

Securing a sustainable future: a consultation on the North Sea Fiscal Regime

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HM TREASURY



HM Revenue
& Customs

**Securing a sustainable future:
a consultation on the
North Sea Fiscal Regime**

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INTRODUCTION

1.1 The UK Government remains committed to promoting a healthy and prosperous UK oil and gas industry and has a stated objective to maximise the economic recovery of the UK's oil and gas reserves.

1.2 The Government has twin objectives for the fiscal regime - to promote investment and production whilst striking the right balance between producers and consumers and ensuring a fair return for the UK taxpayer from our national resources. Government believes that overall the current fiscal regime successfully strikes that balance at the present time and ensures that both producers and consumers benefit appropriately from the production of the UK's oil and gas reserves.

1.3 The UK has substantial oil and gas reserves and up to the end of 2006 these have produced around 36.5 billion barrels of oil equivalent (boe). Total oil and gas production from the UK Continental Shelf (UKCS) peaked in 1999, and has been declining since. However the UKCS' remaining oil and gas potential is significant. The department for Business, Enterprise and Regulatory Reform's (BERR)¹ mid case assumption is that between 12 and 22 billion boe remain to be recovered², a view supported by Oil and Gas UK.³

1.4 Although the UK is already a net importer of oil and gas, indigenous supplies will continue to play a vital role in the UK's energy consumption for many years to come, with the UKCS expected to produce up to ninety per cent of the UK's oil requirements and sixty per cent or more of its gas requirements in 2010.⁴

1.5 The underlying geology and future oil and gas prices are the dominant drivers of investment and, hence, ultimate recovery levels. However Government has a crucial role to play in ensuring that the regulatory and fiscal regimes help deliver the best possible future for the UKCS.

1.6 On the regulatory side BERR, working closely alongside industry, since 1999 through the high level joint PILOT forum has made significant progress in ensuring that the UKCS has the correct regulatory and commercial environment to encourage further investment and exploration, for example through the introduction of the "Promote" licence, the "Fallow" exercise and the "Stewardship" initiative.

THE DISCUSSIONS ON THE NORTH SEA FISCAL REGIME

1.7 In order to ensure that the North Sea fiscal regime is appropriate for the remaining life of the UKCS, the then Chancellor announced in the 2005 Pre-Budget Report that the Government would open discussions with the oil and gas industry to examine wider structural concerns over areas of the North Sea fiscal regime. These

¹ The relevant functions of the DTI (Department for Trade and Industry) - were transferred in July 2007 to the Department for Business, Enterprise & Regulatory Reform – BERR. All references to the organisation in this document are under its new name.

² Source – BERR – UK Oil and Gas Reserves and Resources - http://www.og.dti.gov.uk/information/bb_updates/chapters/reserves_index.htm BERR's high case (Reserves plus Potential Additional Resources plus Undiscovered resources) suggests that as much as 38.7 billion boe could still be recoverable.

³ Oil & Gas UK – 2007 Economic report page 35 – Based in the latest DTI figures "Oil & Gas UK estimates that there are somewhere between 16 and 25 billion boe still to be recovered, with current trends delivering around 20 billion boe". (Oil & Gas UK was set up in April 2007. It incorporates the UK Offshore Operators Association –UKOOA – and all references to the organisation in this document are under its new name.)

⁴ Oil & Gas UK – 2007 Economic report - page 26.

discussions would cover any areas of the fiscal regime which either Government or industry felt could potentially undermine ongoing stability, and impact on the Government's objective to maximise the economic recovery of the UK's oil and gas resources.

1.8 The initial round of discussions lasted from January 2006 through to September 2006 and provided a framework within which UKCS stakeholders could discuss any aspects of the fiscal regime with officials from HM Treasury (HMT), HM Revenue and Customs (HMRC) and BERR. A large number of stakeholders took advantage of this opportunity and meetings were held with a range of delegates from oil and gas companies, representative bodies, academics, the supply chain and other stakeholders.⁵

1.9 At Pre-Budget Report 2006 the Government announced it was considering the conclusions from the discussions and examining the options for further action on the strategic issues that had been raised. At the same time, to address a specific issue within the fiscal regime that had been identified during the course of the discussions, the Government announced the removal of fields from the charge to Petroleum Revenue Tax if they are redeveloped following full decommissioning. Government also announced the creation of a joint Government and industry working group to examine the fiscal impact of the current regime in relation to the change of oil and gas infrastructure use, for example to carbon capture and storage.

1.10 At Budget 2007 Government published "The North Sea Fiscal Regime: a discussion paper".⁶ This discussion paper summarised the contributions received and set out the conclusions that the Government had drawn from the initial phase of discussions about where changes might be necessary. It also outlined criteria for assessing possible options and used these to draw some initial conclusions.

1.11 Following the progress made in the first round of discussions, Government felt it was desirable to continue to discuss with industry the many important issues that had been raised, and possible changes that could be made to the fiscal regime to resolve them. The discussion paper therefore formed the basis for further, more focused, discussions with industry through to the end of September 2007.

1.12 As before a large number of UKCS stakeholders participated in these discussions including both the majority of those who had participated in the first phase of discussions and also previously unheard from interests. This second stage of discussions was even more valuable and constructive than the first round, and Government reiterates its thanks to all the companies, organisations and individuals who were involved in the process for their contributions. The Government recognises the expertise that those in industry have in this area and believes that the best future for the North Seas fiscal regime can be achieved through close co-operation and discussion.

THE NORTH SEA FISCAL REGIME, GOVERNMENT'S CURRENT CONCLUSIONS

1.13 This consultation document builds on the previous discussion paper. It will:

⁵ A list of all bodies which have fed into either the second round of discussions between March and September 2007, or the first round of discussions between January and September 2006, can be found at Annex C. This list shows both those with whom Government had face-to-face meetings and those who submitted written submissions.

⁶ Available from, http://www.hm-treasury.gov.uk/budget/budget_07/documents/bud_bud07_northsea.cfm

- Summarise the further contributions received from industry;
- set out the conclusions that the Government has drawn from the discussions ;and
- assess these conclusions against the criteria for change set out in “The North Sea Fiscal Regime: a discussion paper” (repeated here in Annex B).

1.14 This paper is intended to fulfil a dual purpose. Firstly Chapter 4 sets out a number of proposed changes to the North Sea fiscal regime. It is intended that these changes are formally announced in Budget 2008 and legislated on in Finance Bill 2008. A draft impact assessment for the measures is in Annex A. Where possible, draft legislation for these measures has been published alongside this document on the HMRC website.⁷ Where it has not been possible to include draft legislation in this document Government intends to publish the further draft legislation on the HMRC website as it becomes available. Comments are invited from UKCS stakeholders on this package and on the draft legislation by the end of January 2008.

1.15 Secondly Government believes that on a number of issues further engagement and discussion with stakeholders would be useful before Government draws its final conclusions. These areas where further discussion is believed desirable and where Government would welcome further input from industry are set out in Chapter 5. On these areas Government intends the discussion period to last until the end of June 2008, after which Government will draw its final conclusions.

1.16 If discussions on any particular issues proceed faster than expected then Government may, if it believes appropriate, add action on these areas to the package announced at Budget 2008. This is particularly likely on matters pertaining to change of use issues.⁸ Government again thanks those from industry who participated in the Change of Use working group. As stated later in this document Government believes that some of the proposed legislative changes that were set out in the joint working group report, “Platform for Change”,⁹ should be introduced, but would like to discuss these further with industry before implementing any changes.

SUMMARY

1.17 This document:

- Describes how the current fiscal regime works and summarises the views presented by UKCS stakeholders during the latest round of discussions
- Sets out a proposed package of changes, to be announced in Budget 2008 and legislated on in Finance Bill 2008, and accompanies these where possible with draft legislation. Government invites views and comments on these proposals by the end of January 2008.
- Sets out Government’s current conclusions on the other issues that have been raised, including those areas where Government believes further

⁷ Draft legislation available at <http://www.hmrc.gov.uk/oto/fiscal-regime.pdf>

⁸ It was announced at PBR 2006 that a joint HMR/BERRC/industry working group would be set up to consider the application of the North Sea fiscal regime to ‘change of use’ projects – where North Sea infrastructure previously used for oil and gas production was subsequently used for carbon capture and storage, gas storage or wind power. The main aim of the group was to provide as much clarity and certainty as possible on the application of the current tax rules to such projects.

⁹ Platform for Change, published on 15 November 2007, and available from <http://www.hmrc.gov.uk/oto/change-of-use.htm>

discussions would be productive, and forms the basis for further discussions on these areas through to the end of June 2008.

2

THE CURRENT REGIME

2.1 Profits arising from the extraction of oil and gas in the UKCS potentially fall within three regimes – Petroleum Revenue Tax, Ring-Fence Corporation Tax (RFCT) and Supplementary Charge.

Petroleum Revenue Tax

2.2 Petroleum Revenue Tax (PRT) was introduced by the Oil Taxation Act 1975 and repealed by Finance Act 1993 for all fields given development consent on or after 16 March 1993. It therefore applies only to fields given development consent before that date.

2.3 PRT is a field-based tax. Fields liable to PRT are currently charged at fifty per cent on their net income from extracting oil and gas in the UK or a designated area (the UKCS). There are a number of reliefs and allowances that protect smaller and less profitable fields from paying this tax.

2.4 PRT is charged in respect of profits from oil (for most PRT purposes “oil” includes gas and other hydrocarbon products) won under a licence issued by the Secretary of State for Business, Enterprise & Regulatory Reform. It is assessed on each participator in an oil field.

2.5 For PRT purposes, companies have to make a number of returns for what are termed ‘chargeable periods’. There are two six-month ‘chargeable periods’ each year.

2.6 PRT can produce an assessable profit or an allowable loss. Where there is an allowable loss, this is carried forward to set against assessable profits from the same field in later periods without time limit, unless the participator claims to have it carried back against earlier profits from the same field, again with no time limit.

2.7 If the field reaches the end of its productive life and decommissioning costs are incurred, to the extent that such costs are deductible for PRT purposes, any losses arising can be carried back for offset against profits from the field without limit, subject to the retention of the licence or within two chargeable periods of the relinquishment of the licence.

2.8 Any losses still unused (termed Unrelievable Field Losses) may be set against profits from another field owned by the same company (or an associate) and are relieved in that field in the same way as other non field expenditure.

2.9 As described above, major reforms in 1993 ended the PRT charge for any fields receiving development consent on or after 16 March 1993. Such fields are known as “non taxable fields”. They are not liable to PRT and cannot generate any reliefs or surrender reliefs or losses to those fields (taxable fields) remaining subject to PRT.

2.10 PRT is deductible in arriving at profits chargeable to RFCT and Supplementary charge.

Ring Fence Corporation Tax

2.11 Corporation tax in the North Sea, charged at thirty per cent, is subject to special rules, which were introduced in 1975 to ensure the UK gained the proper benefit from North Sea oil.

2.12 The main purpose and effect of the rules is to stop profits from oil extraction activities and oil rights in the UK and UKCS being reduced for tax purposes by losses from other trading activities.

2.13 A “ring fence” is placed around these profits and the normal rules, which would otherwise allow the profits to be reduced by losses from other activities carried out by the company, or from losses other than from UK oil extraction activities arising to other companies in the same corporate group, are disapplied. The rules work by treating the ring-fenced activities as a separate trade, and then preventing trading losses being set against income from oil extraction activities or oil rights (and ring fence capital gains) except insofar as they are losses derived from such activities.

2.14 Most capital expenditure incurred in the North Sea, whether on putting the plant and machinery in place, or in dismantling it at the end of the life of an oil field, qualifies for 100% First Year Allowances (FYAs), allowing the costs to be written off for tax purposes in the accounting period in which the expenditure is incurred. The general rules applying to capital expenditure incurred in a ring fence trade are set out below:

- **Capital allowances:** There are 100% FYAs for expenditure on plant and machinery for use wholly within a ring fence trade and 24% FYAs for long-life assets (those with a useful economic life of at least 25 years). The remaining long-life asset expenditure, not qualifying for FYAs, attracts an annual allowance of 6%, on a reducing balance basis.
- **Decommissioning expenditure in the North Sea:** Nearly all decommissioning expenditure is capital in nature and is relieved under the capital allowances legislation. There are 100% FYAs relief for all decommissioning expenditure where certain conditions are met. The main conditions are that the:
 - Expenditure is on decommissioning
 - Decommissioning is of plant or machinery which is, or forms part of, offshore installations and submarine pipelines
 - Expenditure is incurred for the purposes of, or in connection with, closing down all or part of an oil field
 - Decommissioning is carried out wholly or substantially to comply with an approved abandonment programme or any condition to which the approval of the abandonment programme is subject
- There is relief on a 25% reducing balance basis for decommissioning expenditure not qualifying for 100% relief, e.g. because the installations are outside UK waters or other relevant conditions are not met.
- **Corporation Tax Loss relief for decommissioning expenditure:** Losses may be carried back for 3 years where the loss is attributable to 100% decommissioning allowance.

2.15 Whilst profits from oil extraction activities are ring fenced, trading losses arising from such activities are relievable for corporation tax in the same way as losses from other trading activities. Losses can be set off sideways against other profits, group relieved, carried forward into future accounting periods or carried back one year. In addition, as described above, to the extent that losses arise from decommissioning activity, such losses can be carried back three years.

2.16 In 2004 the Government introduced Exploration Expenditure Supplement (EES), targeted particularly at those smaller companies entering the North Sea and incurring losses in early years, which they are unable to offset against other profits. The supplement helped to retain the value of losses incurred in exploration and appraisal activity by allowing an uplift of six per cent per annum for such losses, up to a maximum of six accounting periods. In 2006 EES was replaced by the Ring Fence Expenditure Supplement (RFES), which widened the scope to include all North Sea expenditure which cannot be relieved against North Sea profits.

Supplementary Charge

2.17 Finance Act 2002 introduced a Supplementary Charge of ten per cent on adjusted ring-fence profits. Adjusted ring-fence profits are the amount of profit or loss arising from any ring-fenced activities excluding any financing costs. The rate of Supplementary Charge was increased in Finance Act 2006 to twenty per cent, with effect from 1st January 2006.

3

THE 2007 DISCUSSIONS - VIEWS OF INDUSTRY

3.1 Between Budget 2007 and the end of September 2007, discussions were held with a wide range of UKCS stakeholders, including individual oil and gas companies, representative bodies, academics, supply chain representatives and other stakeholders.¹ In addition to these meetings, the Government also received a number of written submissions. **This chapter summarises the views expressed by the participants in those discussions and are not those of HM Treasury or wider Government.** The Government's conclusions and views on the issues raised are then set out in the following chapters.

3.2 This round of discussions built on the issues first raised in the initial round of discussions on the North Sea fiscal regime between the 2005 Pre-Budget Report and the end of September 2006. As with that first round, there were no restrictions on what the Government was willing to discuss and both the conversations and the written submissions covered a broad range of issues, including some not raised in the first round of discussions.

3.3 As a result of the wide range of companies involved in the UKCS, ranging from the super majors through to small independent exploration companies, and the many different positions, interests and strategies that all those companies have, there was, on various issues, no consensus from industry and in several areas the messages given by different sections of industry were contradictory.

3.4 From the headline messages received from across industry there were, however, several common views – which were perhaps best summarised in the submission from Oil & Gas UK,² which stated that the fiscal framework should:

- Promote the economic recovery of the UK's oil and gas reserves;
- Be consistently applied across exploration, development, operation and abandonment;
- Provide certainty for the lifespan of the asset, including ongoing investment and the treatment of future decommissioning liabilities;
- Sustain competitiveness of the UKCS, both globally and regionally;
- Provide an appropriate balance between risk and reward;
- Recognise the long term nature of investments, and refrain for increasing tax rates in response to short term increases in commodity prices;
- Not increase the tax burden on individual fields or assets as a result of future changes in the overall oil tax regime;
- Avoid fiscal anomalies, which can lead to inappropriate behaviour; and
- Ultimately see the UKCS taxed on the same basis as other industries.

¹ A list of all bodies which fed into either the second round of discussions between March and September 2007, or the first round of discussions between January and September 2006, can be found at Annex C. This list shows both those with whom Government had face-to-face meetings and those who submitted written submissions.

² Oil & Gas UK submission addressing the future of the North Sea fiscal regime – 15 October 2007.

3.5 Building on the issues looked at in the first round of discussions, the conversations with UKCS stakeholders, and the submissions that were received, focused on a number of specific issues that are summarised below and then looked at in turn in the remainder of this chapter:

- The Petroleum Revenue Tax (PRT) regime;
- relief for decommissioning costs;
- incentives for development; and
- proposals for separate fiscal regimes for oil and gas developments

3.6 Change of Use issues were also discussed. However the views of industry on these issues have already been set out in “Platform for Change”, published in November 2007, and will not therefore be repeated here at length.

3.7 This chapter does not revisit in detail those issues raised in the first round of discussions that were not subsequently raised again in the second round. The vast majority of issues were raised in both rounds of discussions. However, following the publication of “The North Sea Fiscal Regime: a discussion paper”, certain issues have not been discussed further. This was despite Government’s clearly stated willingness to discuss these issues further if industry so wished. The issues not revisited are:

- Specific exploration incentives;
- a price linked fiscal regime;
- R&D Tax Credits; and
- rebalancing the fiscal regime by abolishing PRT and increasing Supplementary Charge.

3.8 For the original views of Industry on these issues, and the Government’s conclusions, please see “The North Sea Fiscal Regime: a discussion paper”.³

The Petroleum Revenue Tax (PRT) Regime

3.9 As with the first round of discussions on PRT, the views set out by industry were centred on the twin desires for certainty on decommissioning relief and for a reduced tax burden to encourage investment.

3.10 On the first desire, the wish was for increased certainty that Government would honour the existing PRT rules for receiving tax relief on decommissioning costs, or would ensure that in any reforms to PRT the existing decommissioning relief remained accessible. It was felt that the current lack of certainty on this issue, despite the statements made in the Budget 2007 discussion paper, was continuing to have an adverse impact on investment and was also making asset transfers significantly more complex.

3.11 On the second desire, it was felt by some that the current rate of tax imposed on PRT’able fields was acting to disincentivise investment and therefore would ultimately act to reduce the overall recovery of oil and gas from these fields. In particular there was a view that outlying pockets of oil and gas within PRT’able fields, that would require

³ Available from, http://www.hm-treasury.gov.uk/budget/budget_07/documents/bud_bud07_northsea.cfm

significant amounts of infrastructure in their own right to be exploited, were finding it hard to compete for investment with alternatives in non-PRT'able fields.

3.12 In “The North Sea Fiscal Regime: a discussion paper” Government stated that, “its initial analysis suggests that the removal of the PRT system could have benefits for the UKCS.” It also stated however that, “it is possible that the overall outcome of the current work on PRT may be the retention of the current system. Such a retention would not be untenable, and could be desirable for an overall UKCS policy perspective.” In addition, during the course of the latest round of discussions, Government raised the idea of major reform of the PRT system. Whilst PRT would be retained significant changes would be made to the system of allowances and reliefs to simplify the regime, remove barriers to investment and sources of uncertainty and potentially reduce the rate at which the tax was levied.

3.13 These three possibilities formed the major areas of discussion between Government and industry and the views of industry on each are looked at below.

Abolition of PRT **3.14** In general industry believed that if it were possible to create a mechanism for abolishing PRT then this would be the most desirable outcome of the conversations on PRT. Three potential routes to removing PRT were discussed with industry:

- A “Buy-Out” computation whereby companies currently liable for PRT bought themselves out of the regime through an upfront payment to cover their remaining estimated PRT liabilities minus the relief on decommissioning, with PRT then being abolished;
- the switch off of PRT on a field by field basis at the point where the field turned PRT net present value (NPV) neutral – i.e. the point where the remaining estimated revenues from PRT for a field equalled the amount of PRT that could be claimed back in tax relief following decommissioning expenditure;
- the termination of PRT as soon as possible, accompanied by the removal of decommissioning relief for PRT

3.15 On the first – a “Buy Out” computation - this possibility saw a wide range of differing levels of support. These views ranged from a belief that this represented the best way forward for PRT fields, and would result in a win-win situation for both Government and industry, and therefore Government should impose a Buy-Out on all PRT fields, through to strong opposition to such an approach, with a variety of views in between. In general, however, the view was that if such a computation could be made optional then industry would be interested in continuing to discuss this possibility. Specifically there was a wish to look further at the potential commercial terms and means of election for such a deal.

3.16 If such a mechanism went ahead on an optional basis, then some companies were also concerned that Government would subsequently reform PRT in such a way as to create adverse consequences for those that opted to remain within the regime.

3.17 On the second – the switch off of PRT on a field by field basis this option was generally seen as a potential fall back option if it was not possible to proceed with a buyout. However some respondents believed that this could in fact be more attractive than a buyout as it would not involve the early payment of potential PRT liabilities, nor would it involve the early repayment of decommissioning relief by Government that could be created in a buyout.

3.18 On the third – a few respondents also proposed that PRT should be abolished as soon as possible and that in order to achieve certainty, and in the belief that the majority of fields have not yet reached a PRT NPV negative point, this should be accompanied by the abolition of all access to decommissioning relief. Effectively these companies were prepared to forgo the benefit of decommissioning relief for the benefit of a number of years production PRT-free. However, this proposal was raised by only a few companies, and was not generally discussed with industry. It attracted significant opposition from the majority of those with PRT interests, for whom a major reason for initially raising PRT as an issue was concerns over ultimately receiving tax relief related to decommissioning.

Major Reform of PRT 3.19 Early in the discussions some companies raised the idea that if abolition of PRT was not achievable then in order to make PRT liable fields more competitive, and to simplify the PRT system, major reforms could be undertaken to reduce or remove some of the many allowances and reliefs that are currently available for PRT. The savings for Government created by such abolitions could then be used to reduce the overall rate of PRT. It was felt that this would have the potential to increase the competitiveness of PRT liable fields when compared with non PRT liable fields.

3.20 When Government raised this possibility wider with industry the consensus view was that companies would have serious concerns over any such measures, believing that they would create a wide range of winners and losers and would be potentially damaging to the general perception and confidence in the North Seas fiscal regime as a whole, even for those who were winners from any particular reforms.

Retention of PRT 3.21 If PRT were to be retained then industry was keen for any further reassurance that Government could give that the existing rules for receiving tax relief on decommissioning costs would be honoured.

3.22 In addition there was a general proposal that Government should look to create a mechanism within PRT that ensured that incremental investment, and the ensuing production, was exempted from PRT. Although there was recognition that there are significant inherent difficulties in apportioning investment and production between existing and incremental activity, it was generally believed by industry representatives that it should be possible to overcome these.

3.23 During the discussions surrounding PRT, Government raised the question of whether industry would be in favour of any measures to remove fields that are ‘never payers’ out of PRT. This proposal was looked upon favourably, with companies believing that such a measure would create tax certainty and thus encourage incremental investment and asset trading.

Anomalies 3.24 In addition industry also raised a number of anomalies it felt existed within the existing PRT regime, and which needed to be remedied:

- Ensuring access to PRT relief, where a company that had previously been a participant in a PRT field, was subsequently made liable for decommissioning costs under sections 29 or 34 of the Petroleum Act, following default by another participant; and
- ensuring that the expiry of a petroleum production licence for a field does not lead to the loss of PRT relief for costs incurred post licence expiry.

3.25 Finally there was a general view that complying with the existing PRT regime was a complex task and that anything Government could do to simplify the regime, and reduce the compliance burden would be desirable.

3.26 The companies engaging in discussion on PRT in the second phase of discussions were almost solely those with interests in PRT fields. For those companies that had only a very small or no interest in PRT-able fields the major message was to welcome Government's conclusion following the first round of discussions that there should be no rebalancing of the North Sea fiscal regime between PRT and SC. They also observed that, for companies looking to invest in the North Sea, it was invariably felt that fields not within the PRT regime were seen as more attractive investment opportunities than PRT-liable fields, even if the latter, because of the reliefs available, were unlikely ever to pay PRT.

Relief for Decommissioning Costs

3.27 The long shadow of decommissioning is increasingly seen by industry as having an impact on investment and asset trading. It was generally stated that the more certainty Government could give on the fiscal (and regulatory) treatment of decommissioning liabilities the more this would encourage positive behaviour.

Extension of Three Year loss Carryback **3.28** Under the current North Sea Ring Fence Corporation Tax (RFCT) rules, companies are eligible for a three-year carry back of RFCT losses that relate to decommissioning costs. A number of companies have made the case that, in circumstances where they do not have access to other profit streams in the UK against which they can offset decommissioning costs, these rules may lead to premature decommissioning, as companies seek to ensure that they can take full advantage of the existing rules and maximise the potential offset.

3.29 This issue has become increasingly of concern for industry as a greater understanding of the costs and timescales likely to be associated with decommissioning is reached. Work commissioned by industry and submitted to Government alongside the Oil & Gas UK submission looked at 17 randomly selected UKCS oil and gas fields and suggested that under the current rules a significant number of these could be driven to decommission prematurely, leaving between six and ten percent of their remaining potential recoverable reserves in the ground.

3.30 As a solution to this issue industry suggested that Government consider extending the number of years that decommissioning losses can be carried back, or indeed remove the limits altogether and allow a similar situation to the current PRT regime where losses can be carried back indefinitely. As part of this proposal it was also argued that Government would need to look to extend the decommissioning period to capture post cessation decommissioning costs.

Up front relief for funds **3.31** Some companies also argued that Government should allow companies to make provision for decommissioning into alienated trust funds. In order to incentivise this process some argued that tax relief should be made available at the time of payment into such funds. However, others argued that as the provision of such a relief would involve an upfront cost for Government then if Government was willing to make such funds available then they could be more usefully used elsewhere, for example through a reduction in the overall rate of North Sea taxation or in funding incentives for certain types of activity. They also argued that this would create a perverse incentive to alienate funds that could be better used for further investment in the UKCS.

DCPD 3.32 In its submission Oil & Gas UK also made a number of proposals for changes to the fiscal regime to help improve the effectiveness of the 'Decommissioning Cost Provision Deed' (DCPD). These included:

- Ensuring that PRT relief is available for decommissioning expenditure made out of the trust funds associated with the DCPD;
- tax relief should be made available at the time of deposits into such a fund; and
- inheritance tax liability should be removed from such funds.

3.33 In addition some companies have brought forward proposals for assurance/insurance type products to fund decommissioning liabilities.

Development Incentives

3.34 In order to maximise the economic recovery of oil and gas from the UKCS the overall message received from industry was that there would need to be an increase in the level of exploration currently being undertaken and, even more importantly, an increase in the number of small discoveries or discoveries of lower quality or difficult to extract hydrocarbons that are actually being developed and exploited.

3.35 There was general agreement with the conclusions Government had drawn in the Budget 2007 discussion paper that fiscal incentives targeted specifically at exploration seemed unlikely to have much impact on exploration levels and would be likely to have significant deadweight costs.

3.36 However, several respondents proposed that the North Sea fiscal regime should include special incentives for certain types of development, instead of the current approach under which all developments are treated the same within the RFCT and SC system (although differently for pre-1993 fields liable to PRT).

3.37 Such incentives would, it was proposed, act to increase the value of such investments and therefore allow them to better compete for investment, both within the UKCS and globally.

3.38 This view was not held consistently across industry. Several companies believed that Government should not look to pick winners from within the UKCS, but instead should continue to apply a single, simple fiscal regime to all of the UKCS.

3.39 Where respondents did propose that specific measures should be put in place then areas that could be targeted by such measures included:

- All new discoveries;
- lower value, more complex hydrocarbons – for example heavy oil;
- hydrocarbons that required greater risk taking and more complex exploitation solutions - for example High Pressure, High Temperature (HPHT) developments;
- small, marginal deposits of hydrocarbons. For example some respondents stated that due to current costs, discoveries under ten million barrels of oil equivalent (boe) were unlikely to be developed;

- hydrocarbons found in certain areas of the UKCS without current suitable infrastructure – specifically gas West of Shetland;
- oil and gas from onshore licence blocks; and
- previously unexploited hydrocarbons in need of initial ‘pump priming’ – for example coal bed methane.

3.40 Proposals for the type of incentive that could be used also varied, depending on the company. Proposals included:

- Flat removal of some or all of Supplementary Charge;
- a reduction of the taxable value of oil/gas from specific areas or types of hydrocarbon by \$x per barrel or y pence per therm;
- the introduction into the RFCT regime of certain types of allowances for new developments – for example a volume allowance or a time allowance, during which SC would be either reduced or removed.

Separate Taxation Rates for Oil and Gas Extraction

3.41 Although the difficulties faced by gas developments were raised as a significant issue at the April 2007 PILOT meeting, this issue was little raised in the second round of discussions until late September. It was also one of the most divisive issues that was discussed. Some companies believed that the current lower prices being received for gas relative to oil during the period of discussions are likely to remain in the long run and that, therefore, given input prices are driven by oil, a lower tax rate should be applied. Other companies stated that such a split would merely be another form of price linked fiscal regime against which the majority of industry had come out against strongly in the initial round of discussions.

3.42 Different positions were also taken as to whether any such separation of oil and gas should be done from a whole of UKCS viewpoint or whether such proposals should be viewed in the same way as development incentives and targeted at specific types of gas field that were felt to be particularly suffering under current conditions – for example, smaller discoveries, with some companies arguing that any new gas field under twenty million boe was unlikely to be developed, and any new pocket within an existing field under five million boe was likely to suffer a similar fate and that specific incentives should be targeted at such developments, rather than a cross UKCS change to gas taxation.

3.43 There were also significantly differing views over the likely movement of gas prices, relative to oil, in the short and medium term, and therefore the perceived necessity for changes to the North Sea fiscal regime to take account of such price movements, especially given the general view that the North Sea fiscal regime should not be seen to respond to short term changes in commodity prices.

3.44 Some companies also raised concerns about whether a sensible mechanism could be created to discern whether a field should be designated as oil or gas, whereas others believed this could be achieved relatively simply and along the same lines as fields are currently designated oil or gas fields for mapping purposes.

Other Issues

3.45 In addition to the main issues raised certain elements of industry also brought other issues to our attention. These were:

- **Capital Allowances on mid-life decommissioning and long life assets** – Some elements of industry raised concerns about the current exemption of long life assets and mid life decommissioning from the existing one hundred per cent capital allowances regime. Particularly on the latter, companies argued that this led to the fiscal regime acting to influence the timing of elements of decommissioning, with accompanying cost and behavioural concerns.

4

CONCLUSIONS FROM THE DISCUSSIONS - PROPOSED PACKAGE OF CHANGES

4.1 This chapter outlines the package of changes to the North Sea fiscal regime that Government is proposing to announce at Budget 2008.

4.2 This chapter sets out each of the Government's proposals in detail and invites industry's comments, by the end of January 2008. In addition, where possible, Government is publishing draft legislation, to enable more detailed consideration of the measures, on the HMRC website¹. Comments are also invited on this draft legislation, again by the end of January 2008. Where it has not proved possible to publish draft legislation alongside this consultation document, Government will seek to issue it as soon as possible.

4.3 The packages of measures Government is proposing is as follows:

- An extension of the existing Corporation Tax (CT) loss carry back, in relation to decommissioning expenditure, as well as extension of the post-cessation period during which decommissioning expenditure can be allocated to the final period of trading;
- a package of PRT reforms to resolve concerns over sections 29 and 34 of the Petroleum Act, resolve concerns over the impacts of licence expiry, reduce the requirements from industry required in their PRT returns and create a power to allow HMRC, in agreement with industry, to remove fields from the PRT system that are never likely to pay PRT;
- a change to the capital allowances treatment of long life assets and mid-life decommissioning to align these with the treatment of other capital expenditure in the UKCS; and
- a change to the fiscal rules surrounding gas injection to ensure a level playing field for all UKCS operators

4.4 Government believes this package will act to address many of the structural issues that have been discussed with industry over the course of the discussions and will:

- Act to encourage investment;
- reduce the impact of the fiscal regime on investment decisions;
- help facilitate asset trade;
- give industry additional certainty over the treatment of decommissioning liabilities;
- remove anomalies from the fiscal regime;
- improve stability; and
- simplify the fiscal regime and reduce the administrative burden it imposes.

¹ Draft legislation available at <http://www.hmrc.gov.uk/oto/fiscal-regime.pdf>

4.5 Government believes this package of measures is consistent with the criteria published in, “The North Sea Fiscal Regime: a discussion paper” alongside Budget 2007, and repeated in Annex B.

4.6 Government believes implementation of this package of measures will also allow both Government and industry to focus their efforts on the remaining outstanding issues surrounding the North Sea fiscal regime. These outstanding issues, and Government’s current views on them, are set out in Chapter 5.

The Extension of Corporation Tax (CT) Loss Carry back

4.7 The legislation currently allows a three-year carry back for decommissioning losses. It has been argued that this is insufficient to give companies full tax relief for the costs of decommissioning installations and equipment in the North Sea. As a consequence, this is likely to lead in a number of cases to premature decommissioning that would leave some of the UK’s otherwise economically recoverable oil and gas reserves in the ground. Draft legislation for this proposal is published on the HMRC website.

4.8 In response to the arguments and evidence submitted, Government proposes that:

- In addition to the existing CT loss carry back rules, companies will be allowed to offset ring fence losses attributable to decommissioning expenditure against ring fence profits, back to accounting periods beginning on or after 17th April 2002, the date from which the Supplementary Charge applied; and
- The period following cessation of the ring fence trade, during which decommissioning expenditure can be allocated to the final period of trading, be extended from three, to seven years.

4.9 Government analysis suggests that allowing the carry-back of losses, attributable to decommissioning expenditure, to accounting periods beginning on or after 17th April 2002 will effectively allow all companies to receive the tax relief that is likely to be available. Industry is, however, invited to comment on the length of the carry-back period and Government will consider any evidence that indicates this may be insufficient.

4.10 Likewise, Government would welcome any comments from industry concerning the second part of the proposal. The aim is to allow decommissioning costs, incurred after the trade ceases, to be allocated to the final period of trading and then fully relieved, either in that period, or in earlier periods under the CT carry-back rules.

4.11 Government believes this measure will have a number of positive impacts on the UKCS and will contribute to the wider Government aims of maximising the economic recovery of the UKCS’s oil and gas reserves. In particular Government believes this measure will:

- Increase the total amounts of oil and gas recovered from the UKCS by allowing companies to operate fields to the point at which they become commercially uneconomic, rather than the point at which available tax relief for decommissioning ceases to outweigh the expected remaining revenue from oil and gas reserves;

- extend the “window of opportunity” – by extending the lifespan of some fields this should also act to extend the number of years when the infrastructure of these fields could be used to exploit adjacent hydrocarbon reserves or pursue change of use activities; and
- provide the additional certainty surrounding the tax treatment of decommissioning that industry has been seeking, which should act to encourage investment and simplify asset trades.

Package of PRT Reforms

4.12 Whilst, as set out in Chapter 5, discussions are still ongoing between Government and industry on the wider future of the PRT regime, Government believes that the following reforms to the current regime can be made:

- Ensure that a former licence holder that is served with a decommissioning liability under sections 29 or 34 of the Petroleum Act 1998, due to a subsequent licence holder defaulting, will have access to the PRT relief they would have been entitled to had they remained party to the licence;
- create a power to allow HMRC to remove fields from the PRT regime that are never likely to pay PRT due to the availability of reliefs and allowances;
- reduce the administrative burden of complying with PRT by reductions in the scope and reporting requirements for form PRT 1A; and
- ensure that companies have the potential for full PRT relief for decommissioning costs, where licences are terminated prior to the completion of decommissioning.

4.13 Draft legislation for the section 29/34 measure and the PRT 1A measure is available for comment on the HMRC website. For the removal of never payers and providing PRT relief post licence termination, draft legislation will shortly be made available for discussion.

Section 29/34 4.14 In response to the concerns that several companies raised with Government, this proposal will act to ensure that companies are not unfairly penalised by the actions of other companies outside of their own control. It will also ensure that such companies receive the same treatment as companies that bear a decommissioning liability under normal circumstances. This proposal should, as a consequence of removing this risk, simplify asset transfers and remove the currently tax motivated behaviour of holding onto a small portion of a licence when selling an asset in order to ensure access to PRT relief.

Removing Never Payers 4.15 During the discussions Government raised the possibility with industry of providing a mechanism to allow the removal of “never payer” fields from PRT. This proposal was well received and Government therefore proposes to create a power that would allow, with the full consent of the relevant licence holder(s), the removal of a field from PRT if HMRC is satisfied that the field is, due to the current structure of reliefs and allowances, unlikely to ever actually pay PRT, despite being within the scope of PRT.

4.16 It is proposed that companies would be able to make an application to HMRC for fields to be removed permanently from the PRT regime. It is envisaged that this might follow a similar process to the one currently used in the application by companies for the deferral of PRT returns. Indeed it is expected that many of the fields

that have successfully applied for permanent deferral of returns will apply to be taken out of the PRT regime altogether.

4.17 Government believes that this proposal will act to simplify asset transfer through making such fields potentially more attractive by removing the complications surrounding PRT from them. Evidence exists that some new entrants into the North Sea are not willing to become involved or invest in PRT fields, even if they are unlikely to ever pay PRT, due to the perception of there still being the potential, however remote, for these being higher taxed and imposing a greater administrative burden. Finally, by removing more fields from PRT, Government believes this should help simplify the ongoing conversations surrounding the wider questions facing PRT.

PRT Form IA 4.18 As part of the reporting process for PRT fields, participators have to complete form PRT 1A. The main purpose of this return is to ensure that as much data as possible is included in the HMRC database from which the statutory market values for non-arm's length sales can be calculated.

4.19 Following the changes introduced in Finance Act 2006 on the procedure for calculating non-arm's length sales, industry suggested that form PRT 1A could either be withdrawn or have its scope substantially reduced.

4.20 As some information is still required on the non-arm's length sales of what the legislation terms Category 2 oils, the return cannot be withdrawn. But Government proposes to amend the legislation governing the return in order that in future returns will only need to be made in respect of Category 2 oils, rather than all oils.

4.21 Government believes reducing the scope of PRT 1A will ease the administrative burden on participators. Draft legislation to implement this measure is available on the HMRC website for comment.

Licence Expiry 4.22 For tax purposes a company is, broadly, a participator in a field while they hold a relevant licence interest in a field and for two chargeable periods after that licence has been held. It has been put to Government in the course of the discussions that there could be circumstances where a company ceases to be a participator in a field but continues to incur expenditure in respect of that field for a number of years subsequently. The most obvious example is decommissioning.

4.23 When petroleum production licences expire there may be circumstances in which a company has yet to decommission the infrastructure.

4.24 In tax terms the company would then be in a situation where it had an obligation to meet decommissioning expenditure in respect of a PRT liable field but, having ceased to have a licence interest at the point where it ceased producing oil or gas from the field, was unable to claim PRT relief for some or all of that expenditure.

4.25 Government intends to resolve this issue as part of the proposed Budget package and is considering the most appropriate method for ensuring that companies are able to claim PRT relief in respect of decommissioning expenditure in PRT paying fields, in those circumstances where such expenses would not currently be allowable, by virtue of the licence expiring more than two chargeable periods before decommissioning has taken place. Government would welcome any further comments from industry on this issue.

Extending One Hundred per cent Capital Allowances

4.26 As set out in Chapter 2, capital expenditure on plant and machinery, and end of life decommissioning, currently receives 100% First Year Allowances (FYAs) which allow immediate relief for all of the expenditure, in the period in which it is incurred. However, mid-life decommissioning and expenditure on long life assets (those with an economic life of at least 25 years) does not receive 100% FYAs. In the discussions with industry it was argued, especially with regard to mid-life decommissioning, that this treatment acted to artificially influence the timing of decommissioning and consequentially, potentially, to increase overall decommissioning costs.

4.27 Government therefore proposes to extend 100% FYAs for end of life decommissioning, to include mid life decommissioning, and also long life asset expenditure. Draft legislation to implement these measures is available for comment on the HMRC website.

4.28 Government believes this will help to improve the simplicity, cohesiveness and consistency of the North Sea fiscal regime and help move the whole regime closer to a resource rent cash flow tax system. It will also act to remove a potential tax distortion on the timing of decommissioning and allow industry to undertake decommissioning at the optimum economic point, which should also act to reduce the overall costs of decommissioning.

Gas Injection

4.29 Gas from one gas field can be used to enhance the recovery of oil or gas from another field. When gas from a field is injected into a PRT field to enhance gas/oil recovery it is deductible in arriving at the PRT profits of that second field. However, when the injected gas leaves that second field and is sold on it is not subject to PRT. The net result is that the company gets the full cost of the purchased gas, rather than the economic cost, which is net of the income received by selling it on. There may be similar issues with the treatment of injected gas for ring fence CT purposes.

4.30 Government intends to modify the fiscal regime to ensure that companies get relief for the economic costs of the gas, but wishes to discuss this issue first with industry. If possible draft legislation will be published in due course, with a view to legislating in Finance Bill 2008. Through this measure Government will therefore act to ensure that the tax treatment of injected gas reflects the economic reality and that all companies operate on a level playing field. The current treatment of injected gas has the potential for distorting development options.

5

CONCLUSIONS FROM THE DISCUSSIONS - OUTSTANDING ISSUES

5.1 This chapter examines the issues that were raised during the second round of discussions and which Government has not included in its proposed package of measures set out in Chapter 4.

5.2 This chapter outlines the conclusions the Government has drawn from the discussions on these issues. It looks at where Government believes further change may be desirable, if acceptable policy options can be developed, and where the Government believes changes to the fiscal regime are undesirable at this time.

5.3 In terms of timescales for further discussion, Government proposes a third round of discussions lasting from December 2007 through to the end of June 2008. However on some issues, especially Change of Use, Government believes it may be possible to explore sufficiently these issues with industry over the shorter consultation period set out for the proposals in Chapter 4. If this proves to be the case then Government may seek to add to the package of measures set out in Chapter 4 when the final package is announced at Budget 2008.

5.4 In “The North Sea Fiscal Regime: a discussion paper”, alongside some initial views that formed the basis for further discussions between Government and industry, Government also came to conclusions on a number of issues that it did not believe needed to be examined further. At the time Government made clear that on all these issues further discussion was welcome if evidence was available that suggested these initial conclusions were incorrect. On the following issues no further views were forthcoming and Government therefore reiterates the conclusions published in the Budget 2007 discussion paper:¹

- The rebalancing of the abolition of PRT with an increase in the rate of SC;
- specific incentives for exploration;
- a price linked fiscal regime;
- changes to the availability of R&D tax credits

Petroleum Revenue Taxation

5.5 Government reiterates its belief that the removal of the PRT system could have benefits for the UKCS. Its removal would be expected to result in increased investment in PRT paying fields and could, as a result, increase the recovery of the remaining oil and gas reserves contained within those fields and from other fields utilising the same infrastructure.

5.6 Government also accepts that such a removal could be expected to simplify asset transfer and would remove the fiscal fault line that currently exists between fields liable to PRT and fields liable only to RFCT and SC. Government also accepts that there could potentially be benefits from reducing the uncertainty that companies currently believe exists over Government’s future intentions towards PRT, although it is hard to quantify such benefits.

¹ Available from, http://www.hm-treasury.gov.uk/budget/budget_07/documents/bud_bud07_northsea.cfm

5.7 For these reasons Government has been willing to explore with industry potential options for abolishing or reforming the PRT regime. However, Government is clear that the retention of the PRT regime is tenable and, if there are no mutually acceptable options for the removal or major reform of PRT, then such retention could well be desirable from an overall UKCS policy perspective. Government also reiterates that, in line with the criteria set out in the Budget 2007 discussion paper (and repeated in Annex B), any mechanism to remove or reform the PRT system would need to ensure there was still a fair return for the UK taxpayer from the UKCS and did not unbalance the regime.

Abolition of PRT **5.8** Three different methods of abolishing PRT were discussed with industry over the latest round of discussions, with the majority of debate focusing on the proposals for a Buy-Out computation as described in Chapter 3.

5.9 Several companies engaged in this discussion expressed concern over the possibility that Government would seek to impose such a buy-out on all companies with licence interests in PRT liable fields. Having discussed this fully with industry it became apparent that such action would reduce investor confidence in the North Sea fiscal regime, have a potentially inequitable impact on certain companies, and therefore potentially have a negative impact on investment and production. Government can therefore confirm that it will not impose a buyout.

5.10 The central question therefore becomes one of optionality. As was stated throughout the discussions, Government believes there are several, potentially significant, issues over the idea of allowing a buyout mechanism to operate on an optional basis:

- It is likely that several currently PRT paying fields have nevertheless passed the point at which they have turned NPV PRT negative – therefore the remaining PRT expected to be collected is less than the anticipated tax relief. Under a buyout it is envisaged that the licence holders of such fields would effectively receive early payment of such relief, in exchange for the abolition of any future right to receive tax relief for PRT on decommissioning. However, as such fields are likely to be close to decommissioning already, the removal of PRT from such fields is likely to have the most limited impact in terms of potential extra investment and production. Therefore if a buyout was optional there is a potentially significant danger that, whilst the vast majority of such fields would sign up to a buy-out, few fields that would be payers into the Exchequer would also do so, and Government would therefore face a significant risk to the Exchequer. In line with wider fiscal prudence and the Government's objective to ensure a fair return for the UK taxpayer this would be unacceptable;
- one of the significant potential benefits of abolishing PRT would be the accompanying removal of the associated administrative burden for both industry and Government. However under optionality the PRT system would remain and indeed, as set out in Chapter 3, companies that have expressed opposition to the idea of a buyout have already expressed concern over what would happen to fields still remaining with the PRT regime;
- an optional buyout would also seem to present potentially greater issues relating to either industry or Government wishing to revisit buyout contracts post agreement if factors used in the calculation changed, when the impact

of those changing factors could be clearly seen on those companies which had remained in PRT; and

- legal issues could potentially arise were it to be argued that the Government provided any form of differential tax treatment for those that stayed within the PRT regime compared with those that bought out.

5.11 Given the issues set out above Government is not currently attracted to the idea of an optional buyout. However, if industry believes there are potential solutions to the issues outlined above then Government would be happy to discuss them. If there are not any solutions then, given industry's current position in relation to all PRT'able fields being included in a buy-out and the issues that Government believes exists on optionality, the overall conclusion is that a buyout should not be considered further at the current time.

5.12 In addition to optionality, there were a number of other design factors which would need to be resolved if a "Buy Out" was to be taken forward:

- For any field-specific variables, HMRC would wish to be satisfied that estimates of, for example, production, reserves, decommissioning costs etc are auditable and verifiable.
- For other factors, there remains the significant issue of the extent to which field specific solutions would similarly be desired by companies and the administrative issues that might arise. The counterpoint to this is that were proxies, for example for future operating expenditure or capital expenditure to be applied across the board, companies may argue that they did not take account of the particular circumstances of individual fields.
- For US owned companies, the issue of creditability for US tax purposes was also raised as being a significant concern.

5.13 The second potential method for abolishing PRT was the switching off of PRT on a field-by-field basis at the point when fields turn npv negative. Government has a number of concerns with such a mechanism, in particular the potential of it to create perverse, tax driven, investment decisions. Government has therefore viewed this option throughout the discussions as less desirable than a potential buyout. Again however if industry believes there are effective ways around Government's concerns then Government is willing to engage further on this proposal.

5.14 Finally, some companies proposed the termination of PRT as soon as possible, including the removal of all decommissioning relief. Government is categorically not attracted to such a proposal. Government believes that such a proposal would create a large number of winners and losers, damage investor confidence and fail to secure a fair return for the UK taxpayer.

Major reform of PRT

5.15 This option was raised with industry as a potential mid point between retaining PRT and abolishing it. Government believes that through removing or altering some of the existing allowances and reliefs it would be possible to significantly cut the rate of PRT. This would act to reduce the overall level of taxation on PRT fields, would reduce the level of the fiscal fault line between fields which do and do not pay PRT, and would significantly simplify the regime. If elements such as Unrelieved Field Losses ((UFL's) were abolished this would also act to decrease potential uncertainty over decommissioning relief.

5.16 However, Government also recognises that there would be potential issues over winners and losers from such a raft of reforms, and that for some companies, particularly those with significant UFLs, such reforms would significantly change the economic position of the field. Government also recognises that such reforms could have a potential negative impact on investor confidence, even for those who ‘won’. Given these factors, and given the reaction of industry to these proposals, Government is not proposing to take them any further forward, unless there is significant evidence from industry about a desire for fundamental reform.

Retention of PRT 5.17 As Government has stated from the beginning of the conversations about PRT, it does not see the retention of the current PRT system as untenable. With minor reforms to fix anomalies and ensure PRT continues to operate as intended, the regime can continue as at present. Such proposed changes are set out in Chapter 4, and Government would welcome industry’s views on those.

5.18 During some of the later conversations on the future of PRT industry argued that Government should look to create a mechanism that ensured that future incremental investment in PRT fields, and the ensuing production, was exempted from PRT. The potential creation of such a mechanism has been looked at previously and was dismissed on grounds of workability due to the difficulties in apportioning investment and production between existing and new investment and production. However, depending on the details, Government agrees that such a mechanism could be potentially attractive, if it was achievable, and would wish to discuss this further with industry.

PRT Form 2 5.19 A PRT 2 return is made by a Responsible Person nominated by a field’s participators. The purpose of the return is to provide information at field level in three parts: A statement of oil won and saved; a statement of the share of oil won and saved used to determine oil allowance; and details of throughputs through pipelines to determine tariff receipts.

5.20 As a result of the Oil Pricing Regulations introduced in Finance Act 2006 it has been suggested by industry that, in particular, information on oil won and saved is no longer required.

5.21 As part of the discussions with industry, a request has been made to Government to abolish the requirement for the submission of a PRT2 return. Government feels that there is a possibility that the scope of the return could be reduced but some information is likely still to be required and it wishes at this stage to discuss this further with industry.

Relief for Decommissioning Costs

5.22 Alongside the proposals surrounding extending carryback for CT losses incurred through end of life decommissioning industry also presented proposals for allowing up front relief for payments into decommissioning funds and also to make changes to the existing fiscal rules that would apply to the Decommissioning Cost Provision Deed (DCPD).

Up front relief 5.23 Government has examined closely the argument to allow up front relief for monies paid into alienated decommissioning funds. Whilst the potential attraction of having such a facility can be seen in terms of reducing still further the potential exposure to risk from default, Government is not attracted to the proposal for a number of reasons and will not be therefore looking at it further. The reasons are:

- In order for such funds to meet a substantial element of the potential decommissioning bill they would be required to have significant funds paid into them. However, if tax relief were to be granted up front then one condition would be the complete alienation of such funds. Government considers that this would potentially lock away significant funds that could be better utilised in further investment in the UKCS;
- whilst this proposal has been raised with Government it has not been raised in the context of any companies desiring such a product, with many of the individual companies spoken to citing concerns over alienating monies that could be better used for investment in a capital constrained world. This would seem likely therefore to involve complex legislation for potentially little extra value;
- as with the first bullet such funds would require significant tax relief to be given on an annual basis if they were ever going to cover a meaningful element of decommissioning. The potential cost of such a measure would be significant and would not be acceptable given the Government's wider fiscal objectives. If such funds were made available Government also does not believe this would represent their optimum use.

DCPD 5.24 Notwithstanding the points made above in respect of up front relief for deposits into funds, Government is happy to continue the ongoing discussions with industry on the tax treatment of funds within the DPCD arrangements, in order to provide companies with certainty and clarity.

5.25 As mentioned in Chapter 3, some companies have brought forward proposals for assurance/insurance products as alternative funding mechanisms for meeting decommissioning costs. However, it is not clear that there is currently a significant level of demand for such products, nor that changes to the fiscal regime are either required or desired in support of them.

Development Incentives

5.26 In order to maximise the economic recovery of the UK's oil and gas reserves it is important that efforts are made to ensure all possible sources of oil and gas are exploited. As the basin increasingly matures it is also the case that more and more discoveries are of an increasingly marginal size. However, if all these marginal discoveries were to be developed they have the potential to add significantly to the overall amount of oil and gas recovered from the UKCS.

5.27 Government has been looking closely at whether the creation of special incentives for such discoveries, currently considered marginal due to size, complexity, or type of hydrocarbon should be pursued, and thanks again those companies who have come up with ideas and suggestions surrounding this area. Whilst Government believes a case may exist for such incentives there still remains work to be done on this to establish the most effective way such incentives could be implemented, how they should function and to what they should apply. To this end Government wishes to discuss this issue further with industry over the next period of discussions.

5.28 In particular Government would welcome:

- Further evidence from industry of the potential impact such measures could have on investment and production on the UKCS;

- further views on the current point (in terms of size of development) where an incentive would have the maximum impact;
- any further submissions, backed by accompanying rationales, on the types of hydrocarbon or particular circumstances that should be targeted by such measures; and
- any further views on the most effective incentive measures.

Change of Use

5.29 Following Pre-Budget Report 2006, HMRC, BERR and industry set up a joint working group to explore fiscal issues arising from the change of use of North Sea infrastructure. This was prompted by the number of tax issues being raised with HMRC and HMT by companies considering entering into projects for carbon capture and storage, gas storage or wind power. Whilst each scheme had its own particular concerns, there was a general view expressed that a lack of certainty on how the North Sea fiscal regime would impact on changes of use of infrastructure and that this was impacting on the economic modelling of such projects.

5.30 The group met on a number of occasions, with the intention of providing as much clarity and certainty as possible for companies considering change of use. The group considered both the PRT and RFCT regimes and in particular the tax issues that arose as companies moved from an oil/gas production phase to either 'pure' non-oil/gas use of infrastructure, or a period of combined use.

5.31 The discussions covered the tax impacts both when the company used the assets for non-ring fence (and in some circumstances non-PRT activities) and the tax treatment of subsequent receipts and expenditure, particularly in terms of availability of relief for decommissioning costs. Treatment of capital allowances, clawback of PRT relief, tax treatment of certain payments and streaming of losses all featured in the talks.

5.32 The result has been the document 'Platform for Change', published in November 2007. This contains discussions of the generic issues confronting companies planning change of use projects but also considers specific issues which arise for certain technologies. Whilst the main body of the paper aims to provide an explanation of the current tax rules, it also contains an annex which provides the opportunity for industry to suggest changes in the legislation which it believes are required to ensure the tax regime does not create barriers to the successful development of change of use projects.

5.33 Government is keen to discuss further with industry changes to the current fiscal regime that will genuinely facilitate change of use activities. In particular the areas that are considered most pertinent for further discussion, including how significant the issues are genuinely likely to be, are:

- providing effective relief for decommissioning costs, for RFCT and PRT purposes, where the North Sea assets have been subsequently used for change of use purposes;
- the impact of the legislation which requires the clawback of first year capital allowances where assets are used for non-ring fence purposes within five years;
- the application of the capital allowances legislation in respect of deemed disposals when assets move from ring fence use to change of use;

- the deemed disposals rules for PRT purposes; and
- tax treatment of change of use revenues.

5.34 Government considers that some of these areas merit legislative change but wishes to explore them more fully with industry to ensure that any measures are properly targeted and proportionate.

Separate Taxation Rates for Oil and Gas Extraction

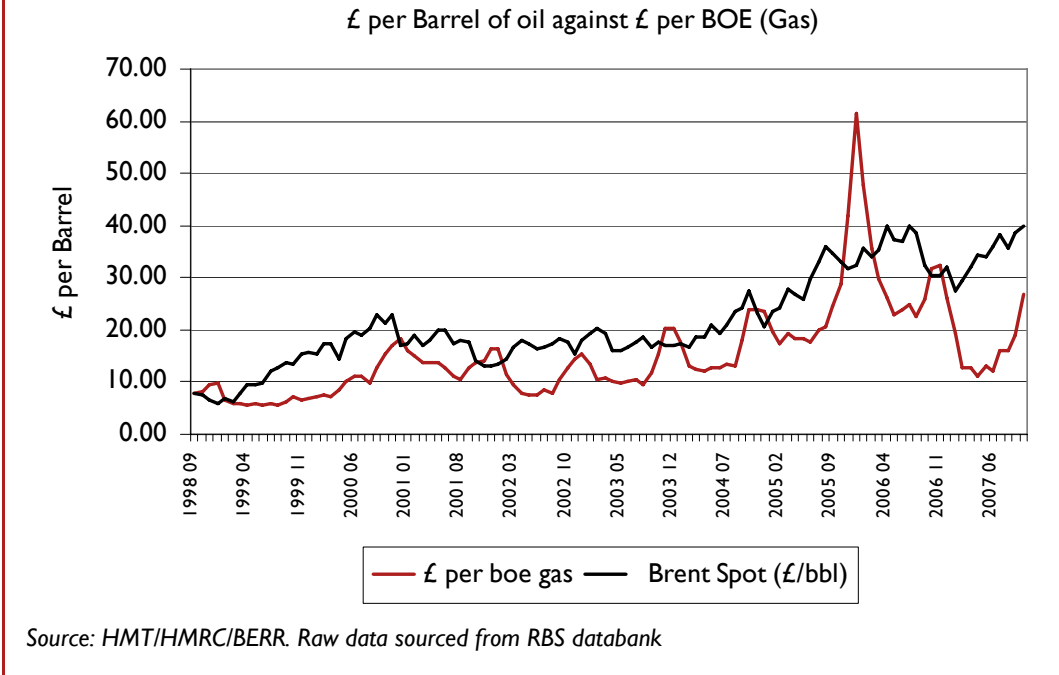
5.35 Following the recent period of lower spot gas prices relative to oil, Government has kept, and will continue to keep, a close watch on this issue. However, at the current point Government does not believe it would be appropriate to create a separate fiscal regime for gas as opposed to oil.

5.36 Government believes that any changes to the fiscal regime that acted to discriminate between different hydrocarbon products would be likely to add significantly to the complexity of the fiscal regime, create distortions within it and come with significant compliance costs for both industry and Government. There would therefore have to be a significant expectation of a long-term divergence between oil and gas prices for this to be considered.

5.37 Whilst Government accepts that the divergence between oil and gas prices over the past year has been painful for those who mainly produce gas there has not been a convincing case presented that this will be a long-term position, nor that the current fiscal terms are in general having a negative effect on gas production. As has often been made clear, industry does not believe the fiscal regime should be seen to respond to short-term changes in commodity prices, nor should the fiscal regime be altered to be a price linked fiscal regime, yet to make changes to the fiscal terms for gas at the current time would seem to be just that.

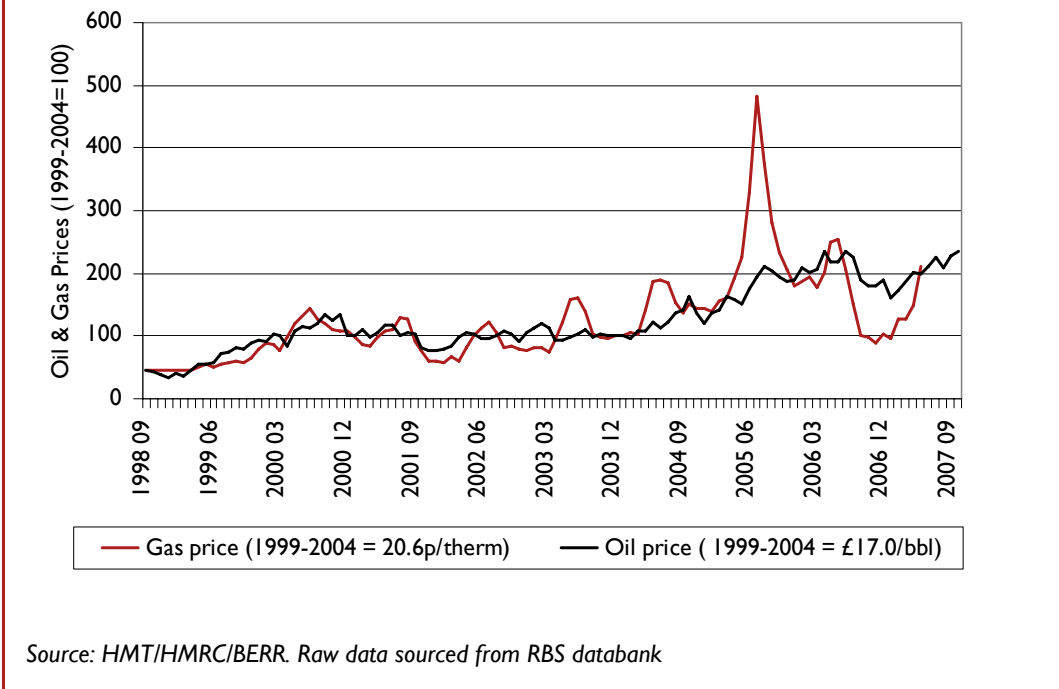
5.38 As is shown in Chart 5.1, which compares oil and gas sterling prices in energy equivalent terms although gas and oil prices did indeed diverge significantly in the first two quarters of 2007 this divergence has lessened significantly in the third quarter. Gas prices have also been higher than oil prices as recently as the fourth quarter of 2006.

Chart 5.1: Comparisons of Gas and Oil prices since 1998



5.39 Moreover, as shown in Chart 5.2 below, which compares oil and six month lagged gas prices in level terms, therefore showing the relative movement of the two since 1998, there is as yet no evidence of a long term divergence in the movement of oil and gas prices, with the prices of the two commodities tending to move in a connected fashion, albeit with seasonal shocks for gas supply.

Chart 5.2 Relative movements of Oil and Gas Spot Prices (lagged 6 months) Since 1998



5.40 As stated above Government will though continue to keep this issue under review and would welcome further conversations with industry about these conclusions. In addition, as set out in the section above on development incentives Government will continue to look closely at the question of whether special incentives are necessary to help facilitate the economic recovery of gas from smaller discoveries or in frontier areas.

6

NEXT STEPS

- 6.1** As stated in the introduction, this paper is intended to fulfil a dual purpose. Firstly, as set out in Chapter 4, a range of proposed changes to the North Sea fiscal regime have been outlined, and industry are invited to comment by the end of January 2008 on these proposals.
- 6.2** Where possible draft legislation for these proposals has been published alongside this document on the HMRC website: <http://www.hmrc.gov.uk/oto/fiscal-regime.pdf>
- 6.3** Secondly, Government believes that on a number of issues further engagement and discussion with stakeholders would be useful, before Government draws its final conclusions. These areas where further discussion is believed desirable and where Government would welcome further input from industry are set out in Chapter 5.
- 6.4** For these areas this paper is therefore intended to form the basis for further discussions. These will last until the end of June 2008.
- 6.5** Chapter 5 also sets out the areas where Government does not believe further discussion would be productive at this stage.
- 6.6** Views on all of the ideas and issues discussed in this document are welcomed, particularly on the conclusions that have been drawn to date.

CONTACT POINT


- 6.7** Any comments or questions should be directed to:

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Or (Particularly for any comments or questions on the draft legislation)

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Summary: Intervention & Options

Department /Agency: HM Treasury and HM Revenue and Customs		Title: Impact Assessment of the extension of Corporation Tax (CT) loss carry back	
Stage: Consultation		Version: 1	Date: December 2007
Related Publications: Securing a Sustainable Future: A Consultation on the North Sea Fiscal Regime			
Available to view or download at: http://www.hm-treasury.gov.uk/consultations_and_legislation/north_sea/consult_northsea_future.cfm			
Contact for enquiries: Rob Douglas		Telephone: 0207 270 5000	
<p>What is the problem under consideration? Why is government intervention necessary?</p> <p>Existing legislation allows a 3 year carry-back for companies with ring fence CT losses, arising from decommissioning expenditure, as well as a 3 year post-cessation period during which this expenditure can be allocated to the final period of trading. Evidence and analysis now indicates that these time limits will be insufficient to give full relief for industry's decommissioning costs. As a result, this is likely to lead to premature decommissioning of oil and gas fields and so leave some of the UK's oil and gas reserves in the ground, that would otherwise be economically recoverable.</p> <p>What are the policy objectives and the intended effects?</p> <p>The objective of these proposals is to further support the Government's aim to maximise the economic recovery of oil and gas from the North Sea through encouraging renewed investment and facilitating asset trade. More specifically, these proposals aim to allow companies to operate fields to the point at which they become commercially uneconomic, rather than to the point at which the available tax relief for decommissioning costs ceases to outweigh the expected remaining revenue from oil and gas reserves.</p> <p>What policy options have been considered? Please justify any preferred option.</p> <ol style="list-style-type: none"> 1) Do nothing. 2) Extend the CT loss carry-back from 3 to 6 years. 3) Extend the CT loss carry-back from 3 years, to accounting periods beginning on or after 17 April 2002. This option is preferred as it should allow full tax relief for decommissioning costs, for effectively all companies, and coincides with the introduction of the CT Supplementary Charge. 4) Extend CT carry back indefinitely. 5) In conjunction with 2) to 4), extend the "post-cessation period" from 3 to 7 years. <p>When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects?</p> <p>The impact of the proposed policy measures is likely to be included in any review of the measures implemented following the HM Treasury November 2007 Consultation on North Sea Taxation.</p> <p>Ministerial Sign-off For Impact Assessments:</p> <p><i>I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.</i></p> <p>Signed by the responsible Minister:</p> <p></p> <p>..... Date: December 2007</p>			

Summary: Analysis & Evidence					
Policy Option: CT loss carry-back extension		Description: Extend CT loss carry-back to accounting periods beginning on or after 17 April 2002 and extend the post-cessation period to 7 years			
COSTS	ANNUAL COSTS		Description and scale of key monetised costs by 'main affected groups'		
	One-off (Transition)	Yrs			
	£ tbc				
	Average Annual Cost (excluding one-off)		Total Cost (PV) £		
	£ tbc				
Other key non-monetised costs by 'main affected groups' May be small information costs associated with the retention of records concerning CT liabilities falling on/after 17 April 2002 until such time as field decommissioning is completed. Scale of computations may also become more involved once decommissioning starts and slots have to be found for losses carried back.					
BENEFITS	ANNUAL BENEFITS		Description and scale of key monetised benefits by 'main affected groups'		
	One-off	Yrs			
	£ tbc				
	Average Annual Benefit (excluding one-off)		Total Benefit (PV) £		
	£ tbc				
Other key non-monetised benefits by 'main affected groups' Measure will provide companies with more certainty as regards receiving tax relief on their decommissioning costs. It may also produce a saving in compliance costs in so far as it may save companies from unnecessary diversification in order to maximise the sideways use of losses.					
Key Assumptions/Sensitivities/Risks					
Price Base Year	Time Period Years	Net Benefit Range (NPV) £	NET BENEFIT (NPV Best estimate) £		
What is the geographic coverage of the policy/option?			UK North Sea		
On what date will the policy be implemented?			Royal Assent 2008		
Which organisation(s) will enforce the policy?			HMRC		
What is the total annual cost of enforcement for these organisations?			£		
Does enforcement comply with Hampton principles?			Yes		
Will implementation go beyond minimum EU requirements?			N/A		
What is the value of the proposed offsetting measure per year?			£		
What is the value of changes in greenhouse gas emissions?			£		
Will the proposal have a significant impact on competition?			No		
Annual cost (£-£) per organisation (excluding one-off)		Micro	Small	Medium	Large
Are any of these organisations exempt?		No	No	N/A	N/A
Impact on Admin Burdens Baseline (2005 Prices) (Increase - Decrease)					
Increase of £ negligible		Decrease £ negligible		Net Impact £ negligible	
Kev:	Annual costs and benefits: Constant Prices		(Net) Present Value		

Evidence Base (for summary sheets)

Rationale for intervention

The Government's overall policy aim for the North Sea is to maximise the economic recovery of the oil and gas reserves whilst striking the right balance between producers and consumers and ensuring a fair return for the UK taxpayer from our national resources.

Oil fields have an unusual profits pattern - following heavy initial investment, large profits are made in the early days of production but tail off as the field ends its productive life. Under the current arrangements companies may not be able to obtain full tax relief for all of their decommissioning costs if they run fields to the point where production ceases to be economic.

A study undertaken by the oil and gas industry suggests that as a result of this a potentially significant number of fields could be driven to decommission early, leaving up to 10 per cent of their potential remaining recoverable reserves in the ground. Providing companies with the certainty that they will be able to obtain relief for, effectively, all of their decommissioning costs removes this consideration from assessing the point of decommissioning. It is therefore expected to lead to an increase in the productive life of oil and gas fields in the North Sea.

Policy proposals

The specific proposals here are to:

- Extend the carry back provisions, relating to ring fence corporation tax losses, attributable to abandonment expenditure, contained within S393A (2A), (2B), (2C) ICTA 1988 from three years to ring fence profits from accounting periods beginning on or after 17th April 2002.
- Extend from 3 to 7 years, the "post-cessation period" (S165 (2) CAA 2001), during which abandonment expenditure can be allocated to the appropriate pool for the chargeable period in which the former trader ceased to carry on the ring fence trade. This will effectively allow all the decommissioning costs incurred after the trade ceases, to be allocated to the final period of trading and then fully relieved, either in that period, or in earlier periods under the corporation tax loss carry-back rules.

These proposals have been developed following a period of extensive consultation with the oil and gas industry between January 2006 and September 2007, aimed at addressing a range of issues. Although these proposals are aimed specifically at reducing the uncertainty over the treatment of decommissioning liabilities, they will also act to encourage renewed investment, facilitate asset trade and reduce the impact of the fiscal regime on investment decisions.

The proposals allow companies to carry back decommissioning costs against all profits beyond the three-year point allowed under the current legislation, to ring fence profits, back to April 2002. Analysis suggests that allowing companies to carry back these losses to accounting periods beginning on or after 17th April 2002 will allow companies to secure tax relief on their decommissioning costs in all probability at a rate comparable with the rate at which their North Sea profits have been taxed. Also, it should be possible to implement these changes for relatively low HMRC system costs and should ensure that the proposal is compliant with State aid rules.

The extension of carry-back from 3 to 6 years and also extending carry-back indefinitely was considered but, due to the reasons above, it was concluded that an extension of carry-back to accounting periods beginning on or after 17th April 2002 was likely to be the best option.

The current rules also allow for the carry-back of abandonment costs incurred up to three years after the cessation of a ring fence trade to be treated as having been incurred in the last period in which the ring fence trade was carried on. However, it is argued that, and available estimates of decommissioning timetables indicate that, this three year post-cessation period will be insufficient to cover all of the decommissioning projects, which will occur in the North Sea. Government has therefore proposed to extend the period from three to seven years after cessation of trade.

Costs and Benefits

The Government expects this measure to provide companies with more certainty as regards receiving tax relief on their decommissioning costs. It may also produce a saving in compliance costs in so far as it may save companies from unnecessary diversification in order to maximise the sideways use of losses. There may be small information costs associated with the retention of records concerning CT liabilities falling on/after 17 April 2002 until such time as field decommissioning is completed. The scale of computations may also become more involved once decommissioning starts and slots have to be found for losses carried back.

The net impact of these measures on the admin burden on business is expected to be negligible.

The Government would welcome any information from the industry that would help assess the impact on the compliance and administrative burden on companies of the two proposed measures outlined in this Impact Assessment.

Specific Impact Tests: Checklist

Type of testing undertaken	<i>Results in Evidence Base?</i>	<i>Results annexed?</i>
Competition Assessment	No	Yes
Small Firms Impact Test	No	Yes
Legal Aid	No	No
Sustainable Development	No	No
Carbon Assessment	No	No
Other Environment	No	No
Health Impact Assessment	No	No
Race Equality	No	No
Disability Equality	No	No
Gender Equality	No	No
Human Rights	No	No
Rural Proofing	No	No

Annexes

Competition Assessment

This change will potentially apply to all companies operating within the North Sea ring fence.

More generous treatment than is afforded to other businesses subject to corporation tax is appropriate since North Sea oil and gas extraction is a non-continuing business and once the reserves are depleted there is no further means of trading and for carrying losses forward. So providing a more generous mechanism for companies to obtain tax relief on their end-of-field-life decommissioning costs, in the same way that they can get relief for start-up costs, removes a potential anomaly and is a concession proportionate with the higher rates of corporation tax applied to North Sea profits since April 2002.

Small Firms' Impact Test

The extension of loss carry back will afford benefits to all companies involved in North Sea oil and gas extraction ranging from large integrated operations operating across a range of oil and gas fields on the UKCS through to small and medium-sized businesses with interests in only one field or in onshore developments.

Summary: Intervention & Options

Department /Agency: HM Treasury and HM Revenue and Customs		Title: Impact Assessment of change to Petroleum Revenue Tax obligations.	
Stage: Consultation	Version: 1	Date: December 2007	
Related Publications: Securing a Sustainable Future: A Consultation on the North Sea Fiscal Regime			
Available to view or download at: http://www.hm-treasury.gov.uk/consultations_and_legislation/north_sea/consult_northsea_future.cfm			
Contact for enquiries: Mike Crabtree		Telephone: 020 7438 7576	

What is the problem under consideration? Why is government intervention necessary?

Whether there is scope for a saving in companies' administrative obligations in relation to Petroleum Revenue Tax (PRT) by removing from the PRT regime those fields that are never likely to pay PRT, as well as an easing of the compliance burden for the remainder (following the legislative changes made in 2006 concerning the valuation of North Sea oil sold other than at 'arms length').

What are the policy objectives and the intended effects?

Reduction in unnecessary information and administrative obligations placed on companies operating fields subject to PRT and in the burden of form filling, consistent with Hampton principles (see HM Treasury Press Notice 101/06, 28 November 2006). Facilitation of asset trade and investment through removing from the PRT regime those fields never likely to pay PRT.

What policy options have been considered? Please justify any preferred option.

1) Do nothing and persist with collecting information that is no longer required, and imposing an obligation that is never likely to result in the payment of tax.

2) Act now to remove redundant information obligations, and to lift an administrative burden in respect of fields that may never pay PRT (or for whom future payments would in all probability be covered by decommissioning losses).

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects?

The evaluation of savings is likely to be included in any review of the measures implemented following the HM Treasury November 2007 Consultation on North Sea Taxation.

Ministerial Sign-off For SELECT STAGE Impact Assessments:

I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.

Signed by the responsible Minister:



..... Date: December 2007

Summary: Analysis & Evidence					
Policy Option: PRT simplification		Description: Removal of "never payer" fields from PRT and a reduction in the scope of the PRT1A form			
COSTS	ANNUAL COSTS		Description and scale of key monetised costs by 'main affected groups'		
	One-off (Transition)	Yrs			
	£ tbc				
	Average Annual Cost (excluding one-off)				
	£ tbc	Total Cost (PV)		£	
Other key non-monetised costs by 'main affected groups' Some costs may be incurred by companies in dismantling their existing PRT obligation systems, and by others in amending their systems to preclude information previously required for the PRT1A returns.					
BENEFITS	ANNUAL BENEFITS		Description and scale of key monetised benefits by 'main affected groups' On-going annual total North Sea industry compliance saving in respect of the removal of 'Category 1' oils from the PRT1A return (until such time as the relevant fields cease production).		
	One-off	Yrs			
	£ 0				
	Average Annual Benefit (excluding one-off)				
	£ 50k-100k	Total Benefit (PV)		£ 75k	
Other key non-monetised benefits by 'main affected groups' Savings arising from the removal of fields from the scope of PRT (the timing and extent of which will depend on whether and when agreements can be reached with the various participating companies).					
Key Assumptions/Sensitivities/Risks Estimate of the saving from PRT1A made with reference to the PRT administrative costs contained in the Standard Cost Model. Some 60 of the 100 or so pre March 1993 PRT liable fields are currently not paying tax because their gross profits are covered by expenditure, allowable losses, or oil allowance.					
Price Base Year 2005	Time Period Years	Net Benefit Range (NPV) £ 50k- 100k	NET BENEFIT (NPV Best estimate) £ 75k		
What is the geographic coverage of the policy/option?			UK North Sea		
On what date will the policy be implemented?			Royal Assent 2008		
Which organisation(s) will enforce the policy?			HMRC		
What is the total annual cost of enforcement for these organisations?			£		
Does enforcement comply with Hampton principles?			Yes		
Will implementation go beyond minimum EU requirements?			N/A		
What is the value of the proposed offsetting measure per year?			£ 0		
What is the value of changes in greenhouse gas emissions?			£ 0		
Will the proposal have a significant impact on competition?			No		
Annual cost (£-£) per organisation (excluding one-off)		Micro	Small	Medium	Large
Are any of these organisations exempt?		No	No	N/A	N/A
Impact on Admin Burdens Baseline (2005 Prices)				(Increase - Decrease)	
Increase of £ 0		Decrease of £ 75k		Net Impact £ - 75k	
Kev:	Annual costs and benefits: Constant Prices		(Net) Present Value		

Evidence Base (for summary sheets)

Rationale for intervention

The Government's overall policy aim for the North Sea is to maximise the economic recovery of the oil and gas reserves whilst striking the right balance between producers and consumers and ensuring a fair return for the UK taxpayer from our national resources.

The main rationale for the changes outlined here is to simplify the PRT regime by reducing companies' administrative obligations and decreasing the compliance burden.

Policy proposals

Petroleum Revenue Tax was abolished for fields given development consent on or after 16 March 1993. A number of fields that were given development consent before that date, whilst falling within the PRT regime, will never actually pay any PRT during their productive life. This is because of the interaction of the various reliefs and allowances within the regime.

HMRC has recognised the compliance burden this imposes on companies that have interests in such fields (the legislation refers to them as 'participators'), in so far as they are required to comply with the mechanics of the PRT regime, via the various returns, whilst not actually being PRT-payers. In recent years HMRC has reduced the regulatory requirements on such companies by allowing companies to defer submitting returns where, because of the lack of practical tax impacts, neither HMRC nor the companies would obtain any benefit from the submission of the returns.

However companies have made the point that despite the relaxed regulatory regime, the potential liability for PRT remained as long as the company was a taxable field for PRT purposes and that this had some impact on asset transfers.

The proposal therefore is, that where the participators can satisfy HMRC that they will be 'never payers' in the future in respect of particular fields (usually because of the amount of oil allowance available to them), that HMRC will make such fields non-taxable fields for PRT purposes. There will, of course, be circumstances where participators wish to stay within the scope of PRT even if they are not going to pay tax on a particular field, for example in order that they can utilise any unrelievable field losses generated. In such situations, the fields will remain within PRT.

The other changes relate to the amount of information that is required on PRT returns submitted to HMRC. Form PRT1A is one of a number of returns that participators in a field are required to complete and submit to HMRC (the information required on the return is listed in section 62 Finance Act 1987). As a result of legislation enacted in Finance Act 2006, oil produced in the North Sea was split into two categories – Category 1 and Category 2. The change in the law means that HMRC only now requires information on Category 2 oils from companies when they complete form PRT1A. We therefore wish to amend section 62 FA 1987 to reflect this. This will result in compliance savings for the companies, inasmuch as they have to submit less information to HMRC and also provide for processing savings for HMRC.

Costs and Benefits

The Government expects there to be an on-going annual total North Sea industry compliance saving in respect of the removal of 'Category 1' oils from the PRT1A return (until such time as the relevant fields cease production). There are also likely to be savings arising from the removal of fields from the scope of PRT (the timing and extent of which will depend on whether and when agreements can be reached with the various participating companies).

Some costs may be incurred by companies in dismantling their existing PRT obligation systems, and by others in amending their systems to preclude information previously required for the PRT1A returns.

The net impact on admin burdens is estimated to be - £75,000.

The Government would welcome any information from the industry that would help assess the impact on the compliance and administrative burden on companies of the proposed measures outlined in this Impact Assessment.

Specific Impact Tests: Checklist

Type of testing undertaken	<i>Results in Evidence Base?</i>	<i>Results annexed?</i>
Competition Assessment	No	Yes
Small Firms Impact Test	No	Yes
Legal Aid	No	No
Sustainable Development	No	No
Carbon Assessment	No	No
Other Environment	No	No
Health Impact Assessment	No	No
Race Equality	No	No
Disability Equality	No	No
Gender Equality	No	No
Human Rights	No	No
Rural Proofing	No	No

Annexes


Competition Assessment

These proposed changes will reduce the compliance cost disparity between North Sea oil and gas fields subject to PRT and those fields outside its scope. The removal of potentially PRT paying fields from PRT will also facilitate the sale of North Sea assets by removing uncertainty over future liability to PRT.

Small Firms' Impact Test

There are no small businesses involved in North Sea oil and gas extraction that are affected by Petroleum Revenue Tax.

Summary: Intervention & Options

Department /Agency: HM Treasury and HM Revenue and Customs	Title: Impact Assessment of Extending 100% First Year Capital Allowances (FYA) within ring fence trades	
Stage: Consultation	Version: 1	Date: December 2007
Related Publications: Securing a Sustainable Future: A Consultation on the North Sea Fiscal Regime		
Available to view or download at: http://www.hm-treasury.gov.uk/consultations_and_legislation/north_sea/consult_northsea_future.cfm		
Contact for enquiries: Rob Douglas		Telephone: 0207 270 5000
<p>What is the problem under consideration? Why is government intervention necessary?</p> <p>Most capital expenditure within the North Sea ring-fence, whether in putting plant and machinery in place, or in dismantling it at the end of the life of an oil field, currently qualifies for 100% FYAs. This allows these costs to be written off for tax purposes in the period in which the expenditure is incurred. However, there are some areas where different rules apply and currently, expenditure on long-life assets and mid-life decommissioning do not qualify for 100% FYAs.</p> <p>What are the policy objectives and the intended effects?</p> <p>By extending 100% FYAs to all decommissioning and long-life asset expenditure it is aimed to: Improve the simplicity, cohesiveness and consistency of the North Sea fiscal regime and help move the whole regime closer to a resource rent cash flow tax system.</p> <p>Remove a potential tax distortion on the timing of decommissioning and allow industry to undertake decommissioning at the optimum economic point. This may also act to reduce the overall maintenance costs by allowing the removal of redundant platforms etc. rather than having to keep them in a safe state for future removal.</p> <p>What policy options have been considered? Please justify any preferred option.</p> <p>1) Do nothing</p> <p>2) 100% capital allowances for mid-life decommissioning and long-life assets. This is the preferred option as it acts to remove the distortion on the timing of decommissioning and ensures a more simple and consistent treatment of capital expenditure.</p> <p>When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects?</p> <p>The impact of the proposed policy measures is likely to be included in any review of the measures implemented following the HM Treasury November 2007 Consultation on North Sea Taxation.</p> <p>Ministerial Sign-off For Impact Assessments:</p> <p style="text-align: center;"><i>I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.</i></p> <p>Signed by the responsible Minister:</p> <p style="text-align: center;"></p> <p style="text-align: right;">..... Date: December 2007</p>		

Summary: Analysis & Evidence					
Policy Option: Extension of 100% FYAs		Description: 100% FYAs to include mid life decommissioning and long life asset expenditure			
COSTS	ANNUAL COSTS		Description and scale of key monetised costs by 'main affected groups'		
	One-off (Transition)	Yrs			
	£ tbc				
	Average Annual Cost (excluding one-off)				
	£ tbc		Total Cost (PV)	£	
Other key non-monetised costs by 'main affected groups' Affected North Sea companies will have to amend their existing systems to allow for additional accelerated capital allowance claims, which in the absence of any future changes will apply until such time as affected oil & gas fields cease production.					
BENEFITS	ANNUAL BENEFITS		Description and scale of key monetised benefits by 'main affected groups'		
	One-off	Yrs			
	£ tbc				
	Average Annual Benefit (excluding one-off)				
	£ tbc		Total Benefit (PV)	£	
Other key non-monetised benefits by 'main affected groups' Accelerated capital allowance claims will enable affected North Sea companies to secure a tax relief timing advantage and possibly give them scope to rationalise their overall capital allowance computations.					
Key Assumptions/Sensitivities/Risks These measures aim to accelerate the timing of capital allowance claims for asset expenditure not already within the existing 100% first year allowance arrangement and as such will not involve anything new or novel.					
Price Base Year	Time Period Years	Net Benefit Range (NPV) £	NET BENEFIT (NPV Best estimate) £		
What is the geographic coverage of the policy/option?			UK North Sea		
On what date will the policy be implemented?			Royal Assent 2008		
Which organisation(s) will enforce the policy?			HMRC		
What is the total annual cost of enforcement for these organisations?			£		
Does enforcement comply with Hampton principles?			Yes		
Will implementation go beyond minimum EU requirements?			N/A		
What is the value of the proposed offsetting measure per year?			£		
What is the value of changes in greenhouse gas emissions?			£		
Will the proposal have a significant impact on competition?			No		
Annual cost (£-£) per organisation (excluding one-off)		Micro	Small	Medium	Large
Are any of these organisations exempt?		No	No	N/A	N/A
Impact on Admin Burdens Baseline (2005 Prices)				(Increase - Decrease)	
Increase of £ negligible		Decrease of £ negligible		Net Impact £ negligible	
Kev:	Annual costs and benefits: Constant Prices		(Net) Present Value		

Evidence Base (for summary sheets)

Rationale for intervention

Government's overall policy aim for the North Sea is to maximise the economic recovery of the oil and gas reserves whilst striking the right balance between producers and consumers and ensuring a fair return for the UK taxpayer from our national resources.

The rationale for change is also detailed in Chapter 4 of the November 2007 HM Treasury Consultation into North Sea Taxation. The proposed changes have been developed following a period of extensive consultation with the oil and gas industry between January 2006 and September 2007, aimed at addressing a range of issues. These proposals aim to:

- Improve the simplicity, cohesiveness and consistency of the North Sea fiscal regime and help move the whole regime closer to a resource rent cash flow tax system.
- Remove a potential tax distortion on the timing of decommissioning and allow industry to undertake decommissioning at the optimum economic point. This may also act to reduce overall maintenance costs by allowing the removal of redundant assets rather than having to keep them in a safe state for future removal.

Policy proposals

The oil industry is very capital intensive and large amounts of money is spent on infrastructure such as pipelines, platforms etc. Most expenditure, whether on putting the plant and machinery in place, or in dismantling at the end of the life of the oil field, currently qualifies for 100% First Year Allowances (FYA), allowing the costs to be written off for tax purposes in the accounting period in which the expenditure is incurred.

The specific proposals are to:

- Extend the availability of immediate 100% relief to all expenditure incurred in decommissioning redundant installations and equipment during the life of a field. Currently, immediate 100% relief is not available in respect of decommissioning (the term "abandonment" is also commonly used) expenditure that is not incurred for the purposes of, or in connection with, the closing down of an oil field, and wholly or substantially, to comply with an abandonment programme under S163 (2) (a) and (3) CAA 2001.
- Allow all expenditure on plant and machinery, for use wholly in a ring fence trade, to qualify for FYA of 100%. Currently, expenditure on long-life assets (assets with a useful economic life of at least 25 years) used in a ring fence trade only qualifies for immediate 24% relief (S52 Capital Allowances Act (CAA) 2001) and, in respect of the remaining expenditure, an annual allowance of 6% (S102 CAA 2001), on a reducing balance basis.

100% FYAs for mid-life decommissioning

Different areas of the North Sea are licensed to companies to enable them to produce oil and gas. Sometimes one company will be the sole licensee for a field, for other fields there will be a number of licensee companies. When the field comes to the end of its economic life, the licensees are obliged to decommission the infrastructure – pipelines, platforms etc, to return the area, broadly to its natural state. Assets are decommissioned under an 'abandonment programme' agreed with BERR (the Department for Business, Enterprise and Regulatory Reform). The programme will be drawn up in respect of specific assets

– so there may be one programme for the oil platform and another for the pipeline – rather than being for ‘the field’ as such.

The companies have to meet all their decommissioning costs, but these are relievable for tax purposes. Most of the expenditure is capital in nature and qualifies for 100% First Year Allowances (FYA), enabling the cost of decommissioning to be written off in the year in which it is incurred.

Currently, however, immediate 100% relief is not available in respect of decommissioning (the term “abandonment” is also commonly used) expenditure that is not incurred for the purposes of, or in connection with, the closing down of an oil field, and wholly or substantially, to comply with an abandonment programme under S163 (2) (a) and (3) CAA 2001.

Typically, the costs that will not qualify for immediate 100% relief are mid-life decommissioning costs, which by their very nature will not normally satisfy the conditions in S163 CAA 2001. In the circumstances we are considering, some infrastructure is being decommissioned, but the field is continuing to produce, so the expenditure is not related to the closing down of the field.

100% FYAs for long-life asset expenditure

Currently, expenditure on long-life assets (assets with a useful economic life of at least 25 years) used in a ring fence trade qualifies for immediate 24% relief (S52 Capital Allowances Act (CAA) 2001) and, in respect of the remaining expenditure, an annual allowance of 6% (S102 CAA 2001), on a reducing balance basis.

However, because of the hostile environment in the North Sea, there are in fact few assets where it is reasonable to expect a useful economic life of at least 25 years from new. This proposal is therefore a simplification measure to disapply the long-life asset regime, for expenditure on plant and machinery used wholly in a ring fence trade, with the result that all such expenditure will qualify for FYA of 100%.

Costs and Benefits

It is expected that accelerated capital allowance claims will enable affected North Sea companies to secure a tax relief timing advantage and possibly give them scope to rationalise their overall capital allowance computations. There may be costs in so far as affected North Sea companies will have to amend their existing systems to allow for additional accelerated capital allowance claims, which in the absence of any future changes will apply until such time as affected oil & gas fields cease production.

The Government expects the net impact of these measures on the admin burden on business to be negligible.

The Government would welcome any information from the industry that would help assess the impact on the compliance and administrative burden on companies of the two proposed measures outlined in this Impact Assessment.

Specific Impact Tests: Checklist

Type of testing undertaken	<i>Results in Evidence Base?</i>	<i>Results annexed?</i>
Competition Assessment	No	Yes
Small Firms Impact Test	No	Yes
Legal Aid	No	No
Sustainable Development	No	No
Carbon Assessment	No	No
Other Environment	No	No
Health Impact Assessment	No	No
Race Equality	No	No
Disability Equality	No	No
Gender Equality	No	No
Human Rights	No	No
Rural Proofing	No	No

Specific Impact Tests: Checklist

Competition Assessment

These measures will help to level the playing field between companies who decommission mid-life and those who decommission at cessation of production. It will also break down the division between assets that for tax purposes are treated as long life and those that are not.

Small Firms' Impact Test

The extension of loss carry back will afford benefits to all companies involved in North Sea oil and gas extraction ranging from large integrated operations operating across a range of oil and gas fields on the UKCS through to small and medium-sized businesses with interests in only one field or in onshore developments.

B

CRITERIA FOR REFORM

B.1 To contribute to the overall Government objective of maximising the economic recovery of UKCS oil and gas reserves it would be desirable for any changes to the North Sea fiscal regime to meet the following criteria, whilst recognising that on certain issues there may be tension between some of these.

- **Promote Investment and Production** – The maximisation of the economic recovery of oil and gas reserves will only be achieved through further promotion of investment in the UKCS and maintaining the current high levels of investment. Therefore, as with recent changes to the fiscal regime, any further changes will be subject to careful analysis to ensure that they have no negative impact on existing and future investment into the UKCS.
- **Ensure a fair return for the UK taxpayer** – The fiscal regime must also act to strike the correct balance between producers and consumers and ensure a fair return for the UK from our national resources. The changes to the fiscal regime announced at the 2005 PBR acted to restore this balance and any further changes would need to be consistent with this.
- **Be non-Distortionary** – Decisions taken by companies in relation to the North Sea should be affected as little as possible by the fiscal regime. The current tax regime, with elements such as the one hundred per cent first year allowances, goes a long way towards achieving this. Any further changes to the regime should be looking to further reduce this impact.
- **Be equitable** – Any changes should not have an inequitable impact on any one type or section of companies involved in the UKCS. Instead the fiscal regime should aim to ensure the tax burden is shared fairly across the UKCS.
- **Improve Stability** – Due to the long lead times for investment projects into the UKCS it is important that the fiscal regime remains as stable as possible, whilst continuing to meet the Government’s overall objectives for the UKCS. Therefore any changes to the fiscal regime should act to enhance stability, both now and for the future, and help ensure that fiscal consideration have a minimal impact on decisions taken in relation to the UKCS.
- **Be sustainable** – Any changes to the fiscal regime should not be made for short term purposes, but be credible for the medium and long term.
- **Reduce the administrative burden** – Any changes to the fiscal regime should not increase the administrative burden on companies involved in the North Sea, either by increasing the complexity of the current regime, or through adding to the reporting requirements. Government should also actively look to reduce the administrative burden where possible.

C

LIST OF CONTRIBUTORS TO THE DISCUSSIONS

C.1 This annex sets out a list of all the stakeholders who have contributed to the discussions to date. Government again extends its thanks to all of these bodies, companies and individuals for their contributions.

Professor Alexander Kemp, University of Aberdeen
Apache North Sea
Association of British Independent Oil Exploration Companies (BRINDEX)
BG Group
Bow Valley Petroleum (UK)
BP
Centrica Energy
Chevron
CNR International
ConocoPhillips
DONG Energy
Elixir Petroleum
Encore Oil
EOG Resources
Europa Oil and Gas
ExxonMobil
Fairfield Energy
Hess Corporation
Iceni Oil and Gas
Maersk Oil North Sea UK
Marathon International
Nautical
Newfield Exploration North Sea
Nippon Oil
Oil Taxation Action Committee (OTAC)
Oil and Gas Independents Association (OGIA)
Oil & Gas UK
Perenco
PetroCanada
Shell
Structured Product Solutions LLP
Talisman Energy
Total E&P
Tullow Oil
United Kingdom Oil Industry Taxation Committee (UKOITC)
WHAM Energy
Wood Mackenzie

D

CONSULTATION CRITERIA

D.1 Government has been consulting with interested parties on the issues covered in this consultation since the announcement by the then Chancellor in 2005. Because of the extensive consultation to date and the need to ensure legislation can be included in Budget 2008 this consultation will end at 31 January 2008. A full copy of the consultation criteria published by the Department for Business Enterprise & Regulatory Reform can be obtained at:

<http://bre.berr.gov.uk/regulation/consultation/code/>

D.2 The Consultation Criteria are:

- Consult widely throughout the process, allowing a minimum of 12 weeks for written consultation at least once during the development of the policy.
- Be clear about who may be affected, what questions are being asked, and the timescale for responses.
- Ensure that your consultation is clear, concise and widely accessible.
- Give feedback regarding the responses received and how the consultation process influenced the policy.
- Monitor your department's effectiveness at consultation, including through the use of a designated consultation co-ordinator.
- Ensure your consultation follows better regulation best practice, including carrying out a Regulatory Impact Assessment if appropriate.

D.3 If you feel that the consultation does not satisfy these criteria, or if you have any complaints about the process, please contact:

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