The North Sea Fiscal Regime: a discussion paper

March 2007

HM TREASURY

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INTRODUCTION

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

1.2 The UK's oil and gas reserves are significant, and up to 2006 have produced around 36 billion barrels of oil equivalent (boe). Estimates of the oil and gas remaining to be produced from the UK Continental Shelf (UKCS) range from 15 to 25 billion boe. 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.

1.3 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.

1.4 To achieve this 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.

1.5 In order to ensure that the North Sea fiscal regime is appropriate for the remaining life of the UKCS the 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, which 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.

1.6 The discussions provided a framework for UKCS stakeholders to discuss any aspects of the North Sea fiscal regime with officials from the Treasury, Revenue and Customs (HMRC) and the Department of Trade and Industry (DTI). 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. These were extremely valuable, and the Government reiterates its thanks to all the companies and individuals who were involved in the process for their contributions.

1.7 That phase of the discussions concluded at the end of September 2006. As announced at the 2006 Pre-Budget Report, the Government has been considering the conclusions drawn from the process and examining the options for further action on these strategic issues.

1.8 This discussion paper summarises the contributions received and sets out the conclusions the Government has drawn from the discussion process about where change may be necessary. It outlines the criteria for assessing possible options and uses these to make some initial observations on possible options.

1.9 The purpose of this paper is to assist Government in its consideration of the issues raised and possible options for further action through forming the basis for further, more focused, discussions with industry. The Government recognises the expertise that those in the industry have in this area and is keen to involve them in the ongoing process.

1.10 As announced in Budget 2007, the Government intends this second stage of the discussions to last until autumn 2007.

1.11 DTI, working alongside industry through the PILOT forum, has also made significant progress in ensuring that the UKCS has the correct regulatory and commercial environment to encourage further investment and exploration and ensure that the remaining potential of the North Sea is maximised. This has already helped to generate significant extra interest and investment in the UKCS.

SUMMARY

1.12 This document:

- describes how the current fiscal system works, and the arguments that have been made for changing it;
- sets out Government's initial conclusions; and
- sets out the criteria against which any options for change will be assessed.

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 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 UK continental shelf). 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 Trade and Industry. It is assessed on each participator in an oil field.

2.5 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.

2.6 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 retaining of the licence or within two payable periods of the relinquishment of the license.

2.7 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.

2.8 Major reforms in 1993 ended the PRT charge for any fields receiving development consent from the Secretary of State 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.

2.9 PRT is deductible in arriving at profits chargeable to corporation tax.

Ring fence Corporation Tax

2.10 Corporation tax in the North Sea is subject to special rules, which were introduced in 1975 to ensure the UK gained the proper benefit from North Sea oil. Following the announcement at Budget 2007 the rate of corporation tax applicable within the North Sea ringfence will, from 2008 be set separately from the headline corporation tax rate applicable outside of the ringfence. The current rate of corporation tax applicable within the North Sea ringfence will remain at thirty per cent.

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

2.12 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.

2.13 Companies subject to supplementary charge (see below) in respect of the ring fence trade are entitled to enhanced capital allowances for the year in which ring fence expenditure is incurred – one hundred per cent for most plant and machinery expenditure and expenditure on mineral extraction and twenty four per cent for expenditure on long-life assets. In addition, all offshore decommissioning expenditure, which is incurred under an approved abandonment programme after a field has ceased production, qualifies for one hundred per cent allowances. As announced at Budget 2007, alongside a separately set corporation tax rate, expenditure incurred within the ringfence on plant and machinery will continue to receive these enhanced capital allowances. Where such expenditure is not eligible for the enhanced capital allowances it will continue to receive twenty five per cent writing down allowances. In addition expenditure incurred prior to the introduction of one hundred per cent first year allowances will continue to receive an annual writing down allowance of twenty five per cent on the pool.

2.14 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, to the extent that losses arise from decommissioning activity, such losses can be carried back three years.

2.15 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 the scope of the EES was widened to include all North Sea expenditure which cannot be relieved against North Sea profits.

Supplementary Charge

2.16 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 (SC) was increased in Finance Act 2006 to twenty per cent, with effect from 1st January 2006.

3 THE 2006 DISCUSSIONS – VIEWS OF INDUSTRY

3.1 Between the 2005 Pre-Budget Report, and the end of September 2006, 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. In addition to these meetings the Government also received a number of written submissions. This chapter summarises the views expressed by the participators in those discussions and not those of HM Treasury or the Government. The Government's conclusions and views on these issues are then set out in the following chapter.

3.2 As was made clear at the start of the discussions, there were no restrictions on what the Government was willing to discuss and both the conversations and written submissions therefore covered a broad range of issues. As a result of the many different positions and interests companies have within the UKCS on various issues there was no consensus in the messages received from industry, and in several areas the messages given from different sections of industry were contradictory.

3.3 On the headline messages received from across industry there were some common views. The general view was that a fiscal (and regulatory) regime should:

- be simple and sustainable;
- be predictable and subject to the minimum necessary amounts of change;
- recognise the long term nature of the oil and gas industry and the long lead times for investment; and
- have a non-distortionary impact on investment and expenditure decisions.

3.4 Beneath these general statements were a number of more specific messages that fell within the following categories:

- the Petroleum Revenue Tax (PRT) system;
- relief for decommissioning costs;
- exploration and development;
- proposals for a price linked fiscal regime; and
- how the North Sea fiscal regime will apply to the change of use of assets.
- This chapter will look at each in turn and summarise the arguments put by Industry.

The Petroleum Revenue Tax System

3.5 There are currently around 120 fields that are potentially chargeable to PRT, of which around 36 currently generate PRT receipts, with the remainder being PRT liable but not currently paying due to the system of reliefs. There are nearly 85 participators with an interest in PRT fields, of which approximately 45 filed PRT returns in 2006.

3.6 According to latest HM Revenue and Customs (HMRC) figures, receipts for PRT in 2005–06 were £2.0 billion, compared with £1.3 billion in 2004–05 and £1.2 billion in 2003–04[1]

3.7 PRT only applies to fields given development consent before 16 March 1993. Although a decreasing number of fields are covered by the PRT regime, and fewer than 40 fields actually pay PRT in any one year, the PRT regime was one of the most frequently raised issues during the discussions. For those who either had only a small or no interest in PRT-liable fields, the major concern was that if, in the future, the PRT regime was abolished then the overall regime might be rebalanced with a corresponding increase in the rate of Supplementary Charge. It was argued that this could have a significant negative impact on the industry, with the benefits of such a change falling to a minority of companies, while the costs would be felt by many.

3.8 For those companies involved in PRT-liable fields the main concern surrounded a desire for increased certainty over the lifespan of PRT and most importantly, a greater certainty that Government would honour the existing PRT rules for receiving tax relief on decommissioning costs. There was a commonly held view that implicit within the PRT regime is a tipping point where tax relief given against past profits to set off the costs of decommissioning will outweigh the revenue that the PRT system is bringing in and at that point the Government may choose to abolish PRT.

3.9 It was felt by some in the industry that this lack of certainty was having an adverse effect on investment in some PRT-liable fields and also making asset transfers significantly more complex. There was therefore a general feeling that anything Government could do to further reduce this uncertainty could have a positive impact on investment in the UKCS.

3.10 The argument was also made by some respondents that, in order to incentivise additional investment in existing PRT liable fields, and maximise recovery of oil and gas from those fields, it would be desirable to remove PRT entirely. However it was felt important, by some, that any such action retained the existing access to decommissioning relief. The majority of those with interests in PRT fields agreed with the wider view that if PRT were to be abolished then it would be undesirable for that to be accompanied by a rebalancing of the regime through an increase in the rate of Supplementary Charge.

3.11 Some possible methods for removing PRT were suggested by Industry during the discussions. These included:

- switching off PRT on a field by field basis at the point where the remaining estimated revenues from PRT for the field equalled the amount of PRT that could be claimed back in tax relief following decommissioning expenditure;
- abolishing relief for decommissioning costs against PRT when actually incurred, but allowing companies to make an upfront provision to cover decommissioning costs; and
- a Buy-Out regime whereby companies currently liable for PRT bought

[1] Figures for paragraphs 3.6 and 3.7 from HM Revenue and Customs – Large Business Service Oil and Gas

themselves out of the PRT regime through making an upfront payment to cover their remaining estimated PRT liabilities minus the relief on decommissioning, with PRT then being abolished.

3.12 In addition, companies suggested that there was greater administrative complexity in the PRT regime, compared with the CT regime. PRT requires two returns a year and contains a number of pricing and valuation rules. Companies suggested that the removal of PRT would reduce a significant compliance burden, albeit that there are a relatively small number of companies within the regime.

3.13 Some companies also made other, more specific observations concerning the PRT regime during the discussions. These included:

- a belief from some that the PRT system disincentivises development of small scale developments that lie within the boundaries of existing PRT fields, but are geographically distant to existing infrastructure and would either require new infrastructure, or would be linked back to infrastructure in non PRT liable fields. Although such developments would therefore face similar challenges to new fields they would remain liable to PRT and it was felt that this could act as a barrier to development; and
- that fields which had been fully decommissioned could remain liable to PRT, yet that new technology and high oil prices could make their redevelopment a possibility. However having been fully decommissioned such fields would face similar challenges to entirely new fields, but would be liable to the same higher rate of tax paid by established PRT fields.

Relief for Decommissioning Costs

3.14 Over the next two decades Industry will gradually decommission many of the installations that have been producing oil and gas in the UKCS. Current DTI estimates for the cost of decommissioning in the UKCS are in the range of fourteen to twenty billion pounds in today's prices, with the wide variance reflecting uncertainties in decommissioning liabilities and the inherent difficulties in estimating decommissioning costs given the lack of experience of major offshore decommissioning activity.

3.15 As set out in Chapter 2, the current corporate taxation rules for the UKCS allow a general one-year carry-back of CT losses and, to the extent that such losses arise from decommissioning costs, a three-year carry back of such losses. Companies have argued that, in the circumstances where they do not have access to other profit streams in the UK to offset the costs of decommissioning against, these rules may lead to premature decommissioning. Their argument is that companies will seek to decommission earlier in order to ensure they can take full advantage of the existing rules and receive the maximum offset. As the production profiles of many fields contain a long tail of production if premature decommissioning were to take place, the result of this would be a small loss of overall oil and gas recovery.

3.16 Industry therefore proposed that Government consider extending the number of years that 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.

Exploration & Development

3.17 In 2006 exploration and appraisal activity in the UKCS saw success rates rise to thirty eight per cent, compared with twenty four per cent the previous year. It is estimated that recoverable reserves of at least half a billion barrels of oil and gas equivalent were discovered in 2006, the highest level since 2001.[2] Although the overall number of wells drilled, at 82, represented a six per cent fall compared to the previous year this still remained well above the levels achieved in the years immediately prior to 2005.[3]

3.18 In February 2007 the DTI announced that 150 oil and gas exploration and production licences were issued in the 24th licensing round. This compares well with the 151 licences in the previous round, which represented a 35-year high. [4]

3.19 The overall message from industry on exploration was that, if recovery of oil and gas from the UKCS were to be maximised, there would need to be an increase in the level of exploration currently being undertaken.

3.20 Whilst it was not felt that the structure of the current fiscal regime was in itself reducing the levels of exploration, there was a view that extra fiscal incentives could have a positive impact on increasing the levels of exploration. Several respondents however admitted that it was unclear what incentives might actually make a significant difference, or whether the resolution of non-fiscal measures would have a much greater impact – for example improving infrastructure to the West of Shetland.

3.21 A difference in opinion between different elements of industry also existed as to whether specific exploration incentives would have any impact, or whether what was needed instead (or additionally) were changes to the fiscal regime to improve the development economics faced by development of existing and new discoveries and thus their materiality. It was proposed that such measures would in turn incentivise greater levels of exploration.

3.22 Possible measures that were suggested specifically to incentivise exploration were:

- a general uplift in capital allowances for exploration and appraisal;
- an uplift in capital allowances targeted at specific types of exploration, i.e. High Pressure High Temperature (HPHT) wells or specific areas, i.e. Southern Gas Basin, Central Graben or West of Shetland; and
- a targeted fund for certain types of activity – i.e. play-opener wells.

3.23 Possible wider measures suggested to incentivise development were:

- the reduction or abolition of Supplementary Charge for new developments arising from new exploration;
- the reduction or abolition of Supplementary Charge from certain new developments – for example Carboniferous Gas or HPHT;
- a reduction of the taxable value of oil/gas from specific areas by $X per barrel/ Y p per therm; and

[2] DTI – "Oil is well under the North Sea" press release of 1 February 2007.
[3] Source Wood Mackenzie Review of 2006 – UK Upstream sector. Exploration and Appraisal drilling in 2005, where 87 wells were spudded, representing the highest levels achieved since 1997.
[4] DTI – "Oil is well under the North Sea" press release of 1 February 2007.

- the introduction of allowances for new developments, for example a volume allowance or time allowance, during which time Supplementary Charge would be either reduced or be abolished.

Change of Use

3.24 As the North Sea matures, so companies are starting to consider alternative uses of North Sea infrastructure. Such uses could include wind farms, gas storage and carbon capture and storage.

3.25 During the course of discussions and elsewhere, companies have raised a number of questions for discussion around the tax treatment of a change of use of North Sea assets from oil extraction to other such activities. They have asked HMRC for clarification on a range of issues including:

- capital allowances;
- potential change in the nature of trade;
- inside Ring Fence/ Outside Ring Fence boundaries; and
- availability of relief for decommissioning costs.

3.26 It was announced at PBR 2006 that HMRC would set up a joint working group with industry to explore the tax issues arising under the current tax regime from change of use.

Price Linked Fiscal Regime

3.27 In the period immediately after the Supplementary Charge increase at the 2005 Pre-Budget Report some calls were made for a specific link between the level of the Supplementary Charge and oil prices whereby, as the oil price increased, so would the Supplementary Charge and if the oil price dropped, there would be a corresponding fall in the Supplementary Charge.

3.28 During the course of the discussions the firm conclusion from Industry was that, whilst they were anxious that any significant falls in the oil price were met by corresponding adjustments in the tax levels imposed on the North Sea, there was no desire for a specific link between oil price and the level of the Supplementary Charge. It was felt that the introduction of such a system would actually increase instability and unpredictability and add further, undesirable, complexity to the regime.

Other issues

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

- **R&D Tax Credits** – As raised in response to previous consultations on R&D tax credits some elements of industry were concerned that the current structure of R&D tax credits was not suited to some companies within the oil and gas industry due to the industry practice of subcontracting R&D to small, specialist firms. Under the current system some elements of industry were concerned

that they were unable to claim R&D Tax Credits directly, and believed they could not therefore receive benefits from them, despite the large amounts of subcontracted R&D being paid for and carried out on behalf of the industry.

- **Set-aside funds for decommissioning** – Various suggestions were made as to how these could be set up, ranging from simple set aside schemes with no adverse tax implications (inheritance tax is chargeable on trust funds) to complex systems of upfront tax relief for both PRT and SC based on a formulaic approach to estimated future decommissioning costs.
- **Separate taxation rates for Oil and Gas extraction** – Some companies that are principally engaged in the extraction of gas argued that they currently receive significantly lower prices for gas as opposed to oil, but are faced by the same inflationary pressures on the cost side. As a result of this the argument was made that the taxation of oil and gas extraction should be considered separately, with a lower rate of taxation being imposed on gas to help incentivise investment in future gas production.

4 CONCLUSIONS FROM THE DISCUSSIONS

4.1 This chapter outlines the conclusions the Government has drawn from the discussion process to date. It looks at where the Government believes change may be desirable, if acceptable policy options can be developed, and where the Government believes changes to the fiscal regime at the current time are undesirable. It also sets out the criteria that recent changes to the North Sea fiscal regime have been subject to and that any future changes to the North Sea fiscal regime would need to meet in order to contribute to the Government's wider objectives for UK oil and gas production.

CRITERIA

4.2 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.

- **Promotes 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.

- **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.

- **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.

- **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.

- **Improves 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.

- **Sustainable –** Any changes to the fiscal regime should not be made for short term purposes, but be credible for the medium and long term.

- **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.

INITIAL CONCLUSIONS

Petroleum Revenue Taxation

4.3 Initial analysis suggests that the removal of the PRT system could have benefits for the UKCS. Its removal would be expected to result in some 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 other fields using the same infrastructure.

4.4 It would also be expected to simplify the transfer of assets and remove the fiscal fault line that currently exists between fields liable to PRT and fields liable only to CT and SCT. There could also be benefits from reducing the uncertainty companies currently believe exists over Government's future intentions towards PRT, although it is hard to quantify such benefits.

4.5 However, in line with the criteria set out above, any mechanism to remove PRT would need to ensure that there was still a fair return for the UK taxpayer from the UKCS and did not unbalance the regime. The Government is also clear of the need to ensure that any removal of, or changes to the PRT system did not penalise other companies within the UKCS who are not currently within the PRT system.

4.6 On this basis the Government is **not** attracted to any mechanism that would remove PRT and then rebalance the fiscal regime through an increase in the Supplementary Charge. This would have an overall negative impact on the UKCS and would not contribute to meeting Government's overall objectives. It would be unlikely to result in overall increased investment and would have a negative impact on exploration and the development of new and existing discoveries. It is also unclear how this would resolve the perceived issue of uncertainty over decommissioning relief that was raised by Industry.

4.7 The Government continues to examine other possible policy options that would facilitate the removal of PRT. However, from the work to date and the discussions with industry, it is clear that there are several factors that could make such options difficult to implement. For example many of the options suggested to date would require the accurate estimating of decommissioning costs and remaining reserve levels – both of which are extremely hard to accurately forecast, but without which measures such as a Buy-Out option, or Field-by-Field switch off would be unworkable. Despite these complications Government remains keen to discuss the various policy options further with industry, and examine jointly whether there are solutions to the various issues that may exist.

4.8 If there are no acceptable options, or if such solutions do not exist to the issues that have been identified, then 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 from an overall UKCS policy perspective.

4.9 If the PRT regime were to be retained, Government would wish to work closely with industry to ensure that the administrative and compliance burdens associated with PRT can be reduced wherever practicable. HMRC are also looking closely at the interaction between the PRT regime and change of use.

PRT on recommissioned fields

4.10 In the 2006 Pre-Budget Report it was announced that fields that are liable to PRT would be removed from the charge to PRT if they were redeveloped following full decommissioning. This will be legislated on in Finance Bill 2007.

4.11 Under current PRT rules, if a field upon which PRT is chargeable (i.e. one given development consent prior to 16 March 1993) was decommissioned and then recommissioned that field could still be liable to the charge to PRT. However the challenge of redeveloping a previously decommissioned field is closest in appearance to the challenge of developing a completely new field – that is fields being developed on previously untouched seabed. Yet such fields are not liable to PRT and Ministers decided that this represented an anomaly that could potentially act to distort investment decisions and reduce the overall recovery of oil and gas from the UKCS.

4.12 As this was a specific, self-contained issue, it was felt appropriate to take it outside of the wider process of examining the North Sea Fiscal Regime.

Relief for Decommissioning Costs

4.13 The Government continues to examine the argument that for some companies there could be a benefit in extending CT loss carryback to allow them to receive full available coverage for the losses incurred through decommissioning. Work is still being undertaken to understand fully the magnitude of this issue and to examine whether acting on this would actually have a positive impact on pushing back decommissioning dates and result in increased recovery of oil and gas from the UKCS. In particular, it is important to establish the extent to which companies will be unable to relieve losses that arise as a result of decommissioning along 'normal' CT routes.

4.14 To this end the Government would welcome the opportunity to discuss this issue further with Industry and also to explore the extent to which CT loss carryback should be extended if such a decision was made in order to have the optimum impact on the recovery of oil and gas.

4.15 The Government is also looking at whether there are other, more targeted policy options, which would also resolve this issue and result in increased recovery of oil and gas.

Exploration & Development

4.16 From the information provided during the discussions, and from the additional analysis that has been undertaken within Government, the conclusion is that the structure of the fiscal regime has no negative impact on the level of exploration being undertaken in the UKCS. The main drivers of exploration are the current and projected future oil price and supply side constraints, and through these the risk that companies are willing to take to explore in certain geological areas.

4.17 A separate question is whether the current levels of exploration are lower than is desirable, and whether the correct way to solve this issue, if it exists, would be through the use of fiscal incentives. This issue is still being examined. However the initial conclusions drawn from the discussions are:

- fiscal incentives specifically targeted at exploration, for example a further uplift in capital allowances, seem unlikely to have much impact on exploration levels, when compared to other factors;
- they would also have significant deadweight costs and would therefore be unattractive from both an efficiency and a public finances perspective;
- such issues are exacerbated by existing supply side constraints;
- an alternative would be fiscal incentives targeted at specific types of exploration – for example, HPHT. However, again it is unclear what impact this may have; and
- it is unclear whether a "play opener" issue exists, and it is therefore unlikely that any incentive targeted specifically at such wells would have any impact.

4.18 The Government would be willing to discuss this further with industry if it is felt that evidence exists that suggests these conclusions are incorrect. There would be especial interest in any additional thoughts from industry on incentives targeted at specific types of exploration, and Government would welcome any evidence that could be provided that these would make a real difference.

4.19 A closely linked, but nevertheless separate, issue is whether new and existing discoveries are not being developed, and hence success in exploration is not necessarily resulting in an increased yield of oil and gas from the UKCS. The argument has been made that the provision, through the fiscal regime, of incentives that improved development economics could result both in an increase in the number of discoveries moving into production and also have a positive impact on the levels of exploration.

4.20 The discussions and our analysis suggest that such a problem is not currently widespread, but that it may be occurring in certain areas of the North Sea, for example where access to infrastructure is restricted, or with certain types of challenging development.

4.21 A number of possible policy measures have been suggested in this area, either for all new developments, or targeted at certain areas. These include a reduction in the Supplementary Charge or the introduction of specific incentives such as a time or production allowance. The Government's initial conclusion is that such measures would be likely to have greater value than incentives aimed specifically at exploration, but that it is currently unclear whether the impact of such measures would be significant, with initial analysis suggesting the overall impact would be marginal. However the Government would welcome more evidence from Industry that such incentives could make a significant difference and again are looking to discuss this further.

Change of Use

4.22 Following the announcement at the 2006 Pre-Budget Report, the Government has set up a Working Group including representatives from the Oil and Gas Industry, DTI and HMRC, to explore how the current tax rules apply to changes of use of North Sea infrastructure. In particular the Group will focus on gas storage, carbon capture and storage and wind farms.

4.23 This group met for the first time on the 1st March 2007 and is aiming to report by the summer. Government will then consider the appropriate way forward on any issues that have arisen.

Price Linked Fiscal Regime

4.24 As was set out during the course of the discussions the Government is not attracted to a regime that explicitly links the level of Supplementary Charge to the oil price. Such a regime would be complicated to design and run, would offer opportunities for non-compliance activity, would increase levels of uncertainty in the UKCS for both companies and Government, and would have a negative impact on the Government's objectives for the fiscal regime. Industry concurred with these views during the discussions, and the Government has no intention of examining this proposal further.

4.25 On whether the level of supplementary charge would be adjusted if the oil price changed significantly all taxes are reviewed on a Budget-by-Budget basis and changes in oil prices are factored into such reviews. However it should be noted that at the 2005 Pre-Budget Report the Chancellor committed to no further increases in the rate of tax imposed on the North Sea during the lifetime of this Parliament.

Other issues

4.26 Government has also examined the arguments made with respect to R&D tax credits, Set Aside Funds for Decommissioning and differential rates of taxation for oil and gas production:

- **R&D Tax Credits** – As has been previously set out, having looked closely into this issue, and based on the evidence presented to us to date, the Government does not believe that the current R&D tax credit system is inaccessible to the oil and gas industry. Whilst the Government accepts that the preferred method of R&D for the industry means that oil and gas companies often cannot themselves claim the credit there would seem to be no reason why it cannot be claimed by those to whom the R&D is subcontracted and factored into the contracts negotiated when that work is commissioned. If however there were further evidence, not previously shown to Government, that a separate issue does exist here, then submissions to that effect would be welcomed.

- **Set Aside Funds for Decommissioning –** Any attempt to produce a formulaic contributory amount based on future decommissioning costs would require an estimate of costs that are liable to change substantially over the coming years. The process also raise issues on the value of relief given if the field is subsequently sold on and what happens to relief given up front if participators fail to meet their decommissioning liabilities. However, if industry has further observations on this issue then Government would welcome those.

- **Separate taxation rates for oil and gas** – Government continues to examine this issue. However any changes to the current regime that acted to discriminate between different hydrocarbon products would be likely to add significantly complexity to the North Sea fiscal regime, create distortions within it, and come with significant compliance costs for both industry and Government. Initial analysis also suggests that the impact on North Sea production and investment of a separate regime could be marginal. However this issue was not looked at widely during the initial discussions and Government would welcome further evidence and conversations with industry on this issue.

5 NEXT STEPS

5.1 As stated in the Introduction, the Government is keen to continue to work closely with industry to examine the options for changes to the fiscal regime. Therefore, the main intention of this paper is to form the basis for further discussions with the UK upstream oil and gas sector to look in more detail at the possible options for reform.

5.2 This next stage in the discussions will last until the end of September 2007.

5.3 Views on the ideas and issues discussed in this paper are welcomed, particularly on the conclusions drawn to date.

CONTACT POINT

5.4 Any comments or questions should be directed to:

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