

# **A Fair Fuel Stabiliser:** a consultation on the future of fuel taxation

---

July 2008

# A Fair Fuel Stabiliser: a consultation on the future of fuel taxation

## Contents

Foreword.....	2
Summary.....	3
1 Background .....	7
2 Problems with the current system.....	10
3 Principles underlying reform.....	13
4 Questions for consultation .....	14
5 Timing and next steps.....	15

## Foreword

---

I understand that the cost of living is currently the number one concern for Britain's families. That's why I believe that it's vital to take forward our green agenda in a way that strengthens family finances – we can go green and save money at the same time. The ideas presented in this document provide just such an example of how the right policies can simultaneously help with the cost of living when things are tough, help to stabilise the economy and tackle climate change.

This consultation document presents the case for a Fair Fuel Stabiliser, and sets out five principles that a reformed system should meet:

1. Any reform should help families when the cost of living is rising. We should be putting money aside in good times to help in difficult times.
2. Any reform should reduce the inflationary impact on the economy from fluctuations in the international oil price.
3. Given Britain's position as an oil producing country, any reform should reduce the sensitivity of the public finances to oil prices, improving the Treasury's ability to forecast and plan ahead.
4. Any reform should provide greater certainty about the price of carbon, encouraging the long term shift towards lower emission vehicles and alternative methods of transport that will be necessary to meet our climate change targets.
5. Any reform should be transparent and simple to administer.

The document then sets out three questions on which we would like to consult:

1. Does the concept of a Fair Fuel Stabiliser meet the five principles set out above?
2. What is the net effect of oil prices on the public finances, and therefore what is the optimum degree of stabilisation to maximise the long term stability of the public finances?
3. How should any Fair Fuel Stabiliser be administered in practice so that it is both transparent and simple?

We welcome submissions from all interested parties on the points raised in this consultation, and will take all views into account as we develop Conservative policy on fuel taxation.

*George Osborne MP*  
*Shadow Chancellor of the Exchequer*

## Summary

---

The old politics of fuel tax has become polarised between those who argue that we should cut the cost of living whatever the cost to the environment, and those who press for escalating tax on fuel whatever the cost to the economy. Instead we will take a new approach that better meets the needs of both the economy and the environment. We call this the Fair Fuel Stabiliser.

Under a Fair Fuel Stabiliser, when fuel prices go up, fuel duty would fall. And when fuel prices go down, fuel duty would rise.

This is a new way of setting fuel duty that will strengthen environmental signals when oil prices fall, and cushion the blow when fuel costs rise. Government will be sharing the pain when prices rise and sharing the gain when they fall. This consultation document presents the case for a Fair Fuel Stabiliser and discusses the options for how it would work in practice.

If a Fair Fuel Stabiliser had been introduced at the 2008 Budget:

- Fuel would be 5p per litre cheaper.
- This would save up to £3.50 on each tank of fuel for a Ford Mondeo, or £2.60 for a Vauxhall Astra.
- If, instead of rising, oil prices had fallen below the \$84 forecast in the Budget, then fuel duty would have risen. In either case forecast government revenues would have been unchanged.

If a Fair Fuel Stabiliser had been in operation over the last year:

- The average household would have saved more than £90 in fuel costs.
- Instead of being 3.3%, official CPI inflation would now be below 3%.

### The Proposal

Under a Fair Fuel Stabiliser, when fuel prices go up, fuel duty would fall. And when fuel prices go down, fuel duty would rise. Government would save in the good times in order to help in the bad times. It's a classic example of fixing the roof when the sun is shining.

The Fair Fuel Stabiliser would bring three key benefits:

1. It would increase the **stability of family finances**. Government would be helping when the cost of living was rising sharply, by setting aside money in good times to help in difficult times.
2. It would enhance **economic stability** by reducing the sensitivity of the public finances and inflation to unpredictable changes in oil prices.
3. It would provide **greater certainty about the price of carbon**, consistent with the principles outlined in the Stern Review.

## **The current system is flawed**

Under the current system, instead of cushioning the blow and helping families to cope, the government adds to the rising cost of living. That's because fuel duty is planned to rise every year by at least the rate of inflation, regardless of what happens to the price of oil. In addition, the other tax levied on fuel, VAT, is charged at the standard rate. So as the price of fuel rises, the amount of VAT charged also rises. This means that when the price of fuel goes up, the amount of tax charged on it also rises.

The result is annual pressure on the Chancellor and Prime Minister to postpone or cancel increases in fuel duty proposed in each Budget, a practice begun by Gordon Brown as Chancellor. This contributes to a sense of uncertainty and instability in government economic policy.

The current system also makes the public finances more unstable. This is because, when oil prices rise, the Government receives an unexpected windfall from taxes on North Sea Oil production. And when oil prices fall, the Government suffers an unexpected shortfall in revenues. This makes it more difficult for the Government to predict accurately the future state of the public finances.

### **Fair Fuel Stabiliser: Stabilising family finances**

The table below shows a simplified example of what would have happened to pump prices if a Fair Fuel Stabiliser had been introduced in the 2008 Budget.

The average price of unleaded petrol in the UK rose from 108p in April to 118p in June. This was driven by an increase in average oil prices of about \$30 per barrel. If a Fair Fuel Stabiliser had been in operation that reduced the overall sensitivity of the public finances to oil prices, the Government could have used the windfall revenues from higher oil prices to reduce the tax of fuel by 5p. So instead of going up by 10p, pump prices would only have risen by 5p.

<b>Oil Price Change</b>	<b>Actual effect on pump prices under current system</b>	<b>Effect on pump prices under Fair Fuel Stabiliser</b>
\$30 a barrel increase	Rise by 10p a litre	Rise by 5p a litre

This would save up to £3.50 on each tank of fuel for a Ford Mondeo, or £2.60 for a Vauxhall Astra.

If a Fair Fuel Stabiliser had been in operation for the last year, it would have saved the average household more than £90 in fuel costs at a time when family finances have been under pressure.

## **Fair Fuel Stabiliser: Enhancing economic stability**

A Fair Fuel Stabiliser would enhance economic stability by reducing the sensitivity of the public finances and inflation to unpredictable international oil prices.

### *The public finances*

Currently, when oil prices rise, the government receives a windfall increase in tax revenues, mainly due to taxes on North Sea oil production. And when oil prices fall, the government suffers an unexpected shortfall in revenues for the same reason.

This volatility caused by oil price movements creates uncertainty in the public finances and makes the projections that the government presents at Budget time even more unreliable. This undermines the ability of the Treasury to plan tax revenues and public spending for future years, and creates unnecessary risks for the public finances.

The best independent evidence suggests that a cautious lower end estimate for the size of the effect of oil prices on the public finances is about £100 million for every \$1 change in the oil price. If this money was used so that around half of the change in fuel prices at the pumps caused by changing oil prices was offset by changes in fuel tax, the public finances would be much better insulated against fluctuating oil prices.

Clearly as the scale of North Sea oil production and revenues change over time, the optimal degree of stabilisation will change. The exact structure of a Fair Fuel Stabiliser should therefore be re-assessed every Parliament to ensure it remains consistent with stable public finances.

### *Inflation*

The stabiliser will also reduce the volatility of inflation. For example, if half of the increase in fuel prices over the past year had been offset by lower fuel duty, consumer price inflation would now be below 3%, and the Governor of the Bank of England would not yet have had to write a letter to the Chancellor explaining why inflation was above the Bank's target range.

Less volatile inflation would make it easier for the MPC to keep inflation within its target range, and would reduce the risk of inflationary wage demands in response to rapid rises in oil prices.

## **Fair Fuel Stabiliser: Stabilising the price of carbon**

Environmental taxes such as fuel duty can play an important role in reducing carbon emissions. In the case of fuel duty this works mainly by encouraging a long term shift towards lower emission vehicles and alternative methods of transport that do less damage to the environment.

But as the Stern Review on the economics of climate change argued, one of the key advantages of environmental taxes is that they “can be kept stable, and thus do not risk fluctuations in the marginal costs that could increase the total costs of mitigation policy.” A stable carbon price helps individuals and businesses to factor environmental costs into medium and long term decisions about investments and

changes in behaviour. As now, each year, the average real value of fuel duty would be maintained to take inflation into account.

A more efficient environmental tax on fuel would be one that helped to reduce volatility in the price of fuel faced by consumers. The Fair Fuel Stabiliser would make our ability to meet our climate change targets for reducing emissions less dependent on volatile international oil markets.

# 1 Background

---

- 1.1 This section explains the current regime for fuel taxation in the UK and describes the rapid increases in fuel prices over the last year.

## **Fuel taxation in the UK**

- 1.2 About 60% of the current retail price of fuel is accounted for by tax. For example, independent estimates suggest that a 115p per litre price for unleaded petrol is typically made up of 50.35p in fuel duty, 17.13p in VAT, 37.35p for the cost of the product, and 10.17p for delivery and retail.<sup>1</sup>
- 1.3 For petrol these levels of tax are broadly comparable with other European countries. For example the European Commission estimated in April that taxes and duties were about 66p per litre in the UK, the same in France and Sweden, 69p in Germany and 72p in the Netherlands.<sup>2</sup> For diesel the rate of tax in the UK was the highest in Europe, at 68p per litre compared to 46p in the Netherlands, 50p in France, 53p in Germany, and 56p in Sweden.
- 1.4 Fuel duty is currently paid by fuel producers. The majority of fuel sold in the UK has duty paid by oil companies rather than fuel retailers, with only 20 businesses covering more than 99% of fuel sales.<sup>3</sup>

## **Recent price trends**

- 1.5 Fuel prices have increased dramatically over the last year due to the rapid increase in the price of oil from under \$70 a barrel to more than \$130 a barrel. Figure 1 shows that monthly changes in the price of petrol and diesel in pence per litre have closely tracked the average international oil price in dollars, although diesel prices have risen faster. This difference is partly due to industry specific factors such as refining capacity.
- 1.6 This increase is exacerbated by an increase in the amount of VAT charged as the retail fuel price rises. As VAT is charged in the UK at 17.5% of the post-duty fuel cost, so the tax charged on a litre of fuel actually rises as the price rises.

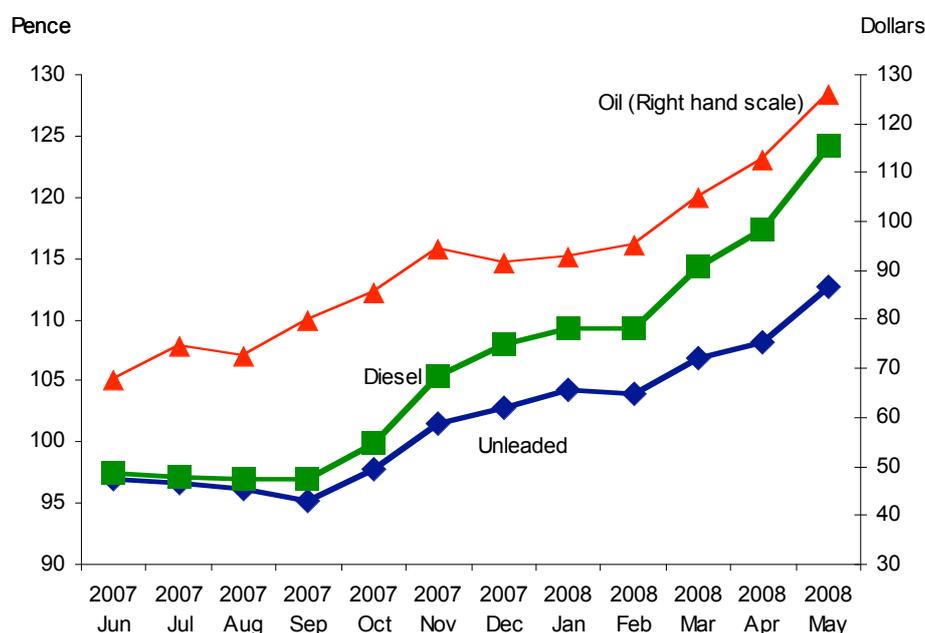
---

<sup>1</sup> <http://www.petrolprices.com/price-of-petrol.html>

<sup>2</sup> EU Oil Bulletin, April 2008, cited in House of Commons Library Standard Note SN/SG/4712

<sup>3</sup> Department for Transport, *Road Transport and the EU Emissions Trading Scheme*, <http://www.dft.gov.uk/pgr/sustainable/climatechange/euemistrascheme?page=2>

**Figure 1: Monthly averages for fuel prices and the international oil price**



Source: Average monthly unleaded and diesel prices from the AA:  
[http://www.theaa.com/motoring\\_advice/fuel/](http://www.theaa.com/motoring_advice/fuel/)

- 1.7 In the UK, price increases have been exacerbated by the rapid decline in the value of the pound since the run on Northern Rock last September. Figures collected by the AA show that petrol price inflation in the UK over the last year has been higher than in any country in the EU, with the sole exception of Estonia.<sup>4</sup> This is illustrated in Table 1.

**Table 1: Annual petrol price inflation in the EU – highest and lowest**

<b>Top Five</b>	
Estonia	28%
<b>UK</b>	<b>17.4%</b>
Austria	15.2%
Latvia	13.8%
Greece	13.5%
<b>Bottom Five</b>	
Luxembourg	6.0%
Slovakia	4.9%
Poland	4.0%
Germany	3.7%
Slovenia	0.9%

Source: AA Fuel Price Report May 2007 – May 2008.

<sup>4</sup> AA Fuel Price Report May 2007 – May 2008.

- 1.8 The result is that increasing fuel prices have contributed to the rapid increase in inflation. According to the ONS, the “Fuel and lubricants” element in the “Operation of personal transport equipment” component of the Consumer Price Index has increased by 19.5% in the 12 months to May 2008.<sup>5</sup> Given that it has a weighting in the index of 38 out of 1000, this means that it has contributed more than 0.7% of the total 3.3% increase in the CPI over the last year – almost one quarter of the total – and that is without taking account of public transport or indirect effects on other prices.
- 1.9 The impact on family budgets has been considerable. According to the Family Expenditure Survey, the average household spent almost £950 on fuel for transport last year.<sup>6</sup> Based on the current rate of price inflation this will increase by more than £185 a year in 2008.

---

<sup>5</sup> ONS, *Consumer Price Indices First Release*, May 2008

<sup>6</sup> RAC, *The cost of transport and its impact on UK residents: An analysis of the ONS (2008) Family Spending Report 2007*, March 2008

## 2 Problems with the current system

---

- 2.1 This section discusses the problems with the current system of fuel taxation, and explores the scope for improvements. It focuses on three areas: the impact of fuel prices on inflation and family budgets; the relationship between oil prices and the public finances; and the poor quality of the environmental signal created by volatile oil and fuel prices.

### Fuel prices and inflation

- 2.2 As discussed in the previous section, fuel prices have a substantial direct impact on inflation. The 19.5% increase in fuel prices in the year to May contributed more than 0.7% of the total 3.3% increase in the CPI over the same period. If fuel prices had been stabilised so that half of this increase had been offset by lower fuel tax, CPI inflation would now be below 3% and the Governor of the Bank of England would not yet have had to write a letter explaining why inflation was above the Bank's target range. The same amount of stabilisation would have saved the average household more than £90 over the year.
- 2.3 The 2007 Budget announced above-inflation increases in fuel duty for three years, but the 2p increase planned for April 2008 was postponed for six months in Budget 2008. Since then the Chancellor has indicated that this increase may be postponed again if oil prices remain high: "I will return to the issue nearer the time - I will take into account what is happening in the oil market and see what is best to help out families and businesses."<sup>7</sup> Recently the Prime Minister has dropped a series of further hints that the 2p increase may be postponed. This practice, introduced by Gordon Brown as Chancellor, is not a stable or sustainable way to conduct tax policy.
- 2.4 Low and stable inflation is a key goal of macroeconomic policy, and oil prices are one of the most volatile contributors to inflation. A policy that reduced the sensitivity of inflation to oil prices would make the job of the Monetary Policy Committee easier at the same time as helping families plan their finances.

### Oil prices and the public finances

- 2.5 Oil prices affect the public finances in a number of ways. First, given the UK's position as a significant oil producer, the most important impact is through revenues from the taxation of oil production in the North Sea. According to the most recent assessment by the National Audit Office, "The Treasury estimates that a one dollar increase in the oil price would, other things being equal, increase North Sea revenues in the first instance by about £200 million."<sup>8</sup> That estimate was made immediately before an increase in the effective rate of corporation tax on most North Sea production from 40% to 50%, which increased the impact on revenues.

---

<sup>7</sup> Alistair Darling, BBC World at One, 28 May 2008.

<sup>8</sup> National Audit Office, *Audit of Assumptions for the 2005 Pre-Budget Report*, Page 19, [http://www.nao.org.uk/publications/nao\\_reports/05-06/0506707.pdf](http://www.nao.org.uk/publications/nao_reports/05-06/0506707.pdf)

- 2.6 There are a number of secondary effects that make the total net impact of oil prices on the public finances slightly more complex. One of the most comprehensive estimates of the overall effect comes from an economic modelling exercise by the independent National Institute of Economic and Social Research (NIESR).<sup>9</sup> They calculate that the average annual net impact on tax revenues of a \$10 increase in oil prices is an increase of about 0.1% of GDP, which corresponds to about £1.4 billion in current prices.<sup>10</sup> This is about 70% of the direct impact on North Sea revenues cited by the NAO, or about £140 million for every \$1 change. This is also without taking account of the increase in effective North Sea taxation from 40% to 50% announced in the 2005 Pre-Budget Report, which would tend to increase the impact.
- 2.7 Of course, the volume of North Sea production of oil and gas is set to decline over the long term. Production estimates are subject to revision, so the operation of any Fair Fuel Stabiliser should be reviewed every Parliament to ensure that the stabilising impact on the public finances is maximised.
- 2.8 The above analysis suggests that the public finances are sensitive to oil prices, with a conservative lower end estimate being that each \$1 increase is associated with around £100 million in higher revenues – about half the estimated direct effect on North Sea revenues cited by the NAO of £200 million per \$1 increase. Table 2 shows the size of the windfall for different average oil prices compared to the Budget 2008 baseline forecast of \$84, using three different assumptions about the impact on revenues. The latest average of independent forecasts for 2008 issued by the Treasury is for oil at \$112 per barrel, while oil prices have recently been fluctuating around \$140.

**Table 2: Net revenue effects of different oil prices compared to Budget 2008**

Average oil price:	\$84	\$112	\$130	\$150
£200m per \$1 (direct effect cited by NAO)	£0 bn	£5.6 bn	£9.2 bn	£13.2 bn
£140m per \$1 (average net effect estimated by NIESR)	£0 bn	£3.9 bn	£6.4 bn	£9.2 bn
<b>£100m per \$1 (cautious lower end estimate used elsewhere in this document)</b>	<b>£0 bn</b>	<b>£2.8 bn</b>	<b>£4.6 bn</b>	<b>£6.6 bn</b>

- 2.9 Given the importance of reliable and stable forecasts for the state of the public finances, the sensitivity of revenues to oil prices is an additional and unwelcome complication when it comes to planning government spending and tax revenues for future years. A policy that would reduce this sensitivity while leaving total

<sup>9</sup> National Institute Economic Review No. 193, October 2005, Box C, “Oil prices and tax revenues”

<sup>10</sup> The estimated effect is small to begin with, but grows over a five year period to almost 0.2% of GDP, or £2.7 billion in the fifth year. There is also a negative effect on real GDP, but this is almost exactly offset by a positive impact on inflation, so that money GDP is broadly unchanged.

revenues broadly unchanged over the medium to long term would therefore be desirable.

- 2.10 Table 2 shows that using a lower end estimate of £100 million per \$1 change in the oil price and the latest average of independent forecasts for 2008 issued by the Treasury of \$112 per barrel, the size of the windfall is equal to £2.8 billion. If all of these additional revenues were used to reduce duty on fuel, they would be more than enough to pay for a 5p reduction in duty, and therefore almost a 6p reduction in the retail price of fuel once the impact of VAT is included. This is roughly half of the increase in retail fuel prices that would normally be associated with an increase in oil prices from \$84 to \$112.
- 2.11 On this basis, a stabiliser that better insulated the public finances against fluctuations in oil prices would be able to offset around half of any change in the price of fuel.

### **Fuel prices and the environment**

- 2.12 Given that the tax-free price of fuel does not properly reflect the damage done by carbon emissions to the environment, there is a strong economic case for the environmental taxation of fuel.
- 2.13 However, the quality of the environmental signal sent by fuel duty is undermined by volatility in the underlying price of fuel. As the Stern Review on the economics of climate change argued, one of the key advantages of carbon taxes is that they “can be kept stable, and thus do not risk fluctuations in the marginal costs that could increase the total costs of mitigation policy.”<sup>11</sup> A stable carbon price helps individuals and businesses to factor environmental costs into medium and long term decisions about investments and changes in behaviour.
- 2.14 A more efficient environmental tax on fuel would therefore be one that helped to reduce volatility in the retail price of fuel faced by consumers. In short, our ability to meet our climate change targets for reducing emissions should not be dependent on volatile international oil markets.
- 2.15 This is also why, in 2006 when he was Environment Secretary, David Miliband suggested a similar policy approach in a letter to Gordon Brown.<sup>12</sup>

---

<sup>11</sup> Stern Review, Section 14.9, p.320,

<sup>12</sup> David Miliband, leaked letter to Gordon Brown, Mail on Sunday, 29 October 2006

### 3 Principles underlying reform

---

- 3.1 We believe that any reformed system of fuel taxation should conform to the following principles.

**Any reform should help families when the cost of living is rising. We should be putting money aside in good times to help in difficult times**

- 3.2 The current system adds to the cost of living when times are difficult, instead of putting money aside in good times so that government can help to cushion the blow in difficult times.

**Any reform should reduce the inflationary impact on the economy from fluctuations in the international oil price.**

- 3.3 Low and stable inflation is a key goal of macroeconomic policy, and oil prices are one of the most volatile contributors to inflation. Any reform should help to dampen the volatility of inflation by reducing duty on fuel when prices are rising and raising it again when they are falling.

**Given Britain's position as an oil producing country, any reform should reduce the sensitivity of the public finances to oil prices, improving the Treasury's ability to forecast and plan ahead**

- 3.4 The sensitivity of the public finances to oil prices undermines the ability of the Treasury to plan the course of public spending and tax receipts, with unexpected windfalls when oil prices rise, and unexpected shortfalls when they fall. Any reform should improve the long term stability of the public finances.

**Any reform should provide greater certainty about the price of carbon, encouraging the long term shift towards lower emission vehicles and alternative methods of transport that will be necessary to meet our climate change targets**

- 3.5 As argued by the Stern Review, the quality of the environmental signal sent by carbon taxes is undermined by price volatility. A more efficient environmental tax on fuel would therefore be one that helped to smooth the resulting volatility in the retail price of fuel faced by consumers.

**Any reform should be transparent and simple to administer**

- 3.6 Fuel duty is relatively easy to calculate and administer. Any reform must maintain these important properties at the same time as meeting the principles above. As discussed above, the majority of fuel sold in the UK has duty paid by oil companies rather than fuel retailers, with only 20 businesses covering more than 99% of fuel sales. This suggests that a reformed system should be relatively simple to administer.

## 4 Questions for consultation

---

4.1 We welcome submissions from the public, academia, business, environmental organisations and any other interested parties in response to the following questions.

**Q1 Does the concept of a Fair Fuel Stabiliser meet the five principles set out above?**

4.2 A Fair Fuel Stabiliser would provide a systematic mechanism to reduce tax on fuel when prices are high and vice versa. Could this potentially meet three important policy priorities – stabilising the public finances, smoothing inflation, and helping to reduce carbon emissions – while at the same time being transparent and simple to administer?

**Q2 What is the net effect of oil prices on the public finances, and therefore what is the optimum degree of stabilisation to maximise the long term stability of the public finances?**

4.3 The evidence presented in Section 2 suggests that a conservative lower end estimate of the net impact on the public finances from oil prices is about £100 million per \$1. On this basis a stabiliser that much better insulated the public finances against fluctuations in oil prices would be able to offset around half of any change in the price of fuel. We welcome further submissions on this issue to identify the optimum degree of stabilisation consistent with stable public finances.

**Q3 How should any Fair Fuel Stabiliser be administered in practice so that it is both transparent and simple?**

4.4 Fuel duty is currently paid by fuel producers. The majority of fuel sold in the UK has duty paid by oil companies rather than fuel retailers, with only 20 businesses covering more than 99% of fuel sales.<sup>13</sup> This suggests that a reformed system would be relatively simple to administer, and that proposals currently being discussed at a European level to use variable rates of VAT to offset high fuel prices are likely to be more complex than a domestic reform of fuel duty.

4.5 A related issue is how frequently changes in fuel duty should be applied in order to stabilise prices, and how they should be calculated. Both oil prices and retail fuel prices are already monitored on a daily basis, so data collection is unlikely to pose significant challenges. We welcome submissions on the frequency with which duty rates should be changed, and on how changes in rates should be calculated and communicated in order to best meet the principles set out in the previous section.

---

<sup>13</sup> Department for Transport, *Road Transport and the EU Emissions Trading Scheme*, <http://www.dft.gov.uk/pgr/sustainable/climatechange/euemistrascheme?page=2>

## 5 Timing and next steps

---

- 5.1 The closing date for responses to this consultation is 19 December 2008.
- 5.2 Responses should be sent to:
- Fair Fuel Stabiliser Consultation
- Office of the Shadow Chancellor, George Osborne MP
- House of Commons
- London
- SW1A 0AA
- 5.3 Or by email to [contact@georgeosborne.co.uk](mailto:contact@georgeosborne.co.uk) Please include the words ‘Fair Fuel Stabiliser Consultation’ in the subject.
- 5.4 Responses to this consultation will be used to inform our policy development process.



Promoted by Alan Mabbutt on behalf of the  
Conservative Party, both at 30 Millbank, London,  
SW1P 4DP. Printed by TPF Group, Avro House,  
Harlequin Avenue, Brentford, TW8 9EW.