HM Treasury

# Driving investment:

## a plan to reform the oil and gas fiscal regime

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# Contents

# Foreword

The UK oil and gas sector is one of the country's greatest industrial success stories. It remains the largest industrial investor, provides just over half of the UK's primary energy needs and supports hundreds of thousands of jobs. However, the oil and gas remaining is becoming increasingly difficult and expensive to extract and shifts in the global oil and gas landscape may make it harder to continue to attract global capital without substantial improvements in the fiscal and regulatory landscape.

The UK is fortunate to have access to significant oil and gas reserves. Sir Ian Wood's definitive report on maximising economic recovery set out the size of the prize, with around a quarter of the UK's offshore oil and gas still to be exploited. That is why at Budget 2014 the Chancellor announced a review of the oil and gas fiscal regime to ensure it is consistent with the principles of Sir Ian's report and to enable the UK Continental Shelf (UKCS) to compete in the global race for investment.

This document sets out the conclusions of that review: a radical plan to reward investment in the UKCS at all stages of the industry life cycle. It recognises that to maximise investment we need to reduce the overall tax burden facing the industry, and sets out long-term principles for the future that we believe the government and industry can both buy into as well as specific actions to ensure a more competitive, simple and predictable fiscal regime.

This package of measures will ensure the UKCS continues to attract investment. And fiscal reform will be accompanied by a stronger regulatory regime. But action by government can at best be part of the solution. There are also challenges for industry to address and as it delivers these reforms the government will expect the industry to make significant improvements in production operations, cost-efficiency and commercial practices in line with the objective of maximising economic recovery.

Engagement with stakeholders has been key to this review and we were very encouraged by the high level of engagement we received in response to our call for evidence. Clearly the industry is facing challenges, but there are many companies who see a strong future for themselves in oil and gas production in the UK.

We are confident that the changes we are making recognise the continuing importance of a successful oil and gas sector to the UK economy and send a clear signal that it is part of a UK that is open for business. We look forward to continuing the dialogue with interested stakeholders as we move into implementation of these reforms.

Rt Hon Danny Alexander MP
Chief Secretary to the Treasury

Priti Patel MP
Exchequer Secretary to the Treasury

# Executive summary

At Budget 2014 the government committed to review the long-term future of the oil and gas fiscal regime. The government's objective in undertaking this review has been to ensure that the UK's tax treatment of the UK Continental Shelf (UKCS) continues to support maximising economic recovery as the basin matures. Over 2014, HM Treasury has sought views on how the government should best adapt the regime to the changing economics of the UKCS, create fiscal stability, help the UKCS compete for investment, simplify the regime and ultimately use the regime to help maximise economic recovery. This document sets out the government's initial conclusions.

There remain significant hydrocarbon reserves within the UK and UKCS, which if recovered will generate significant benefits for the UK. The government estimates that there remain between 11 and 21 billion barrels of oil equivalent (boe) offshore, of which industry experts estimate around 15 to 16.5 billion boe is economically recoverable. And there could also be significant potential onshore. Offshore production will continue for many decades to come, and offers opportunities for companies to develop new techniques that can be utilised in other regions. For the UK, production brings a wide range of benefits including a stronger balance of payments position, improved energy security, and high-value jobs. It also supports a world class supply chain. And a healthy oil and gas sector will continue to be important for the public finances: the Office for Budget Responsibility (OBR) forecasts a significant difference of £28 billion in expected tax revenues between a low and high production future.

As part of the review, the government conducted a call for evidence, the key findings of which are that:

- the fundamentals of the fiscal regime remain sound, but now is the time for significant change within the ring fence in order to continue to attract investment
- UKCS operators are facing strong competition for scarce investment whilst the economics of the basin have changed fundamentally, with implications for the overall level of tax
- there are opportunities to simplify the fiscal regime to provide greater certainty, lower administrative burden, and fewer distortions

The government's view is that current levels of investment cannot be maintained without fiscal change. The trend towards smaller fields and higher costs implies that typical projects in the UKCS will struggle to attract investment in a competitive global environment. Now is the time to make that change to ensure the UKCS can compete for global capital.

This document therefore sets out a radical plan for reform of the fiscal regime. The reforms are designed to support the government's twin objectives of maximising the economic recovery of hydrocarbon resources whilst ensuring a fair return on those resources for the nation. Underpinning these reforms and future oil and gas fiscal policy are the following principles:

- to be consistent with the objective of maximising economic recovery as new projects become ever more marginal, the overall tax burden will need to fall as the basin matures

- when making judgements about fiscal policy, the government will consider the wider economic benefits of oil & gas production, in addition to revenues
- the government's judgement of what constitutes a 'fair return' will take account of the global competitiveness of commercial opportunities in the UK and UKCS, and take account of both commodity prices and costs

The reforms set out in this document will help the UKCS compete for investment, and will encourage exploration, promote effective asset stewardship and provide the right conditions for cost-effective decommissioning. The key changes are:

- an immediate 2% reduction to the rate of the Supplementary Charge from 32% to 30%, to demonstrate the government's commitment to reducing the overall tax burden of the industry, with the ambition of reducing the rate further in future in an affordable way
- the introduction of a basin-wide 'Investment Allowance' to reduce the effective tax rate further for those companies investing in the future of the UKCS. A consultation will be published in early 2015
- an immediate extension of the ring fence expenditure supplement from six to ten accounting periods to ensure companies already investing in the UCKS are given every support to continue
- financial support for seismic surveys in under-explored areas of the UKCS, working with industry on options for shared funding models. Details will be set out at Budget 2015
- further work on options for supporting exploration through the tax system, such as a tax credit or similar mechanism, in a way that is carefully targeted and affordable. The government will open discussions with industry and the new Oil and Gas Authority (OGA), once established, in 2015
- development of options to improve access to decommissioning tax relief and work with the OGA to consider options for reforming the fiscal treatment of infrastructure, with further consultation with industry in 2015

Together, these measures represent a radical plan to reward investment in the UKCS at all stages of the industry life cycle. These reforms will make the fiscal regime more competitive, simpler and more predictable and represent the most balanced and investment-focused way to move to a lower tax burden over time. They will support billions of pounds of investment throughout the lifecycle of fields.

These reforms demonstrate the government's commitment to the tripartite approach recommended in the Wood Review[1]. Action by government must be matched by action by industry and the government expects the industry to make significant improvements in production operations, in improving its cost-efficiency, and in commercial practices in line with the objective of maximising economic recovery, and will ask the OGA to monitor and report on industry's progress in these areas.

[1] 'UKCS Maximising recovery review: final report', Sir Ian Wood, February 2014

# 1 Introduction

1.1 At Budget 2014 the government announced it would review the UK's tax treatment of the North Sea to ensure that it continues to incentivise economic recovery as the basin matures. This chapter outlines the background to the review, the work that has been completed and the structure of the rest of this document.

## The UK's oil & gas resources

1.2 The UK has been a major producer of oil and gas since the 1970s. To date, production in the UK and UKCS has totalled around 42 billion barrels of oil equivalent (boe). The UK government's objectives for managing the UK's oil and gas reserves are twofold:

- to maximise the economic recovery of hydrocarbon resources
- to obtain a fair share of the value of those resources for the nation, primarily through taxation

1.3 Maximising the economic recovery of the UK's oil and gas resources remains an important goal, even as the UK moves towards a less carbon-intensive future. Hydrocarbons will continue to play a role in the energy system for several decades to come, and the government estimates that the UK will still get 70% of its energy from oil and gas in 2030.

1.4 The government estimates that there remain reserves of between 11 and 21 billion boe offshore, and significant potential onshore reserves as well. Sir Ian Wood has suggested that recovering 15 to 16.5 billion boe offshore is a realistic ambition, consistent with maximising economic recovery.[1] These reserves remain a significant resource, and recovering these resources in an economically efficient way will bring wide economic benefits for the UK. These benefits would include an improved balance of payments position, more secure energy supply, a stronger supply chain industry, and continued highly skilled and well paid jobs in many regions of the UK.

## The oil and gas industry

1.5 Around 125 groups of companies are now involved as licensees in offshore exploration and production. The industry is diverse, ranging from major global companies to UK-focused operators and small exploration specialists. It continues to be the UK's largest single industrial sector.[2]

1.6 As the UKCS basin matures recovering the remaining oil and gas offshore is becoming more difficult. In recent years, the offshore industry has faced a growing challenge to maintain production, which has fallen 38% since 2010, and exploration, where rates have been low since 2009.[3] A number of factors are contributing to these outcomes, including:

- new fields are generally smaller, harder to find and more technically challenging to exploit
- extending the production of old fields often entails making significant investment in existing pipelines, platforms and hubs to extend their lives. This is also an issue for many new small fields, which require access to existing infrastructure if they are to

[1] Sir Ian Wood, statement to the industry publication Energy Voice on 20 August 2014
[2] 21% of industrial production by Gross Value Added
[3] DECC estimate

be economic to develop. Without investment, this key infrastructure will be decommissioned earlier than necessary, potentially meaning recoverable resources are left stranded

- at the same time, the UKCS has to compete for global investment capital. Numerous less mature basins overseas offer more commercial opportunities, such as Norway, West Africa and North America

1.7 The UK also has a significant onshore oil and gas industry. Western Europe's largest onshore oil and gas field is in Dorset, at Wytch Farm. Over the last 30 years more than 2,000 wells have been drilled onshore in the UK and approximately 200 of these have been hydraulically fractured (or 'fracked'). The UK's shale gas industry is in its infancy, but has the potential to make a significant contribution to the UK's future energy supply. The scale of this potential was highlighted in a report published by the British Geological Survey (BGS) on 27 June 2013 which estimated that the total volume of gas 'in place' in the Bowland Hodder shale in the north of England is approximately 1,300 trillion cubic feet (central estimate). The BGS study is the first in the UK to provide investors, operators and regulators with an indication of where to target future exploratory drilling, which will be required to determine the extent of gas that can be technically and commercially recovered.

## A tripartite approach to maximise economic recovery

1.8 In light of the challenges facing the offshore industry, the government commissioned Sir Ian Wood to review how to maximise the economic recovery of oil and gas from the UKCS. The Wood Review recommended a new tripartite strategy for maximising economic recovery involving HM Treasury, industry, and a new independent regulator with additional powers and resources. In response, the government has established a new regulator, the Oil and Gas Authority, to be set up in shadow form in early 2015 under the leadership of Andy Samuel.

1.9 The government agrees with the need for a tripartite approach. Within that, HM Treasury's role is to ensure that the oil and gas fiscal regime, which applies both offshore and onshore, supports the goal of maximising economic recovery. The government has taken a range of fiscal measures in support of this goal. Offshore, the government has expanded the system of field allowances to enable development of marginal projects, and introduced Decommissioning Relief Deeds to ensure uncertainty over future tax relief for decommissioning does not tie up capital which could otherwise be available to invest. Onshore, the government has introduced a new allowance for onshore oil and gas projects.

## The oil & gas fiscal review

1.10 In addition to the above measures, at Budget 2014 the government committed to review the long-term future of the fiscal regime. The government's objective in undertaking this review has been to ensure that the UK's tax treatment of the UKCS continues to support maximising economic recovery as the basin matures.

1.11 Over 2014, HM Treasury has taken a thorough look at the fiscal regime. The Treasury has engaged extensively with the industry and its supply chain, providers of finance to the industry, DECC, HMRC, BIS and other stakeholders. Central to this was a call for evidence that ran from July to October, which sought views on how the government should best adapt the regime to the changing economics of the UKCS, create fiscal stability, help the UKCS compete for investment, simplify the regime and ultimately use the regime to help maximise economic recovery. The Treasury received nearly 60 responses, and held meetings with over 50 stakeholders.

1.12 This document sets out the government's initial conclusions. It explains the government's assessment of the case for fiscal reform. It establishes some new principles that will guide fiscal policy in future, and a direction of travel for headline tax rates. It sets out some immediate changes to the regime and indicates other areas where the government is considering reform but on which further work is needed.

1.13 The reforms set out in this document will apply to the whole of the UK's oil and gas production. The focus of the review has been the taxation of offshore production, so much of this document focuses on issues specific to the UKCS. However, certain changes in the regime will be relevant for onshore developments too. Following the conclusions of the Smith Commission, the government has no plans to devolve the fiscal regime and companies will continue to operate under a single set of rules.[4]

1.14 The remainder of this document is structured as follows:

- Chapter 2 summarises the government's assessment of the opportunities remaining in the UKCS for the UK and for industry
- Chapter 3 briefly describes the current fiscal regime and the government's assessment of the case for reform
- Chapter 4 lays out the government's plans for reform of the fiscal regime
- Annex A summarises the responses to the government's call for evidence
- Annex B lists the respondents to the call for evidence

[4] 'Report of the Smith Commission for further devolution of powers to the Scottish Parliament', The Smith Commission, November 2014

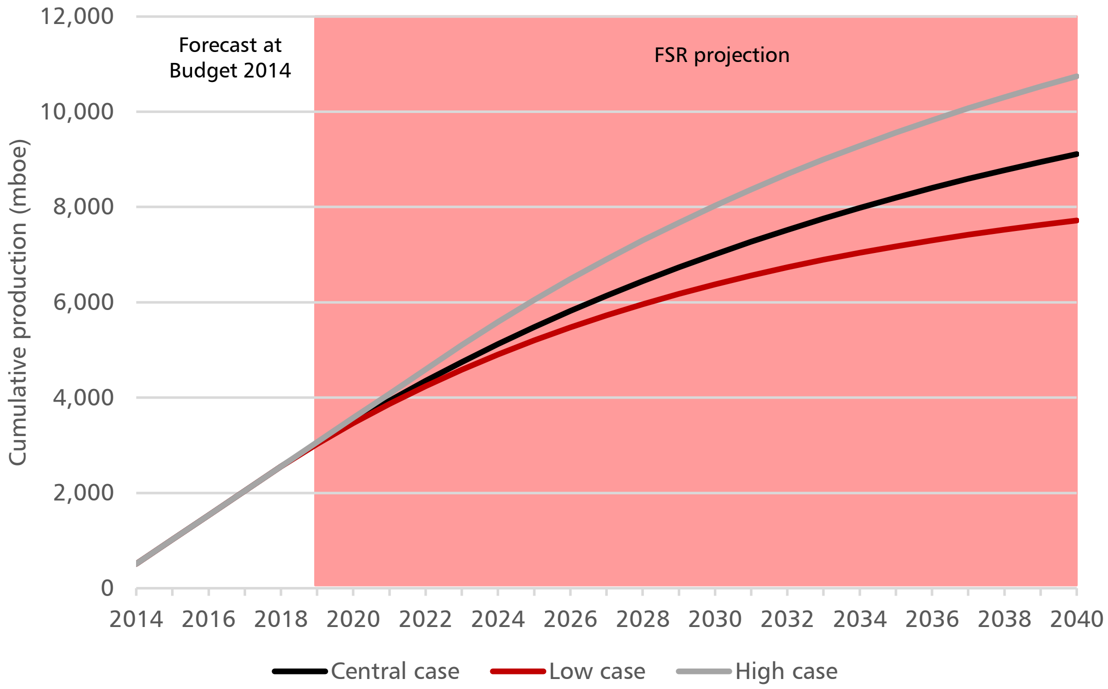
# 2 The future of the UK Continental Shelf

2.1 This chapter summarises the government's assessment of the opportunities remaining in the UKCS for the UK and for industry, setting the context for an assessment of the case for change in the fiscal regime set out in Chapter 3.

## Future production from the UKCS

2.2 Production will continue for many decades to come, but is expected to decline gradually as the reserve base is depleted. In the long-term production will depend on a range of factors including global oil and gas prices, the industry's cost base, the level of investment the UKCS can attract from global investors, and the success of new technologies in accessing harder to reach resources. For this reason, in its annual Fiscal Sustainability Report the OBR makes forecasts of North Sea tax receipts for high, central and low production scenarios. Based on the OBR's most recent long term forecasts, production from 2014 to 2040 inclusive is expected be 9.1 billion boe in a central case, 7.7 billion boe in a low case and 10.7 billion boe in a high case (Chart 2.A).[1] So there would be a significant difference of 3 billion boe between a low production and high production future, and all of these projections would fall short of maximising economic recovery, on which Sir Ian Wood has suggested that recovering 15 to 16.5 billion boe is a realistic ambition.

**Chart 2.A: OBR scenarios for future production, 2014 onwards**




*Source: DECC, OBR*

[1] DECC estimates, based on OBR forecasts

## The opportunities for the exploration and production industry

2.3 The maturity of the basin brings commercial challenges but also opportunities. Not only are there significant resources still to be recovered, but operating in the UKCS provides opportunities to develop and test new techniques and technologies that can be utilised in other regions. The UK is a global centre of expertise for offshore hydrocarbon basin exploitation and is well placed to be at the forefront of the development of technologies in areas such as geoscience, reservoir management, enhanced recovery, deep water and subsea.

2.4 As some fields reach the end of their life, decommissioning will become a major focus of activity in the basin. This will also bring opportunities to develop skills and expertise that can be deployed to other basins. The infrastructure of the UKCS may also support the development of carbon capture and storage, potentially including the ability to combine carbon capture with enhanced oil recovery techniques using $CO_2$.

## Economic benefits to the UK

2.5 Oil and gas production from the UKCS brings a wide range of benefits to the UK economy, all of which add to the importance of maximising economic recovery. In 2013 indigenous oil and gas production was just over 0.5 billion boe, enough to improve the UK's balance of payments position by £28 billion or 1.7% of GDP. Gas production from the UKCS means the UK requires less gas storage than it otherwise would do in order to maintain security of supply. The industry supports many highly paid and high-value jobs, with direct employment of 36,000 and employment in the supply chain of over 200,000.[2]

2.6 Supporting the exploration and production industry is a world leading supply chain based across the UK, but especially in and around Aberdeen and North East England. The UKCS supply chain has a competitive advantage in a number of areas – especially high value-added and subsea technologies. These include those areas specialising in new technologies that are relevant to mature regions such as ultra-high pressure, high temperature drilling and tight gas. The local opportunities provided in the UKCS enable many supply chain companies to scale up their business and develop new technologies that then form the basis of successful export operations. In 2012 alone exports from the supply chain have been estimated to be in the region of £14.8 billion.[3]

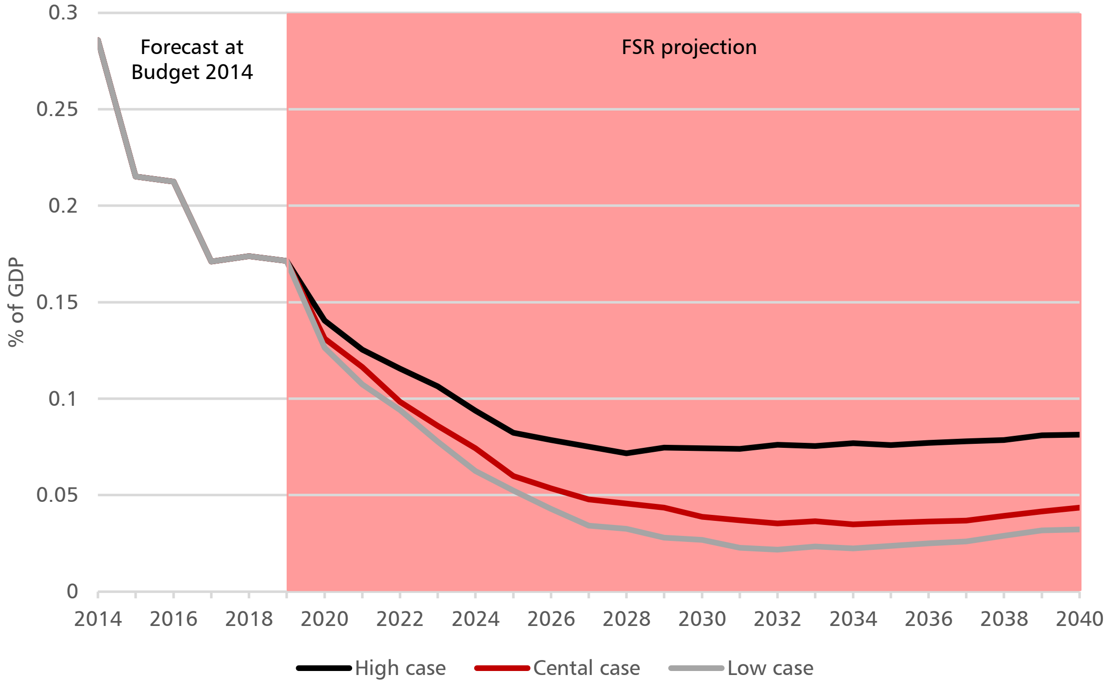
[2] 'UK upstream oil and gas supply chain: Economic contribution', Ernst and Young, April 2014. Not all of these jobs are dependent on the UKCS, as exports account for over 40% of turnover in the supply chain.

[3] 'UK upstream oil and gas supply chain: Economic contribution', Ernst and Young, April 2014

## Future receipts

2.7 In addition to the economic benefits, the UKCS will continue to be an important source of tax revenues. In the context of declining production and margins, it is inevitable that receipts will gradually decline. But OBR forecasts suggest there is significant difference of £28 billion in expected revenues over 2020 to 2040 between a low and high production future. Chart 2.B shows the difference this would make in proportion to GDP. This demonstrates the continued importance of a healthy oil and gas sector to the public finances.

**Chart 2.B: OBR forecasts of annual tax revenues from oil and gas under different production scenarios**




*Source: OBR Fiscal Sustainability Report 2014*

# 3 The oil and gas fiscal regime and the case for reform

3.1 This chapter briefly describes the current regime and sets out the government's assessment of the case for reform, which has been informed by the call for evidence issued in July 2014.

## The current regime

3.2 The fiscal regime which applies to the exploration and production of oil and gas in the UK and UKCS currently comprises three taxes:

- Ring Fence Corporation Tax (RFCT) – This is calculated in the same way as the mainstream corporation tax applicable to all companies but with the addition of a "ring fence". The ring fence prevents taxable profits from oil and gas extraction in the UK and UKCS from being reduced by losses from other activities or by excessive interest payments. The current rate of tax on ring fence profits, which is set separately from the rate of mainstream corporation tax, is 30%.
- Supplementary Charge – This is an additional charge, currently set at a rate of 32%, on a company's ring fence profits (but with no deduction for finance costs).
- Petroleum Revenue Tax (PRT) – This is a field-based tax charged on profits arising from oil and gas production from individual oil fields which were given development consent before 16 March 1993. There are around 100 such fields still producing in the UKCS, of which the majority (around 60) have never been profitable enough to pay PRT. The current rate of PRT is 50%; PRT is deductible as an expense in computing profits chargeable to RFCT and the Supplementary Charge, leading to marginal tax rates set out in Box 3.A.

**Box 3.A: Marginal tax rates**

The combined effect of the current fiscal regime is a marginal tax rate of:

- 81% on profits from PRT-paying fields
- 62% for other fields

## The case for reform

3.3 In order to judge the appropriateness of the current regime and the case for change, in July 2014 the Treasury issued a call for evidence seeking views on how the government should best adapt the regime to the changing economics of the UKCS, create fiscal stability, help the UKCS compete for investment, simplify the regime and ultimately use the regime to help maximise economic recovery.

3.4 The key findings of the call for evidence are that:

1 The fundamentals of the fiscal regime remain sound, but now is the time for significant change within the ring fence in order to attract investment

2 UKCS operators are facing strong competition for scarce investment whilst the economics of the basin have changed fundamentally, with implications for the overall level of tax

3 There are opportunities to simplify the fiscal regime to provide greater certainty, less administrative burden, and fewer distortions

The rest of this chapter summarises these findings. More detail on the responses to the call for evidence is at Annex A.

## The fundamentals of the fiscal regime

3.5 Countries around the world take very different approaches to sharing the profits of natural resource extraction. The government's view when establishing this review was that the UK's approach, based on taxation of ring fenced profits, remained sound. The UK's approach is similar to many other developed nations though each tax regime differs in its detail. The government has not received evidence that would suggest the UK should radically change its approach. The review has therefore focused on what would be the most appropriate structures and tax rates within the ring fence regime.

3.6 Within the regime, there are clearly some aspects that are working well. Oil and gas production is highly capital intensive and so the tax treatment of capital expenditure is a key element of the regime. 100% first year capital allowances are available for virtually all capital expenditure, and it is clear that this remains a vital element of the regime. Tax relief is also available for expenditure on decommissioning, and the introduction of Decommissioning Relief Deeds from 2013 was a welcome move to ensure uncertainty over future tax relief for decommissioning does not tie up capital which would otherwise be available to invest. The introduction of field allowances, which reduce a company's liability to the Supplementary Charge if certain qualifying criteria are met, has supported significant investment in commercially marginal developments (though as explained below there is a case for making changes to the current field allowance model). More generally, stakeholders have also welcomed the level of engagement they have had with the Treasury and HMRC on fiscal issues in recent years.

3.7 **The government's position is that the structures of the ring fence regime remain sound. The government intends to make radical reform but within the ring fence structure.**

## The competition for scarce investment and the changing economics of the basin

3.8 Conditions for the global oil and gas industry are challenging. In recent years it has faced structural challenges including a shortage of key equipment, greater competition for skills and cost escalation in the supply chain. As a result, global corporates have been looking to refocus their portfolios on regions where they can best maximise shareholder value. And for small firms, since the financial crisis of 2008 access to finance has become more difficult for reasons both specific to and wider than the industry.

3.9 UK operators large and small need to compete for capital at a global level. In major and mid-tier companies, major projects are typically sanctioned at board level, following comparisons of opportunities across global portfolios. Similarly, small firms need to attract finance from investors with a global outlook, whether that be from banks or private equity.

3.10 Areas that have been the focus of global investment flows have included North American onshore opportunities, where returns are much more immediate than offshore developments, and new offshore fields in Africa and South America, where there are opportunities of significant scale. It would be challenging for the UKCS to compete directly with these areas on returns alone, given the high costs and relatively small size of its opportunities.

3.11 Where the UKCS must be competitive is with other relatively mature offshore basins in politically stable countries. To spread risk, many companies and investors will continue to want to have interests in such areas, as long as there are commercial opportunities.

3.12 A clear message coming from responses to the call for evidence is that UK operators are increasingly finding that they are struggling to compete for capital. A number of companies disclosed where their UK projects sat within their global portfolios, and were able to demonstrate that, despite the current record level of investment in the UKCS, investment decisions are increasingly favouring other areas over the UKCS. Essentially, this is because rates of post-tax return in the UKCS do not currently compare favourably to many other regions. Responses to the call for evidence suggest that typical rates of return on projects in the UKCS are currently around 15%, compared to 20 to 25% for other relatively mature offshore basins in politically stable countries. Rates of return in onshore developments in North America can be considerably higher still.

3.13 The reasons for the relatively lower returns to be found in the UKCS include the size of opportunities, and the cost of production.

- **Size of opportunities.** Having been producing significant quantities of oil and gas since the 1970s, the UKCS is a mature basin by international standards. Production in the early decades came from large fields of up to three billion boe, but much of the remaining resources will be found in small developments offering only ten million boe or less, although larger fields will occasionally still be found.
- **Cost of production.** The costs of operating in the basin have risen significantly over recent years. Average operating and capital costs per barrel increased by 62% between 2011 and 2013,[1] significantly more than in comparable basins. The drivers of this include:
  - the fixed costs of maintaining infrastructure are being spread over fewer barrels of production
  - the higher costs of running infrastructure that in some areas is operating well beyond its original expected life
  - the technical and physical challenges of operating in remote areas like the West of Shetland
  - the need to use new technologies and methodologies, such as Enhanced Oil Recovery, to achieve greater production

3.14 Sir Ian Wood's Maximising Economic Recovery report[2] also identified some aspects of industry behaviour, such as lack of collaboration on access to processing and transport infrastructure or poor planning and execution efficiency, as contributing to rising costs.

3.15 The other key determinant of project economics are oil and gas prices. Having remained at historically high levels from 2010 to summer 2014, prices have fallen by nearly one third over recent months and are currently at or below the price many companies use to evaluate project economics, implying that some proportion of projects may now not go ahead as planned.

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1 'Economic Report 2014', Oil & Gas UK, October 2014

2 'UKCS Maximising recovery review: final report', Sir Ian Wood, February 2014

Meanwhile, the oil equivalent price of gas remains below that of oil, creating additional barriers in making gas projects commercial.

3.16 It is very difficult to forecast what will happen to oil and gas prices over the long-term and what impact that will have on the economics of the basin. What is certain is that the smaller size of opportunities and higher cost environment means that projects in the UKCS are highly sensitive to fluctuations in oil price and cost of production.

3.17 Attracting investment will be even more vital given the high cost environment. Each pound of investment achieves considerably less than in previous decades. For example, in 2013 the cost of each exploration well was around £70 million, having been £20 million or less for most of the 2000s.[3] So though levels of investment in the UKCS reached record levels in nominal terms in 2013, in real terms investment is achieving rather less.

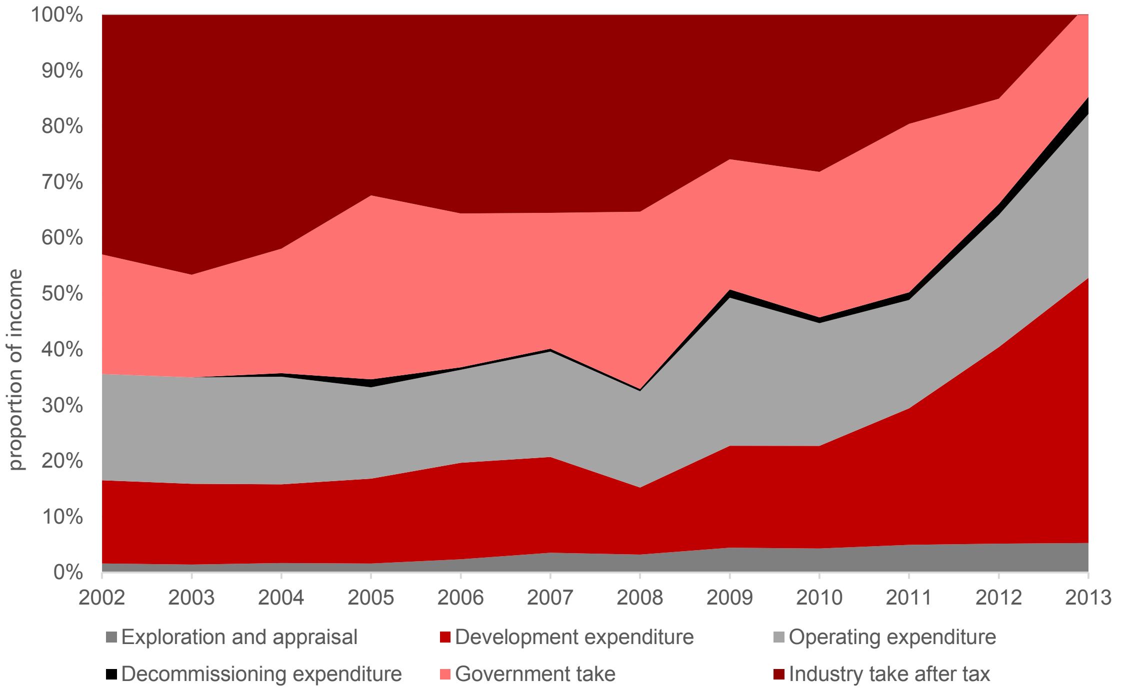
3.18 The final determinant of returns on investment is the fiscal regime. The government has already taken action to support investment by introducing new field allowances. Of £14.4 billion investment in the UKCS in 2013, around £7 billion was in fields receiving an allowance. All new fields approved since the start of 2012 bar one have qualified for an allowance. And, since its introduction in September 2012, all bar a handful of the 50 or so projects in existing offshore fields receiving development approval have qualified for the Brown Field Allowance.[4]

3.19 The impact of field allowances demonstrates the impact tax changes can have, but there is a need for additional action. The most recent survey of industry investment intentions, conducted around a year ago and thus well before the recent steep fall in oil prices, suggests that development capital expenditure could fall by 40% or more by 2018. Taken as a whole, the industry's post-tax cash position in 2013 was negative: all income was either soaked up by operating and decommissioning costs, reinvested in capital expenditure or exploration, or taken in tax (Chart 3.A). Though the current levels of investment are welcome, this is clearly an unsustainable position as companies do need to generate returns to their shareholders whilst continuing to invest.

[3] 'Economic Report 2014', Oil & Gas UK, October 2014

[4] DECC figures

**Chart 3.A: Industry and government share of gross income from the UKCS, 2002 to 2013**




Though the industry's post-tax cash position in 2013 was negative overall, this does not imply that no profits were made. Some companies did make profits and paid tax on them. However, in aggregate capital investment, operating costs and taxes paid exceeded total income generated across the basin.

*Source: DECC*

3.20 **The government's view is therefore that current levels of investment cannot be maintained without fiscal change. The trend towards smaller fields, higher costs and greater sensitivity to price fluctuations implies that typical projects in the UKCS will struggle to attract investment in a competitive global environment. This means that the overall tax burden on the industry will need to fall as projects become more marginal, in order to achieve the goal of maximising economic recovery. The government accepts that this will be a principle of the regime over decades to come.**

## The regime has become overly complex, and risks distorting investment

3.21 In recent years opportunities in the UK and UKCS have become more varied, with developments involving quite different geology, technology and infrastructure. The government responded by introducing a suite of field allowances to allow a range of more marginal developments to become commercial. These were welcomed by industry and, as above, have helped achieve record levels of investment.

3.22 However, field allowances have added complexity to the regime, with each allowance having different criteria. At the point investment decisions are made, it is not always certain whether or how some allowances will apply, creating undue uncertainty. And as a whole the allowances may be distorting investment decisions towards some types of development activity at the expense of others.

3.23 Another source of complexity and potential distortion within the regime is PRT, which has a number of inherent complexities in its design and administration. In particular, there are complex rules that determine the liability to PRT of tariff income, where companies charge fees for third parties to use their pipelines or other infrastructure. And under certain circumstances a

PRT charge is levied on the disposal of assets, which some stakeholders have argued acts as a barrier to asset transfers that could lead to further production.

3.24 A further area of complexity lies in the application of RFES. In a similar way to mainstream corporation tax, trading losses arising within the ring fence are relievable. They can be set off sideways against other profits, group relieved, carried forward into future accounting periods or carried back against the previous year's profits. To assist particularly those smaller companies entering the UKCS and incurring losses during the early stages of development, RFES helps retain the value of losses incurred until they can be set off against profits. This is achieved by allowing an uplift of 10% per annum, up to a maximum of six accounting periods offshore and 10 accounting periods onshore. However stakeholders have highlighted that the mechanism for making claims is complicated and entails making difficult judgements about the timing of claims.

3.25 Taken together these complexities lead to a perception of unpredictability in how the tax regime will impact on specific developments, and hence risk damaging the global competitiveness of the UKCS.

3.26 Though there were many calls for simplification, there were also calls for specific fiscal interventions at various stages of the lifecycle: exploration, production and decommissioning:

- Exploration rates are at historically low levels. Exploration activity remains at an all-time low with only 11 wells drilled in the nine months to September 2014. In the last two years less than 100 million boe economically recoverable reserves have been discovered and if this trend continues the industry will fail to discover the reserves that are estimated to remain. There are a number of challenges facing exploration activity including rig costs, access to good quality seismic information, and access to finance. Though not primarily a fiscal issue, stakeholders have highlighted that there are options to encourage exploration through the fiscal regime, including mechanisms that have been deployed with success by other countries.

- Production has fallen by 38% over the last three years due in part to a rapid decline in production efficiency. Production efficiency, a measure of a field's actual production performance against its maximum capability, is currently at an average of 60% - a decrease of around 20% over the last decade.[5] These recent declines are the result of a range of factors, including the deteriorating reliability of ageing infrastructure and insufficient incremental investment to maintain it. Good stewardship of infrastructure is vital to the basin's future and whilst action by industry and the OGA will be essential, stakeholders have drawn attention to certain fiscal issues which could also help. In particular, the review has identified a number of issues concerning the tax treatment of tariffs (where infrastructure owners charge for its use by 3rd parties), and of asset transfers which could improve stewardship of infrastructure assets.

- Decommissioning will become a major focus of activity in the UKCS in the coming decades. Due to the basin's relative maturity, the UKCS will move into this phase ahead of most comparable basins. As a result, decommissioning in the UKCS will involve the deployment of relatively untested methodologies and require industry to develop new operating models and bring in new skills and expertise.

[5] 'UKCS Maximising recovery review: final report', Sir Ian Wood, February 2014

3.27 The Wood Review explored these issues in more depth. It is clear that in many areas the solutions lie between industry and the new regulator. From 2015, the OGA will begin work on strategies to address these issues. However, there is also a role for the fiscal regime to help set the right conditions for success in all these areas.

3.28 **The government believes that there are some significant opportunities to simplify the fiscal regime, though many of these issues will take time to resolve. The government wants to evolve the fiscal regime to being one that supports the whole lifecycle whilst keeping it as simple as possible.**

## Conclusion on the case for reform

3.29 It is clear that without change, the goal of maximising economic recovery is in doubt. The UKCS will increasingly offer commercial opportunities that are more marginal, and which will struggle to attract investment. **The government's view is that there is a strong case for reforming the fiscal regime to help the UKCS attract investment, and also to seek opportunities to simplify the regime**. Chapter 4 sets out the government's plans for doing so.

# 4 A more competitive, simple and predictable fiscal regime

4.1 This chapter sets out the government's plans for reform of the fiscal regime. They comprise some immediate changes, some to be phased in over time, and other areas where further work is needed. These plans reflect the case for change set out in Chapter 3 and will ensure the tax system enables the opportunities set out in Chapter 2 to be realised.

## Objectives and principles

4.2 In common with natural resource tax systems elsewhere, the government needs to strike a balance between providing sufficient incentive for companies to operate in the UK, whilst ensuring the nation gets a fair share of the proceeds. There is also a trade-off between maximising near-term tax revenues and supporting the near-term investment that will generate higher production, revenues and wider economic benefits in future. This trade-off is particularly acute at the present time, as the need to reduce the UK's fiscal deficit remains a priority, whilst there is a limited window of opportunity to get investment into the UKCS's aging infrastructure.

**Box 4.A: Objectives and principles of the fiscal regime**

Objectives

The government designs the fiscal regime to support its twin objectives of maximising the economic recovery of hydrocarbon resources whilst ensuring a fair return on those resources for the nation.

- Maximising economic recovery means ensuring that all resources are recovered where the benefits of recovery outweigh the costs, in such a way as to maximise value in current terms for the UK as a whole.
- A fair return implies that a share of the profits, or 'rent', should be retained for the nation, whilst ensuring returns on the private investment needed to exploit these resources is sufficient to make extraction activity commercially attractive.

Principles

To achieve these objectives over the future of the basin, the government will apply the following principles:

- To be consistent with the objective of maximising economic recovery as new projects become ever more marginal, the overall tax burden will need to fall as the basin matures.
- When making judgements about fiscal policy, the government will consider the wider economic benefits of oil & gas production, in addition to revenues.
- The government's judgement of what constitutes a 'fair return' will account for the competitiveness of commercial opportunities in the UK and UKCS and take account of both prices and costs.

4.3 In making judgements about these trade-offs, the government has applied a number of new principles, which will apply to oil and gas fiscal policy from now on. Box 4.A sets these out and restates the overall objectives of the regime.

## Helping the UKCS compete for investment

4.4 The overall tax burden is a key determinant of competitiveness. Comparative studies of international oil and gas tax regimes suggest that the tax burden in the UK is roughly average. However, given that the UKCS now offers rather smaller opportunities and at higher cost than most basins, a relatively lower tax burden will be needed to compensate for this.

### Lower headline rates

4.5 As set out above, the government accepts that the overall tax burden will need to fall as the basin matures. Responses to the call for evidence were clear that the headline combined rate of Ring Fence Corporation Tax and the Supplementary Charge is a key metric for global investors, whatever the allowances that may be available for particular developments.

4.6 **The government recognises the need to reduce the overall tax burden facing the industry over time. The government is announcing an immediate cut in the rate of the Supplementary Charge from 32% to 30%, effective from 1st January 2015, and will aim to continue to reduce the rate further in an affordable way.** Future rate reductions will be made in a way that is consistent with the government's plans for deficit reduction.

4.7 In accordance with the principles set out above, any changes in the government's plans for rates will be based on an assessment of commercial conditions**. The Treasury will work with HMRC and the OGA to review commercial conditions on a regular basis, and will seek the views of industry on the competitiveness of the basin before making any changes to its plans for rates. This approach will replace the price-based trigger point set by the Fair Fuel Stabiliser that has been in place since Budget 2011.**

### A basin-wide Investment Allowance

4.8 Changes in headline rates will apply to all companies operating in the basin, but the government is particularly keen to support those companies that are actively investing. In recent years, the government has introduced a suite of field allowances to enable more marginal projects to go ahead. These have been very successful at driving more investment, but have added complexity and distortions into the regime. And with a significant majority of both new field approvals and incremental investments of recent years benefitting from an allowance, there is a strong case for applying a more comprehensive allowance across the basin.

4.9 **The government will consult on a basin-wide 'Investment Allowance' to simplify and replace the existing system of offshore field allowances over time.** Like the current onshore allowance and the new high pressure, high temperature Cluster Allowance (which is being legislated for within Finance Bill 2015), the Investment Allowance will be based on a company's costs. This approach will give greater support to more economically challenging projects and reward investment. By moving away from allowances based on physical characteristics of a field, the new allowance will also ensure greater certainty on future tax treatment at the early stages of project development and simplify the regime. Careful consideration will be needed on the exact structure, appropriate rate, transition arrangements from existing allowances, and how it can best support near field and brown field developments, and new technologies and techniques such as Enhanced Oil Recovery. A consultation document will be published early in 2015.

### An extended Ring Fence Expenditure Supplement

4.10 A majority of the investment in the basin in the coming years is likely to be conducted by companies not currently in a profit-making or taxpaying position, either because their operating costs and/or investments exceed their production income, or because they are not currently producing.

4.11 To support investment by these companies, **the government will extend RFES from six to ten accounting periods for all ring fence oil and gas losses and qualifying pre-commencement expenditure incurred on or after 5 December 2013.** This will align the offshore rules with the rules for onshore developments and thus simplify and unify the RFES regime.

4.12 This review has identified that short-term cash flow is also an issue for companies looking to invest heavily but which are unable to obtain immediate tax relief because, for example, they are not yet producing. A number of ideas were put forward during the call for evidence but all required further development. **The government will consider any more detailed proposals put forward by industry on mechanisms to support cash flow for such companies.** Such proposals would need to clearly demonstrate affordability and cost-effectiveness.

## Encouraging exploration

4.13 Achieving greater exploration success will be essential, and the measures outlined above will make exploration activity more attractive. In considering whether to adopt more specific interventions, the government's view is that the first priority is to improve the collective understanding of the potential of relatively unexplored offshore regions. Currently, companies are often reluctant to undertake seismic surveying in such areas, knowing that they cannot guarantee they will gain exclusive rights to unlicensed acreage. As such, geoscience is a 'public good' which is currently being underprovided. Government and the OGA have a role in helping overcome this barrier, so the **government will provide financial support for seismic surveys in under-explored areas of the UKCS, working with industry on options for shared funding models. Conclusions of this work will be set out at Budget 2015.**

4.14 During the call for evidence, many stakeholders drew attention to fiscal interventions made in other countries that have successfully supported exploration. Such interventions have merits but may also fail to be cost-effective if poorly targeted. **The government will consider options for supporting exploration through the tax system, such as a tax credit or similar mechanism, in a way that is carefully targeted and affordable. The government will open discussions on options with industry and the OGA, once established in 2015.**

## Promoting effective asset stewardship

4.15 A key theme that emerged during the call for evidence was the importance that certain key pipelines, hubs and platforms will have in extending the life of the basin, enabling new marginal developments to tie back to them. Discussions focused on the role that the tax system plays in helping ensure that such assets are well maintained and are accessible to 3rd parties looking to tie back to these assets.

4.16 A number of respondents drew attention to the fact that much of this key infrastructure lies within PRT-paying fields. As such a higher rate of tax applies on returns from investing in those fields and associated infrastructure. The government recognises that this may distort investment away from such infrastructure.

4.17 The government has looked closely at the case for making changes to the rate of PRT, but does not believe this is the most cost-effective way of getting the right investment into key assets. Instead, **the government will keep the rate of PRT under review and consider reducing the rate when fiscal conditions allow.** In the meantime, operators will benefit from reductions in the Supplementary Charge. And a key objective of the new Investment Allowance will be to drive incremental investment in existing fields, including those with critical infrastructure, by providing greater certainty in the investment cycle than the existing Brownfield Allowance.

4.18 The call for evidence also identified a number of issues concerning the tax treatment of tariffs (where infrastructure owners charge for its use by 3rd parties), and of asset transfers which could improve stewardship of infrastructure assets. The government recognises these issues warrant further consideration, but wants to ensure that any fiscal changes are consistent with the new strategy for infrastructure that the OGA will be developing. **The government, working with the OGA, will consider options for reforming the fiscal treatment of infrastructure and consult further with industry in 2015.**

## Providing the right conditions for cost-effective decommissioning

4.19 Industry estimates suggest that decommissioning costs could reach up to £40 billion across the basin.[1] Though costs are borne by industry, the fiscal regime provides support through tax relief on decommissioning as with other capital expenditure. It is in the interests of both the government and industry to ensure that decommissioning is not just environmentally sound, but opens opportunities for the supply chain and is done in as cost-effective a way as possible.

4.20 Key to ensuring cost-effectiveness will be making the most of the opportunities to encourage innovation, for example through greater use of decommissioning specialists. A number of responses to the call for evidence identified that where such specialists are taking ownership of assets, they will not be in a position to offset their decommissioning costs against RFCT and the Supplementary Charge unless they are making profits from production in other fields. This is not an issue for PRT as the relief can be carried back and offset against the tax history of the field. However, stakeholders are not permitted to 'look-back' to RFCT and Supplementary Charge history in the same way. Though stakeholders identified the issue, there is clearly more work needed by government and industry to consider the best solution to this. As such, **the government will consider options to improve access to decommissioning tax relief to encourage new entrants into the UKCS, where this does not increase the overall forecast cost to Government of providing decommissioning tax relief, and consult further with industry in 2015.** And on the regulatory side, decommissioning costs will be one of the OGA's top priorities in its first year of operation.

[1] Oil & Gas UK estimate

## Summary & next steps

4.21 Together, these measures represent **a radical plan to reward investment in the UKCS at all stages of the industry life cycle.** These reforms will make the fiscal regime more competitive, simpler and more predictable and represent the most balanced and investment-focused way to move to a lower tax burden over time. They will support billions of pounds of investment throughout the lifecycle of fields. Table 4.A sets out the timetable of reforms

**Table 4.A: Timetable for fiscal reforms**

| | |
|---|---|
| Autumn Statement 2014 | • *Driving investment* published<br>• RFES extended to 10 accounting periods, effective 5 December 2013<br>• Supplementary charge reduced to 30% from 1 January 2015<br>• Legislation for the Cluster Allowance published within Finance Bill 2015 |
| Early 2015 | • Consultation published on a basin-wide Investment Allowance<br>• Discussions with OGA and industry on shared funding models for seismic surveys<br>• Discussions with OGA and industry on options for supporting exploration through the tax system |
| Budget 2015 | • Government provides update on above areas of work, including publishing details of its plans to support seismic surveying |
| Later in 2015 | • Following discussions with OGA, consultation with industry on options to reform fiscal treatment of infrastructure<br>• Consultation with industry on options to improve access to decommissioning relief |
| 2015 onwards | • Supplementary Charge reduced over time<br>• PRT rates kept under review |

4.22 These reforms demonstrate the government's commitment to the tripartite approach that will help maximise economic recovery. Action on the fiscal regime will be accompanied by a stronger regulatory regime under the new Oil and Gas Authority. Yet action by government can at best be part of the solution, and must be matched by action by industry. In announcing these changes **the government expects the industry to make significant improvements in production operations, in improving its cost-efficiency, and in commercial practices in line with the objective of maximising economic recovery, and will ask the OGA to monitor and report on industry's progress in these areas.** There are clearly many companies who see a strong future for the oil and gas industry in the UK and want to be a part of it. These reforms will support them on their way.

# A Summary of responses to the call for evidence

A.1 To inform the fiscal review, in July 2014 the Treasury issued a call for evidence. The call for evidence posed 15 questions under five headings. Nearly 60 responses were received. This annex summarises those responses, and how the government is responding in each of the five areas. The annex also summarises the discussions of four industry working groups that the Treasury conducted over the call for evidence period. Representatives of around 50 organisations attended those meetings.

## Adapting to the changing economics of the basin

### Q 1. How do stakeholders expect economics of UKCS projects to evolve over the coming decades, including new and incremental investments? Would stakeholders expect to see greater variety in field economics than has been the case in the past? How could evolution in the fiscal regime support the objective of maximising economic recovery as the economics of the basin change?

A.2 Respondents generally agreed that there are further and perhaps considerable opportunities remaining in the UKCS. However, recovering these reserves will entail greater technical challenges and higher costs. As the basin matures operating costs will increase and will need to be spread over lower levels of production. Generally the size of fields and availability of reserves means projects will involve higher risks and lower materiality and therefore be perceived as less attractive to investors.

A.3 Recent years have seen some large capital investments but a number of these are nearing completion and need to be replaced with new developments, underpinned by an upturn in exploration success. Under current tax rates new investments will tend to be dependent on fiscal incentives in particular the field allowances.

A.4 Respondents made varying suggestions as to how the fiscal regime can best support the maximisation of economic recovery which included:

- lowering the overall tax burden to encourage sustained investments
- simplifying the fiscal regime and providing predictability to ensure investor confidence
- creating an environment that allows for and supports new developments and technologies whilst ensuring existing infrastructure is conserved for as long as possible
- offering incentives such as tax relief for exploration activities

### Q 2. How will the changing economics of the basin affect risk? What is the role of the fiscal regime in sharing risk between industry and government?

A.5 Respondents set out how shifts toward smaller discoveries that are more expensive have caused a significant shift in risks and returns, with a detrimental effect on securing investments. Exploration and production companies distinguish between economic and technical risks. Technical risks will be higher as projects seek to exploit harder to reach reserves. Economic risks increase with smaller developments and the increasing need to rely on infrastructure owned by other companies, with projects more susceptible to delays and/or cost overruns.

A.6 Respondents argued that, the government should consider the role the fiscal regime can play in reducing risk. Suggestions included offering further fiscal incentives for particularly high risk developments, as well as ensuring that post-tax returns across the basin are sufficient to justify the risks taken by investors.

**Q 3. In recent years prices for oil and gas have diverged, with the result that gas production is relatively less economic. This is particularly an issue in the Southern North Sea, which is largely a gas producing region. To what extent should the fiscal regime reflect the differing economics of oil and gas production, and of different regions in the UKCS?**

A.7 Those companies which have particular stakes in the Southern North Sea and several advisory firms welcomed the concept of a regime that differentiates between products and/or regions although many recognise there are arguments for and against. Arguments against include the likely complexity of introducing separate regimes for gas and oil and different regions, possible additional costs as a result for both government and industry, especially where fields produce a mixture of both gas and oil. Arguments for were based on the principle that the government should be taxing the economic rents, which are inherently lower where gas fields face similar costs but a lower price. Respondents also drew attention to the potential for brown- or near-field developments using new technologies in the Southern North Sea, with a particular benefit to the UK in greater security of gas supplies. Various proposals were made including introducing a separate headline tax rate for gas, or offering dedicated investment incentives within a uniform headline rate. However, the majority of respondents did not feel that this was a priority area for fiscal reform.

**Q 4. Decommissioning will become an increasingly important activity in the UKCS in the coming decades. Is the fiscal regime set up to ensure that decommissioning will be undertaken in the most cost-effective way?**

A.8 There is industry-wide agreement that decommissioning expenditure is already rising and will continue to do so as more fields reach the end of their lives. A number of respondents welcomed the recent introduction of Decommissioning Relief Deeds which have provided much needed certainty. However, many respondents were not yet satisfied that the fiscal regime is set up in a way that ensures cost-effective decommissioning. In particular, a number of respondents argued that key to ensuring cost-effectiveness will be making the most of the opportunities to bring in late-life and/or decommissioning specialists. Where such specialists are taking ownership of assets, they will not be in a position to offset their decommissioning costs against RFCT and the Supplementary Charge unless they are making profits from production in other fields. This is not an issue for PRT as the relief can be carried back and offset against the tax history of the field. However, stakeholders are not permitted to 'look-back' to RFCT and the Supplementary Charge history in the same way. Though stakeholders identified the issue, there is clearly more work needed by government and industry to consider the best solution to this and whether this would achieve the desired outcome.

### Economics of the basin: government response

A.9 The government accepts that the burden of tax will need to fall as the basin matures, and that there are opportunities to create a more competitive regime. The reforms set out in this document aim to achieve this, in particular with a move to lower tax rates over time and a simplified basin-wide cost-based Investment Allowance to replace the offshore field allowances over time. The government recognises that decommissioning will only grow in importance and will consider options for addressing barriers to access to decommissioning relief in order to ensure decommissioning can be carried out in the most cost-effective way for both government and industry.

## Creating stability in an uncertain environment

### Q 5. How sensitive are project economics to changes in commodity price/input costs?

A.10 Respondents were generally in agreement that all projects in the UKCS are becoming very sensitive to changes in commodity prices and input costs due to the long cycle in UKCS development, decreasing margins and increased risk. Some companies provided specific examples of their changing project economics; a few supplied data across their portfolios.

### Q 6. How can the government ensure the regime provides certainty and stability even as prices and costs change? What criteria should apply in judging any changes to the regime?

A.11 A number of respondents argued that the UK's fiscal regime is perceived as unpredictable and that the government should provide investors with more certainty over future tax rates. Respondents recognised that from time to time it is appropriate for tax rates to change in line with the margins being made, in order that the nation obtains a fair share of the economic rents of production. However, few were attracted to the approach whereby tax rates would change at set trigger points. More preferred an approach whereby, should the government feel excess profits were being made, there should be a period of consultation with industry before determining whether a rate change is appropriate.

### Q 7. Do stakeholders have evidence of specific areas of the tax regime where changes could improve certainty for investors?

A.12 Respondents made a range of suggestions, including that the government should:

- reform field allowances to ensure they provide certainty at the point of investment
- reduce the headline tax rate
- facilitate asset transfers by removing fiscal obstacles on disposal of assets
- simplify the tax treatment of tariff receipts or remove from the scope of upstream tax altogether
- extend RFES beyond six accounting periods
- consult before making fiscal changes

### Creating stability: government response

A.13 In this document the government has set out a principle that the tax burden will need to fall over time as projects become more marginal. The government is announcing an immediate cut in the rate of the Supplementary Charge from 32% to 30%, effective from 1st January 2015, and will aim to continue to reduce the rate in an affordable manner in future. Rate reductions will be made in a way that is consistent with the government's plans for deficit reduction.

A.14 In accordance with the principles set out above, any changes in the government's plans for rates will be based on an assessment of commercial conditions. The Treasury will work with HMRC and the OGA to review commercial conditions on a regular basis, and will seek the views of industry on the competitiveness of the basin before making any changes to its plans for rates. This approach will replace the price-based trigger point set by the Fair Fuel Stabiliser that has been in place since Budget 2011.

A.15 The new cost-based Investment Allowance will be designed to provide certainty over tax treatment of projects at the point of investment. The extension of RFES from six to ten accounting periods will also provide greater certainty.

## Helping the UKCS compete for investment

### Q 8. Is there evidence that the UKCS is becoming uncompetitive and if so, to what extent is the fiscal regime contributing to this? What range of options is there to ensure the UKCS is perceived by investors as attractive to invest in?

A.16 A number of companies provided data that demonstrates that they (or their UK operations) are starting to struggle to compete for investment. Evidence included the position of UK projects within global portfolios and the degree to which they have been attracting investment. Examples were also given of recent difficulties securing buyers for available UKCS assets.

A.17 Most respondents saw the fiscal regime as a key factor in investment decisions and argued overall investor perceptions are often driven by headline tax rates, even where allowances are available that reduce the effective marginal rate on specific projects.

### Competing for investment: government response

A.18 The government is committed to providing the right conditions to attract investment to maximise economic recovery as the basin matures. All reforms set out in this document support this goal. In particular, the government is setting a path to lower tax rates over time which aims to change perceptions in the investment community. A cost-based Investment Allowance and support for exploration will directly reward companies that are investing.

## Simplifying the regime

### Q 9. What are the advantages and disadvantages of the more bespoke allowances introduced in recent years? How can any disadvantages be mitigated? What would be the pros and cons of reverting to a simpler regime with fewer or no allowances and what would need to be considered as part of that transition?

A.19 Respondents recognised the benefits of field allowances, noting that they can encourage investment in more marginal new developments, and in extending production in mature fields, and that they have been vital in attracting investment in recent years.

A.20 However, respondents also argued that the current system is too complex, that it can distort investment decisions, and that too much time and effort goes into the process of acquiring an allowance when it is not always clear that it will make a difference to the development in question.

A.21 The vast majority of stakeholders sought a more transparent approach with fewer allowances. There was wide support for moving to a single and more robust cost-based allowance that addresses the different investment categories and delivers a consistent rate of relief. This would remove the uncertainty of the current system and help ease investment making decisions at time of submission. However, some respondents urged caution and emphasised the need for careful transitional arrangements for developments already benefiting from the current field allowances.

### Q 10. PRT is a complex tax but only applies to fields given development consent before 16 March 1993. The Treasury held several rounds of discussion with industry over the future of PRT in 2007 and 2008, and the government would welcome views on whether developments since would suggest that the conclusions of that work should be revisited. What should be the future of PRT and why?

A.22 Respondents, by and large, wanted to see the rate of PRT reduced to zero arguing that this would remove a tax-driven distortion towards fields that do not pay PRT, make investment in mature fields more worthwhile, thus extending their life and postponing decommissioning. Respondents also saw this as the quickest way of simplifying the tax, though there would be some small administrative burden for companies remaining under a zero-rate regime.

A.23 A number of other ideas for simplifications to PRT were raised, which respondents suggested should be considered if the government was unable to reduce the rate of PRT.

### Simplifying the regime: government response

A.24 In early 2015 the government will consult on the design of a basin-wide cost-based Investment Allowance that will, over time, replace the current system of field allowances. This will greatly simplify the system of field allowances. The government will keep the rate of PRT under review and consider reducing the rate when fiscal conditions allow whilst looking at options for reforming the fiscal treatment of infrastructure and consult further with industry in 2015. And the government is also making RFES simpler by aligning the offshore and onshore rules.

## Helping to maximise economic recovery

### Q 11. How can the fiscal regime best support the themes of the Wood Review?

A.25 All respondents largely agreed with the conclusions of the Wood Review, and saw fiscal reform as a key plank of the tripartite strategy proposed by the Review. There were proposals for various fiscal measures to support the industry lifecycle from exploration through to decommissioning (outlined elsewhere in this annex).

### Q 12. The main way in which the fiscal regime currently helps maximise economic recovery is through the system of field allowances which help make more marginal projects commercially viable. It is important that allowances are cost effective and prioritised where they can achieve greatest impact. Are field allowances targeted on the most valuable projects to maximise economic recovery?

A.26 Although many respondents recognised the benefits of the field allowances, a large number argued they could be made more effective. Various issues were raised with a number of the individual field allowances, and with the extent of their coverage. The most important overarching concerns were that the current field allowance structure is confusing to potential investors and new entrants to the UKCS.

### Q 13. The Wood Review also identified asset stewardship and technology as key issues, including aging infrastructure, under-investment in assets and insufficient uptake of Improved Oil Recovery and Enhanced Oil Recovery techniques and technologies. What evidence is there that the fiscal regime could support action in these areas?

A.27 With regards to asset stewardship, many respondents argued that specialist companies taking ownership of infrastructure could provide the expertise, investment and attention that the basin needs to help extend its life and enhance economic recovery of the remaining reserves. A number of suggestions for fiscal reform were made to enable this, though there was recognition that action by industry and the new regulator will be essential. The issues are discussed below under the summary of working group 4.

A.28 Respondents agreed with the potential of new techniques and technologies to extend the life of the basin. There were suggestions that the fiscal regime should incentivise the deployment of enhanced oil recovery techniques such as $CO_2$ EOR, gas injection, and chemical flooding.

### Q 14. Exploration rates have been relatively low since 2009. What evidence is there that further action on fiscal policy could have a meaningful impact on exploration rates?

A.29 Respondents agreed that declines in exploration activity need reversing as a priority, and many suggested that fiscal change could help drive this. The issues are discussed below under the summary of working group 3.

### Q 15. Investment in existing fields is becoming increasingly important as part of maximising economic recovery. How do the economics of incremental investments differ from other developments and does that justify a different tax treatment? How effective has the brownfield allowance been in supporting incremental investment?

A.30 There is widespread agreement that maintaining existing infrastructure in ageing fields is another crucial component of maximising economic recovery. Respondents made similar points to those raised in answer to question 13. A few respondents stated that the Brown Field Allowance has been effective, but many argued that its scope should be broadened and that approvals take too long.

### Helping maximise economic recovery: government response

A.31 The government's plans for reform of the fiscal regime set out in this document will support billions of pounds of investment throughout the lifecycle of fields, with the government taking action to support exploration and consulting further on the fiscal treatment of infrastructure and reforms to encourage cost-effective decommissioning. In early 2015 a consultation on a new Investment Allowance will explore, among other things, how it can best support near field and brown field developments, and new technologies and techniques. The reforms demonstrate the government's commitment to the tripartite approach proposed by Sir Ian Wood, and must be matched by action by industry.

## Summary of working groups

A.32 As part of the call for evidence, the Treasury ran four working groups with representatives from the offshore industry. What follows is a brief summary of the areas of discussion.

### Working group 1: fiscal structures and principles

A.33 The key objective of working group 1 was to look at how the structure of the ring-fenced regime could remain fit for purpose over the remainder of the basin's lifetime. The group met four times over summer 2014 and considered the following topics:

- what principles should inform changes to the regime in future
- the overall competitiveness of the regime and its impact on attracting investment to the UKCS
- the appropriate balance of risk and reward between industry and government and how this is reflected in tax rates and allowances
- how the fiscal system can support the key themes of the Wood Review
- the pros and cons of the more bespoke system of field allowances that have been put in place over recent years, and how allowance should evolve over time

A.34 Initial meetings of the group discussed the various challenges and opportunities of operating in a maturing basin. There was also a focus on the state of the global industry, how opportunities in the UK and UKCS compared with other basins, perceptions of the UK amongst the global investment community, and the relative competitiveness of the UK's tax regime.

A.35 Further meetings looked at the scope to create greater simplicity and certainty through reform of the field allowance system, and at the case for greater support for companies whose investment and other expenditures exceed their production income. The group also discussed the extent to which changes in tax rates would incentivise investment and the case for changing the fiscal regime to support late life development and decommissioning.

A.36 The group emphasised the importance of the UKCS remaining internationally competitive and many members argued that there is a limited window of opportunity for government and industry to take action and spur investment before key assets are decommissioned.

### Working group 2: petroleum revenue tax

A.37 Working group 2, which met twice, looked at the future of PRT and considered what options exist to ensure the tax is not a barrier to investment.

A.38 A minority of fields are currently subject to PRT, and there was agreement within the group that in most cases PRT-paying fields (those given development consent before 16 March 1993) are entering the tail end of production. Given the complexities of the PRT regime the group therefore focused on the case for removing or zero-rating the tax. Industry representatives argued first that they see the abolition of PRT as theoretically preferential to zero rating but recognised the former would be unpalatable to the Exchequer as it would alter the availability of decommissioning tax relief and hence trigger the Decommissioning Relief Deeds (so PRT relief for decommissioning would be payable from the Exchequer while no more PRT would be payable to the Exchequer).

A.39 A number of members argued that reducing the rate of PRT to zero could lead not just to a cash flow benefit for PRT payers, but to potential benefits for the entire basin, including facilitating asset transfers and extending the life of key infrastructure. Industry members offered anecdotal evidence in support of their argument that this reduction would aid in extending production and postponing decommissioning, to the benefit of the UK.

A.40 A number of more technical and administrative issues were raised, including the treatment of tariff income and of disposals under PRT. Members argued that if the government was unable to reduce the rate of PRT, consideration should be given to these areas as part of further work on infrastructure and decommissioning issues.

### Working group 3: exploration, appraisal and early life development

A.41 Working group 3, which met twice, discussed the interactions between the fiscal regime and exploration and early life developments. The group began by discussing the reasons for the low rates of exploration success in recent years, and acknowledged that fiscal support is at best part of the solution.

A.42 Members of the group argued that in relation to the fiscal treatment of exploration, there are two issues that the government should look to address. Firstly, that companies whose expenditure exceeds their production income, particularly exploration specialists who have no production income, are unable to obtain tax relief on their costs in the same way as companies making a profit from production. Secondly, that exploration activity on the UKCS must be seen as an attractive opportunity compared with overseas prospects and fiscal treatment is an essential enabler of this.

A.43 The group focused its discussion on three potential areas of fiscal change. Many members pointed to international examples of successful fiscal interventions to support exploration and argued that the UK could look to replicate this by introducing a tax credit for exploration or a similar mechanism. Reforms to RFES and the introduction of a basin-wide allowance that would include exploration spend were also proposed.

### Working group 4: assets stewardship

A.44 This group, which met twice, looked at the interactions between the fiscal regime and strong asset stewardship. Points considered included:

- whether the economics of late life investment justifies a different tax treatment
- interactions between the fiscal regime and maintaining aging infrastructure
- the tax treatment of decommissioning
- the effectiveness of the Brownfield Allowance

A.45 The group began by discussing how ownership of infrastructure was key to the future of the basin and that it was vital that late-life assets are not left in the hands of firms with very little equity and little interest in maximising economic recovery. The group was sceptical of the case for moving key infrastructure out of the ring fence entirely, but did suggest that tariff receipts should be exempt from the Supplementary Charge and PRT, arguing that the higher rate of tax was inappropriate for profits from merely transporting hydrocarbons as opposed to producing them. However, the group did recognise that applying different tax rates within the ring fence could lead to complexities in apportioning relievable expenditures between transport and production income streams.

A.46 Industry representatives suggested that the current structure of decommissioning tax relief causes a significant price mismatch between the buyer and vendor that is discouraging asset trades in late life developments. Where companies are purchasing assets, they will not be in a position offset their decommissioning costs against RFCT and the Supplementary Charge unless they are making profits from production in other fields. This is not an issue for PRT as the relief can be carried back and offset against the tax history of the field. However, stakeholders are not permitted to 'look-back' to RFCT and the Supplementary Charge history in the same way.

A.47 The group discussed options to overcome the problem. One option might be for the seller of an asset to retain decommissioning liability and the right to tax relief on it, but though some asset transfers have been structured in this way in the past, group members felt this was not likely to be an attractive option for most companies. An alternative would be a mechanism akin to the PRT rules where the buyer can take on the vendor's tax history in order to access full decommissioning relief. However, the group recognised there would be practical difficulties in attempting to divide companies' tax histories in order to achieve this. A further solution could be for the government to guarantee a standard rate of decommissioning relief to whichever company spends the money – i.e. separate the tax refund from accrued tax histories – something that was explored during consultation over Decommissioning Relief Deeds. The government will consider options which do not increase the expected cost to the Exchequer of providing decommissioning relief.

# B Respondents to the call for evidence

Aberdeen and Grampian Chamber of Commerce

AMEC

Antin Infrastructure Partners

Apache

BG Group

BP

Robert Birdsong

Brindex

Cairn Energy

CBI

CCSA

Centrica Energy

Chevron

CNR

ConocoPhillips

CW Energy

Dana Petroleum

Deloitte

DONG Energy

East of England Energy Group (EEEGR)

ENI UK

Enquest

Ernst & Young LLP

Europa Oil and Gas

ExxonMobil

First Oil Expro Ltd

GDF SUEZ E&P UK Ltd

Hansa Hydrocarbons

Hurricane Energy

JX Nippon Exploration and Production (U.K.) Limited

Juan Carlos Boue, Oxford Institute for Energy Studies

KPMG

The Law Society of Scotland

Maersk Oil

Marathon Oil

Nexen Petroleum UK

NSEA

NSMP

Oil & Gas Independents' Association

Oil and Gas UK

OMV

OTAC

Premier Oil

Professor Alex Kemp, University of Aberdeen

Progressive Energy

PWC

Scottish Government Expert Commission on Oil and gas

Scottish Council for Development and Industry

Sendero Energy / Sherritt International Corporation

Shell

Sinopec

Statoil

Suncor

Talisman Sinopec Energy UK

TAQA

Total E&P Ltd

UKOITC

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