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CLIENT BRIEFING

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TAX AND THE ENERGY SECTOR

Summary

The energy sector has in recent times been one of the more tumultuous in terms of fiscal policy, with political headwinds arising both from the immediate crisis of spiralling energy costs and the longer-term objectives of decarbonisation and net zero. Throw in a likely change of government in the next twelve months, and 2024 looks set to be another stormy year for producers and generators. The recent Autumn Statement trailed a new exemption for the Electricity Generator Levy, fleshed out the trigger for a possible curtailment of the Energy (Oil and Gas) Profits Levy, and was accompanied by some helpful proposed changes in the oil and gas sector. However, much uncertainty remains.

A shifting landscape

2022 and 2023 saw much upheaval in terms of fiscal policy in the energy sector. Two new taxes were brought in - first, the Energy (Oil and Gas) Profits Levy ('EPL'), introduced following political pressure for a 'windfall tax' on what were regarded as the super profits of oil and gas producers following the impact of the war in Ukraine on energy prices; and then the Electricity Generator Levy ('EGL'), charged on the so-called 'exceptional receipts' of those generators generally regarded as being relatively unaffected adversely by the spike in oil and gas prices. Testament to the instability in this policy area is that the EPL was barely six months old before it underwent its first tinkering, with a rise in the rate from 25% to 35% and a reduction in the investment allowance.

Alongside all of that, the longer-term issues affecting North Sea upstream producers trundled on, with the outcome of the *Oil and Gas Fiscal Review* being published alongside various changes to the EGL and EPL as part of the 2023 Autumn Statement. This article considers these changes and looks ahead to what 2024 might hold in store.

EGL - a new exemption

The EGL is charged at the rate of 45% on exceptional receipts of companies and groups generating electricity in the UK from nuclear, renewable, biomass and energy from waste resources. It was introduced by Part 5 of Finance (No. 2) Act 2023 with effect from 1 January 2023. Unlike the EPL, the EGL did not include any investment incentives. A 'new investment exemption' was announced as part of the last Autumn Statement, aiming to fix the gap by providing renewable electricity generators with incentives to expand. Draft legislation was published on 18 December 2023. In short, it will amend Part 5 of that Act so that 'qualifying new generating plant' is taken outside the scope of the 'relevant generating station' definition (and therefore the scope of the EGL) and introduce a new s 311A into that Act to define this concept.

'Qualifying new generating plant' and a 'qualifying project'

New s 311A will define 'qualifying new generating plant' as being new generating plant commissioned as part of a 'qualifying project' which meets the 'new investment condition'.

According to new s 311A(4), a project is a 'qualifying' one if it is a project to commission new generating plant for:

(i) a new generating station, or

(ii) an existing generating station in the case of either:

  (a) 'repowering' - in terms of the legislation, this means that the project results in that existing generating station being '*wholly or substantially comprised of new generating plant*', or

  (b) an increase in capacity, in which case the exemption will apply only to generation receipts attributable on a fair and reasonable basis (determined in accordance with existing s 283 of Finance (No. 2) Act 2023) to the additional capacity added by the new generating plant.

In the context of repowering projects, the accompanying technical note indicates an expectation that the existing station will maintain at least its previous generating capacity, suggesting that HMRC may view the downsizing of a station's capacity as not qualifying even if it passes

the legislative test of having its generating plant wholly replaced as part of the project.

As regards increasing the capacity of existing stations, the draft legislation refers to 'generating capacity', which is not defined in either the draft legislation or the existing EGL legislation. The technical note emphasises the need for an increase in the 'rated' generating capacity (and not just an increase in generation output) suggesting that HMRC would not consider a mere increase in effective capacity to be sufficient. Take the example of a station rated at 100MW capacity but which due to its current state of repair is unable to achieve that, managing to operate at no more than 90MW. A project to commission new generating plant to bring the station's actual generating capacity up to spec (without involving any increase to the station's rated capacity) would, it seems, not benefit from the exemption. This is despite the fact that, in real world terms, there would be an increase in clean energy; and although that may well be the interpretation that prevails, it seems difficult to justify in light of (for instance) the government's stated policy objective of decarbonising the UK's electricity system by 2035.

The technical note also makes clear that general repair, refurbishment or replacement of parts that prolong the life of an existing generating station or 'could' increase its capacity will not be covered by the exemption. This is consistent with the draft legislation, and underscores the government's focus on encouraging investment in new infrastructure.

The new investment condition

The accompanying technical note explains that the exemption is to be afforded only to those qualifying projects in respect of which the 'substantive decision to proceed' was made on or after the date on which the exemption was announced, i.e., 22 November 2023. This is formulated in the draft legislation (new s 311A(2)) in a somewhat roundabout way, it being provided that the 'new investment condition' is met if '*on 21 November 2023 it was reasonable to conclude, having regard to all of the circumstances, that there is a significant likelihood of the project not proceeding*'. The explanatory notes offer another formulation of what this condition requires – being that, as of 21 November 2023, there was '*more than a small, negligible or fanciful risk that the project to create the qualifying new generating plant will not proceed*'.

The grammar of both the legislation and the explanatory notes suggests that the project was already in existence in some form, however preliminary, as of 21 November 2023. That creates room for a (somewhat pedantic) argument that it is not possible to reach any conclusions (reasonable or otherwise) about the significant likelihood of something proceeding when it has not even been conceived at the relevant time. Therefore, strictly speaking, such a project could never meet the new investment condition. The policy rationale of the exemption would not support such a reading of the legislation, but the authors suggest that the legislation would be clearer if the condition were bifurcated and expressed (for example) as being met either '*where the project had not been conceived of by 21 November 2023 or where, having been conceived of by that date, it would be reasonable to conclude…*' and so on.

The technical note provides a (non-exhaustive) list of objective factors intended to be of help to in-scope generators to determine whether the condition is met. These include:

- main board level commitment for the project,
- release of funding by major investors,
- contractual commitments regarding generating equipment and installation activity,
- triggering of options to acquire the interests in land required for the site of the station,
- approval of a credible timetable or programme for the project, and
- public statements announcing the decision to go ahead with the project.

Whilst intended to broadly reflect the 'final investment decision' milestone that will be a familiar concept for in-scope generators (albeit yet another restatement of the 'new investment condition' test!), those in reasonably advanced stages of their investment decisions at the time of the Autumn Statement will no doubt want certainty on the application of the exemption to their particular circumstances, making this an obvious candidate for a non-statutory business clearance. Perhaps in recognition of a degree of uncertainty in this area, new s 311A(3) empowers the Treasury to provide by regulations for cases in which qualifying projects are to be treated as meeting the new investment condition.

EPL – an early finish?

The Autumn Statement was accompanied by a technical note intended to provide greater clarity on the mechanism for disapplication of the EPL, called the energy security investment mechanism ('ESIM').

When introduced on 26 May 2022 as an additional 25% (now 35%) tax on ring fence profits, the EPL was scheduled to end on 31 December 2025, later extended to 31 March 2028. In June 2023, the government announced the ESIM, under which the EPL would be '*disapplied if oil and gas prices fall to historically normal levels for a sustained period*'. Based on the 20-year average to the end of 2022, these ESIM threshold price levels were set at $71.40 per barrel of oil and £0.54 per therm of gas, with the recent technical note confirming that they will be adjusted annually from 1 April 2024 based on the preceding December's CPI figures. The technical note further confirms that the ESIM reference prices will be calculated as the average price of the relevant commodity (i.e., oil or gas) over the six-month reference period ending on the last calendar day of each month, at which point the government will check to see whether the ESIM has been triggered. That will be the case if the ESIM reference prices for both oil and gas are at or below the ESIM threshold prices.

If the ESIM is triggered, then the EPL will cease to apply with effect from the last calendar day of the month in question. Where a company's accounting period straddles that end date, periods before and after will (in accordance with the existing EPL legislation) be treated as separate accounting periods, with the levy profits or losses to be apportioned to them on a just and reasonable basis.

One important point yet to be properly resolved is exactly when and how the ESIM will be legislated. In consulting on the options, the government's opening position was, in effect, that nothing would happen until the ESIM was actually triggered, at which point a written ministerial statement would be made announcing that fact, with legislation then to follow disapplying the EPL from an as then unspecified date. Respondents to the consultation on that point understandably pressed for the legislation to be put in place in advance of the ESIM being triggered (the majority in fact being of the view that this should be '*as soon as possible or in the current Parliament*'), it being noted that no account could be taken of the ESIM on the basis of a mere promise to legislate. In its response to that, the government said that it had '*heard those concerns*' and that legislation would be introduced '*in due course*', which a few paragraphs later becomes '*as soon as parliamentary time allows*'. Whilst somewhat vague, this does at least suggest that the legislation will come pre- rather than post-trigger, although the lack of clarity here is not helped by the statement in the technical note, released on the same date as the government response, which says that legislation will be introduced '*if the ESIM is triggered*'!

Oil and Gas Fiscal Review

Trailed as part of the 2022 Autumn Statement and conducted through a call for evidence over the summer of 2023, the outcomes of the *Oil and Gas Fiscal Review* are broadly positive if rather limited.

Perhaps recognising that the ad hoc and somewhat politically driven nature of the EPL's introduction created a degree of uncertainty, a permanent mechanism for dealing with price 'shocks' (post-2028 or earlier if the ESIM is triggered) is to be developed. One objective of such a mechanism would be to minimise the impact on investment decisions, to which end the suggestion is tentatively mooted that a tax based on revenues rather than profits might be preferable. Regular engagement with stakeholders to understand the latest and evolving context for oil and gas investment is promised, with the specific undertaking of twice annual forums to be chaired by a government minister.

The outcomes document confirms the government's intention to remove the tax barriers to oil and gas assets being repurposed for use in carbon capture, utilisation and storage ('CCUS') projects and the government's plan to legislate in a future finance bill for tax relief for payments made by oil and gas companies to decommissioning funds in respect of repurposed assets. When and with what scope and limitations these measures will be enacted remains to be seen. In addition, receipts from oil and gas assets repurposed for use in CCUS will be excluded from the EPL.

The outcomes document also confirms that the enhanced rate of relief for decarbonisation expenditure against the EPL will expire along with that tax rather than being continued in an adapted form for ring fence corporation tax or the supplementary charge. It does, however, reassure that the existing permanent regime will continue to offer the existing suite of investment incentives, including for decarbonisation.

Finally, as a counterpoint to the dearth of a wider range of decarbonisation-focussed tax measures, we are reminded of the government's largesse more generally, in particular, the making permanent of full expensing under the capital allowances regime and the benefit that this will have for investment in low carbon technologies.

2024 and beyond – hopes and expectations…

'*The government has heard loud and clear that in the fiscal regime certainty and predictability are the most important influence on investment*' – so notes the *Oil and Gas Fiscal Review* outcomes document. Indeed, there can be little doubt that resisting the urge to tinker and, more particularly, to introduce new taxes as short-term political measures, would be top of the wish list for all energy businesses. In that regard, a key macro question facing the sector is what a change of government (assuming it does come this year) will mean for the tax measures announced as part of the Autumn Statement, and more generally. If one were to hazard a guess, measures which further the achievement of the UK's stated target of a 68% reduction in greenhouse gas emissions relative to 1990 by 2030 (and the aim of reaching net zero by 2050), might be expected to be addressed sooner rather than later. In particular, we would expect more certainty on when in-scope generators investing in existing generating stations may be exempt from the EGL and further incentives for oil and gas companies to invest in CCUS. For everything else, certainty remains elusive.

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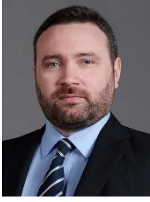

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