UK'S ENERGY WINDFALL TAX - BORROWING FROM THE FUTURE FOR THE POLITICAL PRESENT?

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Legal Briefings – By **Paul Butcher**

Political storms usher in a contentious windfall tax but can the Levy address fundamental challenges with the UK energy market?

> *"What is it about the Sue Gray report that first attracted Boris Johnson to publish his plan for a windfall tax this week?" Sir Keir Starmer, Leader of the Opposition, 25 May 2022*

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UPDATE:

On 21 June 2022, HMRC published draft legislation for the new Energy Profits Levy, along with a detailed explanatory note. Consultation on the draft Energy (Oil and Gas) Profits Levy Bill will run until 28 June 2022. See our blog post here for further details.

Just two weeks ago the Queen's Speech, setting out the UK Government's legislative agenda, made no reference to the multi-billion pound cost-of-living support and energy windfall tax package announced this week (26 May), nor to Northern Ireland protocol legislation (for the latter our podcast here discussed the risks of a UK-EU trade war). So, many will share Keir Starmer's suspicions on what may now be driving the Government's agenda and timetable, amid intense pressure after a series of breaches of lockdown rules and dramatic spikes in retail energy prices.

But this article focuses not on the thorny politics that preceded this announcement but on the implications of the windfall tax for investors and investment. Earlier this month Business Secretary Kwasi Kwarteng summed up the argument against the kind of windfall tax the Labour and Liberal Democrat opposition parties proposed: “I’ve never been a supporter of windfall taxes. It discourages investment and the reason why we want to have investment is because it creates jobs, it creates wealth and it also gives us energy security.”

As the Government brings in its own "energy profits levy" on oil and gas companies and states it will "urgently evaluate the scale" of the "extraordinary profits and the appropriate steps to take" in relation to the electricity generation sector, the concern remains the same: how will it impact future investment?

By introducing a windfall tax the Government is balancing - and risking - a trade-off between dealing with the current acute cost-of-living crisis and the need for the UK to secure the vital long-term transformational investment to meet ambitious targets set out in its recent British energy security strategy. As we argued here, that strategy had precious little detail on the delivery necessary to secure that investment; as the recent report by the Committee of Public Accounts noted: "Government's Net Zero Strategy relies heavily on private investment and innovation driving down costs; however, Government has a poor track record of providing investor confidence". This is notwithstanding the enormous efforts being made by some Government figures – most notably Lord Grimstone, its Minister for Investment.

North Sea tax has always been treated differently to other sectors for good reason - with its generous capital, loss and decommissioning allowances balanced with a much higher tax rate than for other companies. The Government's key method of preventing the new tax hitting investment is a new 80% investment allowance that means oil and gas firms overall receive a 91p tax saving for every £1 invested, nearly double the tax relief currently available.

However, that tax relief is only for investing in "UK extraction", ie, fossil fuels. It is not available for the multi-billion pound decarbonisation investment that many oil and gas companies are planning for the UK's energy transition. Encouraging more investment in North Sea oil and gas extraction, while not doing the same for decarbonisation plans will be controversial with those already opposed to the Government's recent commitment in its energy strategy for a new licensing round in the autumn, which also reflects new geopolitical realities following Russia's Ukraine invasion.

More concerning though for current and future investors in the UK's energy transition will be the implications of the Government's potential plans for a windfall tax on electricity generation – which is, of course, the key sector into which new investment is sought. They will be looking carefully at what is brought forward, including in relation to wider electricity market reforms that Government is currently considering.

Investors have international reach and options. The UK Government will hope the overall package it presents, including in due course for electricity generators, will provide the necessary confidence. Investors will also see that, for example, Spain and Italy have also already announced windfall taxes and that other European countries may also soon follow suit.

Yet the UK finds itself in the strange position, having been so recently celebrated as Europe's poster-boy for decarbonising electricity generation, only to see poor design in its retail energy markets amplify the impact of the global energy crisis. It may be a while yet until the politics settles sufficiently to calm some investors' nerves.

Click here for more analysis of the challenges facing the UK's energy market

The Energy Profits Levy at a glance

The Energy Profits Levy will increase the headline rate of tax on the profits of oil and gas companies operating in the UK and the UK Continental Shelf from 40% to 65%. The Levy will apply to profits arising on or after 26 May 2022. The measure is temporary and will be phased out as oil and gas prices return to "historically more normal" levels. Enacting legislation will also include a sunset clause, removing the tax after 31 December 2025.

The tax base for the Levy will be computed in a similar manner to existing taxes which apply to oil and gas companies: Ring Fence Corporation Tax and Supplementary Charge. The Levy will apply to a company's 'ring fence profits', computed with a number of adjustments, and be charged as if it were an amount of corporation tax. Companies will not be able to offset previous losses or decommissioning expenditure against profits subject to the Levy.

One of the adjustments to be applied to profits subject to the Levy is an investment incentive. To avoid deterring investment, the new 80% investment allowance will be generated on investment expenditure. The UK Treasury notes that the new allowance will mean businesses will overall receive a 91p tax saving for every £1 invested, nearly doubling the tax relief available to oil and gas companies.

The new Levy is expected to raise around £5 billion in its first 12 months.

UK Chancellor Rishi Sunak also referred to the similarly high profits made by companies in the electricity generation sector. These profits will also be targeted but not at the present time. The Government will "urgently evaluate the scale of these extraordinary profits and appropriate steps to take". It is possible that measures will be introduced targeting electricity generators in the Autumn Budget.

Further details of the new Levy can be found in the following HMT publications:

HMT News Story: Millions of most vulnerable households will receive £1,200 of help with cost of living

Energy Profits Levy – Technical Note

Energy Profits Levy Factsheet

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