a major shake-up of the UK’s complicated Controlled Foreign Company (“CFC”) regime (including the proposed introduction of a favourable regime for the taxation of group finance companies). Both of these initiatives represent a welcome move to a more territorial-based tax system;

- the introduction of the Patent Box regime (which will ultimately tax profits from qualifying patents at 10%, rather than at the mainstream corporation tax rate);
- the recently announced proposals on the introduction of an “above the line” R&D tax credit from 2013; and
- a genuine attempt to consult better with and listen to business before introducing new legislation, reforms etc

Transport businesses should ensure that they are prepared and ready to extract maximum benefit from these changes. They should be ensuring that they take advantage of targeted incentives in the “green” space, and where relevant the new R&D credits and Patent Box. Relaxation of the CFC regime from 2012 may also offer some opportunity for global restructuring – the finance company partial exemption regime and the more benign approach to leasing (announced 6 December 2011) should be examined to see how they fit into commercial group structures.

The KPMG Transport Group will continue to help our clients by bringing clarity where there is tax complexity, and assist them in navigating their way through these uncertain times.

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