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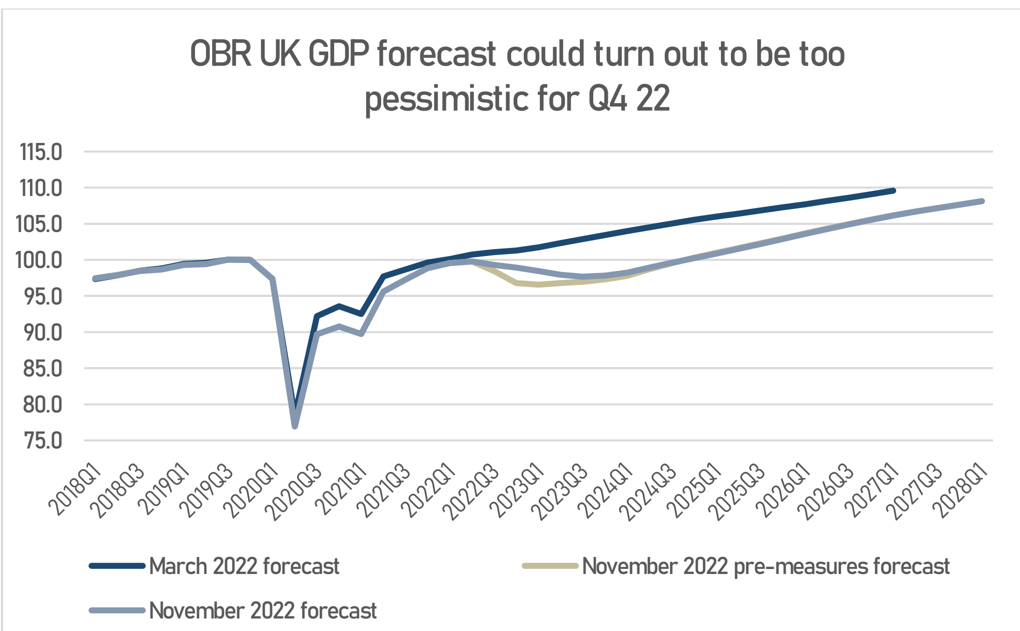
The gloomy UK outlook

The OBR has offered an improved, yet very grim outlook for the UK economy, in line with what the BOE forecasts, including a significant decline in real GDP from Q3 22 until Q3 23, which would make it an economic depression. However, this outlook and the poor public finances are purely driven by inflation. For example, in FY 21/22 the UK government paid £42.9bn in interest expense on its debt. In FY 22/23, it is expected to rise to £120.4bn. In order to offset this rise, the government took over failing Bulb Energy, costing the taxpayer £6.5bn, and capped energy bills, which will cost an estimated £40bn. These costs alone represent 4.8% of UK GDP and to a large degree driven by gas prices. However, the current Ofgem default tariff (£3,549 pa for average household) translates into an average gas price per therm of 301.79 pence[1]. While the next Ofgem default tariff for Jan-Mar 2023 will be higher (£4,279 – although still capped at £2,500 by UK government), there is a chance that prices come down afterwards given that European gas in storage is near record levels for this time of the year[2]. Germany plans to have 40% gas storage filled by Feb 2023, and if achieved, gas prices will likely come down and trade at <200 pence a therm.

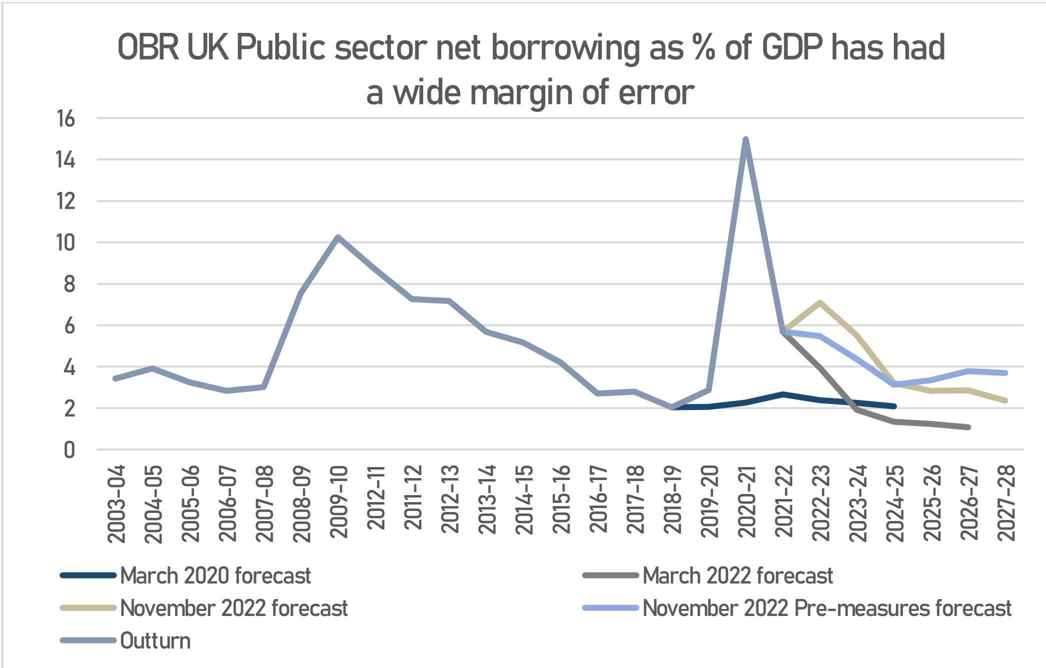


Source: OBR

[1] https://www.gov.uk/government/publications/energy-bills-support/energy-bills-support-factsheet-8-september-2022

[2] https://www.aozorastep.com/Market%20views%20episode%2019.pdf page 13

57 Lansdowne House, Berkeley Square, London W1J 6ER
www.aozorastep.com · david@aozorastep.com



Source: OBR

The revised Energy Levy

The UK Energy Levy is now equivalent to a 75% tax rate for oil & gas producers in the UK. Although the tax rate can give you a £91.25 tax savings for every £100 invested (this is also watered down now with the allowance being reduced from 80% to 29% for non-decarbonisation expenditures[3]), history shows us that higher taxes for oil & gas producers has led to lower production and investment – at least over the last 20 years. Therefore, in theory, the UK might need to import more oil and gas, leading to continued pressure on inflation. The UK general public hates the oil and gas industry, yet, it is very important for everyone to understand how key this industry is in keeping inflation down and that the strongest action against climate change is taxation of products and energy coming from abroad rather than at home.

[3] https://www.gov.uk/government/publications/autumn-statement-2022-energy-taxes-factsheet/energy-taxes-factsheet

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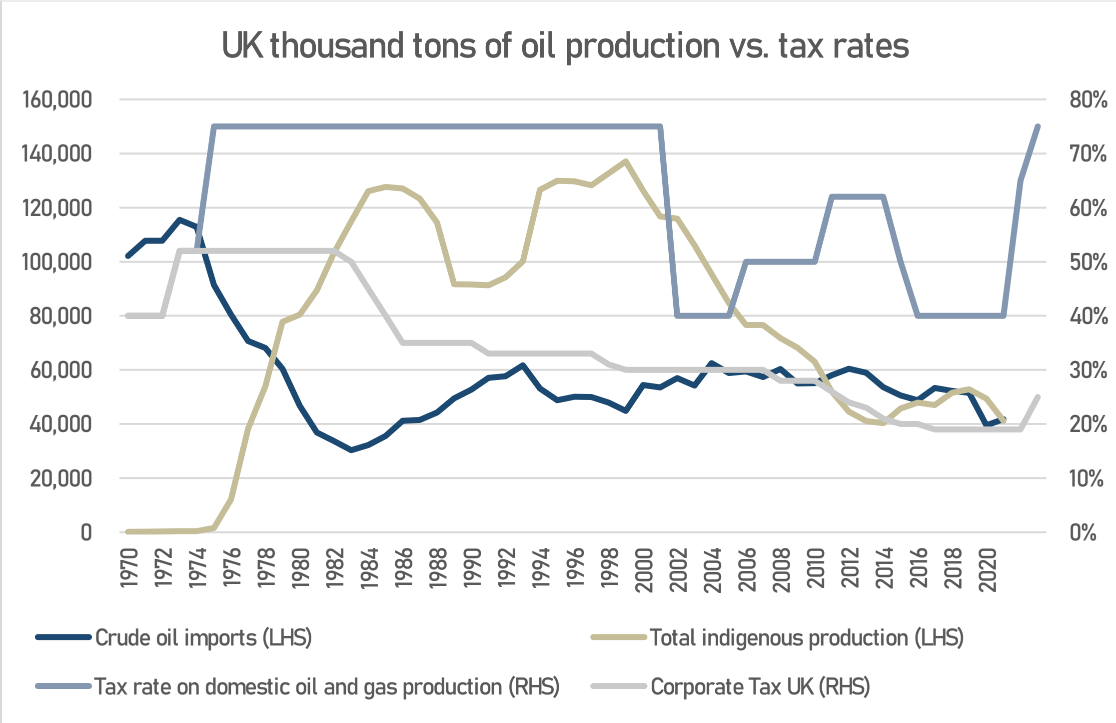
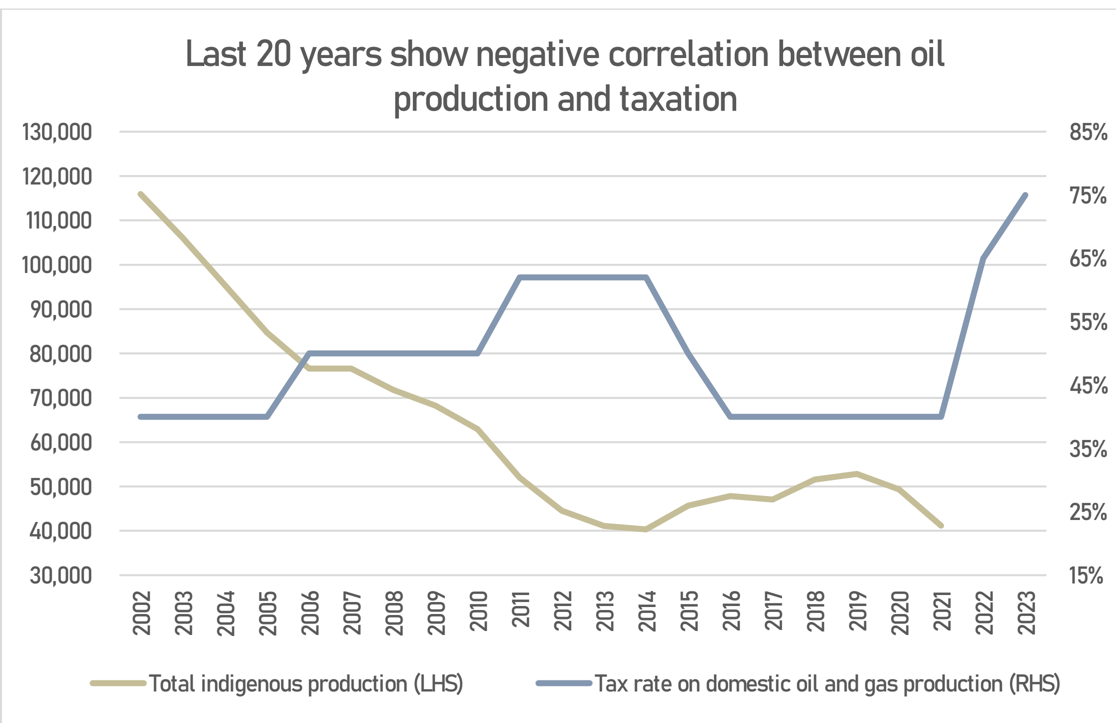


Source: Department for Business, Energy & Industrial Strategy



Source: Department for Business, Energy & Industrial Strategy

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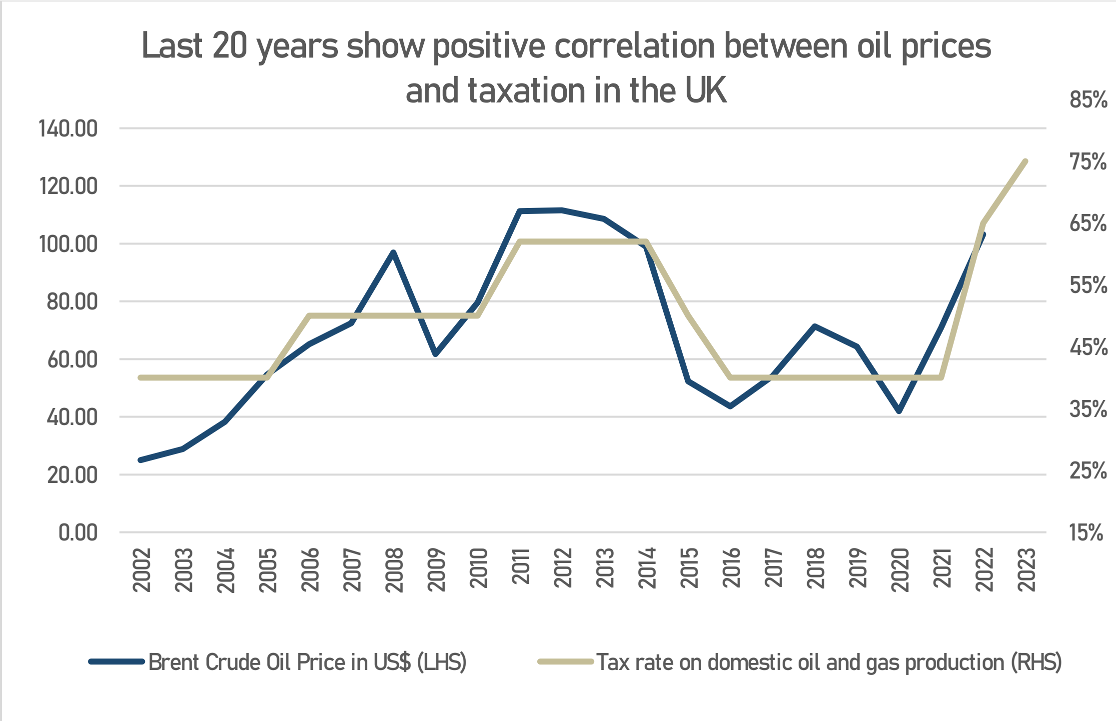

Source: Department for Business, Energy & Industrial Strategy, FRED St. Louis

<u>UK taxation on domestic oil & gas production</u>

Date	Tax	From	To	Total tax rate	Comment
January 1975	Petroleum Revenue Tax	0%	75%	75%	Tax on oil and gas fields which were given development consent before 16 March 1993
January 2002	Ring Fence Corporation Tax	0%	30%	30%	
April 2002	Supplementary charge	0%	10%	40%	On top of 40% oil and gas tax
January 2006	Supplementary charge	10%	20%	50%	
March 2011	Supplementary charge	20%	32%	62%	Expenditures on decommissioning are restricted
January 2015	Supplementary charge	32%	30%	60%	
January 2015	Supplementary charge	30%	20%	50%	Backdated reduction to 20% as oil prices continued to fall
January 2016	Petroleum Revenue Tax	50%	35%	-	
January 2016	Supplementary charge	20%	10%	40%	Backdated reduction in April 2016
January 2016	Petroleum Revenue Tax	35%	0%	-	Backdated reduction in April 2016
May 2022	Energy Profits Levy	0%	25%	65%	Sunset clause 2025, 80% investment relief
January 2023	Energy Profits Levy	25%	35%	75%	Sunset clause 2028, 29% investment relief for fossil fuels, 80% for renewables

Source: HM Revenue & Customs

57 Lansdowne House, Berkeley Square, London W1J 6ER
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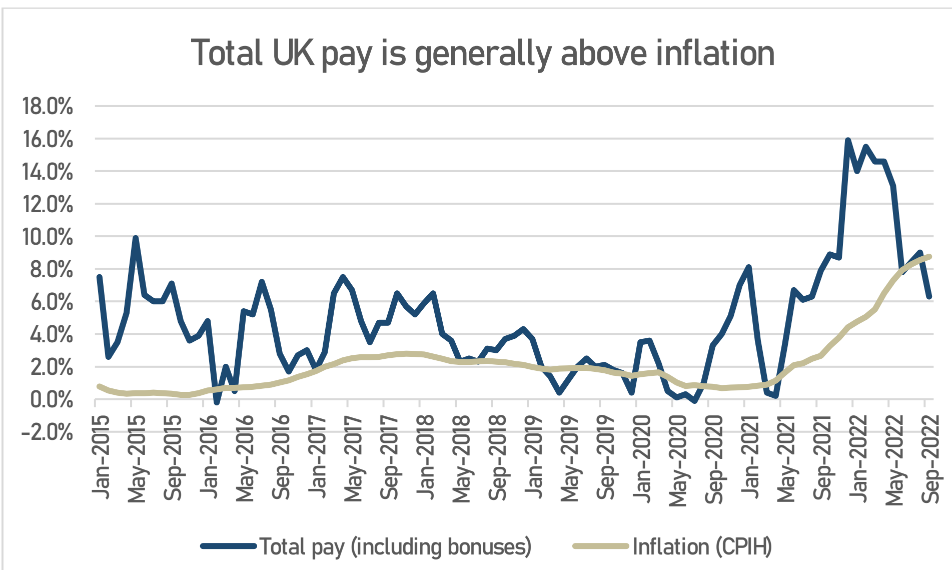
Strikes over real pay

Throughout my personal employment history, I was pretty much always discontent with my pay and always felt underpaid for the output I gave. In this sense, I can fully understand when people strike due to suppressed pay. However, in my case it was always possible to measure my output vs. my pay and compare it to others in the industry. At the same time, and this is something I understand now as an employer, I did not fully understand the total cost of an employee, which goes far beyond the salary and bonus. While the recent strike announcements mostly affect jobs where individual performance is difficult to measure, the demands are in outrageous territory. The danger now is that striking becomes a trend, and like crypto currencies in 2020/21, everybody is getting "fears of missing out" with more industries joining in, completely crippling the economy. Importantly, the UK Autumn Statement laid out a minimum pay rise by 9.7%, which will now prompt employees to ask for a rise above the minimum wage rise. Critically, the unions mostly want RPI + x (which is almost 6% higher than CPIH). In July to September real pay only fell by -2.6% so far though[4]. The outlook for the UK economy is indeed gloomy with the strikes this winter already set to be 3x higher than over the summer when around 560k working days were lost vs. 1.52mio+ over the next two months alone.



Source: ONS

4 https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/employmentandemployeetypes/bulletins/averageweeklyearningsingreatbritain/latest

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Solely UK's largest strikes announced this winter amount to 1.85mio working days lost

Sector	Union/Company	Days	Number of participants	Demands/Offers
Railways	RMT	13th Dec	40,000	7% pay rise was rejected in the summer (3% offered), now 10% pay rise was rejected vs. 14.2% RPI
Railways	RMT	14th Dec	40,000	""
Railways	RMT	16th Dec	40,000	""
Railways	RMT	17th Dec	40,000	""
Railways	RMT	3rd Jan	40,000	""
Railways	RMT	4th Jan	40,000	""
Railways	RMT	6th Jan	40,000	""
Railways	RMT	7th Jan	40,000	""
Royal Mail	CWU	24th Nov	115,000	Workers rejected Royal Mail's offer of 7% pay rise over 2 years and 2% lump sum this year
Royal Mail	CWU	25th Nov	115,000	""
Royal Mail	CWU	30th Nov	115,000	""
Royal Mail	CWU	1st Dec	115,000	""
Universities	UCU	25th Nov	70,000	UCU demands RPI +2% or 12% pay rise (whichever is higher)
Universities	UCU	30th Nov	70,000	""
NHS	RCN	15th Dec	465,000	RCN demands RPI +5%, which would cost £10bn a year (after a 4.75% rise this year)
NHS	RCN	20th Dec	465,000	""

Source: RMT, CWU, UCU, RCN

UK's largest strikes in history

Year	Striking industry	Working days lost
1898	Welsh coal strike	15,257,000
1912	National coal strike	40,890,000
1919	Battle of George Square: Shipbuilding and engineering workers	34,969,000
1921	Black Friday: Coal miners	85,872,000
1926	General strike: Transport and heavy industry workers	162,233,000
1972	UK miners' strike	23,909,000
1979	Winter of discontent: Public sector workers	29,474,000
1984	Battle of Orgreave: Coal miners	27,135,000
2011	Public sector strikes	1,390,000
2022	ESG/Ukraine war/Cost of living crisis	2,500,000+*

*estimated

Source: ONS

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Conclusion

I have struggled to find investments that match this trend of higher taxation on energy and more strikes that slow the economy. Ultimately, I ended up looking for value in sectors that are most exposed to the strikes, such as retail and convenience food. The reason why is two-fold: Firstly, there will be some sort of agreement in terms of pay rise and this could also give the consumer a boost. Secondly, the consumer is still shielded from the biggest driver of inflation: Energy. Since the UK government caps households' energy bills, which is included in the inflation data[5], inflation has likely peaked and therefore will come down from here. Although the economy is unlikely to bounce back quickly, there is a chance that some valuations have hit a bottom in late September.

[5] https://www.ons.gov.uk/news/statementsandletters/classificationreviewoftheenergypriceguaranteeandenergybillreliefscheme

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