

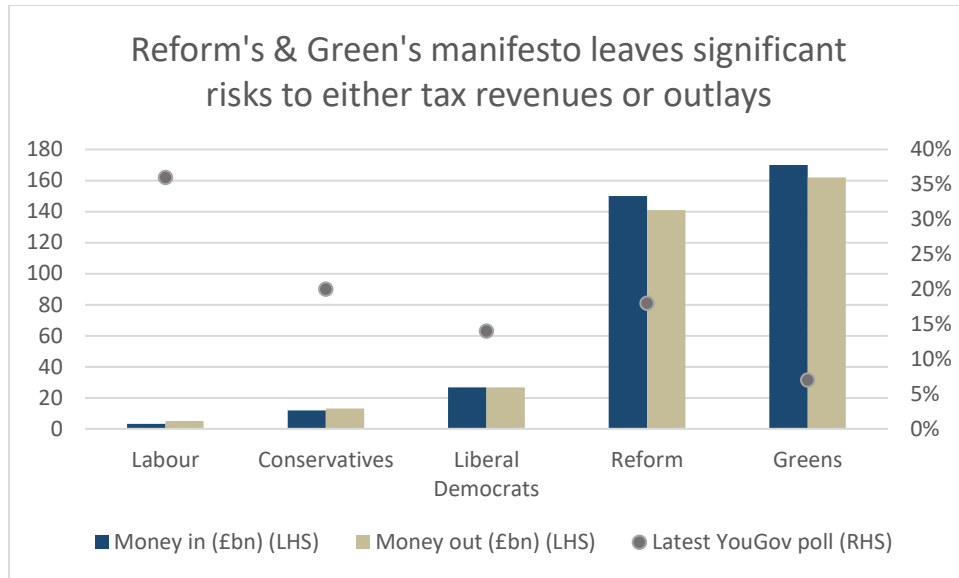
The UK in crisis & what could be done to avert it

When Rishi Sunak became Prime Minister, he set out these 5 goals to achieve by the end of 2023:

1. Halve inflation
2. Grow the economy
3. Reduce government debt
4. Cut NHS waiting lists
5. Stop the boats

Of these goals, only a halving of inflation was achieved, and this was not related to any governmental policies. Sunak's 5 goals, however, have really hit the nail on the coffin when it comes to what is most important to voters. According to a recent YouGov poll, 45% of Britons say the cost of living is their most important issue. This is followed by health at 34%, the economy in general at 32% and immigration at 26%¹. These concerns are not only on top of UK's voters' minds, but is a European, or perhaps even global developed nation phenomena where demographics increasingly appear to be hurting economic growth and prosperity. Migration seems to be a solution, but it is not so straight-forward. This note takes a closer look at these problems, beginning with immigration, followed by healthcare, water, a Labour government and solutions. While Labour is potentially gaining a super majority, the rise of extremes in politics could only increase over coming elections and the risk of error could also jump when comparing the significant changes to the government's budget and tax changes proposed by Reform and Greens vs. the established parties.

¹ <https://yougov.co.uk/politics/articles/49594-general-election-2024-what-are-the-most-important-issues-for-voters>

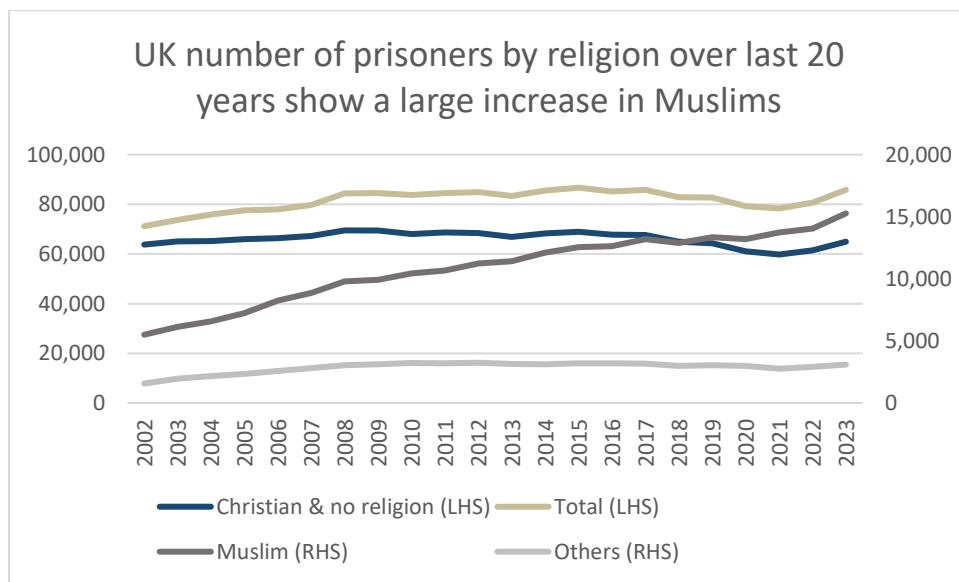


Source: Individual party manifestos

Illegal migration & crime (?)

The initial rise of Reform as a political party in the UK is mainly attributable to Brexit and high migration. Recent polls have now shown Reform even overtaking the Conservatives (although not necessarily solely because of migration). How could migration become such a big problem even with Brexit? Between 2018 and June 2023 a total of 91,918 illegal migrants arrived by boat in the UK. The peak occurred in 2022 with over 45,774. This means around 0.137% of the UK population lives illegally in the UK just counting those who arrived by boat over the last few years. Most of these migrants come from countries that are culturally very different from the UK, have ongoing wars or economic struggles, such as Iran, Iraq, Afghanistan, Syria or Eritrea. However, do these illegal migrants cause crimes other than entering the country illegally? When comparing this to the UK prison population, it becomes clear that the entire growth in prison population from around 75,000 in 2004 to 85,000 in 2023 has come from Muslims as a religion. The Muslim prison population has increased from just over 5,000 in 2002 to over 15,000 in 2023 (+200%), while the population of Muslims in the UK has grown from 1.5mio in 2001 to 3.9mio in 2021 (+160%) and makes up around 6.5% of the total UK population as of 2021 yet takes up a share of 18% of the UK's prison population. Furthermore, as the prison population has declined by those aged <30s and increased substantially by those aged 50+ and 40-49 years old over the last 20 years, hence indicating a decline of criminals that are born in the UK. At the same time, 75% of the people arriving by boat are aged

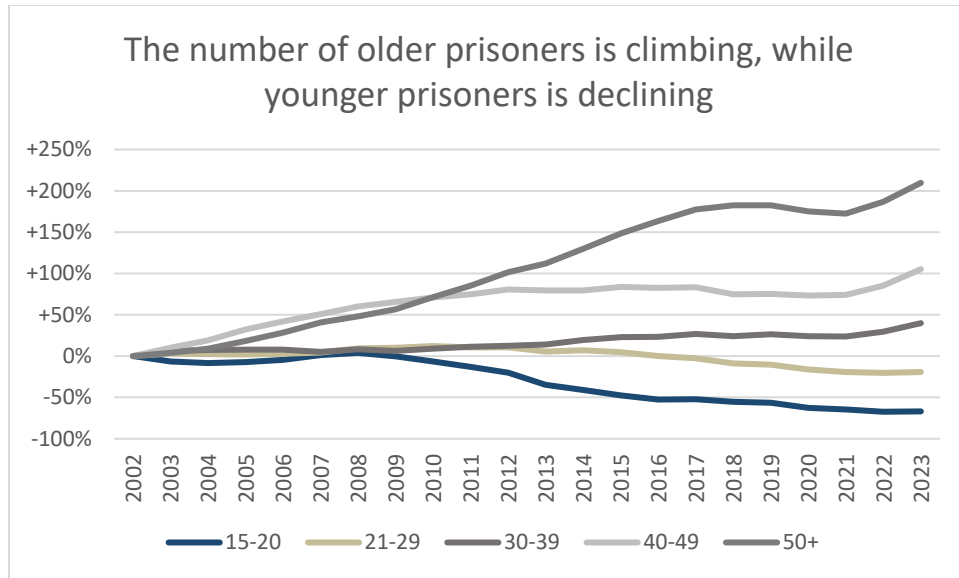
<30 years or younger², hence there is no strong positive correlation of the number of prisoners in the UK and the number of illegal migrants arriving here. Overall, these numbers do not suggest that (illegal) migrants are more prone to committing a crime and ending up in prison (yet). The numbers do suggest, however, that Muslims are 3x more likely to end up in prison than non-Muslims in the UK, and this can explain why there is a desire to reduce migration from certain war-torn countries in the Middle East. Overall, the number of crimes being reported is generally coming down when it comes to violence, theft and burglary, but is not coming down as quickly when including fraud and computer misuse. Importantly, sexual offences have quadrupled over the last 10 years alone. In general, crime remains a key problem that can best be seen in the justice system, which has accumulated a record 67,573 outstanding caseload as of end of 2023, 78% higher compared to end of 2022 and 18,045 cases are over one year old.³ The contention of this topic is unlikely to be addressed by the main political parties – at least for now.



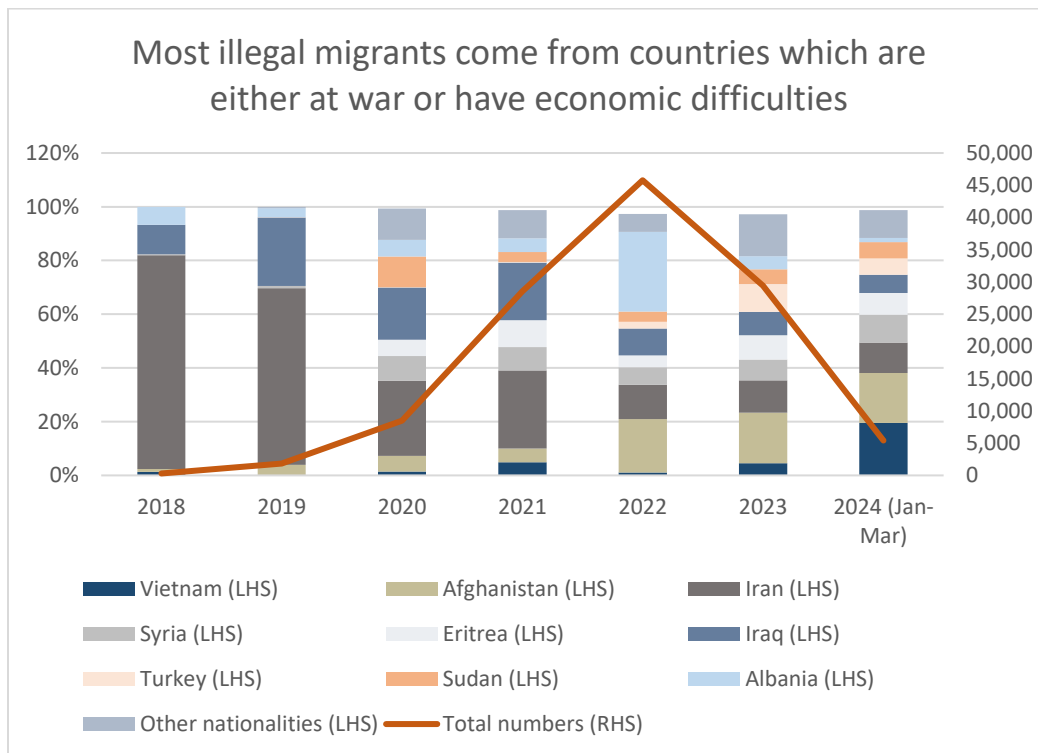
Source: MoJ, Offender Management Statistics Quarterly

² <https://www.migrationwatchuk.org/briefing-paper/505/gender-and-age-of-illegal-boat-crossers>

³ <https://www.lawsociety.org.uk/contact-or-visit-us/press-office/press-releases/backlogs-continue-to-spiral-in-crisis-ridden-criminal-justice-system#:~:text=the%20Crown%20Court%20backlog%20reaching,for%20two%20years%20or%20more>



Source: MoJ, Offender Management Statistics Quarterly



Source: Office for National Statistics – Census 2021

UK population by religion

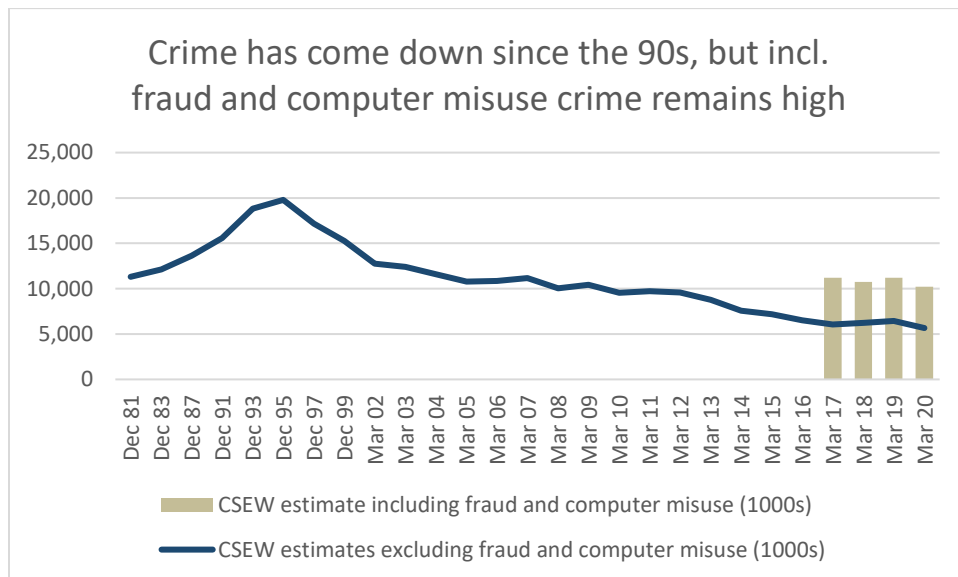
Religion	2011	2021
Christian & no religion	84.5%	83.4%
Muslim	4.9%	6.5%
All others	10.7%	10.2%

Source: Office for National Statistics – Census 2021

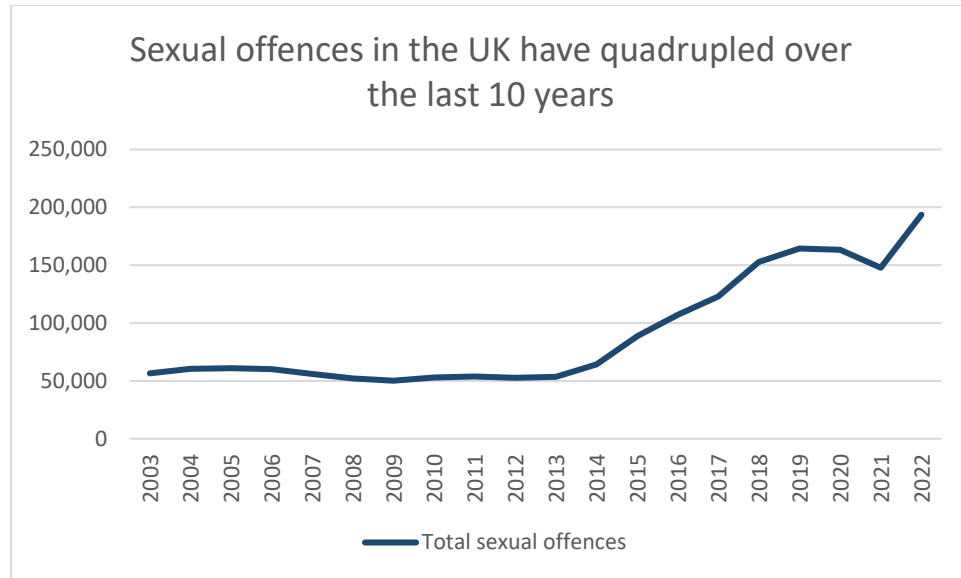
Percentage of category of offence for imprisonment July-October 2023

Offence for imprisonment	Percentage of total
Violence	32%
Sexual offence	20%
Robbery & Theft	17%
Drug offence	17%

Source: MoJ Offender Management Statistics Quarterly, July to October 2023



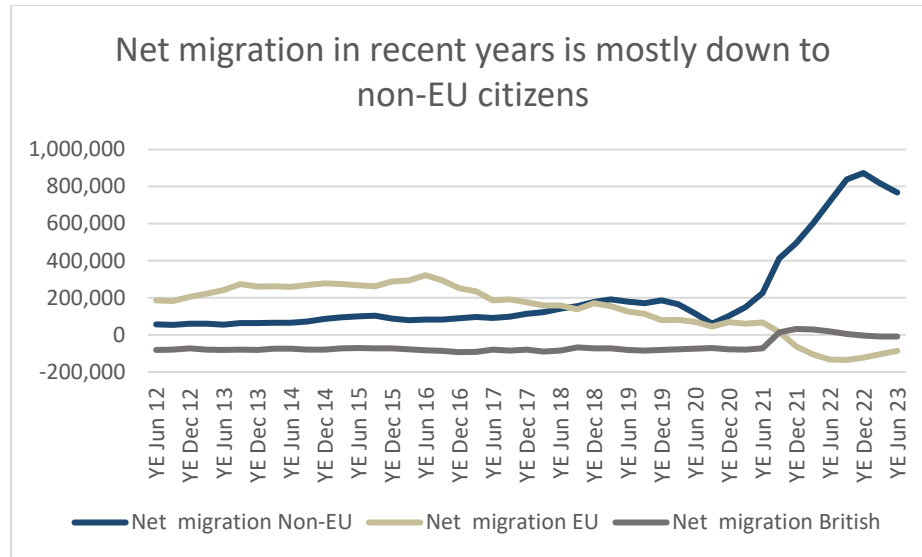
Source: Office for National Statistics



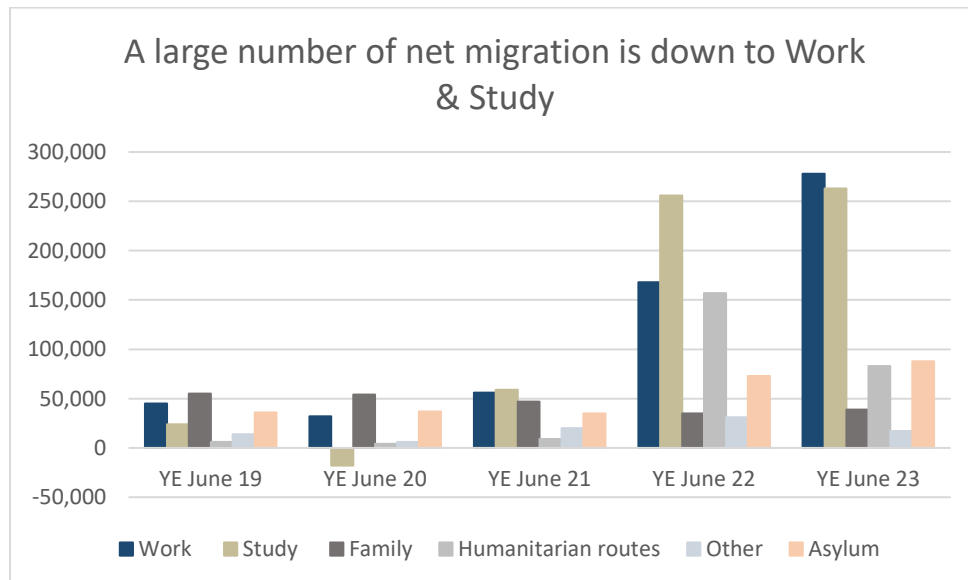
Source: Office for National Statistics

Legal migration patterns are shifting rapidly, too

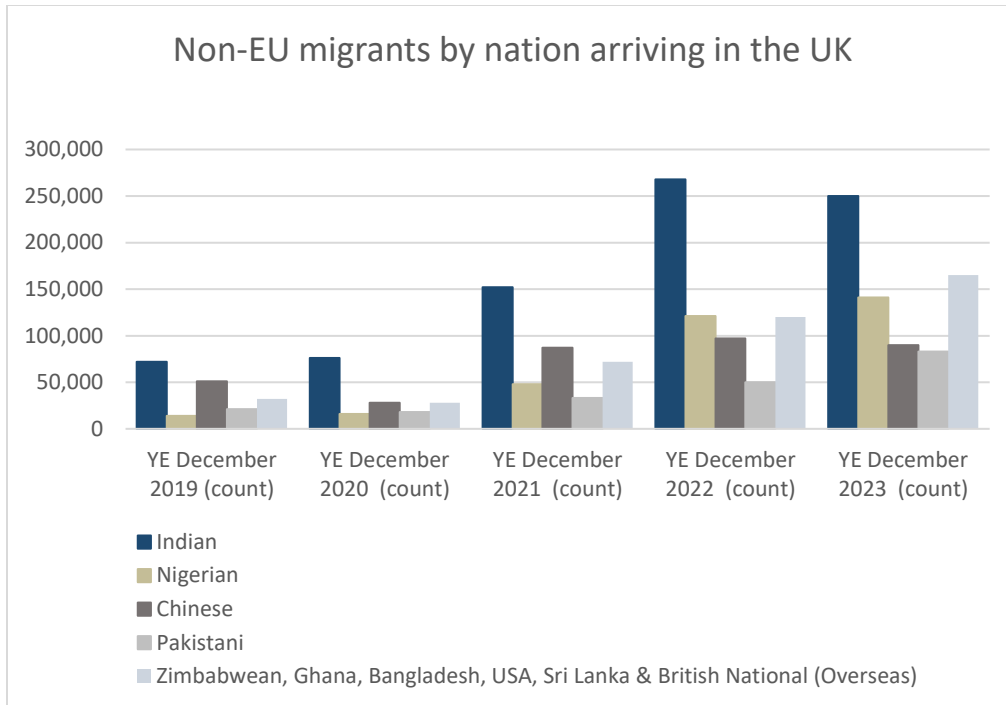
Brexit has shifted migration from EU countries towards non-EU countries during the initial days of the Brexit vote. However, since the end of the lockdowns, non-EU migration exploded. This is largely due to a larger number of study- and work-related migrants, mostly coming from India, Nigeria and Pakistan, as well as Chinese. Within just 5 years, the number of study-related migrants from India shot up from 13.1k in 2018 to over 142.2k in 2022, nearly doubling every single year. Similarly, Nigerian study-related migrants more than doubled every year in just 4 years from 5.3k in 2019 to 89.8k in 2022. This is partly down to universities charging much higher tuition fees to non-UK students compared to UK students (3x higher). Here again, while in general I do not think people mind migration, but when it comes so quickly in such large numbers it can impact the life of entire communities due to the completely different nature of these peoples' cultures. Many work-related visas are likely a result of staff shortages in the NHS and other sectors that faced a lack of labour.



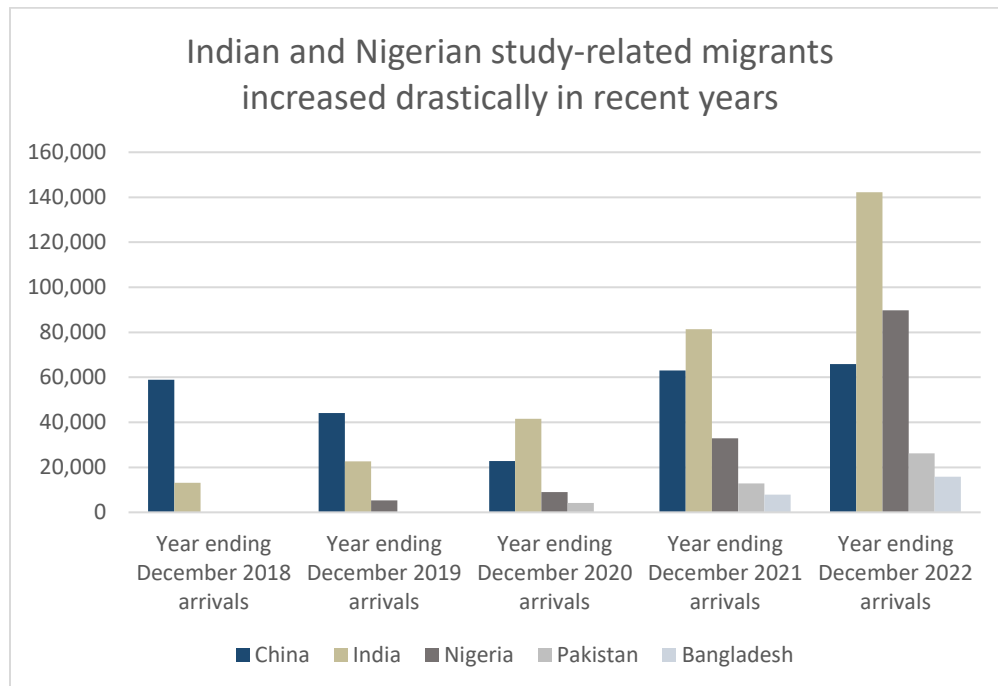
Source: UK Home Office



Source: UK Home Office



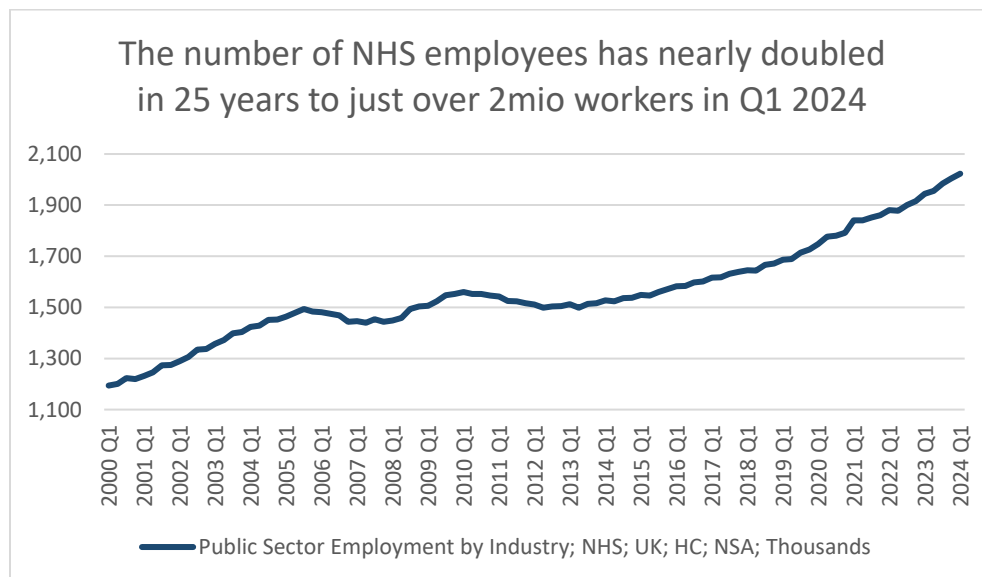
Source: UK Home Office



Source: UK Home Office

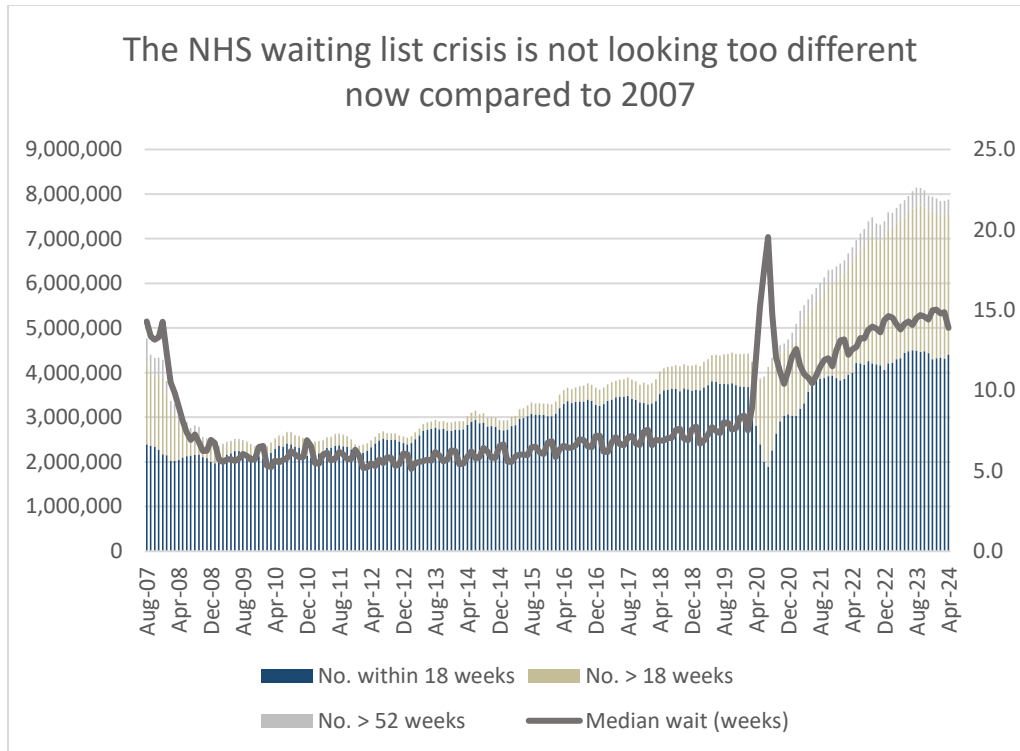
The health care crisis

The number of employees at the NHS has nearly doubled over the last 25 years, while the UK's population has only climbed by around 15%. This makes you wonder how we can have record waiting lists with 6.3mio people awaiting treatment⁴ despite having grown the NHS workforce much faster than the population. This is not purely down to Covid, as the waiting lists already began growing before the pandemic. Moreover, it is a problem of funding, as we have had such high waiting lists before: In 2007. Back then a larger budget allocation to the NHS helped bring these waiting lists down by mid-2008. The NHS and healthcare in general are facing other challenges though. The aging population worldwide increases healthcare demand steadily, and hence a higher need of funding. UK's spending on healthcare as a share of GDP has risen from 6.9% in 1998 to 11.3% in 2022. This appears like an unsustainable position for the government to continue funding.

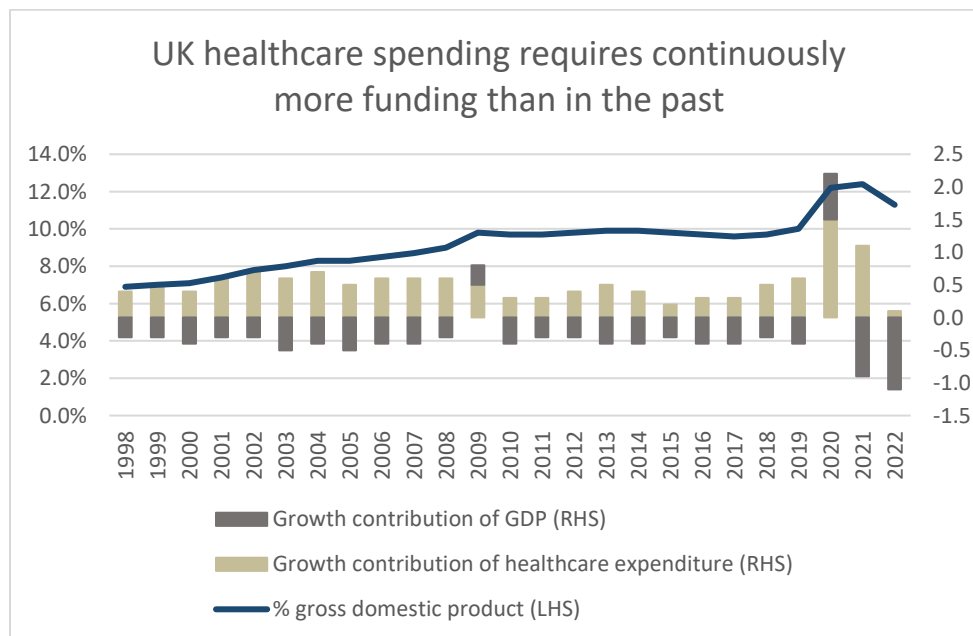


Source: Office for National Statistics

⁴ <https://fullfact.org/election-2024/nhs-waiting-list-repeat-claims-facebook/>



Source: NHS England



Source: Office for National Statistics

The upcoming Water Crisis

A few weeks ago, I had a chance to meet ex-Chancellor of the Exchequer and ex-Defense minister Philipp Hammond at an event that focused on how to turn the UK economy around and asked him the following question:

“The UK has the highest share of inflation linked government bonds in the world at 25% of total government bonds. Last year, more than half of the total interest expense was due to inflation linked government debt. Should the government not stop inflation linked government debt issuance? And secondly, which is related, as it is often used to reduce inflation, the UK has very aggressive regulatory bodies, such as the FCA, OFGEM, OFCOM, OFWAT etc. Now, water companies are not allowed to raise the bills to provide clean water. Isn’t this kind of ridiculous?”

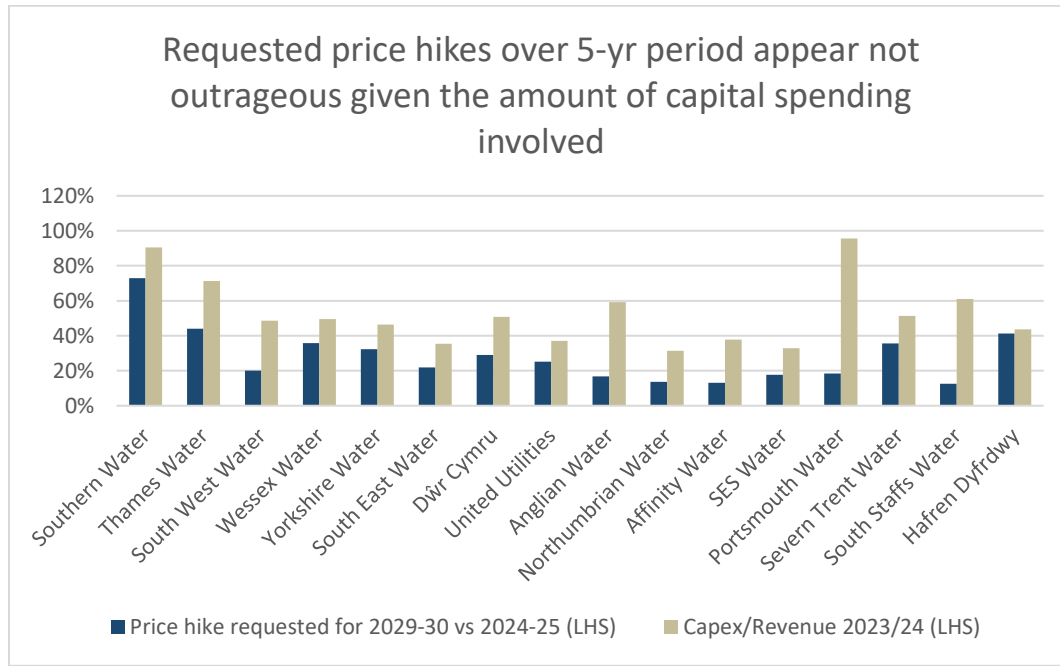
His response was somewhat furious, saying something in the line of: “This is not ridiculous at all. These water companies have been paying large dividends to their shareholders and now they asked to be bailed out. They need to take responsibility. To your first question, I have reduced the amount of inflation linked government debt issuance, but the demand for these bonds is very high, and hence it is attractive pricing wise to issue them.”

His response shocked me. Not only did Thames Water not pay a dividend for nearly a decade (apart from the dividend to the parent company to service their debt), but also because if anything it was a failure of the regulator. This is not only about Thames Water, literally all UK water companies have very weak balance sheets, with more than half of UK water companies having a debt/revenue ratio of more than 4x and adjusted interest expense/revenue of over 30%. The regulator should have allowed higher bills a long time ago. So why haven’t they allowed it? The UK has the highest share of inflation linked government debt, and a large rise in water bills would not only raise the bills of consumers and inflation, but also the cost of managing the debt of the government. However, water only has a 4.42/1,000 weight in the CPI⁵, which would only increase CPI by 0.42%, if water costs were to double in a year. Energy costs, on the other hand, have a 40.88/1,000 weight⁶, meaning a doubling of energy costs would lead to a CPI increase of 4% year-on-year alone. Water companies have asked for a rise in bills of between 13% and 73% over the next

⁵ <https://www.ons.gov.uk/economy/inflationandpriceindices/timeseries/cjww/mm23>

⁶ <https://www.ons.gov.uk/economy/inflationandpriceindices/timeseries/cjvf/mm23>

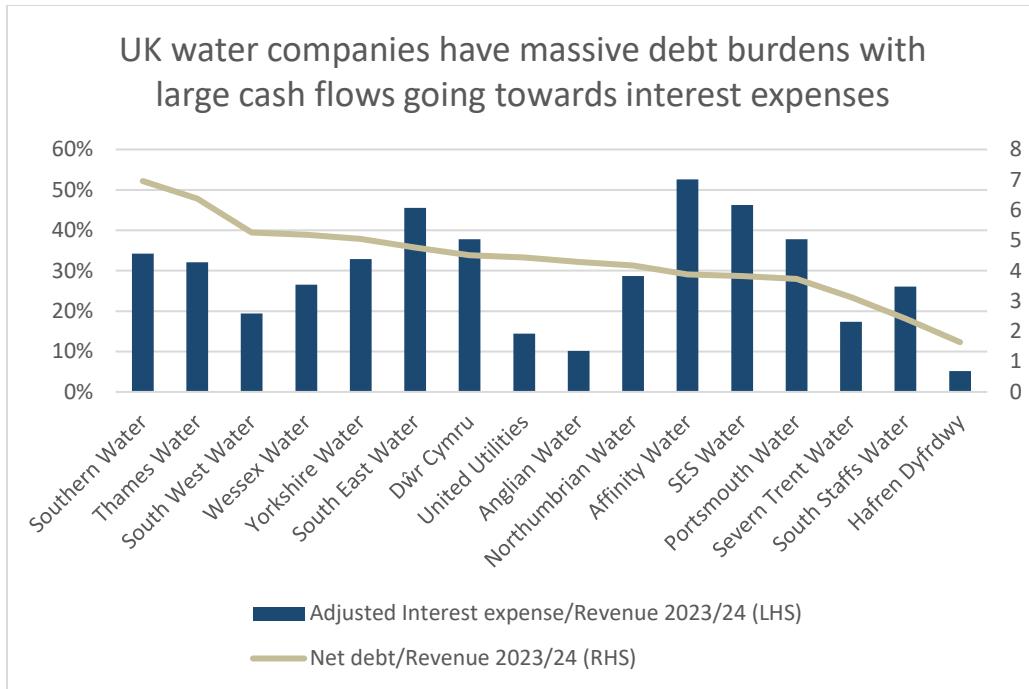
five years⁷. This compares to a decline in water bills in real terms between today and 2019/20⁸. When the day of reckoning comes, it will likely be an outsider party that would risk significant, yet necessary changes.



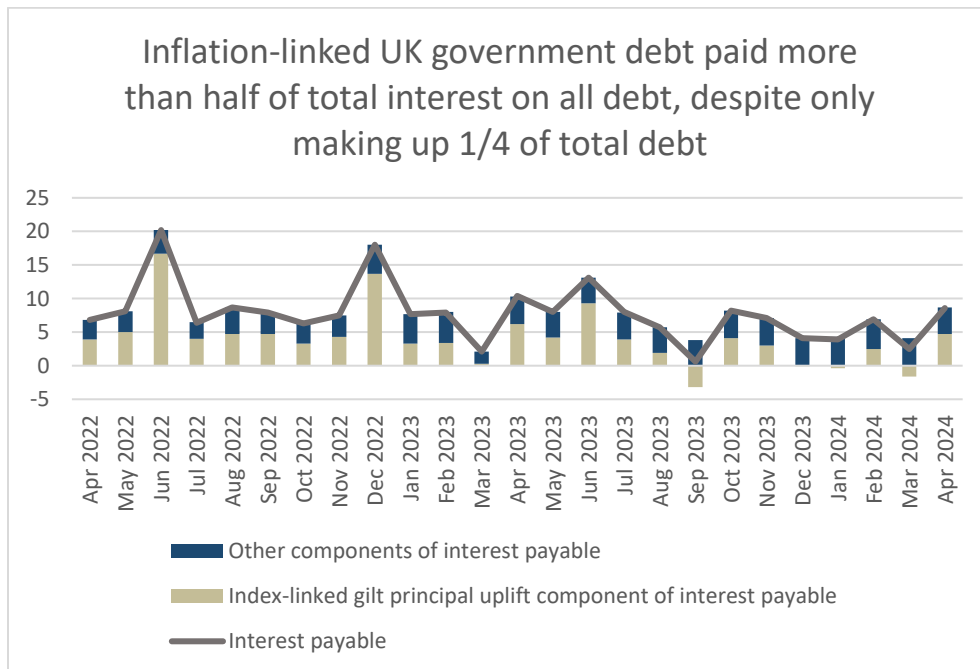
Source: OFWAT 2024 Price Review, individual water companies' annual reports

⁷ <https://www.ofwat.gov.uk/regulated-companies/price-review/2024-price-review/business-plans/key-facts-and-data-from-water-company-plans/>

⁸ <https://www.ofwat.gov.uk/average-bills-press-statement-2024-25/#:~:text=%E2%80%9CWhile%20water%20bills%20will%20vary,will%20be%20a%20real%20worry.>



Source: Individual water companies' annual reports



Source: Office for National Statistics

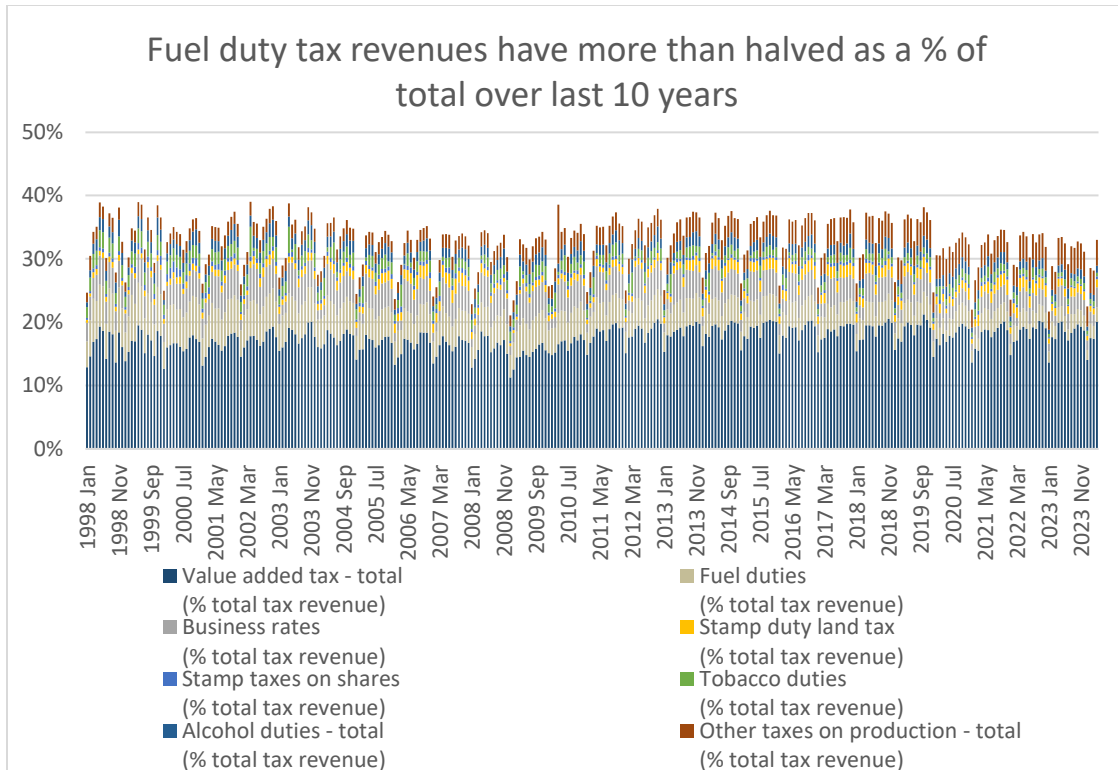
The energy transition & what a Labour government might bring

The biggest problem with the energy transition lies within tax revenues to the government. Fuel duties, i.e. taxes on gasoline and diesel used to make up 4-5% of total tax revenues. Unlike other taxes, this duty has not been raised with inflation since 2011 and has led to a decline to only ~2% of total tax revenues coming from the fuel duty, which is still significant at £25bn a year. In addition, £2.6bn of tax revenues were generated from oil and gas producers in the North Sea in 2021/22, while £9.9bn was generated in 2022/23 amidst the energy crisis, i.e. ~1% of tax revenue⁹. However, Labour's plan to increase the Energy Profits Levy (EPL) by 3% to 38% and eliminate investment allowances would make it more attractive for oil and gas producers to stop investing and exiting the UK, as the free cash flow (FCF) generation is higher. The energy policies and transition to net zero is hence a big risk to the UK government's finances. The £1.25bn estimated tax revenue from this additional tax increase of the EPL might end up zero when producers are leaving the UK. The current changes in taxes have already led to a decline in oil and gas production of over 25% from the largest UK producer, Harbour Energy¹⁰. It could therefore be tempting to raise corporate taxes further, as they only make up around 10% of total tax revenues, and at least on paper does not harm the individual taxpayer. The most anticipated tax hike, which could come later this year is the capital gains tax that is currently taxed between 10-24%¹¹ and could be raised to income tax levels. This could lead to a doubling of tax income from this source – an increase of over £12-15bn a year and is likely needed to offset the potential reduction of over £25bn from the fuel duty over time.

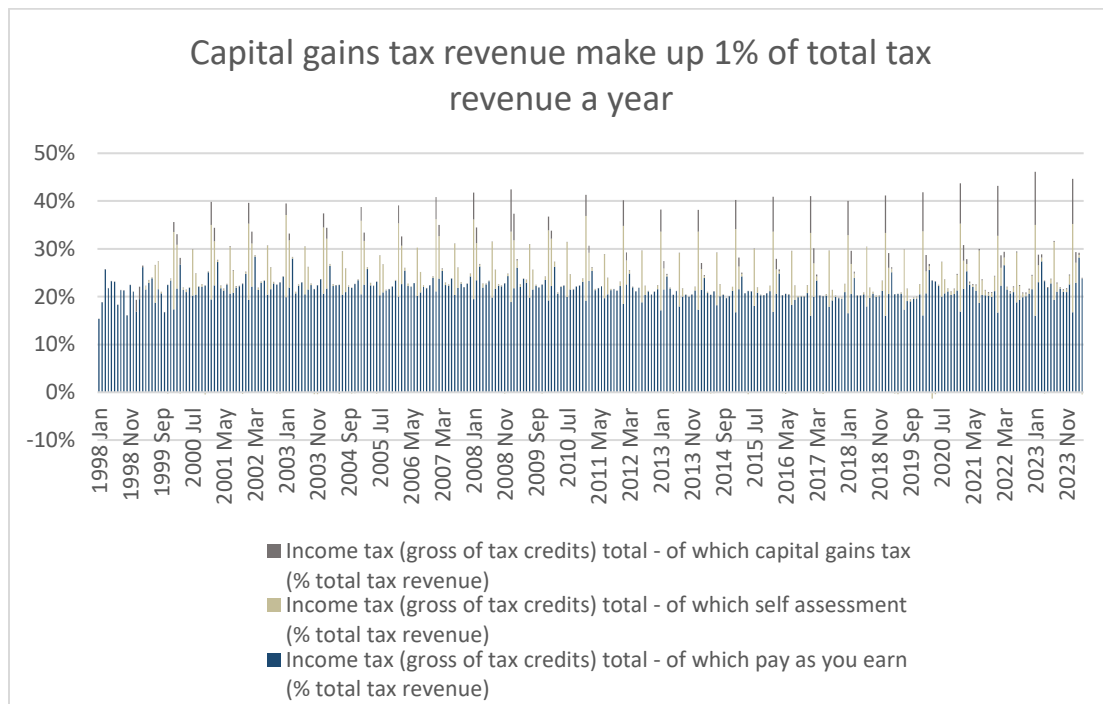
⁹ <https://commonslibrary.parliament.uk/research-briefings/sn00341/#:~:text=Petrol%20and%20diesel%20prices%20rose,9.9%20billion%20in%202022%2F23>.

¹⁰ <https://x.com/AozoraStep/status/1758592929260605513>

¹¹ <https://www.wellersaccountants.co.uk/blog/what-is-capital-gains-tax-in-the-uk>

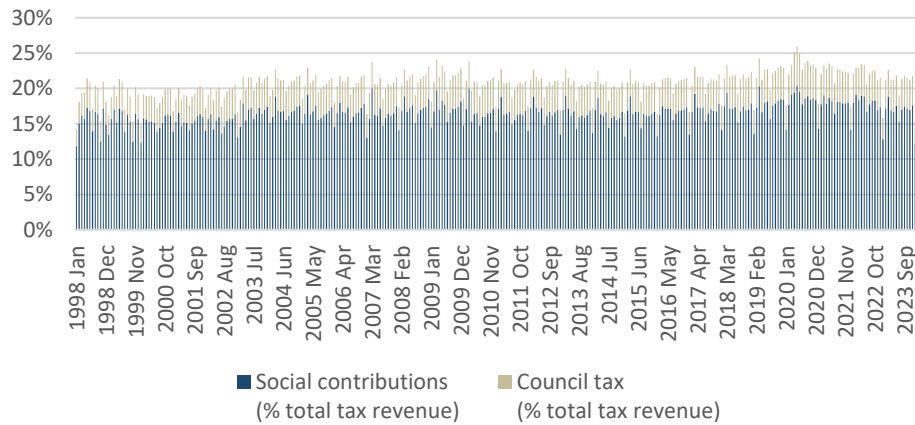


Source: Office for National Statistics



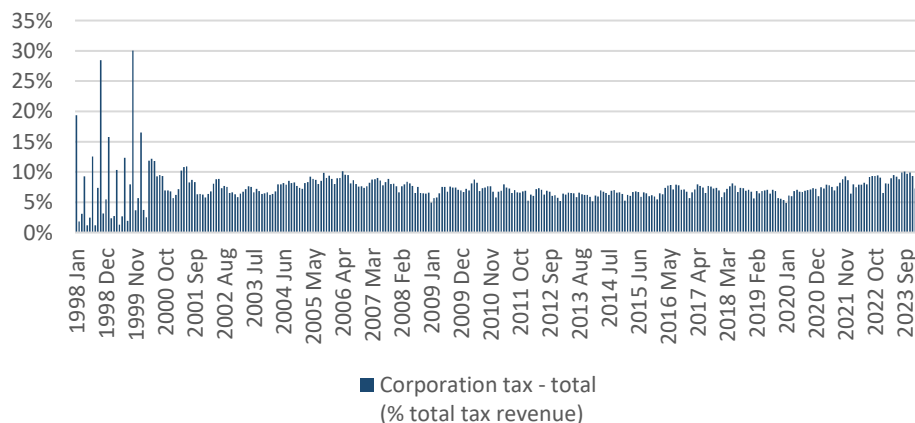
Source: Office for National Statistics

It would be difficult politically to raise taxes via an increase in social contributions or council tax



Source: Office for National Statistics

It could be tempting to raise corporate taxes further



Source: Office for National Statistics

Serica Energy: Free cash flow (FCF) will be 40% higher by reducing capex to zero

New Labour plans
2024

	CT	SCT	EPL
\$m	30%	10%	38%
Revenue	1,031	1,031	1,031
Hedging			
Opex	(318)	(318)	(318)
Capex	(170)	(170)	(170)
Decom			
Interest	(8)	(8)	
Tax losses			
Investment allowance			
Taxable profits	535	535.3	543.3
2024 Tax charge	161	53.5	206.5

CT = Corporate Tax

SCT = Supplementary Charge Tax

FCF

90

EPL = Energy Profits Levy

New Labour plans with reduction of capex to zero
2024

	CT	SCT	EPL
\$m	30%	10%	38%
Revenue	1,031	1,031	1,031
Hedging			
Opex	(318)	(318)	(318)
Capex			
Decom			
Interest	(8)	(8)	
Tax losses			
Investment allowance			
Taxable profits	705	705.3	713.3
2024 Tax charge	212	70.5	271.1

CT = Corporate Tax

SCT = Supplementary Charge Tax

FCF

127

EPL = Energy Profits Levy

Source: Serica Energy, own estimates with \$80/bbl, 70p/therm, 43.5k boepd, no tax losses assumed

Endgame UK: Growth path ahead

Like many developed countries in the world, the UK faces the problems of an aging population, high government debt, de-globalisation and energy transition. The problems of the UK are somewhat amplified though due to the government's high share of inflation-linked bonds (25% of total) and a publicly funded healthcare system, which both puts the country at a disadvantage in light of the other aforementioned trends. The government could either asks its citizens for more money, which has been done over the last few years, or take more radical steps, such as privatizing healthcare, stop the issuance of inflation linked government debt and funnel the massive £1.4trn pension pots (defined benefit pensions only)¹² into the UK economy instead of partly abroad. Privatizing healthcare could raise £ billions by simply selling the real estate and equipment. Stopping the issuance of inflation linked government debt could enable the

¹² <https://www.ppf.co.uk/PPF-7800-index>

country to inflate their way out of any future problems. And by redirecting the pension pots into the UK economy you could have an investment boom that could outpace that of the US economy. UK's defined pension assets are currently only 18% allocated in equities vs. 61% in 2006¹³. As of 2023, at least 11.7% of the bond portfolio and nearly 80% of the equity portfolio is invested abroad, which equals over 23% of the £1.4trn, i.e. over £322bn (13% of GDP). However, these changes are so fundamental, it would likely be labelled populism. It is therefore key that the main political parties tackle these problems, rather than leaving the door open to upcoming parties with less experience.



¹³ <https://www.ppf.co.uk/-/media/PPF-Website/Public/Purple-Book-Data-2023/PPF-The-Purple-Book-2023.pdf>

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