

IMPACT OF UKCS FISCAL POLICY ON UK ECONOMIC GROWTH

Autumn 2024



An analysis of the change in tax receipts,
economic value, jobs, and energy security.

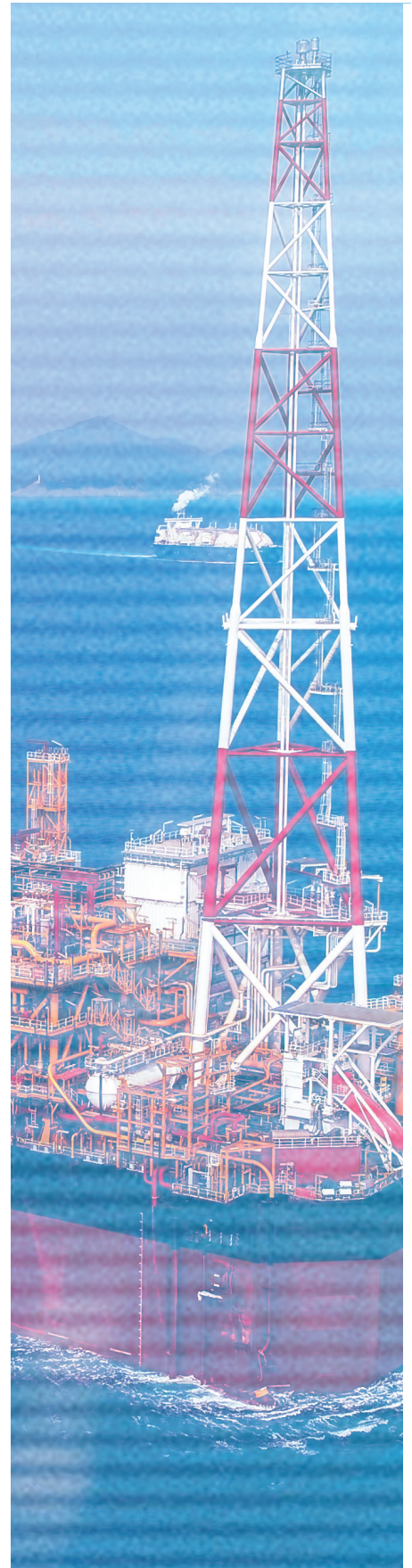




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Summary of the modelled impacts of the Government's confirmed tax changes

The UK Continental Shelf (UKCS) is a strategic national economic asset that can, in the right policy environment, continue to deliver macroeconomic benefits and homegrown energy across the UK, whilst being at the heart of the energy transition. Policy decisions made in this period and beyond will shape the investment landscape for the offshore energy sector and the economy for decades to come.

The recent period of protracted and significant fiscal instability has undermined investor confidence on the UKCS with a number of public examples of projects being cancelled or deferred as the risk of investing has increased. The fiscal changes have also been accompanied by negative commentary about the offshore energy sector, further damaging investor confidence.

The original Energy Profits Levy (EPL) introduced in May 2022 was intended to be a temporary tax in response to the economic environment at the time. These unprecedented oil and gas prices have since returned to align with long-term real averages, and the windfall conditions that the EPL was designed to address have passed.

The changes announced in July to increase the EPL rate to 38% (giving a headline tax rate for UK upstream investors of 78%), extending the tax by another year to 2030 and the removal of the energy profits levy investment allowance will have a material impact on the sector. The reduction of the extent to which capital allowances, namely first year allowances, associated with the Energy Profits Levy can be taken into account when calculating EPL profits also announced risks stopping investment in the sector. Such a decision on capital relief would also deviate from a fundamental tax principle that is seen in the broader UK economy and many OECD countries that you can gain full capital relief on spend.

An economic model based on individual asset and project data has been used to evaluate the impact of the proposed tax regime.

Increasing the headline rate to 78%, extending for a year and removing all allowances associated with EPL compared to the current regime would lead to:

- A reduction in viable capital investment on the UKCS from £14.1 billion to £2.3 billion in the period 2025 to 2029.
- A reduction in the total economic value of the sector of £13 billion in the period 2025 to 2029. The loss of economic value directly impacts the UK supply chain companies and risks losing the capability and assets to other regions.

- Approximately 35,000 jobs are at risk in 2029 alone due to projects not going ahead.
- The sector's total tax yield peaks in 2026 before declining compared to the current scenario, which continues to increase HMT receipts over the period. The future proposal could yield a further £2 billion in total tax in the short-term but at a long-term cost of reduced tax yield from accelerated production decline.
- 63% of additional production that could be sanctioned under the current regime would be uneconomic under the future proposal in the long-term. The UK would be more reliant on other countries to meet the UK energy demand at a cost to the UK economy and net-zero.
- 53 production hubs are expected to reach economic limit by 2035, there is the potential for approximately 50 cumulative additional years across 20 hubs in the right investment environment due to further activity which is unlikely under this proposal.

The assessment concludes that most discretionary investment in the sector will be curtailed if all allowances are removed, resulting in a rapid cessation of investment and eventual loss of critical infrastructure. This would result in a £49 billion loss of economic value over the coming decades and directly impact jobs across the sector. The impact on investment and the policy aims under this windfall tax proposal to increase tax revenues would not endure, and the strategic macro goal of driving economic growth in the UK economy would be at risk.

Under a regime where capital allowances are retained, the model shows the impact could be reduced with the ability to protect a significant proportion of existing viable capital investment. The UKCS is a capital-intensive sector, the balance between tax rates, revenue and being able to expense capital immediately through first year allowances is fundamental.

Fiscal principles to deliver the UK's economic, energy security and net-zero aims

The objective of any fiscal regime is a fundamental decision for any government, and this decision will dictate the shape of tax receipts for decades. Successful fiscal regimes that deliver enduring economic value are based on a clear and stable set of principles.

These should serve the government's fiscal, economic, and energy policy objectives while ensuring the energy sector has sufficient confidence to continue investing in long-term projects. Below, we set out high-level principles that should be considered alongside broader UKCS fiscal regime reform.

1. Long-term certainty and stability: Fiscal certainty supports investors' confidence and increases the likelihood and quantum of investment.

- To ensure that investors and lenders have sufficient confidence in their project economics, fiscal rules should be stable and predictable over a typical project lifecycle to enable investment.
- Changes should be prospective, i.e., not retroactively applied to ensure that they can be effectively factored into investment decisions.
- If introduced, targeted taxes like windfall taxes should be responsive and capable of swiftly rebalancing when the conditions subside. The mechanism by which such a tax is applied and then unwound should be clear and transparent to investors. Proposed changes should be clearly communicated and made following consultation with industry prior to their implementation to mitigate unintended consequences and help provide certainty.

2. Balanced risk and reward: To support the UK's competitiveness for attracting capital on an international scale, it is crucial to recognise the importance of balancing competitive returns for both the government and investors.

- The fiscal regime should allow both the government and companies to make a competitive return. The tax burden must be appropriate to the maturing nature of the UKCS and the size of the opportunities.
- Targeted taxes should be profit-based and only applicable to the windfall profits, ensuring that increased costs associated with production during a high-price environment are considered. Investors should be entitled, at a minimum, full recovery of capital costs through tax relief at rate, in line with well-established corporate and international tax norms.

3. Objective-driven: Fiscal policy should be designed with clear objectives in mind. In the North Sea context:

- Targeted taxes should support the priorities of government. Investors should be encouraged to invest in facilitating these priorities through investment stimulus such as targeted investment allowances applicable to decarbonisation projects.
- The direct and indirect impact of such taxes should be carefully considered to ensure that they do not undermine specific short- and long-term policy aims, such as increasing economic growth, protecting jobs, or delivering net-zero.

Conclusions

Under a fiscal regime that removes first year allowances, the aim to increase tax revenues we do not believe would endure, and the strategic goal of economic growth in the UK economy would be put at risk.

Alternative fiscal regime options could balance the contribution to the Treasury and economic goals while continuing to promote investment across the energy landscape which must be a fundamental priority of this Government. This investment would support UK energy security, retain critical supply chains and jobs in the UK, and help the UK reach its net-zero goals by 2050. The UKCS needs a competitive and progressive regime that promotes investment in the UKCS. A windfall tax designed for a short term price shock which has since dissipated needs to be reconsidered.

The supply chain, which will be critical to delivering a homegrown transition, is already being pulled to other regions which offer a more stable and attractive environment. Once the supply chain, infrastructure and skilled people leave, the challenge to get them back comes at an increased cost of doing business for the offshore energy sector in the UK further risking our energy security. The future proposal announced fiscal policy threatens both the existing supply chain anchored in the UK and the supply chain we will need to attract into the UK for the transition.

A fiscal regime based on clear principles that provide investors with certainty is essential to the delivery of energy security, net zero, and macroeconomic growth. Competition for capital is fierce, and therefore, the attractiveness of the UK on an international scale will be critical. It is important, therefore, to understand the context of other regimes. For example, the assumption that the proposal replicates the Norwegian regime is incorrect. Neither the current regime nor the regime proposed can be likened to the Norwegian regime. In addition to being stable, the Norwegian regime also recognises relief irrespective of tax position and full expensing of costs, which is highly attractive when allocating capital.

A homegrown energy transition has the biggest potential to deliver short- and long-term economic growth. To be successful, policy needs to position the UK as an irresistible investment environment for energy investment. The UK tax regime must be internationally competitive to attract and retain businesses in the UK for the long term. The UK tax regime must have long term predictability; full expensing of capital should be maintained with long term certainty on allowances which are designed to ensure a competitive regime. A homegrown energy transition will strengthen the UK energy supply chain, accelerate the production of domestically produced energy, and mean no individual, community, or sector is left behind in our journey to net zero.

1. Additional Information

1.1 Fiscal model outputs

The model's inputs are based on detailed submissions from operators and considers an impact at an asset, hub, and portfolio level

A mid-price deck of \$80/barrel for oil and 65 pence/therm for gas has been assumed as a base case and applied without change across the life of the basin. To screen if a project will be sanctioned, a modest Profit Investment Ratio (PIR -ratio of net profit to gross capital investment) of 0.25 has been selected, which also aligns with NSTA guidance.

However, it is recognised that for many companies investing in UKCS, where projects compete globally for capital, the PIR threshold or equivalent will be more than 0.25 and vary from operator to operator.

To calculate GVA, the model has used a multiplier on production based on the 2019-2022 and a multiplier for the same period on direct, indirect, and induced jobs to calculate the impact.

1.2 Fiscal scenarios

The following scenarios are presented, with both being applied in perpetuity recognising the lack of confidence in the sunset by industry and broader investors:

Scenario 1: EPL 2 (current scenario)

Headline tax rate at 75% and maximum relief at 91.4p

Scenario 2: EPL3 (Future proposal)

Headline tax rate at 78% and maximum relief at 46.25p

Scenario	Total Tax Rate %	Maximum Capital Relief %	5 year period 2025 to 2029					Total			
			Capital Investment £Billion	Additional Production (boe)	Total Tax Take £Billion	Additional GVA £Billion	Additional Jobs in 2029	Capital Investment £Billion	Additional Production (boe)	Total Tax Take £Billion	Additional GVA £Billion
EPL2: Current Scenario in perpetuity	75	91.4	£14.1	553	£33.5	£28	55554	16.7	1431	108	79
EPL3: Labour Proposal in perpetuity	78	46.25	£2.3	283	£35.5	£16	20314	4.9	536	96	30

Delta	5 year period 2025 to 2029					Total			
	Capital Investment £Billion	Additional Production (boe)	Total Tax Take £Billion	Additional GVA £Billion	Additional Jobs in 2029	Capital Investment £Billion	Additional Production (boe)	Total Tax Take £Billion	Additional GVA £Billion
EPL2: Current Scenario - EPL3 Labour Proposal	-£11.8	-270	£2.0	-£13	-35240	-£11.8	-895	-£12	-£49

Increasing the headline rate to 78%, extending for a year and removing all allowances associated with EPL compared to the current regime would:

- A reduction in viable capital investment on the UKCS from £14.1 billion to £2.3 billion in the period 2025 to 2029.
- A reduction in the total economic value of the sector of £13 billion in the period 2025 to 2029. The loss of economic value directly impacts the UK supply chain companies and risks losing the capability and assets to other regions.
- Approximately 35,000 jobs are at risk in 2029 alone due to projects not going ahead.
- The sector's total tax yield peaks in 2026 before declining compared to the current scenario, which continues to increase HMT receipts over the period. The future proposal could yield a further £2 billion in total tax in the short-term but at a long-term cost of reduced tax yield from accelerated production decline.

Modelling shows there is a potential increase in viable capital investment when capital allowances are retained under EPL, however does not fully recover the total capital expenditure under the current regime. The risk associated with further fiscal regime changes will also have an impact.

One of the proposed fiscal regime's most profound impacts is on viable capital investment. Continued investment in the sector is fundamental for energy security, retaining key infrastructure, and anchoring the supply chain. The fiscal environment will influence the scale of the capital investment that could be made by the sector.

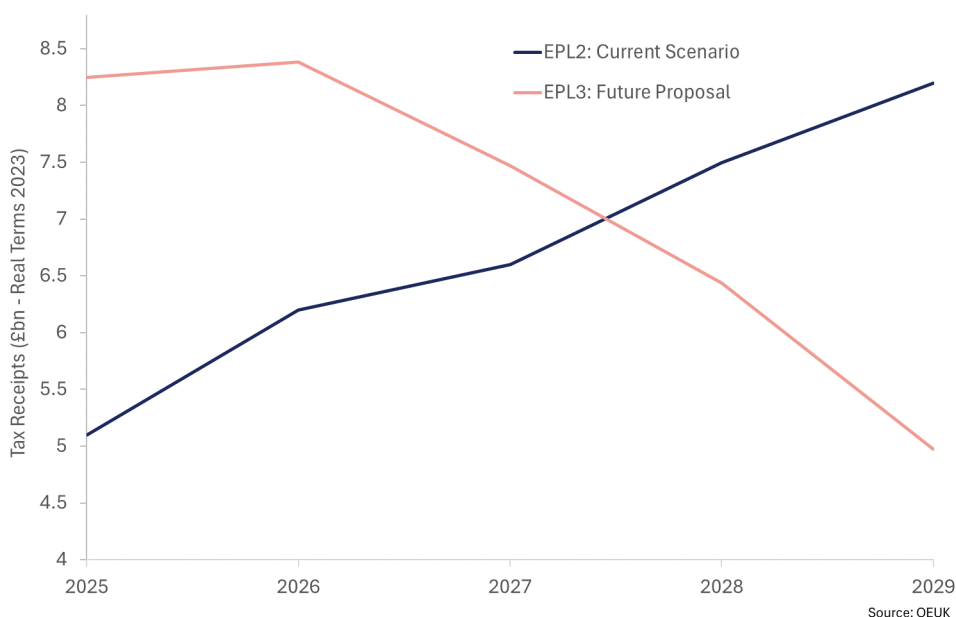


Figure 1:
Shape of tax receipts
under different fiscal
scenarios

The NSTA estimates that there are significant contingent reserves in the UKCS amounting to 4.5 billion boe. Unlocking some of these resources, will require further capital spending, which could increase the later years' spending by around £2-5 billion, depending on the opportunities realised. However, this would only be possible in the right investment environment. Unlocking the total value of the contingent resources in the right environment could deliver £248 billion to the UK economy through GVA over the production lifetime.

This under-investment due to the future proposal has a further knock-on impact on additional production that could be sanctioned.

Analysis shows a significant difference in cumulative incremental production when comparing scenarios. Furthermore, the loss to GVA because of reduced production is notable in comparison. In an environment where all activity in the asset stewardship goes ahead, 118 projects, of which 80% are infill activity, there is a potential for more than 50 additional cumulative years across 20 hubs.

Over the longer term, our analysis shows that the proposal to remove all allowances would reduce tax receipts, viable production, and broader economic contributions.

- A reduction in viable capital investment on the UKCS from £16.7 billion to £4.5 billion in total.
- A reduction in total economic value of £49 billion.
- A loss of £12 billion in tax receipts compared to the current scenario.
- 63% of additional production that could be sanctioned under the current regime would be uneconomic under the future proposal in the long-term. Under the future proposal the UK would become more reliant on other countries to meet its energy demand at a cost to the UK economy and net-zero with 2-5 times greater carbon emissions than domestic production.

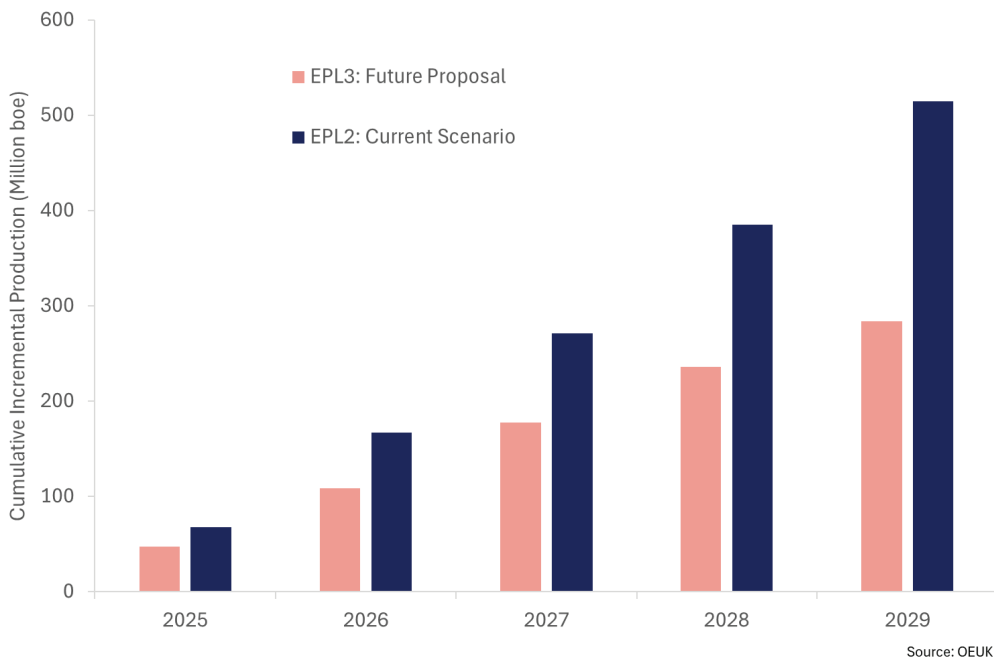


Figure 2:
Impact on cumulative incremental production under different fiscal scenarios

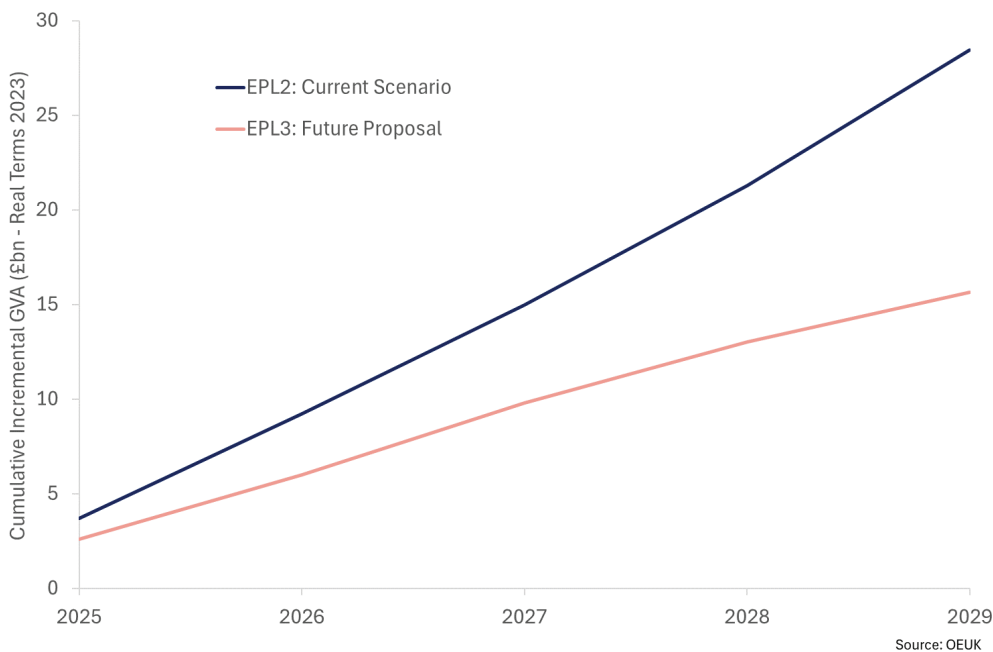


Figure 3:
Impact on cumulative gross value add under different fiscal scenarios

Despite reassurances from all parties, industry has little confidence that the windfall tax will be unwound in 2030. Therefore, they are embedding a 78% with limited capital relief into their long-term assumptions and decision-making processes.

If companies believed that the sunset clause would be applied and could manage the risk premium on the UK, there is potential for a further 13 projects to be deemed economic under that scenario; however, some of these projects will be reliant on infrastructure that may have ceased production due to decreased activity and therefore timing will be critical.

2. UK oil and gas fiscal environment

2.1 Energy Profits Levy (EPL)

Given the volatility of policymaking, investors have negligible confidence that the sunset clause in the current EPL will be honoured by any future government or applied given the election cycle. Confidence has been further diminished by the recent unexpected extension of that date by the current government.

For investors today, including the Financial Institutions themselves, EPL is assumed to be applied in perpetuity. This significantly undermines project economics and erodes balance sheet strength, reducing liquidity beyond sustainable levels for many companies. Again, given the nature of the EPL's creation and extension, the reassurance of a return to a 40% headline rate provides industry with little confidence.

The EPL was not intended to be a long-term tax and was introduced after a period of sustained high prices. These prices are now trading at a pre-Ukraine invasion level and have fallen back to historic averages. Coupled with this, the energy cap has dropped to its lowest point in two years despite the increased tax rate remaining in place. The OBR themselves are reporting a decrease in prices and ultimately reduced tax take across the economy.

The long-term level and pace of this private investment will be influenced by the fiscal regime chosen by the government immediately following the 2024 General Election. The UK's international attractiveness will be benchmarked by its identification and ranking as a positive and stable investment environment.

As noted previously, policy decisions and rhetoric in this period and beyond will shape the investment landscape for the offshore energy sector and the economy for decades to come.

2.2 Trigger Price Mechanism (ESIM)

The introduction of the Energy Security Investment Mechanism in June 2022 and its placing in legislation was a step to provide some certainty on the unwinding of the EPL. It was expected to unlock some further borrowing capacity in those raising finance off the balance sheet. However, the conditions around both oil and gas triggers needing to be met and the prices being set in lower quartiles of prices seen mean it has had a muted impact on the market. Furthermore, the third extension to 2029 in the 2024 Spring Budget and fourth to 2030 under the proposed regime has led to any upside of ESIM being reduced.

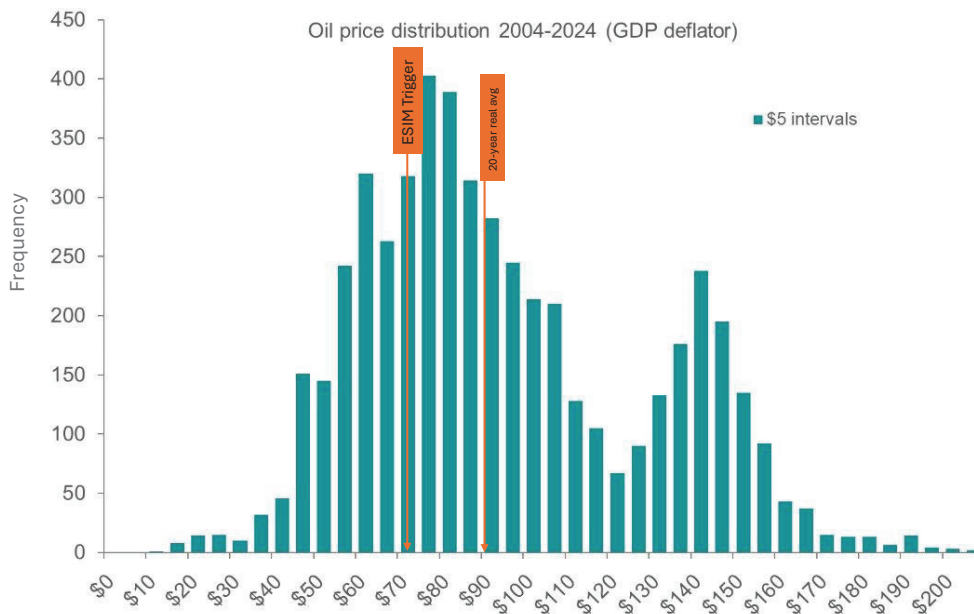
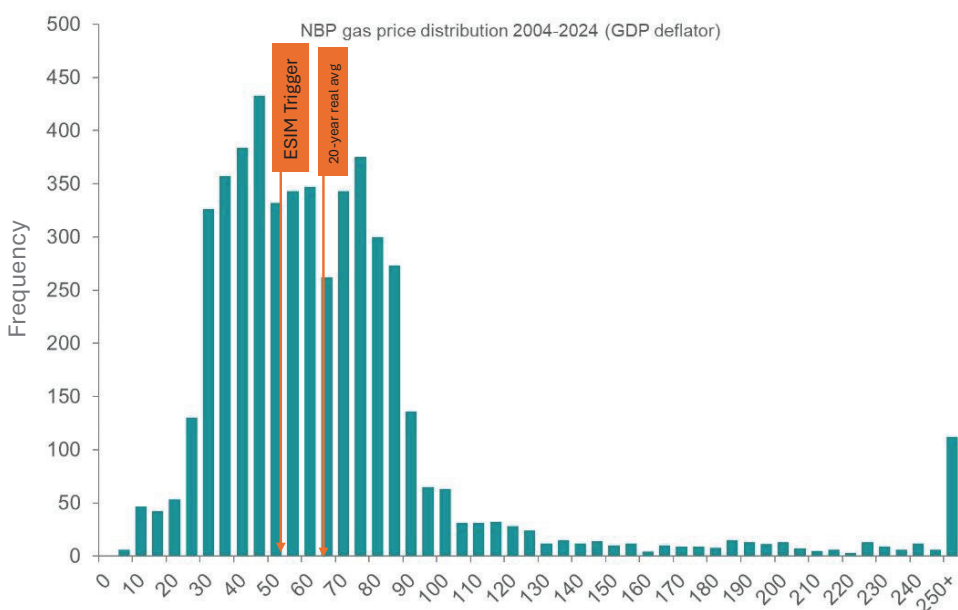


Figure 4: Distribution curve of prices over the past 20 years in relation to ESIM triggers.



2.3 Comparison of UK tax regime and comparison to other regions

Corporation tax is the main tax that a limited company must pay. A company will pay corporation tax on its profit in that accounting period, minus any overheads and expenses.

The UK upstream oil and gas sector sits within modified corporation tax rules, which ring-fences profits relating to the exploration for and production of oil and gas in the UK and on the UK Continental Shelf (UKCS). This is taxed at a higher rate than the rest of the economy and is made up of four taxes: Ring Fence Corporation Tax (30%) Supplementary Charge (10%), Energy Profit Levy (35%) and Petroleum Revenue Tax (0%).

RFCT is calculated in the same way as Corporation Tax but with the addition of a 'ring fence' that treats these activities as a separate trade. The ring fence prevents taxable profits from oil and gas extraction from being reduced by losses from other activities or by excessive interest payments.

All companies, not just those involved in the exploration and production of oil and gas in UK waters, can expense the costs of running their business against their profits. Both inside and outside the ring fence, the UK has variations of 100% first-year allowances for plant and machinery, which allows companies to recognise the full cost of this activity in the year of spend, which reduces the tax bill that year. This is not a subsidy and can only be used if there is sufficient tax capacity.

There are no subsidies for upstream oil and gas production. Relief is cashless, and there is no payment sent from HMT to industry to fund this.

Figure 5:
Fiscal Regime
Comparison

North Sea tax regime comparison

Tax Regime	EPL 2 (current scenario)	EPL 3 (future proposal)	Norwegian regime
Ring Fence Corporate Tax			
Tax	30%	30%	6.2%***
First-year capital allowance	£30	£30	£1.03****
Supplementary Charge			
Tax	10%	10%	71.8%
First-year capital allowance	£10	£10	£71.8
Investment Allowance*****	£6.25*	£6.25*	£0
Energy Profits Levy			
Tax	35%	38% A	0%
First-year capital allowance	£35	£0 B	0%
Investment Allowance	£10.15**	£0 C	0%
Sunset year	2029*****	2029	-
Other			
Decommissioning relief	40%	40%	78%
Total			
Relief irrespective of tax position	0%	0%	71.8%
Relief only in tax position	91.4%	46.25%	6.2%
1 Total relief for £100 of expenditure	£91.4	£46.25	£78.0
2 Total tax rate	£75	£78	£78
3 Relief irrespective of tax position	No	No	Yes

North Sea tax scheme proposed by the Labour party for the following election cycle (2024 – 2028) stipulates the removal of:

- A** Increase on the EPL tax rate from 35% to 38%
- B** Energy Profits Levy relief (specifically the first-year capital expenditure allowance)
- C** Investment allowance at 29.0%

Source: Rystad Energy research and analysis

An important distinguisher between the current regime and the future proposal is the relationship between rate and relief. The impact of a lower relief than the headline rate reduces both the post-tax value of the investment and the rates of return, which challenges the ability of companies to sanction projects in the medium to longer term. The impact of this on production and jobs is seen most acutely in the medium-longer term and risks UK energy security with an accelerated decline in production.

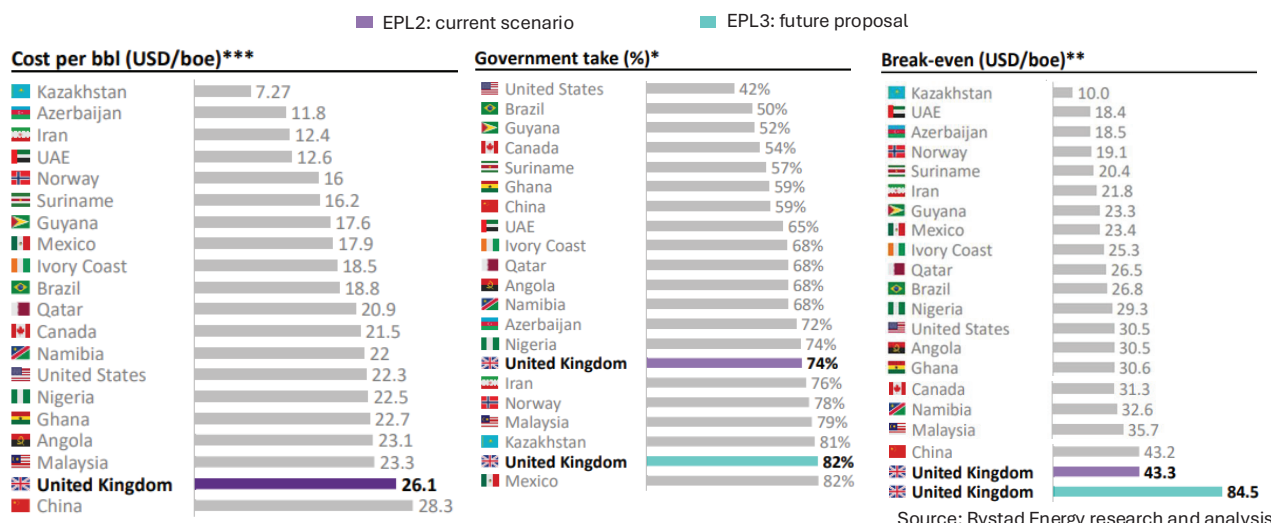
As stated, neither scenario can be likened to the Norwegian regime. In addition to being stable for several years, the Norwegian regime also allows recognition of relief irrespective of tax position and full expensing of costs, making this approach to relief highly attractive.

Whilst the fiscal regime is only one factor when sanctioning further activity, the regime's international competitiveness compared to other jurisdictions becomes fundamental to further production and anchoring the supply chain. Capital investment in Norway was around six times greater in the same period last year.

Competition for capital is fierce, and therefore, the attractiveness of the UK on an international scale will be critical. At this time, the UK is not viewed as an attractive investment environment, which is further compounded by the future proposal, as shown by the analysis in this paper.

The data from Rystad below shows that the UK is currently one of the costliest basins for producing oil and gas. The increase in the headline rate from 35% to 38% immediately impacts companies with assets in a tax-paying position. However, the biggest impact is the reduction in capital relief expected under the future proposal. This is a key driver for the ranking and significantly increases the breakeven point shown above.

Figure 6:
UK Competitiveness
comparison by
Rystad Energy

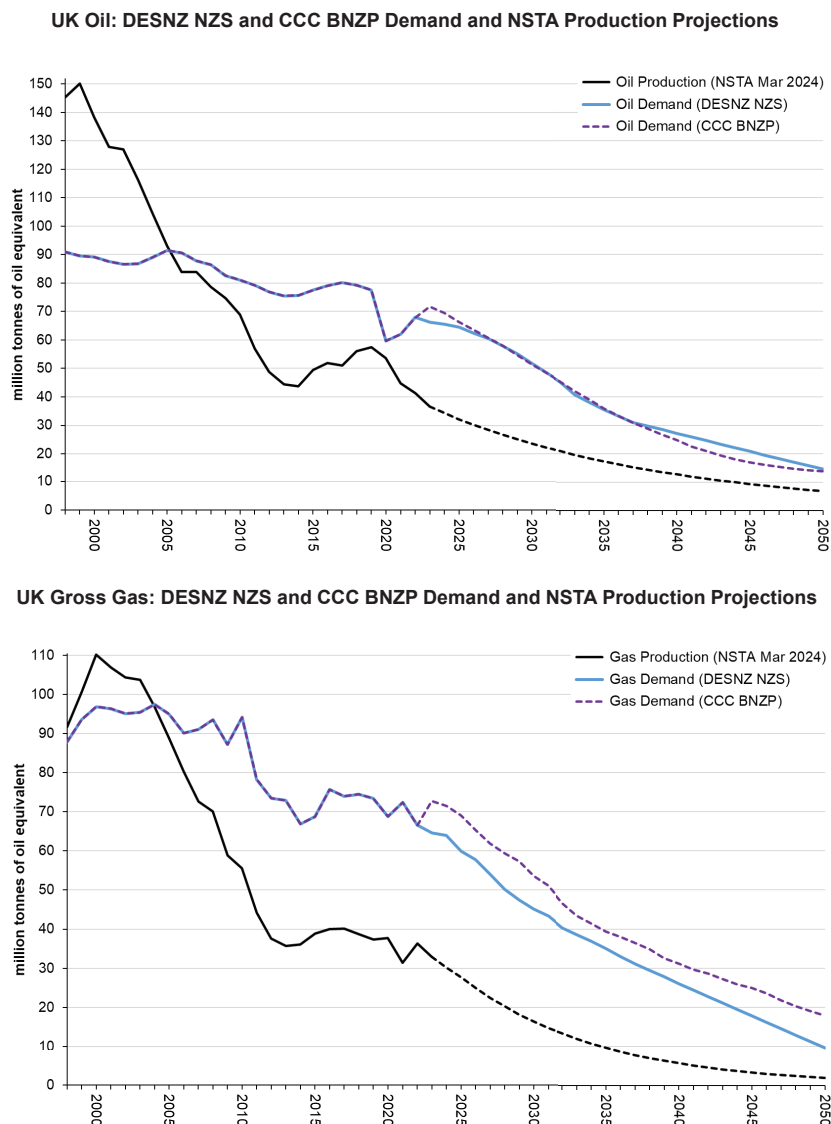


3. Role of oil and gas production

The UK relies on oil and gas for 75% of its total energy needs. The UK domestic oil and gas sector currently provides approximately 50% of that total demand for the UK, with the remainder of the oil and gas needs provided through imports. In 2022, a total of £112 billion of oil and gas was imported into the UK to support energy needs. The sector supports over 200,000 skilled jobs, contributed over £19 billion to the UK economy in 2022/2023, and contributes significantly to UK energy security.

Progress is being made in decarbonising the economy; however, the UK transition to net zero will take several decades, and oil and gas will continue to play an important role. A total of 24 million UK homes, representing over 80% of the UK housing stock, are currently heated using natural gas. The energy-intensive parts of the UK economy, such as petrochemicals, refining, steel manufacturing, and glass, remain reliant on hydrocarbons.

Figure 7:
DESNZ and CCC Oil
and Gas Demand
projections



Under the Climate Change Committee balanced pathway, it is estimated that oil and gas will meet 50% of the UK energy needs between now and 2050, with abated hydrocarbons meeting approximately 20% of the UK's energy needs in 2050.

The oil and gas sector is committed through the North Sea Transition Deal (NSTD) to reducing emissions associated with production operations. Emissions have been reduced by over 20% compared with a 2018 baseline, and the sector remains on track to deliver 50% emissions reduction by 2030.

In 2023, the total production from the UK fell by over 12%, significantly above the decline rate for oil and gas consumption in the UK. In a no-further investment case, the UK would be 85% reliant on imports to meet gas demand by 2030, with implications for jobs, economic value, the viability of the supply chain, UK energy security and carbon intensity of UK demand.

4. Oil and gas price environment

Oil and gas prices have returned to align with the long-term average real-term prices. Energy prices for UK consumers have returned to their lowest levels since prior to the invasion of Ukraine. The government's support for consumers ended in April 2023.

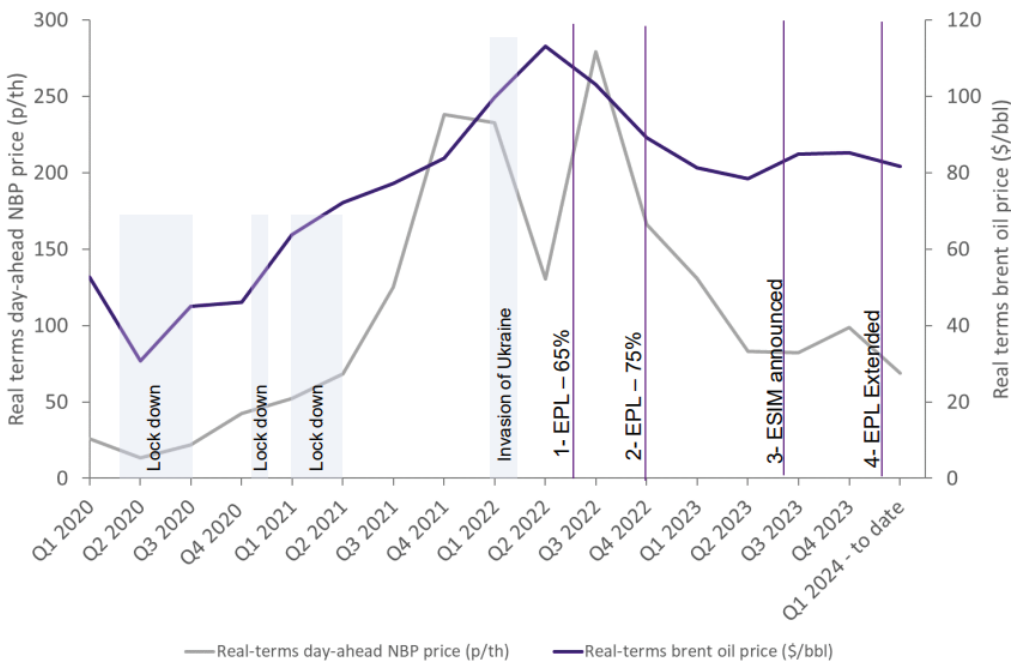


Figure 8:
Relationship between prices and windfall taxes

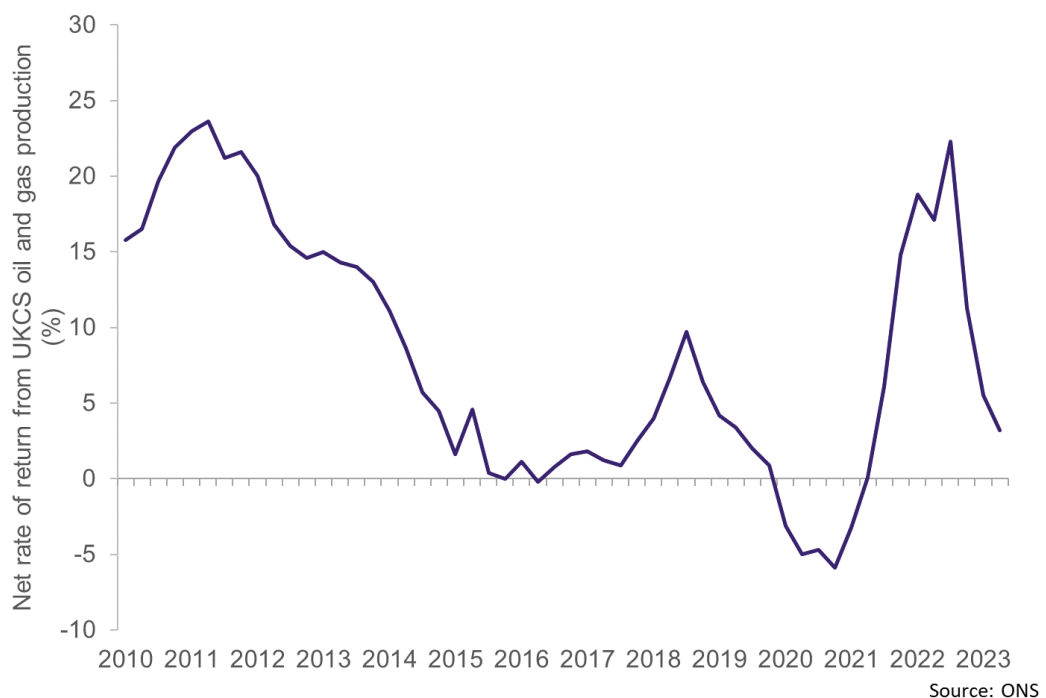
5. Profitability of the UK Continental Shelf

The introduction of a windfall tax for both oil and gas producers and electricity generators was made on the basis of windfall profits made by the organisations associated with these activities.

As commodity prices have returned to align with long-term real-term averages, profits made in both oil and gas and energy generation have reduced. In 2023, the government recognised this by removing the electricity generator levy on electricity-generating companies.

Independent data from the Office of National Statistics (ONS) indicates the profits for those investing in the UK Continental Shelf (Oil and Gas producers) has fallen to levels that are not considered to be windfall profits and significantly below other areas of the UK economy.

Figure 9:
Office of National
Statistics UKCS Rate
of Return



6. Office of Budget Responsibility (OBR forecast)

The modelling conducted to support this paper predicts a higher tax take than those forecasted by the OBR.

The OBR modelling takes a simplified approach and is based on input production data from the NSTA and average prices for a fixed period. The OBR model is also rationalised against HMRC actual payments on a delay. The OBR model does not correctly incorporate the change in losses position throughout the five-year period.

The OBR expected tax yield from EPL has fallen by over 60% during the last two years. This is in part due to a softening of commodity prices, a reduction in expected production volumes and impact of inflation on underlying profitability of assets.

The model used in this paper considers losses in the period. The model uses an oil price higher than the OBR forecast and a more conservative gas price, which aligns with our expectations of the market. The model should be seen as a representative “ceiling tax take.”

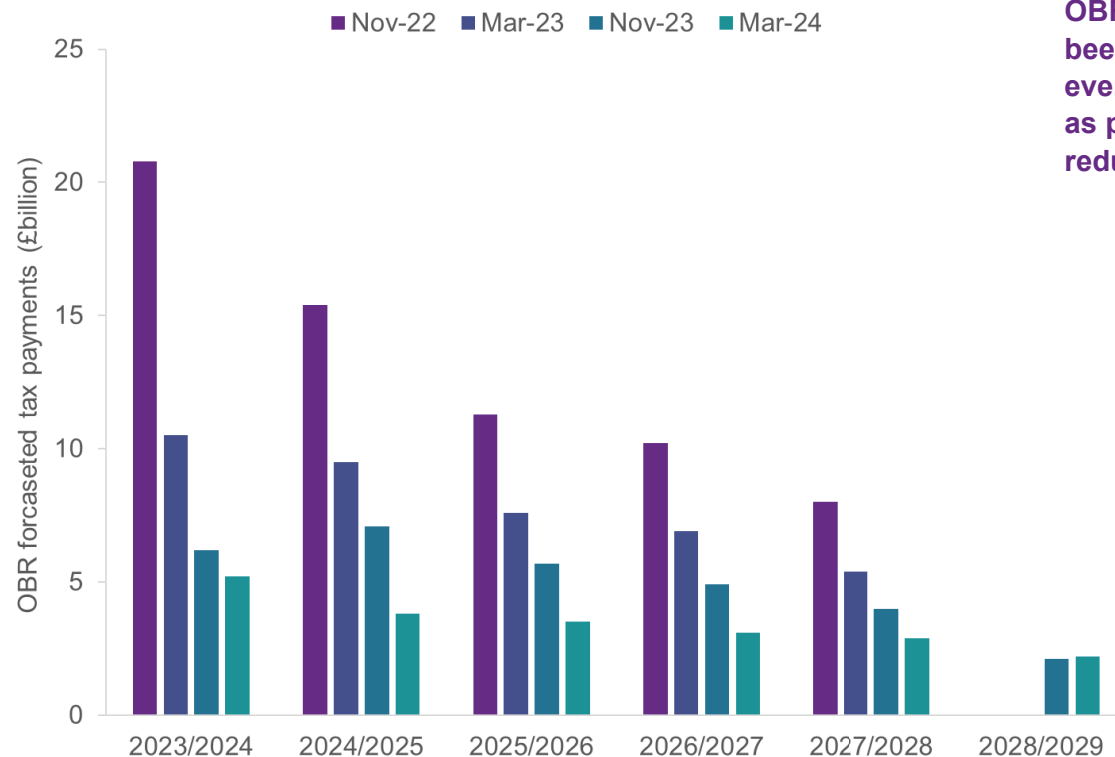


Figure 10:
OBR forecast has been revised down every fiscal moment as prices have reduced

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