Assessing the economic impact of changes to the Energy Profits Levy on UKCS investment projects

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# Section 1. Introduction

On 26 May 2022, the United Kingdom announced the introduction of temporary Energy Profits Levy (EPL) to tax profits of oil and gas companies operating in the UK Continental Shelf (UKCS). The EPL was an answer to record profits being reported by major oil and gas companies due to a high price environment[[1]](#footnote-1). In its original design, the scheme set a temporary 25% levy on oil and gas ring fence profits with an investment allowance of 80% in addition to the existing Ring Fence Corporation Tax (CT) and Supplementary Charge (SC). The levy was due to expire by December 2025.

However, the EPL has since been amended three times with significant changes to its provisions. In the Autumn Statement of November 2022[[2]](#footnote-2) it was announced that EPL rate would increase from 25% to 35% from January 2023, and its duration extended to 31st March 2028. The investment allowance was reduced to 29% to maintain the same cash value of relief given through the allowance. An 80% investment allowance was given for expenditures related to decarbonisation of oil and gas production. Then, in the 2024 Spring Budget[[3]](#footnote-3), it was announced that the EPL will be extended by one year to March 2029 and that the Spring Finance Bill will include legislation supporting the Energy Security Investment Mechanism (ESIM) [[4]](#footnote-4), which sets a price threshold that removes the EPL if triggered.

Adding to the uncertainty, the newly elected Labour Party published a policy paper announcing further changes to the EPL applying from 1 November 2024[[5]](#footnote-5). The changes include increasing the Levy rate from 35% to 38%, taking the headline tax rate to 78%. The period is extended by one year to 31 March 2020. Notably, the 29% Investment Allowance on the EPL will be abolished for qualifying expenditure incurred on or from 1 November 2024. The paper states that “the government will also reduce the extent to which capital allowance claims (including First Year Allowances) can be taken into account in calculating levy profits.”, although the specifics of this are not yet published. The Energy Security Investment Mechanism and the decarbonisation allowance will remain in place.

The amount of changes has raised concerns over the stability and predictability of the UKCS tax environment, which is crucial for long-term investment decisions in the oil and gas sector. Trade body Offshore Energies UK (OEUK) has called for the [[6]](#footnote-6)stability of the tax regime to support investment, and published an industry manifesto to highlight the importance of the sector within the UK economy[[7]](#footnote-7). The Government has defended the changes by stating that the one year extension to the Levy will raise an additional £1.5 billion, and that certainty is given with the ESIM which puts a price floor for to the EPL.

Industry, however, has been vocal about the negative effects of the EPL across the UKCS. Companies have made decisions to diversify away from the UKCS[[8]](#footnote-8). Investment cuts have been announced by important North Sea operators[[9]](#footnote-9). Lack of new investment has resulted in reduced capacity of the Forties Pipeline System[[10]](#footnote-10). Energy consultancies like Rystad[[11]](#footnote-11), and investment bank Stifel[[12]](#footnote-12) have warned of the negative impact of the EPL. The prospect of a tougher tax regime if the Labour proposal materialises, has resulted in further backlash from industry. Estimates by Wood Mackenzie suggest that North Sea producers could freeze investment until the EPL sunset in 2029.

In this short note, we extend our previous study[[13]](#footnote-13) of the EPL impact on UKCS investment to analyse the impact of the EPL changes that will come into force from 1 November 2024. We achieve this by developing a simplified economic model of three oil fields designed to be representative of recent UKCS assets. Our contribution to the ongoing debate involves examining if under the UKCS tax regime delaying investment and field start-up improves or worsens project economics. In addition, we evaluate the changes in post-tax Net Present Value (NPV) and what this means for investment decisions in the UKCS.

We begin by outlining the core assumptions of the modelling procedure. We then compare the results by testing the economics of fields under different startup assumptions. Subsequently, we assess the economics under different tax arrangements. We then discuss policy implications. Finally, we provide concluding remarks and observations.

# Section 2. Data and Methodology

Our assessment is underpinned by a Discounted Cash Flow (DCF) model for three oil fields designed to be representative of UKCS assets of recent vintage. We make a simplifying assumption by modelling cashflows on fiscal years. So instead of the year beginning on 1 January and ending 31 December, the year begins 1 April and ends 31 March. This allows a more straightforward approach to model the EPL as its expiry is in the month of March. The modelling assumes projects beginning investment in fiscal year 2025.

Table 2 show the cost and size assumptions used for each field based on different reports by the North Sea Transition Authority. Production profiles for the three oil fields were designed to exhibit the typical behaviour of UKCS assets. During the initial years production increases until it hits a plateau and then decline begins. Smaller fields show faster decline rates while larger fields will have slower decline rates.

Table 1. Cost assumptions for model fields

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Variable** | **Units** | **Field 1 - Small** | **Field 2 - Medium** | **Field 3 - Large** |
| Recoverable reserves | Million barrels (MMbbls) | 10 | 50 | 100 |
| Development costs (DEVEX) | USD/bbl | 19 | 13 | 10 |
| Annual Operating costs (OPEX) | % of DEVEX | 9.25 | 8.25 | 7.75 |
| Carbon emissions costs | % of OPEX | 5 | 5 | 5 |
| Decommissioning costs (DECOMX) | % of DEVEX | 10 | 10 | 10 |
| No. of years to complete decommissioning | Years | 1 | 1 | 3 |

The model incorporates the UK oil and gas permanent tax regime and the variations under the different EPL arrangements. Table 2 presents the main elements of the tax regimes under consideration. There are two main elements to the permanent regime: the Ring Fence Corporation Tax (CT) at a 30% rate and the Supplementary Charge (SC) at a 10% rate. Both have capital allowances on 100% first year basis. An additional element for the SC is the Investment Allowance (IA) of 62.5% which further reduces taxable income starting when the related income commences. Regarding decommissioning, the UK Government published in 2013 the Decommissioning Relief Deed (DRD) which is a contract between companies and the UK Government that provides certainty on the tax relief that will be obtained when oil and gas assets are decommissioned. Decommissioning costs are allowed as deductions for RFCT, and SC on 100% first-year basis but are not allowed for EPL. We consider two tax cases: first the case where the operator has existing ring fence income to set against their investment costs and claim immediate relief; second, the case where the operator has no other income available and must use the Ring Fence Expenditure Supplement (RFES)[[14]](#footnote-14).

Table 2. Rates and elements of the modelled tax regimes in %

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
|  | **CT** | **SC** | **I.A for SC** | **EPL** | **C.A for EPL** | **I.A for EPL** | **Expiry** |
| Permanent system | 30 | 10 | 62.5 | - | - | - | - |
| Base EPL | 30 | 10 | 62.5 | 35 | 100 | 29 | 31 March 2029 |
| EPL A | 30 | 10 | 62.5 | 38 | 100 | - | 31 March 2030 |
| EPL B | 30 | 10 | 62.5 | 38 | - | - | 31 March 2030 |

The Energy Profits Levy as currently applicable (base EPL) is modelled with the following characteristics. A 35% tax on UK oil and gas profits, taking the headline rate to 75%. The investment allowance is set 29%. We do not model the case of decarbonisation expenditures that qualify for the 80% allowance. The expiry date is set to 31 March 2029.

We incorporate the new Government’s changes by increasing the rate to 38%, removing the investment allowance for EPL and extending the expiry date one year to March 2030; we refer to this arrangement as EPL A. We further test for the possibility that the capital allowance on the Levy be removed; we refer this this arrangement as EPL 3b.

Our market environment assumptions seek to be consistent with mid- to long-term price scenarios used by companies and investors when evaluating long term investment opportunities. Current oil price volatility and high inflation, while important in the short-term might not reflect the investment environment in 5 or 10 years. Table 3 sets out the assumed values for various market variables. The scheduling of development costs for each field over time is shown in Table 4. Particularly, for oil price the assumption has been set based on the average oil price forecast from the March 2024 Economic and Fiscal Outlook of the Office for Budget Responsibility[[15]](#footnote-15)

We model three investment start-up dates for the projects: 2025, 2026, and 2027. The objective in analysing three start up dates is to understand the potential economic benefits or losses from delaying projects.

# Section 3. Results and Discussion

## Section 3.1 Impact of EPL for different investment start up dates.

We begin by analysing the incentives to delay or accelerate investments by comparing the post-tax NPV at different start-up dates. In this section we consider only the tax case where the operator has other income against which to claim immediate tax relief, to isolate the impact of the Base EPL, EPL A, and EPL B compared to the permanent system. Economic intuition suggests that there is an incentive to delay investments to the point where the relief available is realised, but the operator avoids profits applicable for EPL.

Table 3. Assumptions for market variables

|  |  |  |
| --- | --- | --- |
| **Variable** | **Value** | **Units** |
| Real Brent oil price[[16]](#footnote-16) | 70 | USD/bbl |
| Consumer price index | 2 | % |
| Discount rate | 10 | % |
| Exchange rate | 1.3217[[17]](#footnote-17) | USD per £ |

Table 4. DEVEX schedule (%) for representative fields

|  |  |  |  |
| --- | --- | --- | --- |
| **Project year** | **Field 1** | **Field 2** | **Field 3** |
| **0** | 50 | 30 | 20 |
| **1** | 50 | 30 | 30 |
| **2** |  | 40 | 30 |
| **3** |  |  | 20 |

Figure 1 presents the modelling results for the small field under different tax arrangements. The results indicate that in pre-tax conditions and under the permanent system there is no incentive to delay investment. Notice how the post-tax NPV decreases as start-up is delayed. This is explained by the time value of money. Receiving early profits is more valuable to the operator.

Under the base EPL, however, it makes economic sense to delay the investment. In this example, delaying by two years to 2027 even results in a higher NPV compared with the permanent system assuming. This is because the project obtains immediate relief on the capital allowance, with few of its profits taxed by the higher EPL headline rate. Under the new chanes to the EPL, presented as EPL the incentive to delay remains, but the post-tax NPV has reduced due to the higher headline rate, and reduced relief because of the removal of the 29% investment allowance on EPL.

The impact on NPV from EPL B, the case where the capital allowance for EPL is removed, is quite dramatic. This is because profits are taxed fully at 38% with no possibility to claim relief for investment expenditures. Notice how the post-tax NPV in EPL B compared with EPL A is more than halved. In this case, delaying is the best option for the operator if value wants to be derived from the project.

Figure 1.

The implications for the medium-sized field shown in Figure 2 are similar. Under pre-tax conditions and the permanent system there is no incentive to delay, but in EPL A and EPL B delaying is sensible to avoid generating profits that will be taxed under the EPL. In the case of the base EPL however, it seems that delaying is only optimal until 2026 but not beyond. This is explained by the timing of expenditures and profits from the cashflows. If investment is delayed, the field does not claim relief for all its capital expenditures, which offsets the benefits of avoiding the higher headline tax rate for the profits.

Another highlight from the results is that while in the medium sized field EPL B significantly reduces the value of the field, it is not as stark as the impact of the small field. Closer examination of the cash flows suggests that this is because the different lead times to develop and then begin production in a project. A small project will normally be developed faster reaching peak production earlier which will be entirely taxed with the new EPL headline rate. With the medium field, development and peak production take more time so less of the profits are taxed with the new headline rate.

Figure 2.

The results for the large field shown in Figure 3 confirm that under pre-tax conditions and the permanent system, there is no incentive to delay. However, in the EPL cases it is not the case that delaying results in improved project economics. Under the Base EPL there is no incentive to delay as NPV decreases if start up is delayed. In EPL A and B delaying one year marginally improves the value of the project, but delaying by two years results in a similar NPV than that of 2025. As was the case with the medium field, what explains this behaviour is the timing of expenditures and profits in the cash flows. In the case of the base EPL the operator will benefit of investing early on because it will claim tax, while longer lead times make it so that profits will occur after the expiry of the EPL. In EPL A and B, the operator will want to delay by at most one year to avoid generating profits during the applicability of the EPL but reach peak production as soon as the EPL has expired.

Figure 3.

Taken together, the results of this section show that operators for small and mediu sized fields have an incentive to delay investments. This is especially true in the more stringent regime from EPL B. By removing the investment and capital allowance for EPL, operators will be better-off delaying any investment to avoid being taxed at the higher rate without the possibility to claim relief. The impact in small projects is quite dramatic as EPL B can even turn them uneconomic if higher costs and lower prices are realised. In other words, EPL B curtails investment instead of promoting it.

Moreover, the stark reduction in NPV from EPL A or B compared to other arrangements, even if delaying, supports the claim that UKCS will lack appeal and competitiveness against other basins. The continuous changes to the temporary regimes plus stringent tax measures significantly impact project economics, a condition that will be negatively weighed by potential investors.

## Section 3.2 Impact of EPL on cash flows under different tax cases arrangements.

In this section we assess the impact of the new EPL changes compared with the permanent system and the currently applicable EPL on the cashflows of UKCS investment projects. We analyse projects starting up investment in fiscal year 2025. We present results for the tax case where there is ring fence income available to claim immediate relief, and for the case where there is no income available and the RFES applies. Note that in the case where there is no other income available, EPL A and EPL B exhibit the same NPV and cashflows because in both cases the investment allowance is removed, and for both schemes the RFES mechanism applies instead of the capital allowance.

Table 5 presents the post-tax NPV values for the three fields under different tax arrangements. In this study, we focus on the impact of EPL A and EPL B compared to other arrangements. From the results, both schemes of EPL significantly reduce the post-tax NPV of the fields. The effect is stronger in the small field. In EPL A project NPV has more than halved compared to the pre-tax NPV and the investment hurdle not reached. Under EPL B the project even becomes uneconomic. This means that it is unlikely that an operator decides to invest in a small project. The operator will be better off delaying the investment as suggested in section 3.1. Notice also that this result is underpinned by the assumptions, if the costs were higher or the oil price lower, the post-tax NPV under the new EPL will turn uneconomic.

Table 5. Post-tax NPV of three oil projects under different tax arrangements

(Real 2025 NPV@10%)

|  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  | **Tax case – other income** | | | | | **Tax case - no other income** | | | |
| **Field** | **Pre-tax** | **Permanent** | **Base EPL** | **EPL**  **A** | **EPL B** | **Pre-tax** | **Permanent** | **Base EPL** | **EPL A/B** |
| Small | £69 | £47 | £49 | £28 | -£11 | £69 | £39 | £5 | -£19 |
| Medium | £512 | £373 | £425 | £328 | £200 | £512 | £301 | £235 | £127 |
| Large | £861 | £575 | £758 | £605 | £416 | £861 | £575 | £514 | £347 |

Notes: All values in £million.

Table 6. Investment hurdle ratios by tax case, minimum to invest set at 30%

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Income case** | **Tax regime** | **Field** | | |
| **Small** | **Medium** | **Large** |
| Other income available | Pre-tax | 66% | 149% | 168% |
| Permanent system | 45% | 109% | 112% |
| Base EPL | 47% | 124% | 148% |
| EPL A | 27% | 95% | 118% |
| EPL B | -11% | 58% | 81% |
| No other income, needs RFES | Pre-tax | 66% | 149% | 168% |
| Permanent system | 38% | 88% | 112% |
| Base EPL | 5% | 68% | 100% |
| EPL A / EPL B | -18% | 37% | 68% |
| Note: the ratio is defined as Post-tax NPV@10% / Real 2025 investment costs | | | | |

For the medium and the large field, the post-tax NPV remains positive, but the removal of the investment and/or capital for EPL severely reduces the project´s value. Analysing the cashflows for each field under the different tax arrangements is helpful to understand what are the drivers behind the impact of the different EPL schemes. Figure 4 shows the post-tax free cashflow for the small field under different EPL schemes for the case where the operator has ring-fence income available to claim immediate relief on expenditures. In the first two years of investment, the capital allowance in the Base EPL and EPL A improves the post tax cash flow for the operator in the early years. However, EPL B post-tax cashflow is lower than the other EPL cases due to the removal of the capital allowance for EPL. The permanent system and EPL B have the lowest cashflows in the first year as the capital allowance only applies for CT and SC but not for EPL. After 2025, the post-tax net cashflow of the Base EPL is slightly higher to that of EPL 3 reflecting the 3% rate increase. The extended duration of EPL A and B is also reflected in the cashflow with all cases converging with the permanent system until 2030.

The cashflow further supports the claim of the previous section about the incentive to delay investments under EPL A and B. The operator of the small field will look to start the investment close to the sunset of the EPL to avoid the profits being extracted at such a high rate, waiting for a net cashflow profile similar in behaviour to that of the permanent system.

In similar manner, Figure 5 shows the post-tax net cashflow for the medium field. The results largely follow the same trend as for small field with some differences. For example, under the Base EPL and EPL A between 2026 and 2027, the operator is still able to claim relief with the capital allowance. This improves the cash flow compared with EPL B where the cashflow doesn’t peak and remains mostly flat. Moreover, the additional year in EPL A and B further reduces the cashflow until it converges to the permanent system once the EPL expires. The cash flow once again illustrates how the operator will try to delay investment in the case of EPL B to avoid being taxed at the higher rate while not having access to the capital allowance for EPL.

Figure 4.

The results for the large field as presented in Figure 6, suggest the same effects and incentives as the smaller and medium fields apply. However, the large field has an advantage compared with the other fields: the project lifetime is significantly longer than the other two fields. The additional years of production provide some kind safety net for the project. Despite, the early profits of years 2027-2029 being severely reduced under EPL A and B compared to the permanent system, the longer production period allows the operator to incur in sensible economic profits. Nonetheless, compared the value of the investment under EPL B is reduced as the removal of the capital allowance makes the early cash flow worse

Figure 5

Let us now turn to the results of the tax position where the operator has no other income available to claim immediate relief and the RFES applies. This tax position is common in small operators or new players in the basin where there is no additional assets to claim relief from. These types of companies will, in general, be at a disadvantage when developing a UKCS oil and gas fields because the project has no opportunity to offset early losses from the capital investment.

Figure 7 shows the cash flows for the small field. Comparing to the cashflows from Figure 4, early losses are higher when no other income is available. This is because the operator has no option to immediately claim relief. When revenues are realised, the net cash flow peaks at a slightly higher level while the RFES applies, comparing to the case where there is other income available. However, this effect is not enough to offset the early losses. Because of the time-value of money, early relief is preferred.

**Figure 6.**

Continuing with the cash flow for the small field in Figure 7, notice how EPL A and B severely reduce the cashflow compared to the permanent system or the Base EPL, especially after 2028 when the RFES is exhausted. This is due to a combination of: 1) the operator not being able to claim immediate tax relief and 2) much of the income generated by the field being within the duration of the Levy. In the small field, as seen in Table 5, this leads to a NPV close to zero.

Figures 8 and 9 show the effect for the medium and large fields. The results show a similar story to the small field. However, the size of the projects makes it so that the projects hold value, but the best part of the early profits are captured by the more stringent conditions of EPL A and EPL B.

Figure 7.

Figure 8

The results in Table 5 and Figures 4 through 7 clearly show that the value of UKCS investment projects under tax conditions like the ones proposed for EPL A and EPL B could be severely reduced. Notably:

1. Small projects will likely not be developed under EPL A or EPL B for any income case. In the optimistic case that the operator decides to invest, there is a strong incentive to delay the project closer to the EPL expiry date.
2. The one-year extension and abolishment of the investment allowance in EPL A, while reducing value, it is not as strong comparing with the Base EPL. However, the removal of the capital allowance in EPL B reduces value by such an extent that there is no inbuilt incentive to increase capital expenditures while the Levy applies.
3. Operators without other income to claim relief for capital expenditures will, in general, be worse off than those who have other income available. This poses problems mostly to small firms and new players in the UKCS.

Figure 9

# Section 3 Policy implications

# Currently drafting.

# Section 4 Concluding remarks and observations

To be written once we agree on the points to highlight.

1. See <https://www.theguardian.com/business/2022/may/05/shell-profits-windfall-tax> [↑](#footnote-ref-1)
2. See the revised Energy Profits Levy factsheet from November 2022 at <https://www.gov.uk/government/publications/autumn-statement-2022-energy-taxes-factsheet/energy-taxes-factsheet> [↑](#footnote-ref-2)
3. See <https://www.gov.uk/government/publications/spring-budget-2024> [↑](#footnote-ref-3)
4. See the ESIM mechanism here <https://www.gov.uk/government/consultations/energy-profits-levy-and-the-energy-security-investment-mechanism-discussion-note/discussion-note-energy-profits-levy-energy-security-investment-mechanism> [↑](#footnote-ref-4)
5. See <https://www.gov.uk/government/publications/july-statement-2024-changes-to-the-energy-oil-and-gas-profits-levy/changes-to-the-energy-oil-and-gas-profits-levy> [↑](#footnote-ref-5)
6. See <https://www.offshore-mag.com/regional-reports/north-sea-europe/article/14310742/oeuk-urges-more-positive-uk-offshore-energy-policy> [↑](#footnote-ref-6)
7. See <https://oeuk.org.uk/manifesto/> [↑](#footnote-ref-7)
8. See a summary of claims in an analysis by Rystad Energy <https://www.energyindepth.org/after-two-years-its-clear-uks-windfall-tax-harms-north-sea-oil-natural-gas-investment/> [↑](#footnote-ref-8)
9. See the case of Total Energies at <https://oeuk.org.uk/oeuk-calls-on-government-to-rebuild-investor-confidence-after-windfall-tax-changes/> [↑](#footnote-ref-9)
10. See declarations from INEOS <https://www.offshore-energy.biz/ineos-windfall-taxes-and-mixed-signals-from-politicians-tearing-down-uks-oil-gas-industry/> [↑](#footnote-ref-10)
11. See <https://www.energyindepth.org/after-two-years-its-clear-uks-windfall-tax-harms-north-sea-oil-natural-gas-investment/> [↑](#footnote-ref-11)
12. See <https://www.energyvoice.com/oilandgas/north-sea/553700/new-report-finds-north-sea-could-lose-100000-jobs-under-labour-windfall-tax-plans/> [↑](#footnote-ref-12)
13. See North Sea Paper 148 here <https://www.abdn.ac.uk/business/documents/NSP-148_access_final.pdf> [↑](#footnote-ref-13)
14. See Taxation overview by the NSTA on the RFES <https://www.nstauthority.co.uk/exploration-production/taxation/overview/> [↑](#footnote-ref-14)
15. See Table 3.A in the Appendix <https://obr.uk/docs/dlm_uploads/E03057758_OBR_EFO-March-2024_Web-AccessibleFinal.pdf> [↑](#footnote-ref-15)
16. Based on the March 2024 Economic and Fiscal Outlook by the Office for Budget Responsibility <https://obr.uk/docs/dlm_uploads/E03057758_OBR_EFO-March-2024_Web-AccessibleFinal.pdf> . In its 2023 Annual Report, Shell’s mid-price scenario projects a similar price. See p.282 in <https://www.shell.com/news-and-insights/annual-reports-and-publications/annual-reports-download-centre.html> [↑](#footnote-ref-16)
17. From the Bank of England average spot exchange rate for September 2024. [↑](#footnote-ref-17)