Hot Air

The United Kingdom announced last month that it would impose a “temporary levy” on “extraordinary profits” of oil and gas producers, to help ease the burden of soaring energy prices on consumers. The extraordinary measures were more appropriately dubbed a “windfall tax”, by the UK press and political establishment, to help ease the so called “cost of living crisis”.

The Conservative government was at pains to add that they will phase out the tax, as oil and gas prices decline in future. However, the companies are not so sure. As BP noted in a statement, “Today’s announcement is not for a one-off tax - it is a multiyear proposal. We will now need to look at the impact of both the new levy and the tax relief on our North Sea investment plans.”

As Milton Friedman, the Nobel Prize winning economist, once drily noted back in the days when academics were allowed a sense of humour, “Nothing is so permanent as a temporary government program”. Friedman was only half joking. Back in 1842, the UK parliament under the government of Robert Peel, enacted the Income Tax Act as a “temporary measure” and at a rate of 2.9%; by 1974 when Friedman made his famous quip, the UK’s income tax had become permanent with a top rate of 84%!

The impact for our oil and gas holdings (Shell plc and BP plc) is negligible. As the UK represents a mid-single digit proportion of production (3% and 5% respectively), we expect a low single digit percentage impact to earnings from the windfall tax (around 1-2% respectively).

Whereas the Conservatives today bill themselves as the “party of business”, the facts suggest that is what they used to be. According to the Office for Budget Responsibility, the UK tax burden (measured as a percentage of Gross Domestic Product) is today at the highest level since the 1960’s. This was true even before Covid-19, which has of course only made matters worse. Long gone are the supply side economic policies of Margaret Thatcher and her chancellor, Nigel Lawson, who rationalised the public sector, reduced the tax burden to the lowest levels in a century and ushered in an era of rejuvenated growth and prosperity.

Gone too are Cameron and Osbourne’s “austerity”. Public sector spending today as a proportion of GDP post Covid has ballooned. Meanwhile the productivity of those services has collapsed due to lockdowns and working from home, for which they are ill-equipped.

Johnson’s government ruled out a windfall tax when it was proposed by Labour just five months ago. Now they are weak in opinion polls due to the “Partygate” scandal and rampant inflation impacting real incomes. Against that backdrop, it is unsurprising they are borrowing Labour’s popular idea. However, they should tread carefully, or risk biting the hand that feeds them. By way of example, Shell recently re-domiciled from the Netherlands to the UK in order to avoid punitive environmental regulations on its global business, which would have put the company at a disadvantage versus international competitors not subjected to the same. Separately, BHP recently left the UK for an Australian domicile. The UK government was smart enough to limit the windfall tax to UK territory, which will level the playing field and prevent companies fleeing. ▶▶

The windfall tax is short-sighted in our view. Firstly, as BP suggested, the profitability of future oil and gas projects in the North Sea will be negatively affected by the higher tax, resulting in fewer projects being approved, reducing the UK's long-term self-sufficiency in energy. Secondly, the UK's "cost of capital" will be negatively impacted. Long-term capital-intensive investments in (low carbon) nuclear and renewable energy are characterised by big upfront spending, requiring visibility on the tax rates. Since the windfall tax was imposed retrospectively, it increases the risk for all future capital investments in energy. In that regard, the windfall tax will not be a free lunch, the UK will pay for it in the future, via investors demanding higher returns. Paradoxically, it is the big oil and gas companies (Shell, BP, etc.) whom the UK government is encouraging to lead the energy transition.

The government's answer to that conundrum, which would make George Orwell proud, is an "investment allowance". In other words, "don't worry about the 25% windfall tax on all your historical investments, going forward we will give you a tax break if you invest even more".

Politics is simple. Firstly, say and do anything you can to get into power. Secondly, once in power, do anything you must to stay there. Boris' windfall taxes may get an "F" for economics but get an "A plus" for politics! ■

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