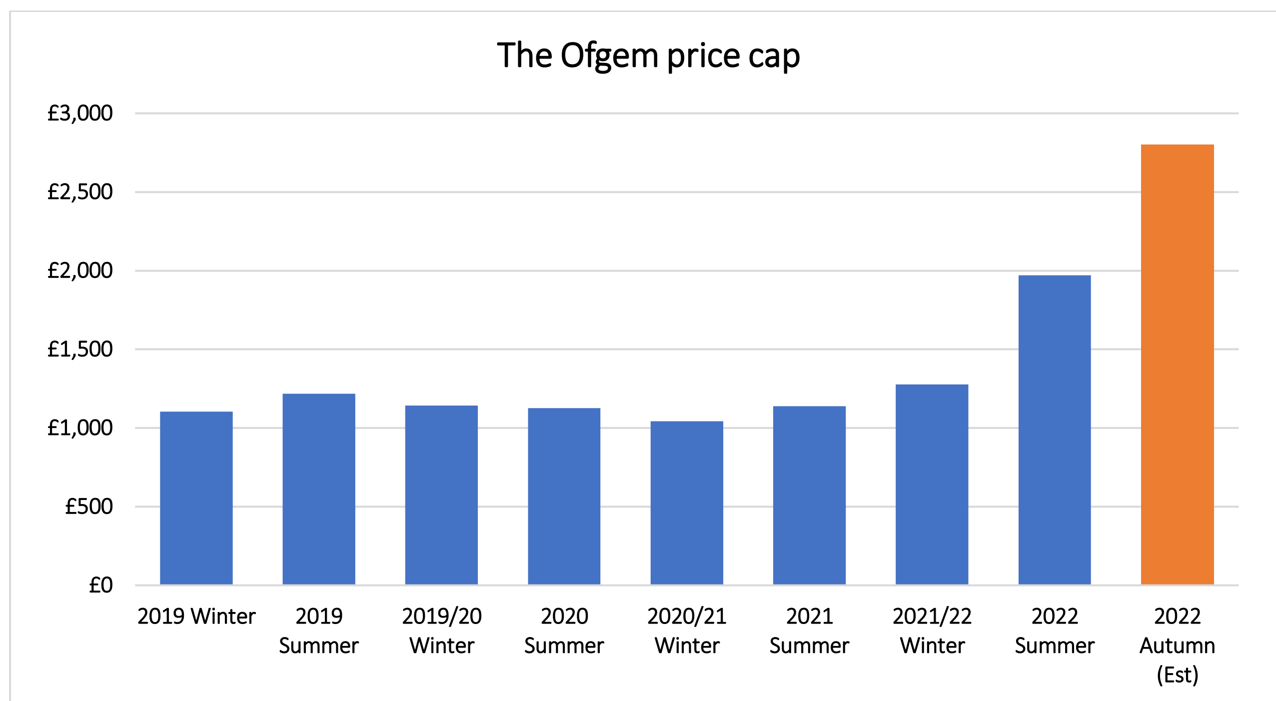
The Chancellor's May economy statement: all about energy

In late May, the Chancellor announced new measures to counter the rising cost of living, in particular energy prices.



Source: Ofgem.

Initial measures for 2022

In early February 2022, the Chancellor announced a package of measures to reduce the impact of the £693 April 2022 increase in Ofgem's energy price cap. These were primarily:

- A £150 council tax rebate for those with properties in bands A–D in England, with corresponding funding for Scotland, Wales and Northern Ireland under the Barnett formula;
- An Energy Bills Support Scheme to provide a £200 reduction in utility bills for the year starting in October 2022. This was effectively a loan, to be repaid by £40 a year added to bills from April 2023. The scheme applied throughout the UK apart from Northern Ireland, which again received Barnett formula cash; and
- Extra discretionary funding of £500 million under the Household Support Fund for English councils to allow them to provide support for vulnerable people and individuals on low incomes, again with Barnett money for the UK's other constituents.

The package, which has had problems with the distribution of the council tax rebates, had a value of about £9 billion. However, with the suggestion from Ofgem that the October price cap will be around £2,800 and inflation already running at 9%, February's measures looked increasingly inadequate under widespread criticism.

A new helping hand

After many rumours about windfall taxes and whether/where they would be levied, on 26 May Rishi Sunak revealed a new round of cost-of-living measures, greater in scope than many had expected:

- The reduction provided under the Energy Bills Support Scheme will increase by £200 to £400 and turn into a grant, not a loan, i.e. there will be no clawback from future bills.
- Eight million households throughout the UK on means-tested benefits (e.g. Universal Credit. Working Tax Credit and Pension Credit) will receive a Cost of Living Payment of £650. This will be made in two directly paid instalments, one in July and the second in the autumn. Payments from HMRC for those on tax credits only will follow shortly after each to avoid duplicate payments.
- Another eight million pensioner households eligible for the Winter Fuel Payment (WFP) will be paid a top-up £300 Pension Cost of Living Payment over November and December. Eligibility will be based on being over State Pension age (aged 66 or above) between 19–25 September 2022 and entitled to the WFP.
- Six million people in the UK who receive disability benefits (e.g. Disability Living Allowance) will receive a one-off payment of £150 in September.
- The Household Support Fund will receive an additional £500 million for distribution by English councils, with corresponding funding for Scotland, Wales and Northern Ireland under the Barnett formula.
- These payments are not mutually exclusive so, for example, a low-income pensioner could receive a total of £1,150 support (£200 + £650 + £300) in addition to the £350 (£150 + £200) from February's measures.

Paying the bill

The total cost of the package is put at £15.3 billion. To help finance this there will be a new temporary Energy Profits Levy on oil and gas company profits of 25%, bringing the total tax rate payable by these companies to 65% and raising £5 billion in its first year.

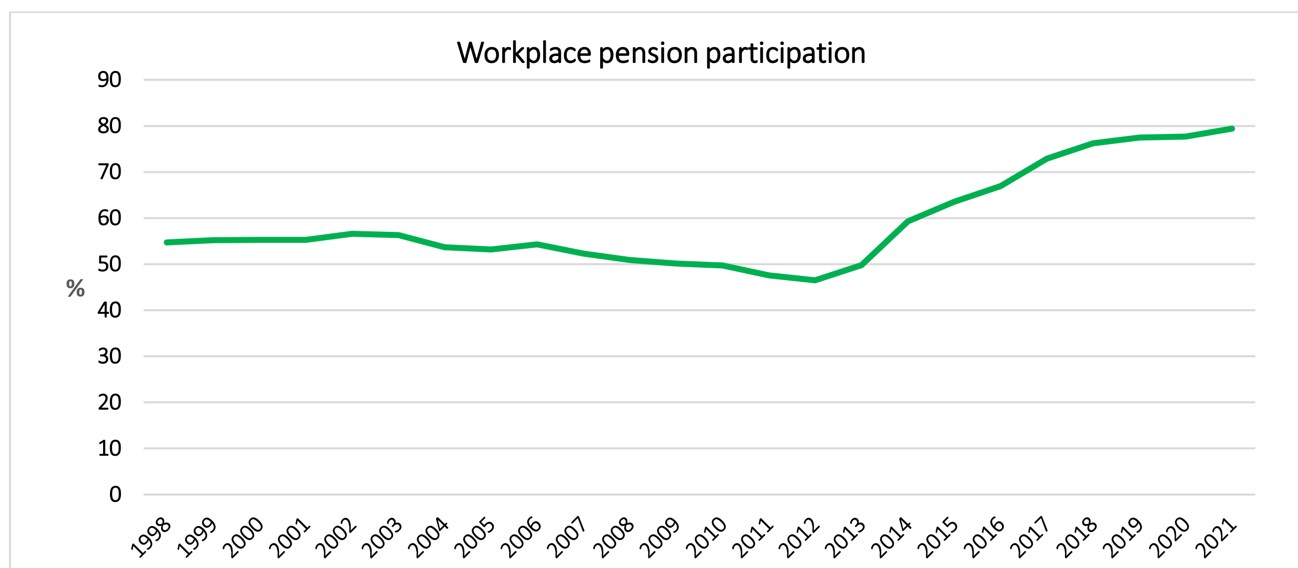
The levy will be phased out if oil and gas prices return to "historically more normal levels" and in any case will end by the start of 2026. To encourage oil and gas companies to invest, the Chancellor will introduce a new Investment Allowance that will mean total tax relief equivalent to 91.25% of new investment.

The levy will not apply to electricity generators, but the Treasury will now urgently evaluate the scale of the extraordinary profits being made by generating companies and consider "the appropriate steps to take".

One interesting non-energy nugget that emerged in the Chancellor's speech was that "…subject to the Secretary of State's review, benefits will be uprated by this September's CPI" and "Similarly, the Triple Lock will apply for the state pension." That could mean rises of around 10% coming in from April 2023.

Auto-enrolment: an unusual success story

Party(ing) politicians are held in low esteem at present, but there is one cross-party measure that deserves to be recognised – automatic pension enrolment. But its success shouldn't be an excuse for complacency.



Source: ONS.

Eighteen years ago, the Pensions Commission, set up by the Blair government, published its first report into UK pension provision. In 2005 a second report appeared, addressing the three "killer facts" highlighted by its predecessor:

- More than half of UK private sector workers were relying solely on their state pension to provide for their retirement;
- Only about 1 in 200 people made what the Commission considered to be rational pension savings decisions. Most entered a pension arrangement if they were compulsorily enrolled by the state, automatically entered into an arrangement by their employer or sold a plan by a pension provider; and
- For small and medium sized employers, establishing an occupational pension scheme involved excessive administrative costs.

The Pensions Commission reports were followed by two pieces of legislation in 2007 and 2008 that laid the groundwork for the introduction of employee automatic enrolment in pension schemes. An election intervened in 2010, replacing Labour with the Coalition Government, which immediately established a review of the proposals in the wake of the Global Financial Crisis. The Coalition decided to go ahead, subject to some amendments to the phasing in of the new regime from October 2012.

The success of automatic enrolment was recently underlined by a new set of data from the Office for National Statistics (ONS). As the graph shows, once the gradual introduction of automatic enrolment started, the proportion of eligible workers in workplace pension schemes steadily rose from 46.5% in April 2012 to 79.4% in April 2021.

Broadly speaking the automatic enrolment rules now apply to any worker aged between 22 and state pension age (66) with earnings of at least £10,000 a year.

There remain two areas that need to be addressed as part of automatic enrolment:

- The minimum total contribution level (currently 8% of pay between £120 a week and £967 a week) is widely seen as too low to provide an adequate retirement income; and
- While gig workers are covered, the self-employed are outside the regime and have become the sector of the population most reliant on state provision.

If either of those points apply to you, manual action is required – you cannot rely on what many see as one of the key ingredients for automatic enrolment's success: inertia.

Buy-to-let tax changes bite with rising interest rates

Changes to tax rules made some years ago could soon inflict financial pain as interest rates rise.

In the post-election Budget of 2015, the then Chancellor, George Osborne, announced a surprise set of changes to the tax rules for buy-to-let (BTL) residential properties. The most significant was the treatment of interest on BTL mortgages. At the time, interest paid could be offset fully against rental income, meaning that the interest received full tax relief at up to 45%. The Chancellor decided to replace this treatment with one in which:

- Interest could not be deducted from rent, thereby increasing the tax charged on rental income and, as a corollary, the property owner's total taxable income; but
- A tax credit of 20% of interest paid would be given.

The reform was dramatic enough for Mr Osborne to phase it in over four years from April 2017, meaning that it did not take full effect until the 2020/21 tax year. By then, the Bank of England had reduced its base interest rate to 0.1% in response to the Covid-19 pandemic. Consequently, the reduction of tax relief on interest was less of an issue for BTL in 2020 than looked likely in 2015.

Just over two years later, the picture is altering rapidly as the Bank of England ratchets up interest rates to deal with post-pandemic inflation. One leading property agent has calculated that for some higher rate taxpaying BTL investors, an increase in mortgage rates of 2% could reduce their net income to nil:

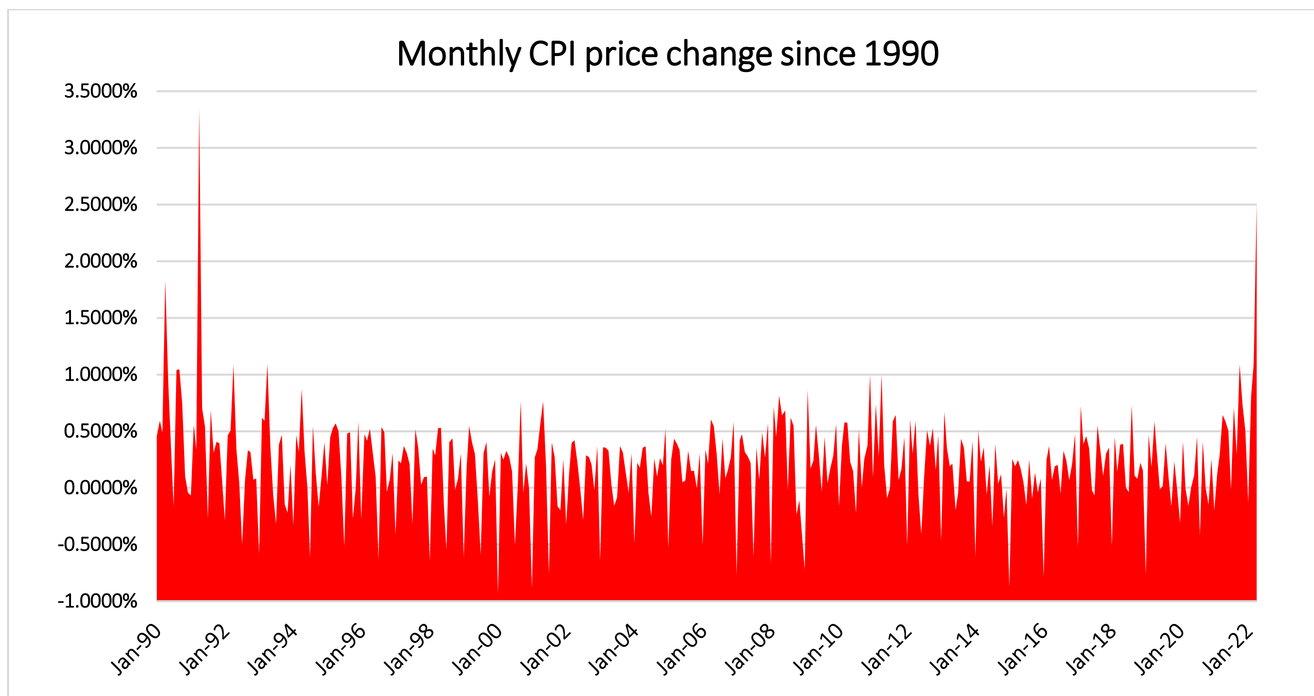
	Mortgage Interest Rate	
	2.10%	**4.10%**
Rental income	£12,000	£12,000
Expenses (31%)	£3,720	£3,720
Net taxable Income	£8,280	£8,280
Tax @ 40%	-£3,312	-£3,312
Post-tax income	£4,968	£4,968
Interest	-£3,182	-£6,212
Tax relief	£636	£1,242
Net income after tax and interest	£2,422	-£2

**Based on 75% mortgage on a property valued at £202,000 with a gross rental yield of 5.94% and expenses at the average rate reported to HMRC in 2020/21.*

The dramatic change to interest and tax relief highlights the risks inherent in borrowing to invest. The multiplier effect works of borrowing in both directions.

Spiking inflation: what's going on?

In April, UK inflation reached a level not seen since the early 1980s – many people's entire adult lives.



Source: ONS.

UK inflation was widely expected to jump in April as the new Ofgem utility price cap took effect. Nevertheless, when the April annual CPI rate of 9.0% was announced in mid-May, it dominated the headlines. In all the shock-horror coverage, some additional context was generally missed:

- Prices rose by 2.5% between March 2022 and April 2022 – more than they had risen in the entire year to April 2021. Study the graph and you will see there was one month to beat that April 2022 for price rises – April 1991 after the standard rate of VAT rose from 15% to 17.5%.
- Two energy-linked sectors – Housing and Household Services (which includes utility bills) and Transport – accounted for about half of the overall inflation rate. There is nothing the Chancellor or Bank of England can do about global energy prices.
- In April, 'core inflation', which strips out energy, food, alcohol and tobacco prices, was running at 6.2%. In April 2021, the same measure was running at 0.7%. That gives a good indication of how broadly prices have increased.
- The rate of monthly CPI increases started to pick up from April last year, so the next few months will probably see little change in the annual inflation rate.
- All other things being equal – a dangerous assumption – the next step up in inflation will be in the October rate, due out in November, around the likely time of the Autumn Budget. The reason for the increase will again be a change in the Ofgem price cap. In October 2021, the cap's increase was 12%. It means households could see their energy bills rise in October to £2,800 a year from the current cap of £1,971. At the same time, the Bank of England is forecasting that the inflation will peak at "slightly over 10%" in the final quarter of 2022.

Europe and the US are experiencing similar inflationary spikes, although at the time of writing the UK was, unfortunately, in the lead. The one solace is that the Bank of England says, “CPI inflation is projected to fall to a little above the 2% target in two years’ time.”

Retirement spending surprises

Recent research has cast a new light on retirement spending habits.

Do you expect your spending to reduce gradually once you retire?

It is often thought that as people pass through retirement their spending falls, assuming they do not have to pay for residential care. However, fresh research by the Institute for Fiscal Studies (IFS) using recent UK population data suggests this is not what happens. It appears that earlier investigations may have been mistaken in their approach.

The IFS found that if weekly per person expenditure was simply plotted against age, then there was a distinct downward drift, as the old research had suggested – between 62 and 72 there was a drop of about 15%. However, a more detailed examination looking at groups of retirees based on their year of birth revealed a different picture.

Within each group, after adjusting for inflation, expenditure generally rose slightly year-by-year, except for those well into their 80s. What the snapshot picture of spending across all ages missed was that the younger the retiree group, the higher was their initial expenditure, probably because of greater pension and other wealth.

The composition of that spending changed with age, but again the IFS found common beliefs that were not always correct. While across the different groups spending on motoring fell with age, holiday expenditure continued rising until age 80. However, there was once more a wealth-related gap between the birth date groups:

- Of those aged 82 and born between 1924–1928, 57% spent on motoring while 19% had holiday expenditure.
- For those aged 62 and born between 1944–1948 the corresponding proportions were 83% and 41%. This mirrors another IFS finding that later-born generations spend more at the start of retirement on categories such as leisure services and holidays.

The IFS concluded that "…if the spending patterns of current retirees are a good guide to how people in the future will want to spend, current savers might be best advised not to plan their retirement saving on the basis that their overall spending will fall sharply during retirement." In other words, your retirement plans may need a review if you have assumed you can live with a decreasing income (even before considering inflation).

Pension tax relief knowledge gap

How well is the tax relief on pensions understood? Research suggests not well at all, potentially undermining saving motivations.

Of late, HMRC has been publishing past research that had previously been kept under wraps. One interesting document to emerge details research commissioned in 2015 by Ipsos – the opinion polling company – into the understanding of pension tax relief. Ipsos interviewed over 700 adults and found:

- While nine in ten adults correctly believed that employers contribute to workplace pensions alongside employees, just four in ten thought that the government contributed through tax relief. One in three opted for the safety of "don't know", while one in four thought the government provided no top-up. Overall awareness was no different from the average for those in or out of work or for those not currently in pension schemes. However, six in ten of those with non-workplace pensions (e.g. personal pensions) were aware of the benefit of tax relief.
- Among pensions owners aware of tax relief, many underestimated its value. Basic rate taxpayers estimated the government had topped up their contributions by around 6% (around 25% in reality), whilst higher or additional rate taxpayers estimated the government had topped up by around 15% (around 67% or higher in reality).
- Despite the underestimates of the amount of pension tax relief, about half of those aware of its existence said it was "fairly important" or "very important" in their decision to contribute.
- The most important factor in the decision to contribute to a pension for about one third of pension owners was that their employer would contribute. Half as many gave tax relief as the major reason, coincidentally the same proportion that referred to the availability of a 25% tax-free lump sum at retirement.
- As if to underline the misunderstanding of pension tax relief, two thirds of respondents said they would be encouraged to save or save more into pension each month if pension contributions were tax free and pensions taxed in retirement – which is what approximately happens now, if you ignore the extra benefit of tax-free cash.

There are regularly suggestions leading up to Budgets that pensions tax relief will be cut back because of its multi-billion pound cost to the Treasury. One day, a Chancellor may decide to do just that because the impact of his action will not be understood either… As the song says, you don't know what you've lost 'til it's gone.