The Oil Drum: Europe
DISCUSSIONS ABOUT ENERGY AND OUR FUTURE

Fuel duty and the effect of oil prices on the UK economy

Posted by Chris Vernon on December 9, 2006 - 6:12pm in The Oil Drum: Europe
Topic: Economics/Finance
Tags: oil, tax policy, united kingdom [list all tags]

UK Chancellor Gordon Brown has published his 274 page Pre-Budget Report (.pdf) today (06/12/06). This is the first policy statement from the treasury since the Stern review's presentation of the economic case for addressing climate change. Stern concluded that to stabilise climate change at manageable levels, emissions would need to stabilise in the next 20 years and fall between 1% and 3% after that. This would cost 1% of GDP, considerably less than the impact of unchecked climate change.

How would Brown respond? Insufficiently, it would appear.

The only "green taxes" were to add 1.25p per litre to fuel duty from midnight and increase air passenger duty from £5 to £10 for most flights. Interestingly Brown rejected demands to re-link petrol prices to inflation.

Gordon Brown, UK Chancellor

Fuel duty

The 1.25p per litre increase on fuel duty deserves some consideration. We covered the structure of UK Petrol Prices earlier in the year. Briefly the price at the pump is:

Price of the product + Excise duty + VAT

Before this announcement fuel duty stood at **47.1p per litre**, unchanged since 1st Oct 2003. Despite being promised an increase three times since then only now are we seeing a 1.25p or 2.65% increase. It is reported to be an inflation based increase. However inflation over the last 38 months totals 6% (link).

The increased duty is not an increase at all. It maintains the ongoing reduction in real terms, exactly the wrong policy as we approach peak oil and at odds with the requirement for green taxes.

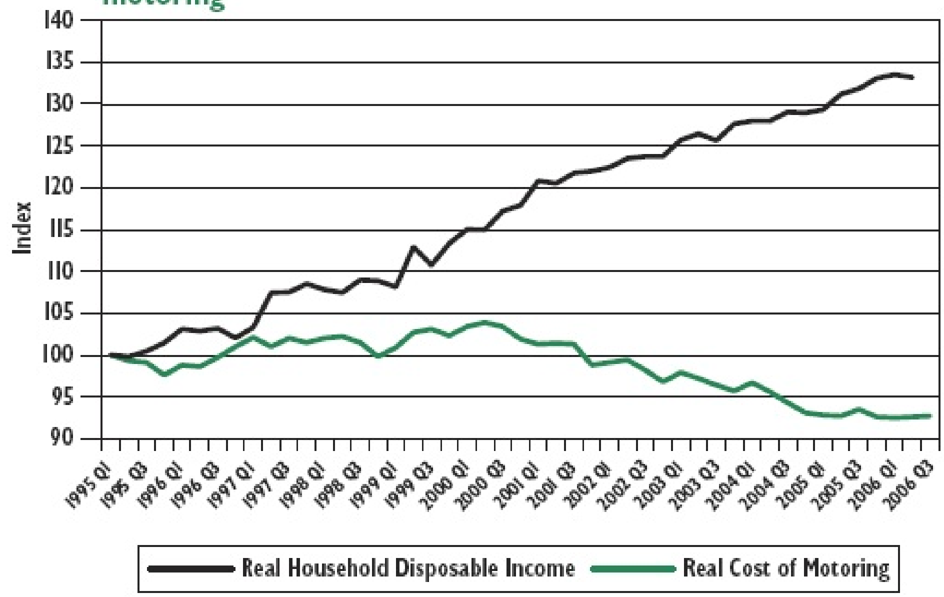
On this subject the Pre-Budget report contains this statement:

> It is the Government's policy that fuel duty rates should rise each year at least in line with inflation as the UK seeks to reduce polluting emissions and fund public services. In Budget 2006, owing to sustained oil market volatility, the inflation-based increase in main fuel duty rates was deferred until 1 September 2006. However, with the risk of volatility remaining high, the Government announced in July that the increase would not go ahead in September and the position would be reviewed at the time of the Pre-Budget Report.

I think this is misleading. It correctly refers to the 2006 spring budget increase being deferred to September 2006 and subsequently until today yet it **fails to mention** the previous *"inflation-based increases"* of 2004 and 2005 which never happened. There's little point in having a policy that fuel duty rates rise at least in line with inflation if for two out of three years you don't bother!

This reduced fuel taxation along with cheaper cars has reduced the cost of motoring in the UK:

Chart 7.3: Index of household disposable income and cost of motoring

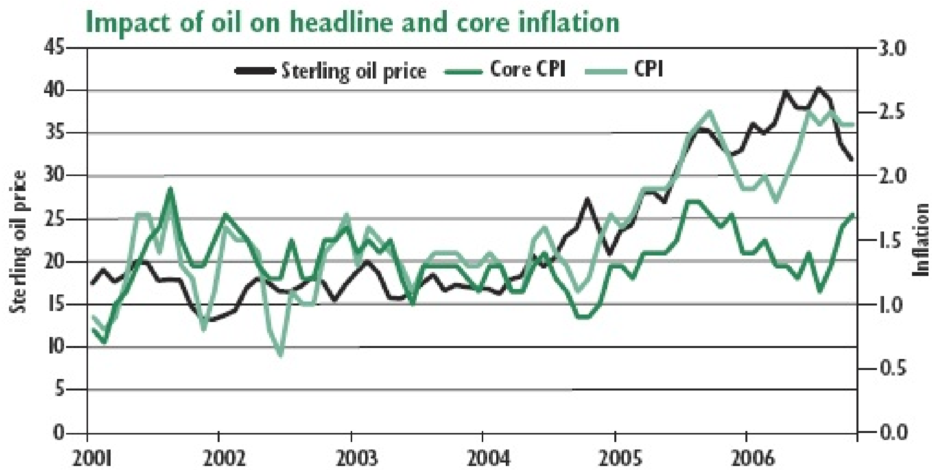


The effect of oil prices on the UK economy and public finances

This is an extract from the Pre-Budget Report:

> Oil prices have increased sharply since 2004, driven partly by demand from emerging markets. Higher oil prices have adverse effects on the supply side, dampening output and demand and leading to higher consumer inflation. Demand is weakened through the erosion of consumers' purchasing power due to higher fuel costs and added pressure on businesses' profit margins in response to higher production costs.
>
> Whether higher oil prices lead to a temporary increase in consumer inflation or a more sustained rise depends on the extent of second round effects in wages and costs in response to the original increase in oil prices. The initial impact of higher oil prices led to an increase in CPI, which reached 2.5 per cent in June and August this year, with some additional impetus from higher food prices. However, core inflationa has remained below 2 per cent, in line with the average of recent years. This is consistent with the lack of evidence of any second-round effects from higher energy and food prices in the UK.

However, it is important to remain vigilant. As the Chancellor stated earlier this year in his letter to the Pay Review Bodies, *"It will be important to ensure that public sector pay increases do not contribute to inflationary pressures in the economy going forwards. To do so would risk converting a temporary increase in inflation into a permanent increase. The Pay Review Bodies should therefore continue to base their pay settlements on the achievement of the inflation target of 2 per cent"*.



Measures of core inflation exclude certain items from the CPI basket whose price effects might be considered to be temporary and/or volatile, for example, energy prices and seasonal food prices.

Oil prices also affect the UK's public finances. While higher oil prices have a positive effect on tax revenues from petroleum revenue tax and North Sea corporation tax, there are a number of offsetting effects that limit the overall impact on the public finances. The scale and timing of these effects is extremely uncertain, as they depend on the responses of individuals and businesses to rising prices. The offsetting effects include:

- any temporary increase in inflation, which increases the indexation of allowances and limits for income tax and national insurance contributions and of indexation of tax credits and social security benefits. Higher inflation also increases the costs of servicing indexed-linked bonds;
- higher petrol pump prices, which reduces the demand for road fuels and therefore reduces revenues from fuel duties; and
- possible impacts on the wider economy, for example, if higher input prices reduce companies' profit margins, receipts from non-North Sea corporation tax will fall.

Oil and commodity prices

Another extract:

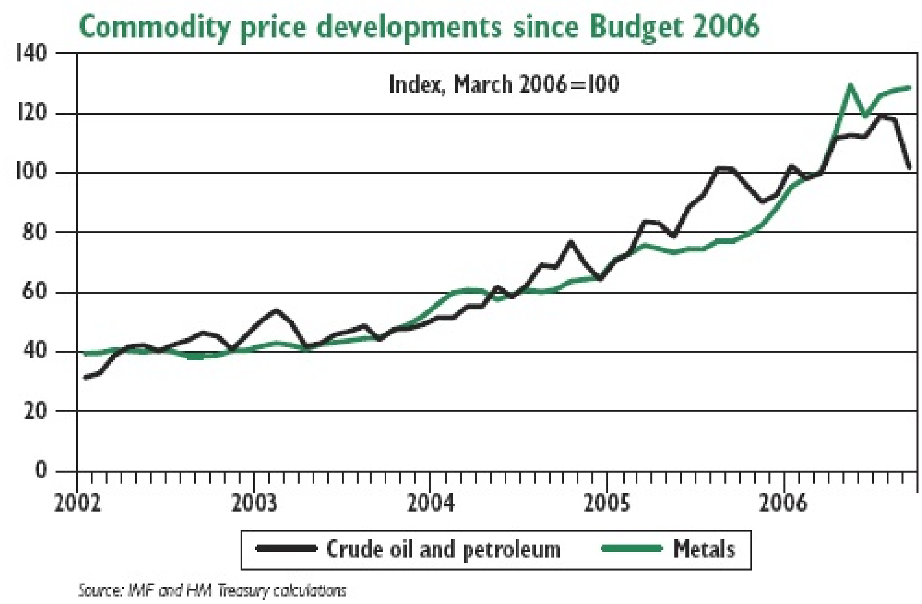
Looking ahead, high nominal oil prices are expected to be sustained into the medium term. Oil futures prices have remained high, reflecting continued, predominantly upside, risks and spare capacity below historical norms. Geo-political uncertainties, particularly in the Middle East and Nigeria, and the weather, may contribute to supply disruptions. In addition, OPEC cut production by 1.2 million barrels per day in order to defend an oil price of $60 a barrel. The impact of this cut on oil prices is partly offset by the market's reaction to a corresponding increase in OPEC spare capacity, which other things equal reduces the associated risk premium. The International Energy Agency's latest demand

and supply projections suggest that market tightness will ease in the second half of 2007.

Fuel and many non-fuel commodity prices have increased significantly over the past four years. In some cases, notably many base metals, the increase has been rapid. The rise in metals prices has largely been demand driven, particularly from China and other emerging markets, but has been exacerbated by supply constraints stemming from low investment in productive capacity in the 1990s and early 2000s. The combined effect has been to reduce global inventories, creating tighter market conditions.

Iron ore, zinc, lead and copper prices have risen by between 113 and 255 per cent since 2003. Futures prices have also risen substantially, though markets and external forecasters expect some moderation from current high prices as new supply comes on line.

Changes in metals prices tend to be positively correlated with the business cycle and can provide a useful indicator for tracking changes in global demand. Historically, most periods of large rises in metals prices have been associated with strong world growth. Notably, the recent decline in energy prices has not been matched by metals prices, suggesting that global demand growth is likely to remain strong.



Zero carbon housing

This point has raised a few eyebrows. The Pre-Budget Report outlines an aspiration that **within 10 years all new homes will be zero carbon**. Apparently we will shortly receive a "Code for Sustainable Homes" improving on current building regulations. The report does not define what "zero carbon" means nor the materials, technology and designs employed to provide it. We are promised: *"full details will be published at the time of Budget 2007."*

The sceptical amongst us may think that given what we know about North Sea oil and gas reserves there won't be enough carbon based fuels to fuel our existing housing stock by 2017, let alone new build. If that's the case then clearly any new houses won't be built to run directly on oil, gas or coal (grid electricity will still make a carbon contribution though). Brown may achieve his zero carbon new homes in 10 years time, not by proactive, designed intent but simply through lack of carbon based fuels.

North Sea revenues

Thanks to rbkpeak who mentioned in the comments that the report also states that forecast treasury receipts from the North Sea for 2007/08 are now some £3bn lower than previously forecast, this is blamed on *"revised production and expenditure forecasts and stronger dollar-sterling exchange rate"*. That's quite a hole and just what Euan discussed in this report: Lies, Damned Lies and Government Oil Production Forecasts?

The Guardian Newspaper describes it thus:

> An unexpected and sharp drop in tax revenue from North Sea oil companies and a rise in inflation have resulted in the chancellor having to raise taxes and borrow more money, the Treasury said today.
>
> In spite of boasting of a stronger economy in his pre-budget report, which normally would boost tax revenues, Mr Brown has suffered an expected drop in revenues of £3bn in 2007/08 and £2bn in 2008/09 from the North Sea.
>
> This was due to a bigger-than-expected drop in oil production, a fall in the value of the dollar in which oil is priced, and a rise in investment by North Sea operators, which reduces their taxable profits.

The Pre-Budget Report has this to say on North Sea revenue:

> The significant increase in oil prices since the start of 2004 has led to large rises in the profitability of North Sea companies. The net rate of return for UK Continental Shelf companies was close to 40 per cent in the first half of 2006, substantially above the 13 per cent return recorded by other non-financial companies. Given the upward shift in the expected price of oil in the medium term, oil and gas companies should continue to register strong profit figures over the forecast period.
>
> North Sea revenues for 2006-07 are expected to be close to their Budget projection at just over £10 billion. Oil prices are likely to average around $9 a barrel higher than the $57.4 assumed in Budget 2006 and this would be expected to result in higher tax revenues. However, while North Sea profits remain very strong, the further boost to taxable profits from higher than expected dollar oil prices is being offset by a stronger dollar-sterling exchange rate (which reduces the rise in the sterling price of oil), lower than anticipated production, higher capital investment and increased operating expenditure. The forecast for North Sea revenues assumes a further rise in receipts to £10.7 billion in 2007-08, but this is a much more modest increase than assumed in the Budget 2006 forecast and reflects developments in prices and production as well as continued downward pressure on profits from higher capital and operating expenditure. The projections for North Sea revenues use the NAO audited assumption on oil prices. In line with the average of independent forecasts, oil prices are expected to be $60.3 a barrel in 2007, around $2 higher than assumed in the Budget 2006 forecast. However, the stronger dollar-sterling rate means that oil prices in sterling are lower from 2007 onwards than assumed in Budget 2006.
>
> Investment in the North Sea has continued to increase and is now substantially higher than the capital expenditure projections incorporated into the North Sea revenues forecast prior to the announcement of the increase in the Supplementary Charge. This demonstrates the continuing attractiveness and competitiveness of the North Sea as a place to invest. However, despite the highest levels of investment this decade, North Sea

production has been lower than expected in 2006. This seems mainly due to rising maintenance requirements for North Sea infrastructure, with further pressure created by increased global competition for equipment and skilled personnel pushing up costs as operators everywhere try to maximise production. Production is expected to rise in 2007, with a number of new developments, including the Buzzard field coming on stream. However, the overall level of production is expected to be significantly lower than assumed in the Budget 2006 forecast reflecting the lower starting point and more modest increases expected by operators. Beyond 2007-08, production is expected to gradually return to its previously assumed levels, helped by the higher levels of capital expenditure. This reduces the shortfall in revenues relative to the Budget 2006 forecast.