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Briefing

Fossil fuel tax breaks in the UK

"The tax measures announced by the Chancellor [are] a turning point for the industry"
Industry lobby group Oil & Gas UK on Budget 2012[1]

"Fossil fuel subsidies… need to be removed for a healthy energy economy"
Fatih Birol, Chief Economist, International Energy Agency, January 2012[2]

Update: *This briefing was originally published in November 2012. It was updated in January 2013 to include information on the financial value of fossil fuel tax breaks to UK companies.*

Summary

Fossil fuel subsidies help keep economies hooked on oil and gas, increase the risks of climate change, and make it harder for clean sources to break through. The International Energy Agency and OECD say that tax breaks are a type of subsidy[3] [4].

Yet in the UK the Chancellor has **ramped up tax breaks for North Sea oil and gas production** and plans new ones for **shale gas**:

- The oil and gas industry claims to be very highly taxed. But **most new oil and gas fields in the North Sea pay as little as 30 per cent tax** because of tax breaks.
- 80 per cent (32 out of 40) of oil and gas projects started in the North Sea since Budget 2009 have done so benefitting from a 'field allowance', which can reduce the tax they pay on their profits by many hundreds of millions of pounds.
- Throughout 2012 George Osborne massively ramped up these field allowances. Allowances have been given since Budget 2012 that are worth **over £800 million in direct subsidy to the oil and gas industry** – a figure that will rise as more companies announce activity.
- These tax breaks are in addition to the massive subsidy the fossil fuel industry gets by **not having to pay the full costs of the economic, social and environmental damage** it causes through air pollution, climate change and oil spills.
- The oil and gas set to be extracted as a result of just one of the Chancellor's recent tax measures will, when burned, produce as much CO_2 as the UK emits in a year.

The Chancellor is also promising tax breaks for shale gas – a move that must be reversed, with no further exploration for, or production of, 'unconventional' gas permitted.

For more than 40 years we've seen that the wellbeing of people and planet go hand in hand – and it's been the inspiration for our campaigns. Together with thousands of people like you we've secured safer food and water, defended wildlife and natural habitats, championed the move to clean energy and acted to keep our climate stable. Be a Friend of the Earth – see things differently.

Fossil fuel extraction – how much tax do they pay?

In theory, oil and gas production in the UK is subject to a high rate of taxation:

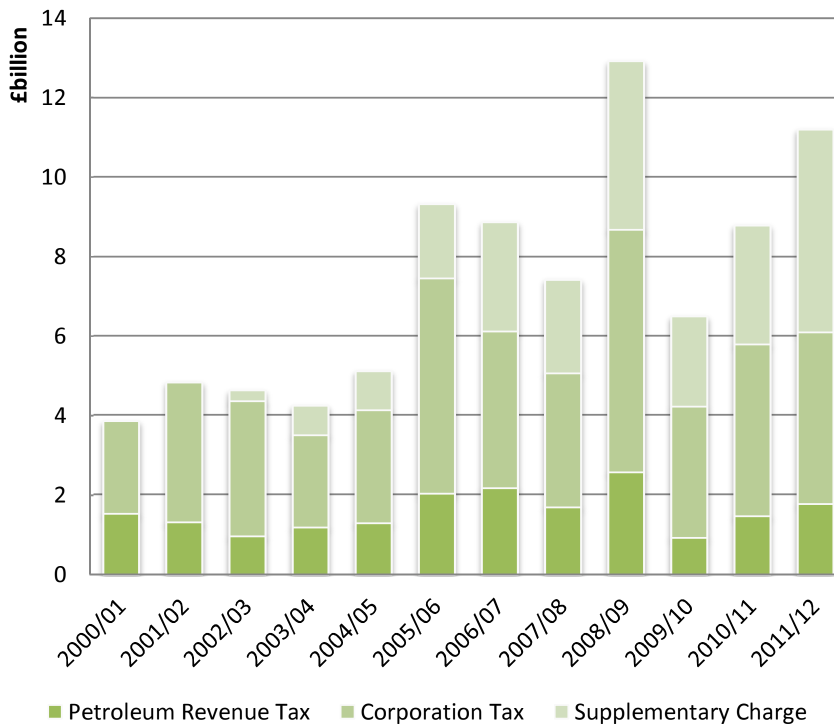
- a higher **corporation tax** rate of 30% on profits from oil and gas production
- an extra '**supplementary charge'** of another 32%, taking the tax rate to 62%. In some fields, this charge is reduced by 'field allowances' (see below).

In addition, profits from older fields (before 1993) must pay the old Petroleum Revenue Tax (PRT) of 50%, which can be deducted from their corporation tax base. In practice this means profits from around 30 such fields will pay a marginal tax rate of 81 per cent[5].

Government figures for 2010/11 suggest that the total tax take from the three types of tax mentioned above was £8.8 billion in 2010/11 (see chart 1).

Chart 1: UK exchequer receipts, 2000/01 to 2011/12

Source: DECC[6]. Figures presented are for receipts from PRT, corporation tax and supplementary charge. Figures for 2011/12 are estimates. Figures in 2010/11 prices.



A high level of tax is appropriate, because:

1. Even after tax, fossil fuels remain highly profitable.
2. Fossil fuels are common resources that do not 'belong' to the company that extracts them. The Government says that because oil and gas are a natural resource that belong to the UK, companies that are given the right to drill for it should ensure that a large chunk of the benefits return to the public purse[7].

3. In fact the tax rate on fossil fuels should be even higher in recognition of the environmental damage fossil fuels cause from air pollution or climate change (see below).

There are two central points here. The first is that more oil and gas should not be actively encouraged through the tax system. The second, related point, is that where that activity is taking place, it should be subject to a very high rate of tax in recognition of its environmental impact. What is happening now is lowering the rate of tax on new or some existing fields specifically to get more oil and gas extraction happening.

Tax breaks

In practice, profits from most newer fields are not subject to anything close to the 62% tax rate because of the rapid expansion of tax breaks called **field allowances**.

Field allowances were introduced by Alistair Darling in Budget 2009 and have since been expanded by George Osborne. Field allowances give tax breaks to encourage production from "small or technically challenging new fields". In 2012 new field allowances have been created, and an existing one has been expanded:

> *"to increase investment and production in fields and projects that are economic but - for tax reasons - are considered to be commercially marginal. They support the Government's overall aim of maximising the economic production of the UK's hydrocarbon resources"*
> (HM Revenue & Customs)[8]

Field allowances reduce a company's tax bill by allowing a certain amount of income from the field (see second column below) to be exempt from the 32% supplementary charge.

Table 1 lists the different types of field allowance available, when they were introduced, and how much tax they might save a relevant company from paying in total. For example, a company making £600 million a year for five years (£3 billion in total), which qualified for a field allowance for a new field off the coast of Shetland, would not have to pay almost £1 billion of tax it would otherwise have to pay on that profit. The following section estimates out the total value of these allowances to the industry.

These tax breaks work. In October 2012 the Government announced the new £1.6 billion 'MonArb' project – "the production of an extra 100 million barrels of oil equivalent from the existing Montrose, Arbroath, Brechin, Arkwright, Carnoustie and Wood fields… [and] includes consent for the new Cayley and Shaw fields". This investment was only possible because "the announcement of the Brown Field Allowance by the Treasury was key to unlocking the project"[9].

Data published by DECC shows that **since field allowances were introduced in 2009, 80 per cent of newly-approved oil and gas fields have benefitted from one of these tax breaks[10].** It appears that without tax breaks, many hundreds of millions of barrels of UK oil or gas may have stayed in the ground.

Table 1: Field allowances for different types of UK oil and gas field

Field Allowance (year introduced)	**Maximum total field allowance** (how much income from the field can be exempted from 32% tax)	**Therefore reduces tax paid by a maximum of***
Small field (2009, increased Budget 2012). Covers small fields – although the definition of 'small field' was also broadened in Budget 2012.	Set at £75 million in 2009. Increased to £150 million with effect from Budget 2012.	£48 million
Ultra heavy oil field – particularly viscous oil (2009)	£800 million	£256 million
Ultra high pressure / high temperature field (2009, extended in 2010)	£800 million	£256 million
Remote deep-water gas fields (2010)	£800 million	£960 million
Large deep-water oil fields, intended for use west of Shetland (Budget 2012)	£3 billion	£960 million
Large shallow-water gas fields (July 2012)[11]	£500 million	£160 million
Brown-field allowance for some projects in already producing fields (September 2012)[12]	Increases at a rate of £50 per tonne to incremental reserves, to cap of: £250 million / £500 million for projects in fields paying Petroleum Revenue Tax (PRT)	Upper cap of: £80 million / £160 million (PRT)

How much are tax breaks worth to the oil and gas industry?

Tax breaks were first introduced by Alistair Darling in 2009, and have been ramped up significantly by George Osborne in 2012.

The 'worth' of the tax breaks to the industry is because the industry is let off the payment of tax for a certain amount of their profits from particular fields. (see above).

Assuming that all of the tax breaks were taken up in full, the tax breaks given out by George Osborne since Budget 2012 amount are so far worth **£864 million** to the oil and gas industry.

This takes the total value of allowances awarded since they were created in 2009 to **£1,164 million** (see Table 2).

This figure was correct as of the end of January 2013. It is very likely to continue to increase quickly as new fields are licenced and new field allowances awarded. For example, the figures do not yet include the field allowance to be awarded to Dana Petroleum for its $1.6 billion oil and gas development east of Shetland, announced December 2012.

* The maximum field allowance is a total figure, not an annual figure. With supplementary charge at 32%, the total tax reduction for a company benefitting from a full Small Field Allowance is £48 million (32% of £150 million)

Table 2: value of the Government's tax breaks to the oil and gas industry†

	Budget 2009 to Budget 2012	Since Budget 2012	Total
Number of field allowances taken up	20 *(all Small Field Allowance)*	15 *(13 Small Field Allowance; 1 Brown Field Allowance; 1 Shallow-Water Field)*	35
Total value of allowances over five years, assuming taken up in full	£300 million	**£864 million**	**£1,164 milllion**

Shale gas

The Chancellor also used his party conference speech 2012 to announce a consultation on "a generous new tax regime for shale so that Britain is not left behind as gas prices tumble on the other side of the Atlantic"[13], to boost domestic production. The coalition mid-term report, published January 2013, underlined its commitment to a favourable tax regime for shale gas[14].

DECC states that "at least for the next decade … EU shale gas production is not expected to have as great an impact on EU gas prices as has been the case with US shale gas production on [US gas] prices"[15]. Indeed former Energy Minister Charles Hendry has said "betting the farm on shale brings serious risks of future gas price rises"[16].

Shale gas also poses big risks for the local environment and human health, threatens investment in renewable energy and is unlikely to lead to significantly lower prices.

For environmental reasons, there should be a moratorium on shale gas development in the UK. In its absence, shale should certainty not be given favourable treatment in the tax system, but taxed very highly.

Another tax measure: plant decommissioning tax certainty

Budget 2012 saw the Chancellor commit to give certainty to fossil fuel companies about the level of tax they will have to pay in the future when decommissioning equipment like oil rigs. Decommissioning costs are estimated at approximately £30 billion. PwC cited uncertainty about the level of tax for decommissioning as the number one thing the oil and gas industry want to end. So the Chancellor's announcement was greeted extremely enthusiastically by industry lobby group Oil & Gas UK (see the quote that opens this briefing).

OGUK claims that a fixed rate of tax will lead to £40 billion of new investment, producing 1.7 billion barrel equivalents of oil and gas. Friends of the Earth calculates that this much oil and gas, when burned, would produce as much CO_2 as the UK currently emits in a year[17].

† Calculation by Friends of the Earth based on DECC data on field allowances [see endnote 10]. Figures are undiscounted. Figures are conservative as Small Field Allowances awarded prior to Budget 2012 but not yet claimed in full would have increased in value following the budget's uprating of the value of the SFA, which is not reflected here. Assumes all allowances claimed to their full value.

Promising to set a fixed level of tax in the future is not a subsidy in itself. However it is not at all clear why decommissioning fossil fuel production plant should attract any tax 'relief' at all. If the Chancellor had wanted to provide certainty in keeping with the environmental impact of fossil fuels, he would have introduced the certainty of no tax breaks.

Benefits to the Exchequer

The Treasury is dependent on oil and gas tax revenues and is going out of its way to get more production happening, so it can tax it. DECC is clear that it aims to "guarantee… every last economic drop of oil and gas is produced for the benefit of the UK"[18]. By encouraging investment in fossil fuels, the Treasury rakes in tax revenues over the long term.

For example, the long term tax revenues from the 'Brown Field Allowance' introduced in September 2012 will "significantly outweigh the initial cost of the allowance"[19]. The Chancellor expects his promise to give tax certainty for decommissioning to spark so much investment that he will receive an extra £1.145 billion in taxes over the next five years[20].

For as long as oil and gas extraction is taking place, it is right to tax it heavily. But we need to begin weaning our tax base off it, rather than what is happening now: actively increasing fossil fuel production in order to get more long-term tax revenue into the Exchequer.

There is nothing sustainable about building one's tax receipts upon a stock off which we must wean ourselves as soon as possible. The more the public finances depend on fossil fuel revenues, the harder a fall will face the finances in the future.

Reduced rate of VAT for domestic energy use

The OECD argues that in addition to support for the production of fossil fuels, there's also an indirect subsidy in the UK for the consumption of fossil fuels. This is because of the reduced rate of VAT (5%) that is paid on domestic energy use which is predominantly fossil-fuel powered. The OECD say that this is worth approximately £2.8 billion for natural gas alone in 2010.

But it is highly arguable whether this is a fossil fuel subsidy. It is a subsidy on all energy use.

Scrapping this lower rate of VAT overnight would be the wrong thing to do – it would push many more people into fuel poverty, hitting those on lowest-incomes hardest as their bills rise.

Rather than indiscriminately removing the reduced rate of VAT, a much broader look is needed at the issue of energy pricing and energy bills. This should include:

- A major programme of energy efficiency, prioritizing the fuel poor and those on low incomes, to massively reduce the amount of energy needed to heat homes
- Giving proper consideration to reworking energy bills around a principle of 'rising block tariffs' – where, unlike now, the initial units of energy used are the cheapest, and higher users end up paying proportionately more.

Why tax breaks for oil and gas production are wrong

The UK – and the world – has to move rapidly to decarbonise energy. Taxes should be used as a disincentive for polluting activity that keeps our economy hooked on fossil fuels. Instead, the Government's policy is actively encouraging new oil and gas production, primarily for revenue purposes. All tools of Government should focus on making renewables energy cheaper and energy saving more attractive, not bolstering rich oil companies. This is also important to ensure that the UK does not exist in a 'fools' paradise' in which government revenue is dependent on domestic fossil fuel reserves which are declining fast and which must ultimately run out.

In November 2012 the International Energy Agency warned about the implications of fossil fuel subsidies within the world's current energy path:

> *"The world is still failing to put the global energy system onto a more sustainable path. Global energy demand grows by more than one-third over the period to 2035 in the New Policies Scenario (our central scenario)… despite the growth in low carbon sources of energy, fossil fuels remain dominant in the global energy mix, supported by subsidies that amounted to $523 billion in 2011, up almost 30% on 2010 and six times more than subsidies to renewables… Emissions in the New Policies Scenario correspond to a long-term average global temperature increase of 3.6 °C."*
> International Energy Agency, World Energy Outlook, November 2012[21]

EU State Aid rules are clear that there should be two main conditions for subsidising energy industries: environmental protection and helping infant technologies[22]. The EU's draft September 2012 paper on the internal market says that Member States should actively work to "*remove all… direct and indirect support for fossil fuels*"[23]. The G20 – of which the UK is a member – has pledged to eradicate fossil fuel subsidies.

The Treasury isn't listening. It claims that it doesn't matter in environmental terms where the oil and gas is produced, because an extra barrel produced in the UK will just displace a barrel bought in from somewhere else. But this is wrong:

- It bolsters the domestic oil and gas industry and thus supports vested interests that continue to lobby for favourable tax treatment and support in the years ahead
- It comes with a significant opportunity cost: propping up the declining oil and gas industry diverts attention from the urgent need for a credible and coherent long-term policy and financial framework to support renewable energy.
- In defiance of expert predictions[24], the Chancellor wants to see lower gas prices for domestic consumers by increasing domestic supply, in particular of shale. In practice it seems unlikely he will get his wish: it looks like that for EU gas prices, the only way is up[25]. But for the sake of argument, *were* he to achieve lower gas prices in the UK by bolstering domestic production, then basic economics suggests that lower prices would lead to higher use of fossil fuels in the UK.

The biggest subsidy the fossil fuel industry receives is not being made to pay the costs of the damage they cause. Former World Bank economist Lord Stern estimated that climate change caused by fossil fuels could reduce global GDP by 20 per cent; air pollution and oil spills are other side effects.

The Government's moves to support the fossil fuel industry are the reverse of what we need to see to get our economy – and our government's revenue – off its fossil fuel dependency. If the economics of a particular field make it unattractive to extract fossil fuels, then that oil and gas should stay where they are safe: in the ground.

Contact David Powell, Economics Campaigner, 0117 924 9945 / david.powell@foe.co.uk

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