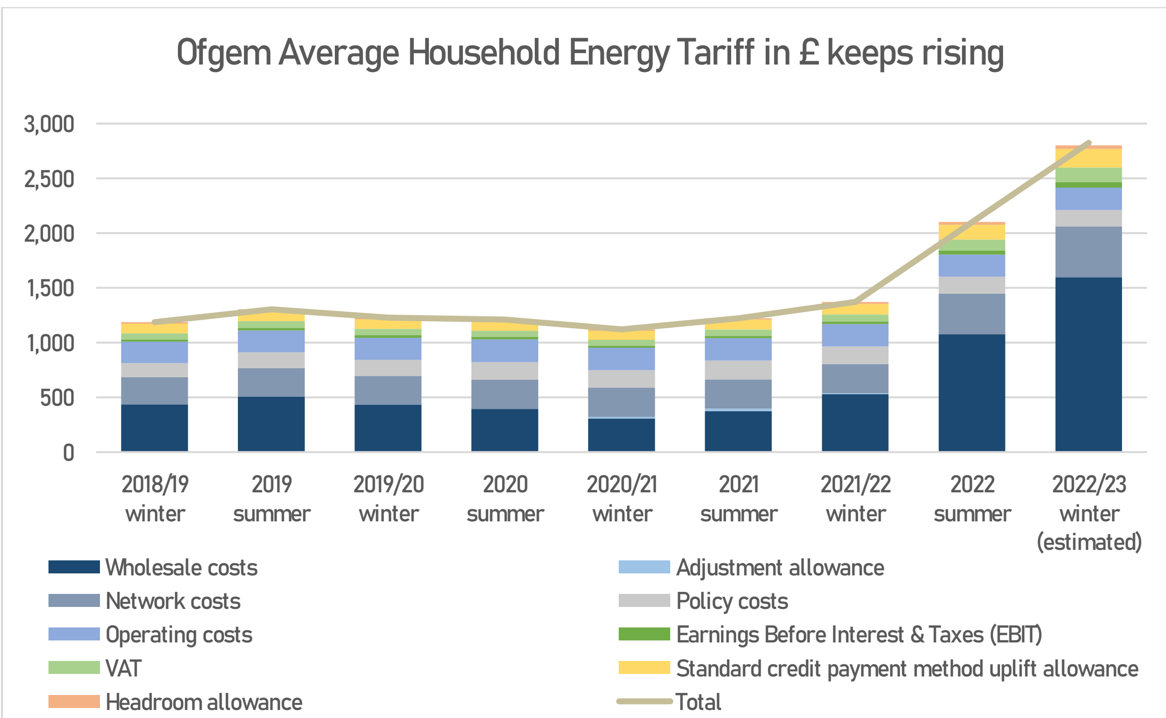
AozoraStep

The UK Energy Profits Levy

UK's Chancellor of the Exchequer, Rishi Sunak, announced the widely speculated windfall tax on oil & gas producing companies yesterday. The package would help most households with £550 energy subsidies, pensioners to receive £850 and 8mio of most vulnerable households to receive £1,200[1] (The Uk had around 27.8mio households as of 2020[2]). This largely offsets the increase in energy costs, which are set to rise to £2,800 in October, up £1,400 compared to pre-pandemic norm. Of the £15bn support package, £5bn is expected to be collected from oil & gas producing companies via a new Energy Profits Levy. This brings to mind, how exactly is the oil & gas industry taxed in the UK?



Source: Ofgem, personal estimate

[1] https://twitter.com/RishiSunak/status/1529790556695674881

[2] https://www.ons.gov.uk/peoplepopulationandcommunity/birthsdeathsandmarriages/families#:~:text=There%20were%20an%20estimated%2027.8,over%20the%20last%2010%20years

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The Ring Fence Corporation Tax

The UK corporate tax rate is currently 19% and will be raised to 25% next year. Oil & gas producing companies have had to pay higher taxes since the Ring Fence Corporation Tax (RFCT) was introduced[3], which is a 30% tax that replaces the corporation tax for these companies and has the following elements:

- Main: It works like the corporation tax, but profits cannot be reduced by losses from other activities or by excessive interest payments
- Disposals: If proceeds from a disposal of ring fenced assets are reinvested in other ring fence assets, then any gain on the disposal is tax exempt
- Capital Expenditures: Capital expenditures qualify for 100% relief from the EFCT
- Decommissioning: Expenditure on decommissioning of fields and assets qualifies for 100% relief until 17 April 2002 when the supplementary charge was introduced

The Supplementary Charge

The Supplementary Charge was introduced on 17th April 2002 at 10% and brought the total tax on upstream oil & gas companies to 40% in the UK[4]. The Supplementary Charge worked the same way as the RFCT except without the deduction for financing costs. Amidst rising energy prices, the Supplementary Charge was increased to 20% in 2006 and then to 32% in 2011, while also restricting for relief of decommissioning expenditure. As oil prices declined, the Supplementary Charge was then lowered to 20% in 2015 and back to 10% in 2016. The tax also allowed a 100% first-year capital allowance back in April 2002, but certain items, such as drilling, are excluded[5].

The Energy Profits Levy

The new Energy Profits Levy announced yesterday works just like the RFTC and the Supplementary Charge, but has no relief for financing costs and decommissioning costs[6]. It offers an investment incentive where 80% of the capital expenditure can be used to reduce profits subject to the levy. However, there will be no cross over from other levies and RFCT losses cannot be used to reduce profits subject to the Energy Profits Levy.

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[3] https://www.gov.uk/guidance/oil-gas-and-mining-ring-fence-corporation-tax#ring-fence-corporation-tax
[4] https://www.gov.uk/hmrc-internal-manuals/oil-taxation-manual/ot21200
[5] https://www.gov.uk/hmrc-internal-manuals/oil-taxation-manual/ot26056
[6] https://www.gov.uk/government/publications/cost-of-living-support/energy-profits-levy-technical-note

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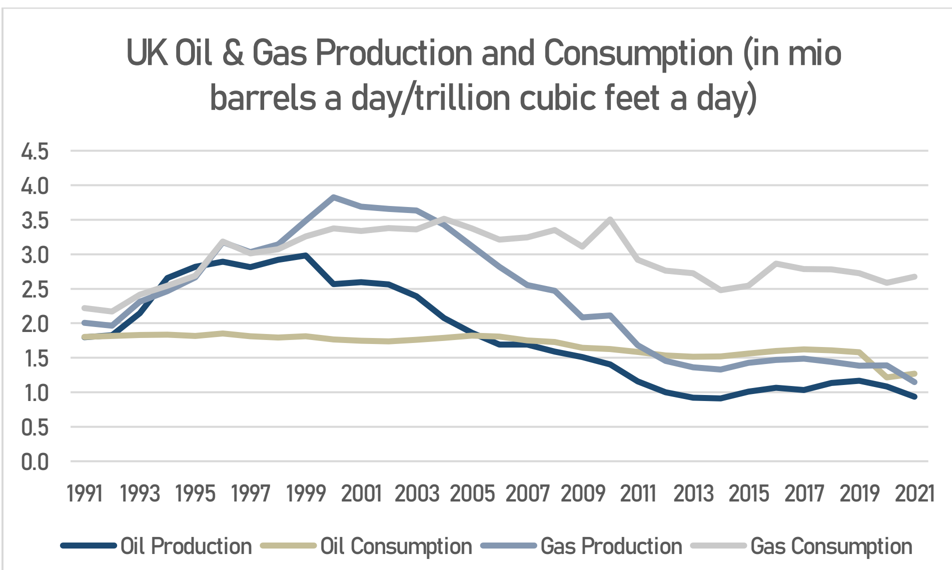
Which impact did prior tax rises have?

UK oil production peaked in 1999 and since then gradually declined until in 2006 consumption was above production for the first time since the early 1990s. The peak in production coincided with the introduction of new regulatory reforms, the Control of Major Accident Hazards Regulations (COMAH)[7]. Similarly, UK's gas production peaked in 2000 and by 2004 the UK became a net importer of natural gas. There is no doubt that heightened regulations and higher taxes have led to a decline in production of oil and gas. Some might argue that we are running out of reserves, but this is not true, as proven reserves need to be proven, i.e. explored to be added as reserves. Worldometers tracks UK reserves of oil, for instance, and although they are declining, every year new reserves are added, and between 1990 and 2000 actually increased[8]. The latest UK Oil and Gas Reserves and Resources report by the UK Oil & Gas Authority suggests that even in a year like 2020 where all drilling was stopped, 570 mmboe were produced and 270 mmboe were added to 2P reserves.



Source: EIA

7 https://www.hse.gov.uk/pubns/books/l111.htm#:~:text=The%20Control%20of%20Major%20Accident%20Hazards%20(COMAH)%20Regulations%202015%20came,Regulations%201999%20have%20been%20revoked

8 https://www.worldometers.info/oil/uk-oil/

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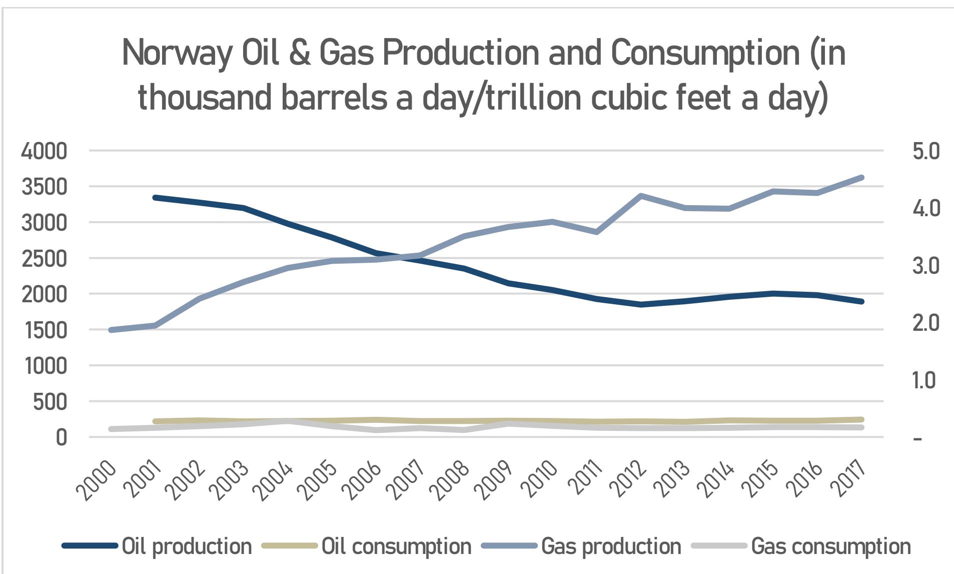
How does the UK compare to Norway?

In Norway the total tax rate on oil & gas production is a whopping 78%. While this at first seems like a lot and in a way shows that the UK can increase taxes without problems, there are important details to be known. The Norwegian corporate tax rate is 22% and this gives an additional 56% on top of that for oil & gas producers. However, different to the UK, the 56% special tax is purely focused on net income and can be offset with exploration costs, decommissioning costs and adjusts whenever the industry is in turmoil, such as in 2020 when depreciation and tax losses could be fully refunded[9]. This tax system is reflected in production, as although oil production has declined since early 2000, natural gas production has steadily climbed.



Source: EIA

[9] https://www.norskpetroleum.no/en/economy/petroleum-tax/

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Conclusion on the UK's Energy Profit Levy

Given the history and the structure of the Energy Profit Levy, I believe, despite the sunset clause of 31 December 2025, the levy will be permanent and will have sustaining damage on the industry and UK as a country of investment as a whole. Just a few weeks ago, Business Secretary Kwasi Kwarteng emphasized once again the importance of oil & gas investments in the North Sea[10]. The sudden U-Turn by Sunak could be seen as a betrayal of the industry. Importantly, with the energy transition in mind, the UK generated £25.9bn in Fuel Duty tax revenues (3.1% of total tax revenues)[11] and it is forecasted that in the current fiscal year, the UK will raise £7.8bn from the RFCT and Supplementary Charge (1% of total tax revenues)[12]. Therefore, I expect that the UK will soon have to raise taxes on renewable energy production to replace lost tax revenues, which will inevitably happen, especially in light of the new Energy Profit Levy, which will likely deter future investments.

[10] https://twitter.com/KwasiKwarteng/status/1525177655355654144

[11] https://www.ons.gov.uk/economy/governmentpublicsectorandtaxes/publicsectorfinance/bulletins/publicsectorfinances/april2022

[12] https://obr.uk/forecasts-in-depth/tax-by-tax-spend-by-spend/oil-and-gas-revenues/#:~:text=Since%202008%2D09%20UK%20oil,and%20higher%20tax%2Ddeductible%20expenditure

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