HM Treasury

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summary of responses

December 2013

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Contents

Foreword

Shale gas represents a huge economic opportunity for the UK. It could create thousands of jobs, generate billions of pounds of business investment, lead to substantial revenue for the Exchequer and increase our energy security. Critically, it also has potential to drive down energy bills for households and businesses.

Shale gas will bring benefits to local communities. Companies have agreed to pay £100,000 to communities situated near an exploratory well site that is fracked. If gas is then produced, one per cent of the revenue – potentially up to £10 million – will also go to the local area.

So kick starting exploration for shale gas is part of our economic plan.

We are committed to putting the right fiscal framework in place to ensure companies can fully explore the potential of our indigenous natural resources. That is why the Chancellor announced a new tax allowance for onshore oil and gas at Autumn Statement, which was introduced with immediate effect.

I was very encouraged by the high level of engagement throughout the consultation process, through written responses and in working groups. This allowed us to develop a tax regime that will help achieve our objectives – particularly the need to incentivise early investment. An independent report by oil and gas consultants Wood Mackenzie has already shown that the introduction of this allowance will make the UK regime for shale gas the most competitive of all the European fiscal regimes they reviewed.

The UK's oil and gas sector is one of the country's greatest industrial success stories and onshore projects could be part of this. We have one of the most stringent regulatory regimes in the world, so this activity can be carried out safely and sustainably.

I am confident that the regime we are putting in place will ensure the UK does not miss out on the opportunities that shale gas – and other onshore oil and gas – can bring.

Nicky Morgan

Nicky Morgan
Economic Secretary to the Treasury

1 Introduction

1.1 This document summarises the responses received during the consultation carried out by the government between July and September 2013 on proposals for a fiscal regime for shale gas. It also sets out the government's responses to the outcomes of the consultation and next steps.

1.2 This work follows the government's announcement at Budget 2013 that it would introduce a new tax allowance and extend the Ring Fence Expenditure Supplement for shale gas projects to incentivise investment and support the development of the UK's shale gas industry. It forms part of a wider package of measures the government has introduced this year, including:

- streamlining the permitting process to ensure permits are issued quicker and to a defined timetable providing certainty to the industry
- publishing new planning guidance to clarify the process for developers
- working with industry on a robust scheme to ensure local communities benefit from hosting shale projects, with operators providing at least £100,000 per fracked well site during exploration and no less than one per cent of revenues during production

1.3 As outlined in the consultation, the government believes that shale gas has the potential to form a critical part of the UK's future energy mix. The development of the country's indigenous resources makes us less dependent on imported gas supplies and reduces our exposure to geopolitical risks and lengthening supply chains. Shale gas could also bring substantial economic benefits – thousands of jobs; investment and lower energy bills. The benefits would extend beyond oil and gas to other manufacturing sectors – to construction, engineering and others – which is why major industrial employers have publicly supported its development.

1.4 The government is therefore committed to getting the fiscal framework right so we can explore this potential and ensure the UK is able to take advantage of these opportunities.

1.5 To achieve this, the consultation document set out the government's objectives and proposed approach for the shale gas tax regime – the introduction of a pad allowance, extended beyond shale gas to all onshore unconventional hydrocarbons, and an extension to the Ring Fence Expenditure Supplement.

1.6 Having considered all responses, the government has published draft legislation for Finance Bill 2014. The new onshore allowance is being introduced with immediate effect (from 5 December 2013). The consultation on draft legislation closes on 4 February 2014.

Consultation process

1.7 The government is grateful to all respondents who took the time to provide comments on the proposals. Responses were received from oil and gas companies, representative bodies, professional services firms, civil society and individuals. The government received 33 responses.

1.8 As part of the consultation process, the government also held several working groups with companies and tax professionals to discuss the details of the proposals. Summaries of the working group meetings can be found at Annex A.

2 Pad allowance

Objectives

2.1 The consultation document outlined that the government will adopt an approach to the shale gas tax regime that:

- encourages early investment in the exploration for, and development of, shale gas in the UK
- maximises the economic production of the UK's shale gas reserves
- is flexible enough to adapt as the industry moves from the exploration phase to production, but stable enough to provide certainty for companies currently considering investment in the UK
- uses existing mechanisms for delivering relief as far as possible to avoid adding unnecessary complexity to the ring fence regime
- ensures a fair return for the taxpayer, is not open to abuse and is affordable, in line with the government's objective for long term sustainability in the public finances

Q1. Would the proposed pad allowance achieve the objectives set out in paragraph 3.2 of the consultation document (reproduced above)?

2.2 The majority of respondents agreed that the pad allowance would achieve the government's objectives. They said it would increase the attractiveness of economic but uncommercial projects and therefore act as an investment incentive. Respondents highlighted that the structure of the allowance could accommodate both the exploration and production phases of the industry, and could be adjusted as the sector matured. A number of respondents noted that to fully achieve the government's objectives, the fiscal regime would need to be simple both in terms of implementation and day-to-day handling.

2.3 Several respondents commented that the allowance would provide a fair return to the taxpayer as it only provided relief on a portion of a company's profits. A few respondents noted that the effective tax rate for shale gas projects would still be in the range of 40 per cent to 50 per cent – depending on the level set – significantly higher than for most companies operating in the UK. Many respondents also highlighted that the allowance only rewarded successful effort; if there is no shale gas production in the UK then no allowance can be claimed.

2.4 A number of respondents questioned the need to provide any fiscal support for shale gas and said the government should consult on whether the objectives outlined are the right ones, not just on whether the tax proposals meet these objectives.

Box 2.A: Government response

- The government welcomes industry's support for the objectives of this tax regime, and the fact that the overall structure of the proposed approach is expected to achieve these objectives.
- The shale gas industry is in its early stages in the UK and work is needed to assess how much of our substantial shale gas resource is technically and commercially recoverable. The government has already committed to supporting the industry during this critical exploration phase and providing it with the certainty needed on tax treatment. It is therefore appropriate to consult only on those aspects of the policy on which a final decision has not been made – in line with the government's consultation principles and the tax consultation framework.

Pad allowance – variations and interaction with commercial models

2.5 As set out in the consultation, the pad allowance would operate similarly to existing field allowances by exempting a portion of profits from the supplementary charge – reducing the effective tax rate on that portion from 62 per cent to 30 per cent.

2.6 The consultation proposed that the amount of profit exempt from the supplementary charge would be a proportion of the capital expenditure incurred in relation to a shale gas pad.

2.7 The amount of allowance activated (i.e. made available to set off against profits) in any accounting period would be no more than the production income from the pad. Any activated allowance not used to reduce the supplementary charge otherwise payable by a company in a particular period would be carried forward to the next year. The consultation asked:

Q2. Are there variations to the pad allowance option that would better meet the objectives outlined in paragraph 3.2? If so, please provide evidence to support your case.

Q3. Do you think there are any commercial models that are likely to be adopted that would be incompatible with the pad allowance?

Variations to the pad allowance

2.8 While most respondents agreed that the proposed pad allowance would achieve the government's objectives, a few variations were suggested which respondents believed would help the allowance better achieve all objectives.

2.9 A large number of respondents recommended the introduction of some form of cross pad relief, which would allow companies to transfer allowance generated on an unsuccessful, or under-performing, pad to a successful one so it could be activated. They suggested that this would increase confidence; at least partly alleviate the heavy financial risks faced; and increase investment appetite. Without cross pad relief, they said large amounts of capital expenditure, and therefore generated allowance, could be stranded in unsuccessful pads, lessening the investment incentive and requiring companies to introduce a discount on the allowance in their investment decisions.

2.10 A number of respondents proposed changes to the way in which allowances could be used by companies. Some respondents recommended treating unutilised but activated allowances in a similar way to tax losses for the Ring Fence Expenditure Supplement (RFES), allowing them to be uplifted by ten per cent for up to ten years until they can be used. Others argued that vendors in commercial transactions should be able to transfer a greater than equity proportion of unactivated allowances to acquirers. A few respondents suggested the introduction of group relief for allowances, which would allow the transfer of activated allowances across companies in the same group. All these proposals were expected to increase the value of the allowance to companies, and therefore to increase its ability to incentivise investment.

Commercial models

2.11 Most respondents could not identify any commercial models that would be incompatible with the proposed allowance. However, one respondent noted that as the industry develops, more complex commercial arrangements and partnerships may emerge. As such, they believed it was important for the allowance to be realised against any shale related profits, such as tariff income and capacity payments, rather than purely against profits from hydrocarbon sales.

2.12 Several respondents highlighted that given the period of time it was thought would be needed to bring shale investments to commercial fruition, many initial investors will need to bring in new investors. They said that current reinvestment relief rules, which allow companies to sell their oil/gas assets without generating a corporation tax charge on any gain if they reinvest the proceeds back into the UK Continental Shelf, should therefore be amended to cover exploration and appraisal (or pre-trading) activities.

2.13 Similarly, a number of respondents said that one part of the Substantial Shareholdings Exemption (SSE) (paragraph 15A Schedule 7AC) should be extended so that it covers exploration and appraisal activities. The SSE provides an exemption from corporation tax on gains arising from the sale of shares in a company held by another company. The strategy of a number of smaller oil and gas exploration companies, including shale operators, will likely be to discover new reserves and sell on all or part of their licence to help fund development. These companies would not currently be able to make use of the SSE, because if they were to transfer a pre-development consent asset to a new subsidiary, the subsidiary would not be carrying on a trade and so would need to wait 12 months before selling the shares.

Box 2.B: Government response

- The government accepts there is a case for introducing cross pad relief to allow companies to transfer allowance generated on an unsuccessful site to a successful one. This will provide a greater degree of certainty to companies on the availability of the allowance and therefore achieves the intended incentive effect. The government will allow the transfer of generated allowance between sites in the same company after a period of three years after the expenditure has been incurred. This time delay will help ensure there is no incentive for companies to abandon projects prematurely. The allowance will still need to be activated by production income from the successful site.
- At present, the government does not believe it is appropriate to change the way that allowances can be used within and between companies. It therefore will not: extend RFES to allowances; allow companies to transfer greater than equity share of unactivated allowance to acquirers; or allow activated allowances to be transferred across companies in the same group. The government does not believe these changes would materially affect the investment incentive provided by the allowance and thinks they could expose the Exchequer to unnecessary risk.
- The government agrees with respondents that the inability of pre-trading companies to access reinvestment relief or the substantial shareholdings exemption in paragraph 15A could undermine investment in exploration. The government will therefore legislate in Finance Bill 2014 to extend both to exploration and appraisal (E&A) activities. The extensions will apply to onshore and offshore E&A.
- The definition of production income for the purposes of this allowance will come from existing legislation. It will include arms length sales, non arms length sales and capacity payments, but not tariff income or gas used for production purposes.

Capital expenditure

2.14 The consultation said the amount of production income exempt from the supplementary charge would be a proportion of the capital expenditure incurred in relation to a shale gas pad. It proposed that, for the purposes of the allowance, capital expenditure would be limited to expenditure that attracts 100 per cent first year capital allowances.The consultation asked:

Q4. Do you agree that, for the purposes of the pad allowance, capital expenditure should cover expenditure that would attract 100 per cent first year capital allowances?

2.15 The majority of respondents who considered this question believed that the government's proposed approach was a good starting point, but suggested the definition would need to be widened in some areas. Several respondents suggested the inclusion of costs relating to the mid-life plugging and abandonment of wells. They argued that to drill and produce from a new lateral well would require the previous lateral to be plugged. Therefore, the investment required to plug the lateral should be counted as a drilling cost to stimulate new production.

2.16 A number of respondents noted that the allowance should not distort a company's decision to lease or buy assets. Therefore, they suggested that costs of certain leased assets should be regarded as qualifying capital expenditure for the purposes of the allowance.

2.17 A small number of respondents said that the definition of capital expenditure for the purposes of the pad allowance should be restricted to expenditure that currently qualifies for 100 per cent first year capital allowances. They argued that this would minimise complexity.

Box 2.C: Government response

- The government accepts that the definition of capital expenditure for the purposes of the allowance should be extended beyond expenditure which qualifies for first year capital allowances. This is consistent with the approach adopted for the brown field allowance.
- The government will publish guidance on what qualifies as capital expenditure in relation to a site. This will include all expenditure that currently qualifies for 100 per cent first year capital allowances. It will also include the costs of the site, of gaining access to the hydrocarbons, of restoring capital assets to their original position during production, and the mid-life plugging and abandonment of wells. Site expenditure may include expenditure on buildings and land access and some capitalised expenditure on leased assets.
- The government will continue to work with industry, through the UK Onshore Operators Group (UKOOG), to refine this guidance and ensure it is consistent with achieving the government's objectives.

Administrative burdens and revenue protection

2.18 The consultation sought views on whether the allowance would introduce an additional administrative burden for business and whether current arrangements were sufficiently robust to protect the Exchequer. It asked:

Q5. Will the pad allowance introduce any additional administrative burdens for businesses, particularly the need to track expenditure on a pad-level? If so, are there options the Government could consider to reduce this burden?

Q6. Do you agree that the current arrangements to protect the Exchequer are sufficiently robust for the pad allowance? Do you think there are any additional measures that would be helpful in this regard?

Administrative burdens

2.19 Most respondents believed there would be some additional administrative burden, particularly in the case of a company owning multiple pads, but that this was proportionate and should be manageable. One respondent noted that, from US experience, the rigour of tracking expenditure on a pad level was good practice. They said that given the limited number of pads during exploration there should not be any issues with cost control departments tracking expenditures to their source and that these procedures could be easily upscaled to accommodate multiple pads during full scale development.

2.20 A minority of respondents said that the allowance would not create any additional administrative burden for businesses.

Protection of the Exchequer

2.21 All respondents who considered this question agreed that the arrangements currently in place to protect the Exchequer would be sufficiently robust.

Box 2.D: Government response

- The government is keen to ensure that changes to the tax regime do not introduce any unnecessary or disproportionate administrative burdens. The government welcomes industry's view that this allowance does not introduce such burdens.
- The government agrees with respondents that current arrangements to protect the Exchequer are sufficiently robust. As with other taxes, HMRC will continue to monitor this position as the industry develops and the allowance is used.

Level of allowance

2.22 The consultation did not propose a specific proportion of capital expenditure that would set the level of the allowance. Instead, it asked for evidence on the economics of shale gas projects to inform the government's position on the appropriate level. The consultation confirmed that in setting the level, the government would consider its objectives for the tax regime, in particular the need to incentivise early investment. The consultation asked:

Q7. Can you provide evidence on the potential economics and commercial framework of shale gas projects?

2.23 Most respondents noted the significant uncertainty around the project economics for shale gas in the UK. The economic viability of projects will depend on production levels, costs and prices.

Box 2.E: Government response

- The government welcomed the evidence provided by respondents, and noted the significant uncertainty around forecasts.
- The government has considered this evidence, together with evidence gathered prior to the consultation, and has decided to set the level of the allowance at 75 per cent. This level was set in light of the government's objectives for the shale gas tax regime, in particular the need to incentivise early investment.
- The government acknowledges that as the industry develops, and costs potentially decline, this rate may need to be revised. The rate will therefore be kept under review.

Scope

2.24 The consultation proposed extending the allowance to all onshore unconventional hydrocarbons, using the definition: "an extensive and continuous occurrence of petroleum which has not migrated from its source rock and is not significantly affected by hydrodynamic influence". It confirmed that if the allowance was extended, the government would propose removing the eligibility of these projects from all other field allowances.

2.25 The consultation also sought views on extending the allowance to all onshore hydrocarbon developments. It said that if the allowance was extended to all onshore hydrocarbon projects, the government would look to remove the eligibility of onshore projects from all other field allowances. The pad allowance would become the only allowance for onshore activities. The consultation asked:

Q8. Do you agree with the government's proposed approach of extending the pad allowance to cover all onshore unconventional hydrocarbons?

Q9. Do you agree with the proposed definition of unconventional hydrocarbons?

Q10. Do you think there is a case for extending the allowance to all onshore hydrocarbon projects? If so, please provide evidence to support your case. Might there be risks associated with this option?

Q11. If the allowance was extended to all onshore unconventional hydrocarbons, or to all onshore hydrocarbons, do you think there are any potential risks or unintended consequences of removing these projects from the scope of all current field allowances and instead providing the projects with the proposed pad allowance?

Q12. Do you have views on the impact of the tax regime on the longer-term potential for offshore shale gas or oil production?

Extension to all onshore unconventional hydrocarbons

2.26 Most respondents agreed that the allowance should be extended at least to all onshore unconventional hydrocarbons, though many supported extending further to all onshore hydrocarbons (see question 10 below). They noted that it seemed unnecessary and impractical to require a separate tax regime for shale gas, when these projects shared many similar characteristics with other unconventional hydrocarbon projects.

2.27 One respondent noted that the scope should also cover all pre-development related works. They argued that this would be important for an allowance that aims to encourage exploration and appraisal activities – which happen before development consent is granted by the relevant national authority.

Definition of unconventional hydrocarbons

2.28 A number of respondents largely agreed with the definition, but said more work was needed since it could be very widely, or incorrectly, interpreted. One respondent did not support a separate definition for unconventional hydrocarbons. They said introducing this would increase the complexity of applying the fiscal regime to different types of hydrocarbons which could be found in the same licence area.

Extension to all onshore hydrocarbon projects

2.29 Several respondents noted that during the course of the working groups, most participants had strongly favoured this option as it avoided the definitional challenges and would be simpler to operate than an allowance which distinguished between production from conventional and unconventional sources. It also recognised that most onshore oil and gas projects face similar commercial obstacles.

2.30 In the working groups, HM Treasury had said that an extension to all onshore hydrocarbons would likely require a production cap to ensure very large, commercially viable projects which did not require fiscal support were not eligible. Most respondents agreed that this was sensible, but one respondent noted that if a volume cap was included, it would be important that this was set at a sufficiently high level so as not to discourage full resource exploitation from large multi-well pads. A low volume cap, they said, could limit the amount of production that is economically viable at each pad.

2.31 One respondent said that replacing the current small field allowance with a pad allowance could be detrimental to conventional onshore developments, but noted that this would be dependent on the level of allowance set by the government. A number of respondents said that any decision to extend the allowance beyond shale gas should not undermine the government's stated aim of driving early investment in the shale gas industry.

Interaction with other field allowances

2.32 Several respondents noted that it would be important to introduce sufficient transitional arrangements if onshore projects became ineligible for other field allowances. Otherwise, there was a risk that the changes could operate detrimentally for investments already committed to, and as a disincentive to future investment in projects currently being considered.

Offshore

2.33 Most respondents agreed with the government's assessment that the development of offshore shale gas resources was unlikely to happen in the short term. However, one respondent said the government should start considering what fiscal incentive could be introduced to encourage exploration for offshore shale gas, and noted that the proposal in the consultation was unlikely to be directly transferable for offshore projects.

2.34 Another respondent commented that oil and gas in 'tight' rocks which require hydraulic fracturing exist offshore as well as onshore. They said the capital costs of developing these resources are typically higher than other types of offshore developments and are comparable to other challenging projects that have been supported by the field allowance mechanism. They suggested that offshore tight gas could benefit from targeted allowances, potentially along similar lines as the proposed new allowance.

Box 2.F: Government response

- The government has considered the views on scope expressed in response to the consultation. It has decided to extend the scope of the allowance to all onshore hydrocarbons. This decision is based on the significant difficulty of apportioning costs and production income from a single pad between conventional and unconventional sources and the similar cost characteristics and commercial obstacles faced by all onshore oil and gas projects.
- As discussed in the working groups, the government wants to ensure the allowance is appropriately targeted so as only to support projects that would not have gone ahead without it. Very large conventional oil or gas fields are likely to be commercially viable without fiscal support. The government will therefore introduce a production cap of 7 million tonnes of oil equivalent on the onshore allowance – in line with the upper limit of the current small field allowance.
- Projects which have a central estimate of reserves of 7 million tonnes of oil equivalent at the point of gaining project development approval will not qualify for the allowance. But any allowance generated from capital spend prior to approval of the development plan can still be activated and used.
- A company will stop being able to generate allowance where actual production exceeds the cap during the lifetime of a project. The government agrees to keep the level of this cap under review.
- In the case of conventional hydrocarbons, the cap will apply to the entire field, as determined by the relevant national authority (the Department of Energy and Climate Change or the Department of Enterprise, Trade and Investment in Northern Ireland), regardless of the number of drilling sites. For unconventional hydrocarbons, the cap will apply to the onshore drilling and extraction site (or "pad").
- The government did not receive evidence through the consultation to suggest that existing onshore projects require further fiscal support. Therefore, existing onshore projects which have already received development consent will not qualify for the onshore allowance, but will keep any other allowances they have already qualified for (such as the small field allowance). These projects were considered commercially viable prior to the introduction of the new allowance, so an extension to these would not assist in achieving the objective of incentivising early investment. However, the government is willing to review this decision in future, if companies provide evidence to suggest that there are incremental activities in existing projects that are economic but not commercially viable without support.
- The government accepts there is a case for introducing transitional arrangements for companies currently factoring other allowances into their project plans. Companies currently considering new projects have a legitimate expectation that the full range of field allowances will be open to them – subject to meeting the qualifying criteria. Therefore, where companies are considering projects but have not yet received development consent, they will be able to choose between existing allowances (for which their project qualifies) or the new onshore allowance. This transition period will last until the end of 2014. From 2015, new onshore projects will only qualify for the onshore allowance.
- The government agrees with respondents that it is too early to assess the potential for offshore shale gas production. However, the government will keep the case for fiscal support here, and for offshore tight gas, under review and will consider any evidence brought forward by industry.

Timing

2.35 As outlined in the consultation, the quickest that existing field allowances can be fully used is over five years, with a maximum of 20 per cent of the total allowance activated each year. The consultation asked:

Q13. Do you think that the five-year minimum activation period, which is a feature of existing field allowances, is appropriate for the pad allowance given the objectives set out in paragraph 3.2 (of the consultation document)? If not, can you provide evidence in support of an alternative rate of access to the allowance?

2.36 The majority of respondents who considered this question were in favour of reducing or removing the minimum activation period. One respondent noted that a complete removal of this activation period would be administratively simpler because it would negate the need to track multiple pools of allowance with different years of capital spend. Several respondents said that the uncertainties surrounding the production curve for UK shale plays meant that it was possible that a profile with a much higher upfront production rate, coupled with a higher decline rate could prevent the full value of the allowance being realised.

2.37 A minority of respondents thought that the current five year minimum activation period was appropriate for the proposed allowance.

Box 2.G: Government response

- The government accepts the case that, given potentially steep production decline rates, the five year minimum activation period risks leaving significant amounts of unactivated allowance, undermining its investment incentive.
- The government has therefore decided to remove the minimum activation period for the onshore allowance. Companies will be able to use the allowance as soon as it has been activated by production income.

Split between participants

2.38 The consultation noted that existing field allowances are divided between participants in a field in proportion to each company's share of equity in the field. But given the structure of the onshore allowance, the government proposed that each participant in a pad would generate their own allowance based on the capital expenditure they incur. The consultation asked:

Q14. Do you agree that the allowance should be split between participants in a pad based on actual expenditure incurred by each participator? If not, what do you consider to be a more appropriate method to split the allowance between the participants?

2.39 The majority of respondents agreed with the government's proposed approach. Respondents noted that the proposal fit well with the government's aims, by ensuring the allowance benefits investors who are taking the economic risk. One respondent said that in a case where the allowance could be received by parties who were not making the investment, it was possible that they could be incentivised to encourage unnecessary expenditure.

2.40 One respondent did not agree with the proposed approach, and suggested the allowance should be split based on equity share. They said equity share represents an equitable and true reflection of the respective contributions by the partners in a project. As such, it represents the fairest way to allocate the benefits from the proposed allowance between partners.

Box 2.H: Government response

- The government has considered the responses on how to split the allowance between participants. Since the onshore allowance is structured around the level of capital expenditure incurred, the government believes it is appropriate to split the allowance based on this actual spend. This approach is best to achieve the investment incentive the government is trying to create through the allowance.

3 Ring Fence Expenditure Supplement

3.1 At Budget 2013, the government committed to extend the Ring Fence Expenditure Supplement (RFES) for shale gas projects from six to ten accounting periods. RFES allows companies without profits in the oil and gas ring fence tax regime to uplift their losses by 10 per cent to maintain their time value until they can be set off against future profits. The extension for shale gas was designed to recognise the longer payback period for these projects. In the consultation, the government proposed to extend RFES from six to ten accounting periods for all onshore unconventional projects. The consultation asked:

Q15. Will companies be able to disaggregate their onshore unconventional hydrocarbon losses from wider company losses in order to make the further four RFES claims? Would doing so pose a disproportionate administrative burden?

Q16. Are there alternative approaches the government could consider for the administration for the extension of the Ring Fence Expenditure Supplement for onshore unconventional hydrocarbon projects?

Q17. Do you agree that the extension of the RFES should apply to all onshore unconventional hydrocarbon projects, using the definition set out in Box.4.A [of the consultation document]?

Disaggregation of onshore unconventional hydrocarbon losses

3.2 Most respondents said companies will be able to disaggregate their onshore unconventional hydrocarbon losses from wider company losses. One respondent noted that rules already exist within legislation for distinguishing between ring fence and non-ring fence activities, and the RFES legislation already has rules that deal with the distinction between losses that are non-qualifying, those which qualify for the Exploration Expenditure Supplement, and those which qualify for RFES. Therefore, it is unlikely that this further disaggregation would pose major difficulties. Several respondents noted that this disaggregation would introduce an additional administrative burden, but that it should be manageable.

Alternative approaches

3.3 Most respondents who considered this question were content with the government's proposal for the administration of the RFES extension. However, several noted that RFES should also be extended for offshore losses. They argued that the capital cost of exploration and development offshore is materially higher than for onshore projects.

3.4 A number of respondents said the government could introduce greater flexibility in the timing of the making and withdrawal of RFES claims. They commented that the current RFES regime could be viewed as slightly arbitrary, with companies having to predict their tax profile through the RFES period and having to make difficult judgement calls on when to make claims. This had the potential to undermine the intended investment incentive that RFES was designed to generate.

3.5 Several respondents said the introduction of an allowance was a more powerful mechanism for encouraging the development and production of shale gas than the RFES extension. As such, they advocated increasing the level of the allowance and abandoning the RFES extension.

Extension to all onshore unconventional hydrocarbon projects

3.6 Most respondents who responded to this question argued that the scope for the RFES extension should mirror the scope of the pad allowance to simplify the regime as far as possible.

Box 3.A: Government response

- The government will extend RFES from six to ten accounting periods for all onshore oil and gas losses and pre-trading expenditure. It believes that limiting the extension to just shale gas, or to unconventional hydrocarbons, would significantly increase the complexity of the onshore oil and gas tax regime. An extension to all onshore losses and pre-trading expenditure will reduce the administrative burden on companies, and acknowledges the similar commercial obstacles faced by all onshore activity.
- The government will continue to consider the case for an extension of RFES for offshore losses and pre-trading expenditure.

A Summary of working groups

Working group: UK Onshore Operators Group

Meeting date: 6 August, 2013

Meeting time: 3pm – 5pm

Location: HM Treasury

Agenda Item	Summary	Actions
Introduction	HMT outlined the timeline for the formal consultation period, which ends on 13 September. Companies were invited to meet with officials separately to discuss company specific issues, if this would be helpful. When the consultation closes, responses will be considered and a final policy announcement will be made in the autumn, with any necessary legislative changes included in Finance Bill 2014.	
Scope of the pad allowance and RFES extension	HMT outlined the proposal in the consultation document to extend the scope of the pad allowance and RFES extension to all onshore unconventional hydrocarbon projects. This extension was reliant on introducing a definition of unconventional hydrocarbons. During discussion, industry raised concerns that it would be technically impossible to accurately apportion costs between conventional and unconventional extraction from the same pad. HMT agreed to consider options to extend the scope of the regime to all onshore hydrocarbon projects, but would want to ensure that any large conventional projects that would not require support from a pad allowance, and therefore would pose significant deadweight to the Exchequer, were out of scope.	HMT: to consider possible options to extend scope of the regime to all onshore oil and gas projects.
Definition of a pad	HMT noted that the current definition of a pad in the consultation document is "the drilling and extraction site". While this may be sufficient for shale gas, any definition would also need to be suitable for coal bed methane and shale oil. Industry noted that the current definition was unlikely to suffice for coal bed methane, given that well sites were often spread over a much wider area. It would be important to remain consistent with whatever definition was used in the DECC licensing regime for the 14th round.	
Definition of capital	HMT confirmed that the consultation document currently proposes that, for the purposes of the pad allowance,	Working group:

expenditure "in relation to" a pad	capital expenditure would be limited to expenditure that attracts 100 per cent first year capital allowances. However, given previous discussions with companies, it was acknowledged that this may need to be extended to accommodate other spending unique to unconventional (or other onshore) developments. This would be consistent with the government's approach to the definition of capital expenditure in relation to the Brown Field Allowance. In discussion, industry identified some issues around the treatment of mid-life and terminal decommissioning costs. They also highlighted the potential for companies to drill exploratory wells separate to the main pad to gather better data about the subsurface – rather than to produce hydrocarbons. These costs would not be on the pad, but would be considered by companies to be 'in relation to' a pad. HMT agreed to consider industry proposals for additions to the definition of capital expenditure for this allowance. However, they would want to ensure that any decision around decommissioning costs would not introduce an incentive for companies to decommission wells earlier than necessary.	to send list of expenditure that HMT should consider for inclusion in definition of capex to UKOOG. **Working group:** to provide HMT with estimated costs for mid-life and terminal decommissioning costs, where possible.
Split between participants	HMT said it had proposed splitting the allowance between participants in a pad based on the actual capital expenditure that each participant incurs. This is in contrast to existing field allowances for new fields which are divided between participants in a field in proportion to each company's share of equity in the field. In the event of a change in licence interest, unactivated allowance would pass to the acquirer, in proportion to the share of the vendor's interest acquired in the pad. Activated allowance would remain with the vendor. The group was broadly content with this approach, subject to details on implementation.	
Industry views on possible variations	Industry raised an issue around the treatment of capital expenditure on unsuccessful pads. Given the proposed link to production income, capex on these pads would be stranded, and the risk of this could undermine the incentive to invest created by the pad allowance. They noted that early pads would be disproportionately impacted by large infrastructure costs. HMT said that it would need to see evidence that the risk of stranded capex was a material consideration in a company's investment decision.	**Working group:** to propose potential approach to cross-pad relief and evidence to demonstrate materiality of stranded capital.

Working group: onshore and offshore operators; tax and finance professionals

Meeting date: 13 August, 2013

Meeting time: 10am – 3pm

Location: 7 Down Street, London

Agenda Item	Summary	Actions
Introduction	HMT outlined the timeline for the formal consultation period, which ends on 13 September. Companies were invited to meet with officials separately to discuss company specific issues, if this would be helpful. When the consultation closes, responses will be considered and a final policy announcement will be made in the autumn, with any necessary legislative changes included in Finance Bill 2014.	
Scope of the pad allowance and RFES extension	HMT set out a proposal to extend the scope of the fiscal changes beyond unconventional hydrocarbons to all onshore hydrocarbons. This was in response to concerns raised previously that it would be difficult to apportion costs between conventional and unconventional hydrocarbons where they were extracted from the same pad. The proposal included a cap on production/expected reserves of 7 million tonnes, in line with the cap for the Small Field Allowance. If the scope of the changes was extended to all onshore hydrocarbons, HMT said it would propose making onshore projects ineligible for all other field allowances. This would require transitional arrangements for projects that currently qualify for the Small Field Allowance. The group was broadly comfortable that, subject to the detail of implementation, the proposal to extend the scope of the allowance with a production/expected reserves cap would help the government achieve its objectives for the tax regime.	Working group: companies with projects that currently qualify for the Small Field Allowance to consider proposed transitional arrangements and raise any issues with HMT as necessary.
Definition of a pad	HMT noted that the current definition of a pad in the consultation document is "the drilling and extraction site". While this may be sufficient for shale gas, any definition would also need to be suitable for coal bed methane and conventional projects. HMT proposed that, where a field determination was made by the Department of Energy and Climate Change (DECC), then this field would be considered one pad, even if it included multiple well sites. It was noted that it may be helpful to link the definition of a pad to a development that would be subject to a standalone Field Development Plan. DECC are currently working on what	DECC: to confirm proposed approach for unconventionals equivalent of Field Development Plans. HMT: to consider

	the equivalent will be for unconventional pads in the case where there is no field determination. Subject to this work, it may be possible to identify a pad by reference to an FDP and unconventional equivalent.	linking definition of pad to standalone FDP and unconventional equivalent.
Definition of capital expenditure "in relation to" a pad	HMT confirmed that the consultation document currently proposes that, for the purposes of the pad allowance, capital expenditure would be limited to expenditure that attracts 100 per cent first year capital allowances. However, given previous discussions, it was acknowledged that this may need to be extended to accommodate other spending unique to unconventional (or other onshore) developments. This would be consistent with the government's approach to the definition of capital expenditure in relation to the Brown Field Allowance. In discussion, industry noted that certain lease costs should be included in the definition, particularly for compressors. Issues were also identified around shared infrastructure and mid-life and terminal decommissioning costs. HMT agreed to consider industry proposals for additions to the definition of capital expenditure for this allowance. However, they would want to ensure that any decision around decommissioning costs would not introduce an incentive for companies to decommission wells earlier than necessary.	Working group: to send list of expenditure that HMT should consider for inclusion in definition of capex to UKOOG. Working group: to provide HMT with estimated costs for mid-life and terminal decommissioning costs, where possible.
Evidence on potential economics of shale gas projects	HMRC outlined what data it would be useful to receive from companies in their consultation responses. The group noted that the data provided would be speculative given the lack of exploratory wells drilled.	HMRC: to circulate list of information it would be useful for respondents to submit with their consultation responses.
Production income	HMRC noted that existing field allowance legislation defines relevant income as "production income of the company from any oil extraction activities carried on in the field that is taken into account in calculating the company's adjusted ring fence profits for the accounting period". The government proposed to use the current definition, which would include arms length sales, non arm's length sales, capacity payments but not reinjected gas or tariff receipts. Industry asked for clarification on how payments made through the EMR capacity mechanism would link to	HMT: to confirm how payments made through the capacity mechanism would be treated.

	this definition.	
Split between participants	HMT said it had proposed splitting the allowance between participants in a pad based on the actual capital expenditure that each participant incurs. This is in contrast to existing field allowances for new fields which are divided between participants in a field in proportion to each company's share of equity in the field. In the event of an acquisition, unactivated allowance would pass to the acquirer, in proportion to the share of the vendor's interest acquired in the pad. Activated allowance would remain with the vendor. The group was broadly content with this approach, subject to details on implementation.	
Ring Fence Expenditure Supplement	HMRC reiterated the government's approach to extending the Ring Fence Expenditure Supplement as outlined in the consultation document.	
Industry views on possible variations	Following previous discussions with industry, HMT said that it had considered the issue of a cross-pad allowance, which would give some relief to unsuccessful pads. This would be a policy issue for ministers; no decision had been taken on this issue. However, should ministers decide that cross-pad relief would help the government achieve its objectives for the tax regime, it would be important to have an effective mechanism for delivering this. HMT outlined a proposal that would allow companies to transfer a portion (say, 60 per cent) of the capital expenditure they incur on an unsuccessful pad to a successful one. The group said that any stranded capital in an unsuccessful pad could undermine the incentive effect of the allowance. They agreed to make an alternative proposal. HMT asked for evidence to demonstrate that stranded capital would have a material impact on companies' investment decisions.	HMT: to circulate date for cross-pad relief meeting. **Working group:** to propose potential alternative approach to cross-pad relief and evidence to demonstrate materiality of stranded capital.
AOB	HMT outlined current rules for reinvestment relief within the oil and gas ring fence. They noted that an issue had been identified with companies operating offshore around the restriction of relief to companies that have commenced a trade. They asked whether this could pose a problem for onshore operators. The group said that this could be an issue for onshore operators, and that an extension to companies preparing to commence a trade would be welcomed. HMT said they would consider this in more detail.	

Working group: onshore and offshore operators; tax and finance professionals

Meeting date: 23 August, 2013

Meeting time: 2pm – 3.30pm

Location: HM Treasury

Agenda Item	Summary	Actions
Introduction	HMT said that it had considered the issues raised in previous working groups about the need for some form of cross pad relief that would ensure large amounts of allowance were not stranded in unsuccessful pads. While there was still no commitment that cross pad relief would be introduced, HMT wanted to consider with industry the possible options for this relief if evidence suggested it was necessary to achieve the government's objectives. HMT noted that in previous meetings, industry had said that allowing companies to transfer anything less than 100 per cent of the allowance generated on unsuccessful pads could undermine the incentive effect. However, HMT said that if cross pad relief was to be introduced, it would need to either include a discount or a time delay – to ensure that the allowance didn't unintentionally incentivise companies to withdraw from unsuccessful pads prematurely.	
Cross pad relief	Industry reiterated the importance of introducing cross pad relief. Without it, they argued, companies would need to introduce a discount on the value of the allowance in their investment decisions. It would increase uncertainty about the availability of the allowance and undermine its investment incentive. They said that in the early stages of the industry there was a high risk of unsuccessful pads. If these pads did not generate any allowance, then companies would be less likely to undertake the significant investment required to fully explore the UK's shale resources. Industry acknowledged that there may need to be a time delay on cross pad relief, given the government's concerns around incentivising companies to withdraw from unsuccessful pads before they had been fully appraised. They said a time delay was preferable to a discount on the amount of allowance that could be transferred because it was a simpler approach, was easier to model and would ensure that companies don't write off any stranded capital expenditure (except in the case where their successful pads do not produce enough to activate all allowance from unsuccessful pads).	

	They argued for a short time delay of two or three years. They said this would ensure there was no acceleration of relief in comparison to the scenario in which all pad developments were successful, based on current industry estimates of the average production profile. Industry noted that there would still be a link to success because companies would not be able to activate any allowance over and above their total onshore shale gas production. If a company is unsuccessful on all pads, they would not generate any allowance. Therefore, the allowance does not reward failure and has a built-in mechanism for protecting the taxpayer. Industry said that while cross pad relief would add an element of complexity to the regime, it would result in a simpler mechanism to understand and apply in concept, since investors would have greater confidence that investment would result in an allowance. HMT said that it would consider a possible mechanism to introduce cross pad relief with a time delay, but would need to see firm evidence in consultation responses that this would materially impact investment decisions.	

B List of respondents

3 Legs Resources
BDO LLP
BP
Brindex
Celtique Energie
Centrica
Cuadrilla
Deloitte
Ernst & Young
Friends of the Earth
GFrac Technologies
IGas
Maersk Oil
MMP Tax Ltd
Oil & Gas UK
Perenco
PwC
Total
Trapoil
UKOITC
UKOOG

There were also 12 responses from individuals.

HM Treasury contacts

This document can be downloaded from www.gov.uk

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