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Is the energy sector at a turning point?

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This is part of a series Driving Growth: Innovation and Sustainability in Scotland which is a series of research topics and podcasts discussing the Scottish economy and key opportunities to improve growth.

At the Institute, much of our work involves analysing data and interpreting what the numbers reveal about the state of the economy. An important part of this is by engaging directly with businesses to understand how they are experiencing the current environment and what decisions they are making as a result.

It seems that the discussion in the energy sector has become very unified. No matter whether companies are what would be traditionally oil and gas extraction, renewable energy generation, or the vast and rich supply chain which is to some extent (although not completely) technology/ energy source agnostic, the message is the same – the investment environment in the UK is extremely difficult. Projects are stalling, being shelved, scaled down. It is not the story of the clean energy revolution we would all hope for, and it feels like an economic opportunity potentially missed.

What is this driving in practice? In our latest podcast in partnership with Deloitte, we discuss the potential impacts on the workforce in Scotland, as well as the analysis contained in this blog. But in short, volatility in local demand is influencing the deployment of our workforce to other parts of the world.

This makes the issue somewhat invisible to UK policymakers - we are not seeing large numbers of unemployed energy workers, because many are simply likely to be working abroad. The lack of local opportunity will of course mean that some older workers choose to exit, and that fewer younger workers enter the energy industry, but the main impact is the displacement of activity. Which means while we don't have a big rise in unemployment, what we do have is a downturn in economic activity, both directly and in the supply chain, and a likely downturn in high wage tax revenue.

So, why is the environment difficult? Part of this is the fiscal (so, tax!) regime, which we set out for the uninitiated below. But it is not the only thing that is causing challenges – if you want an in-depth chat about the impacts of employment regulations in the UK, we also discuss this in our podcast. There is a feeling that the industry is at a crossroads, and there is anticipation of the UK Budget and whether this will improve conditions on the ground for the energy industry. Will politics or economic realities win out?

After our explainer on the fiscal regime, in this paper we discuss the implications of different pathways for investment on the UK, Scottish and North East Economy. We focus on the oil and gas sector specifically, to show the implications for different speeds of decline, one called "Managed Decline" and the other "Accelerated Decline". These scenarios have been provided by our colleagues at the Energy Transition Institute at Robert Gordon University and are consistent with the scenarios used in their recent report "Striking the Balance".

The purpose of this paper is to show the economic impact of faster decline in the oil and gas industry, and the implications for Scotland and the North East. Given the difficulties in the investment environment, with new industries not rising to replace this activity, this poses challenges to policy makers to improve the investment environment where possible.

A recap – the current fiscal (tax!) regime

The corporation tax regime which is applied on the oil and gas sector is very separate and distinctive compared to onshore companies. In the current regime, there are three main elements:

- Ring Fence Corporation Tax (RFCT) (30%)
- Supplementary Charge (SC) (10%)
- Energy Profits Levy (EPL) (38%)

This means that the rate charged on profits in this sector is 78%.

This is considerably higher that the headline rate for onshore companies (25%). However there are many reasons why this would be the case: oil and gas reserves, like many other natural resources, are part of the national resources of a country. The Government grants licences for the extraction of these resources, but there are conditions placed on this, recognising the high profitability of the sector and the fact that the activity draws upon a public resource. So, it is not unusual for there to be a higher rate on extraction activities which deplete a national asset.

This headline rate is offset with a complex set of capital allowances which are designed to encourage investment, particularly in the early years of development where costs can be high.

- RFCT (30%): 100% first-year capital allowances for most expenditures, with some assets eligible for writing down allowances (for example, qualifying machinery can be written down 10% or 20% per year, depending on the category of the asset).
- SC (10%): No additional capital allowances, but RFCT allowances reduce profits taxed under SC.
- EPL (35%): 66% investment allowance for decarbonisation investment, no general relief.

A recap – the history of the fiscal regime

Following the 2015 oil price shock, the UK Government had reduced the overall tax burden on the sector to support it and encourage investment. The headline rate from January 2016 consisted of the Supplementary charge and the RCFT, which in total was 40%. (There was also the historic Petroleum Revenue Tax (PRT), which was reduced to zero, effectively abolishing it. This is still available to claim back money in the current regime, but let's not get into the weeds…).

In 2022, following the Russian invasion of Ukraine and the oil price shock, the Energy Profits Levy was introduced as a "windfall tax" to capture the extraordinary profits being generated from high energy prices.

The EPL has evolved considerably since it was introduced, in three main aspects:

- Rate: initially set at 25% in May 2022, it was increased to 35% in January 2023.
- Timing: initially scheduled to end by the end of 2025, this was extended to 2028 in Autumn 2022, and 2029 in spring 2024, although it is subject to the Energy Security Investment Mechanism (ESIM) or the "sunset clause" if prices are below specified levels for specified periods of time.
- Capital Allowances: These were first set at 80% for all investment, before changing to 29% for most investment (except decarbonisation) in January 2023. In November 2024 the general allowance was abolished and decarbonisation reduced from 80% to 66%.

The abolition of the capital allowances was probably one of the most controversial issues for industry at the Budget in 2024, given the change that made for the returns to new or existing capital projects.

Impact of different pathways for capital expenditure

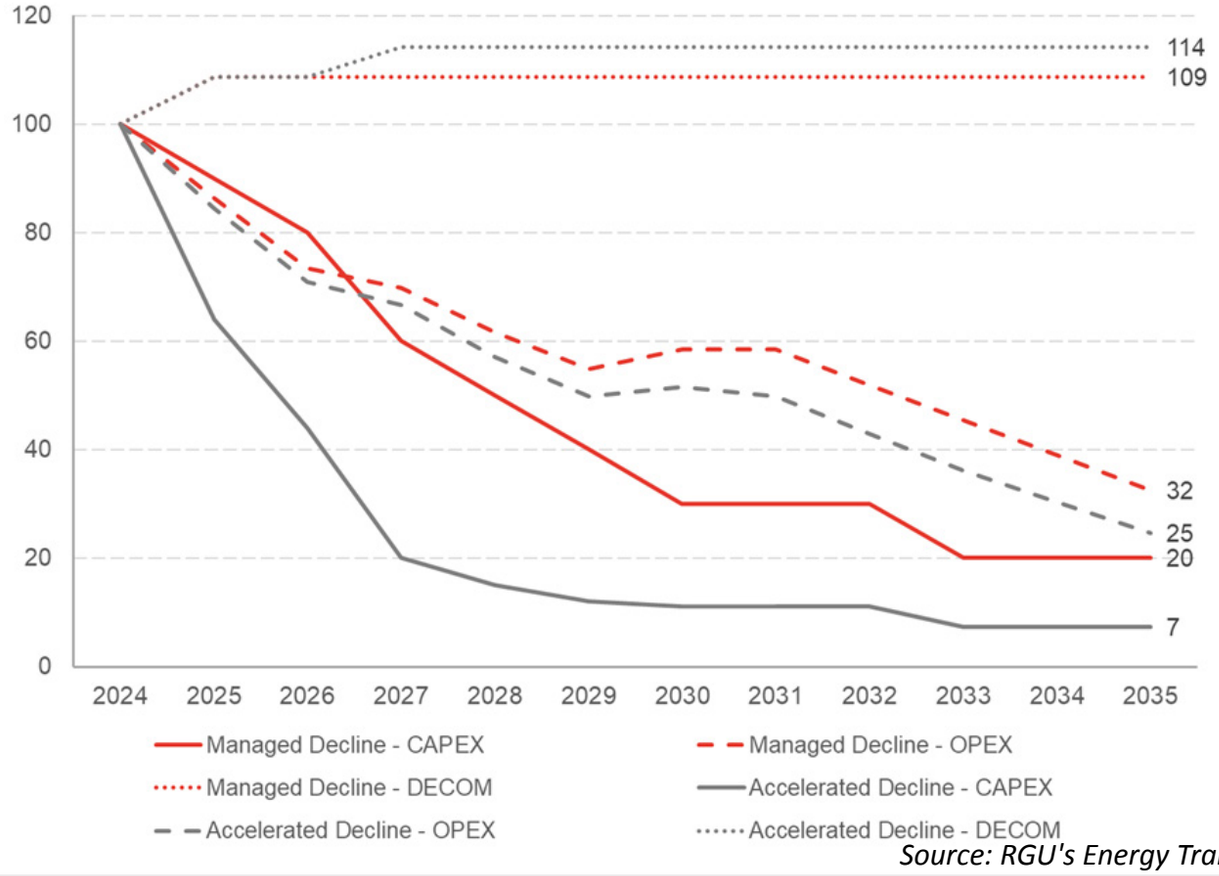
The key thing to remember when the future of the oil and gas industry is being discussed is that economic activity, capital expenditure, operating expenditure and employment in the oil and gas industry WILL all decline over the next 10 years.

The question is about how fast the industry and related economic activity and jobs will decline: and of course, to what extent that will be offset by activity in new and emerging industries. We have, of course, discussed above that the supply chain cannot be simply portioned into oil & gas versus renewables, and it is important to keep in mind that that is a false dichotomy.

To look at the potential economic impact of different pathways for industry activity over the next 10 years, the Energy Transition Institute at Robert Gordon University have provided us with scenarios for capital expenditure (CAPEX), operating expenditure (OPEX) and decommissioning expenditure (DECOM). ETI have used intelligence from the North Sea industry to understand the impact of different regimes and production levels on the outlook for supply chain spending for CAPEX, OPEX and DECOM.

These provide 2 scenarios, which ETI call “Managed Decline” and “Accelerated Decline”. The change from 2024 is shown in the chart below under the two scenarios. Capital investment falls away much more quickly in the accelerated decline scenario, resulting in around 35% of the CAPEX that would occur in the managed decline scenario.

Chart 1: Scenarios for CAPEX, OPEX and DECOM, 2024=100



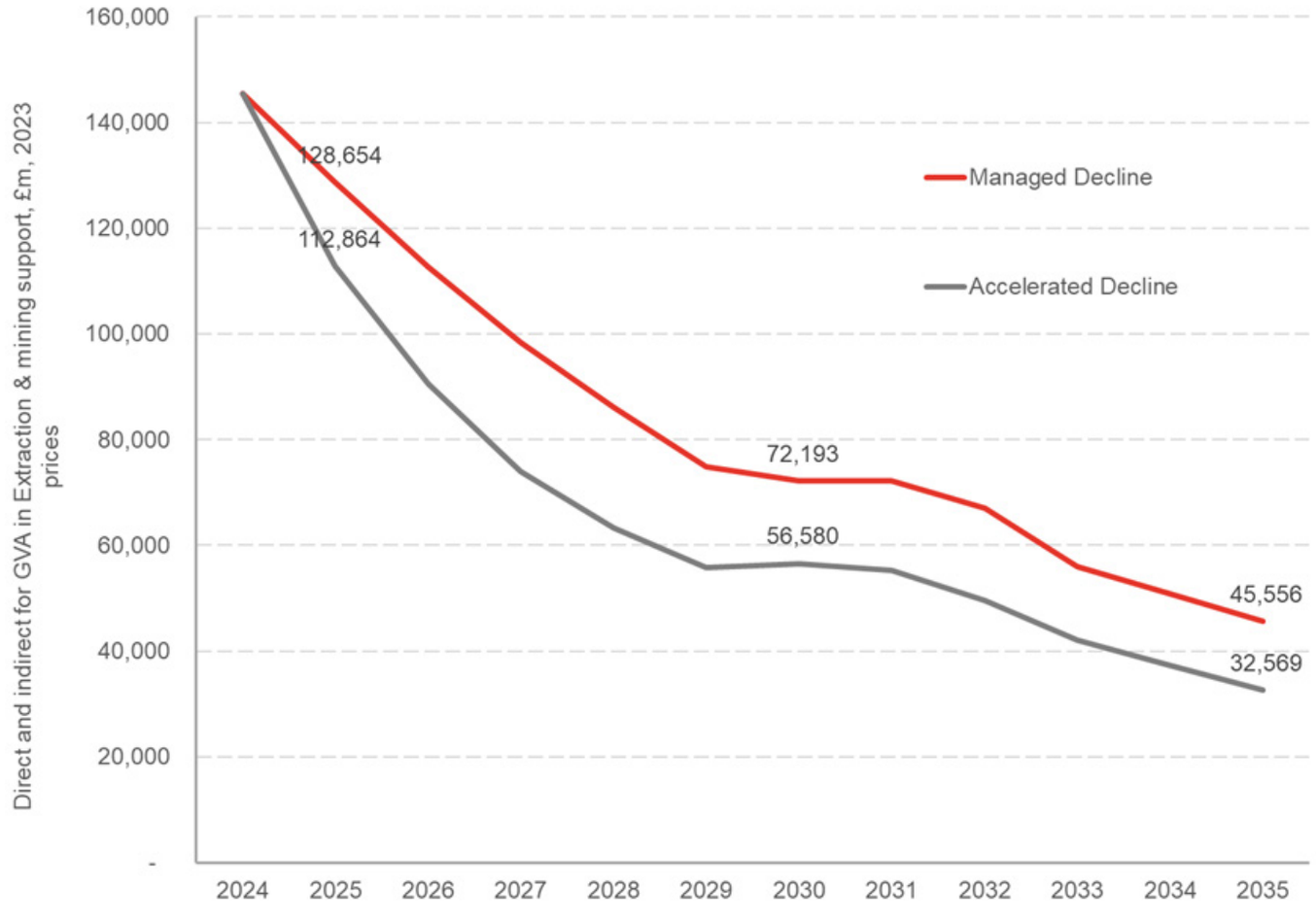
Source: RGU's Energy Transition Institute

The second thing to note is that although the trajectory for capital investment is very different for the two scenarios above, the outlook for OPEX is much more similar. This is an important factor which reduces the difference in overall economic impact. Although lower capital investment in new projects could be lower, existing extraction facilities are still likely to be maintained and operational given the money that has been invested to date.

DECOM is slightly higher in the Accelerated Decline scenario, consistent with an acceleration of the decommissioning of assets.

We have modelled this supply chain spending to understand the differential impact on the UK economy reflecting the different nature of OPEX and CAPEX to ensure the supply chain is as accurately captured as possible (from the UK Supply and Use tables).

Chart 2: UK Direct and Indirect GVA from Extraction & Mining Support Service, 2023 prices



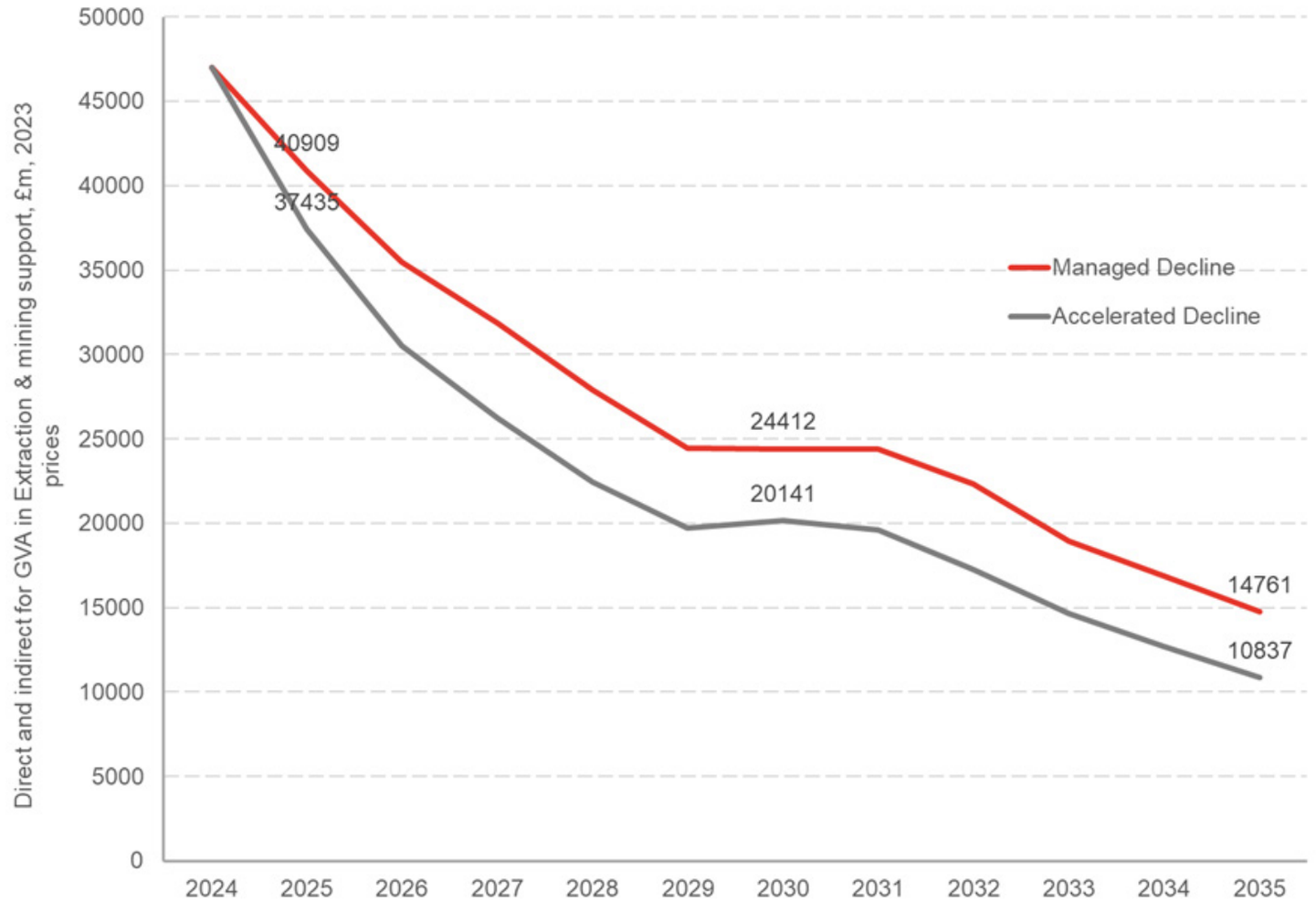
Note: Extraction and mining support are defined as industry 6 & 9 combined
Source: FAI Analysis, ETI Analysis, ONS Supply and Use Tables, ONS Input-Output Analytical Tables

So, between 2024 and 2035, Oil & Gas GVA falls 78% in the Accelerated Scenario, compared to 69% in the Managed Scenario. The difference in this by 2035 is worth £13 bn in 2023 prices. This is a large amount, of course, but given the likely size of the UK economy by then (almost £3tn) it represents around 0.5% of the economy.

The situation is very different if we look at Scotland, of course, given the concentration of North Sea activity in Scotland specifically. Identifying the direct activity in Scotland is straightforward, but identifying indirect activity is much more tricky, given data constraints. As in our previous blog on North Sea jobs, we have drawn upon the Scottish Government's Offshore Satellite Account to model this appropriately.

These data together suggest that around 82% of direct effects from these industries are likely to be in Scotland, and around 22% of indirect activities.

Chart 3: Scotland Direct and Indirect GVA from Extraction & Mining Support Service, 2023 prices



Note: Extraction and mining support are defined as industry 6 & 9 combined
Source: FAI Analysis, ETI Analysis, ONS Supply and Use Tables, ONS Input-Output Analytical Tables

Between 2024 and 2035, Oil & Gas GVA falls 77% in the Accelerated Scenario, compared to 68% in the Managed Scenario. By 2035, this difference is worth £4 bn in 2023 prices.

We said above that the difference represented 0.4% of the UK economy. For Scotland, though, this represents 1.8% of the economy. Remember, this is just the difference between two scenarios for the pace of decline, and reflects the large supply chain impacts that oil and gas currently generates in the Scottish economy. For comparison, the entire "Spirits and Wines" industry in Scotland makes up 1.8% of the economy, although of course **this is just direct GVA**, so not quite the same concept.

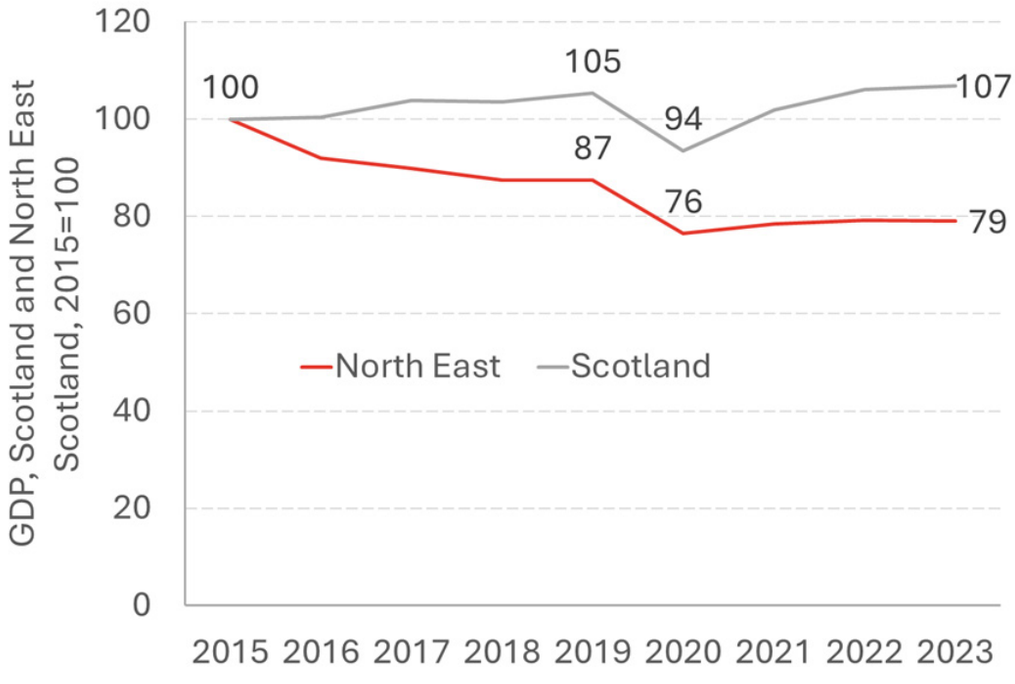
Understanding the impact on the North East gets trickier still to regionalise. We know that the vast majority of Scottish extraction activity and mining support services in based in the North East of Scotland, and this can be seen in regional GVA data. But the indirect impacts are more difficult to quantify, given there are not proper economic accounts for parts of Scotland. But using fairly sensible assumptions suggests the difference between the two scenarios could be around £1 billion in 2023 prices, or roughly 5% of the North East economy.

Why this is important – the experience of the North East since 2015

However, we don't need forecasts for the North East to quantify to potential impact – we can simply examine what has happened over the past 10 years, since the 2015 oil price shock. Anyone who knows Aberdeen will have felt these impacts, with clear downturns in supply chain activity – and wider induced spending in retail and hospitality - as the oil and gas industry suffered.

This chart shows the evolution of the North East Scotland economy between 2015 and 2023.

Chart 4: Scotland and North East Scotland GDP, 2015=100



Source: ONS

This chart shows the evolution of the North East Scotland economy between 2015 and 2023. Two main things stand out from this chart:

- Before the pandemic (2015 to 2019) the economy of the North East contracted by 13% compared to growth of 5% in Scotland;
- Compared to pre-pandemic levels of activity, the North East economy is around 10% smaller in 2023 , compared to the Scottish economy which is about 2% bigger.

This highlights the economic impacts of the difficult periods in 2015-16 and then post-COVID for the energy sector in the North East.

In conclusion - do we need to recalibrate our understanding of this opportunity?

Often, Ministers from the UK or Scottish Government will talk about job opportunities in clean energy and associated supply chains. In the wake of a tight labour market and lack of supply of skills, we need to think about how we can keep the economic activity for the energy industry as a whole, including existing supply chains – as well as the jobs – here in the UK and Scotland.

The reality right now is that the investment environment is not garnering the confidence or the money required to move forward at pace. We discussed the view of investors in an earlier pod, which cited policy certainty as a key factor, but (of course) that a good return must be expected for investment. That is just not the feeling right now. And if the Government want growth, that is problematic.

The industry stands at a crossroads – the decision made in the next couple of years are likely to determine where we are by 2030 – and maybe 2050. In the short term, the industry waits for the 26th November for positive signalling from Government.