Title: Funding the Oil and Gas Authority (OGA): Levy design. **IA No:** DECC0185 **Lead department or agency:** Department of Energy and Climate Change (DECC) **Other departments or agencies:** None.	**Impact Assessment (IA)** **Date:** 25 March 2015 **Stage:** Consultation **Source of intervention:** Domestic **Type of measure:** Secondary legislation **Contact for enquiries:** **Anthony Moulds** **Anthony.Moulds@decc.gsi.gov.uk**

Summary: Intervention and Options

Not applicable

Cost of Preferred Option				
Total Net Present Value	**Business Net Present Value**	**Net cost to business per year** (EANCB in 2009 prices)	**In scope of One-In, Two-Out?**	**Measure qualifies as**
-£136.4m	-£153.9m	£13.4m	No	Tax and spend

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

The Government is creating a strong, effective regulator – the Oil and Gas Authority (OGA) – which will be established as an Executive Agency on 1 April 2015, before transitioning to a Government Company in summer/autumn 2016. The Government agrees with the recommendation in the Wood Review that delivering the objective of maximising the economic recovery of offshore UK petroleum (MER UK) requires the OGA to be better resourced than the current equivalent team in DECC.

The creation of an additional cost-recovery mechanism is therefore considered necessary to fund fully the OGA as it is appropriate for the body to recover its costs from companies who will benefit from the services of the Regulator. A levy is considered the fairest, simplest and most sustainable method of achieving this aim. The OGA must ensure that the levy design is compliant with Managing Public Money[1] guidelines in that charges on market participants should be reflective of the costs they impose on the Regulator. A power to raise such a levy was included in the Infrastructure Bill, which received Royal Assent in February 2015 (Infrastructure Act 2015). Secondary legislation is required in order to implement the levy.

What are the policy objectives and the intended effects?

The objective is to implement a levy to ensure that the OGA is both adequately funded and that it recovers its costs from companies who will benefit from the services of the Regulator. The intended effect is to enable the OGA to fulfil its remit of being a strong, effective steward and regulator, using its powers as a last resort for the good of the UK.

What policy options have been considered, including any alternatives to regulation?

Two broad options were considered:

Option 0: The 'do nothing' option is a continuation of current arrangements where around 20% of regulatory costs are recovered through the existing charging regime and all others are met by general taxation. This option was ruled out as it would not have met the policy objectives.

Option 1: Introduce a cost-recovery mechanism in the form of a levy to ensure that the OGA is fully funded by the companies that benefit from its services. The total sum to be recovered annually would be of equal value under different levy design options, but the distribution of costs amongst operators or groups of operators would vary.

Five levy design options were considered in detail:

Option 1a: Cost reflective allocation whereby the total annual levy is divided between pre-production and production licenses. The allocation would be based on the level of regulatory services undertaken annually on behalf of each group – estimated at 11% and 89% respectively for current activity – and then divided equally amongst the number of licenses in each group. This is the preferred option as it is consistent with MPM principles in that charges will reflect costs imposed on the OGA.

[1] HM Treasury (2013) Managing Public Money 2013 [web], available at: https://www.gov.uk/government/publications/managing-public-money.

Option 1b: As with Option 1a, cost reflective allocation based on services undertaken for pre-production (11%) and production licensees (89%). The second step would then allocate the total annual levy on each company in each group in proportion to the size (acreage) of each license.
Option 1c: Production based allocation. The total annual levy would be apportioned to operators based on outturn production levels attained.
Option 1d: Acreage based allocation. The total annual levy would be apportioned to operators based on the acreage held under license.
Option 1e: Licence rental based allocation. The total annual levy would be apportioned to operators in proportion to their licence rental payments.

Will the policy be reviewed? It will be reviewed. **Review date:** Annual review of charging level.					
Does implementation go beyond minimum EU requirements?			**N/A**		
Are any of these organisations in scope? If Micros not exempted set out reason in Evidence Base.	**Micro:** **Yes**	**< 20:** **Yes**	**Small:** **Yes**	**Medium:** **Yes**	**Large:** **Yes**
What is the CO2 equivalent change in greenhouse gas emissions? (Million tonnes CO2 equivalent)			**Traded:** **n/a**	**Non-traded:** **n/a**	

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

Signed by the responsible Minister: .... Date: 25/3/15

Summary: Analysis & Evidence

Policy Option 1

Description: Establish a levy to recover OGA costs from oil and gas licence holders. Allocate costs amongst licence holders according to Option 1a.

FULL ECONOMIC ASSESSMENT

Price Base Year 2015	PV Base Year 2015	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low: -£116.5m	**High: -**£156.2m	**Best Estimate: -**£136.4m

COSTS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Cost** (Present Value)
Low	n/a	n/a	£13.6m	£116.5m
High	n/a		£18.2m	£156.2m
Best Estimate	**n/a**		**£15.9m**	**£136.4m**

Description and scale of key monetised costs by 'main affected groups'

The estimates reflect the additional costs associated with the set-up and operation of the OGA. There is uncertainty around the OGA costs beyond FY2015/16 at this stage as they will vary annually in line with activity levels on the UKCS and the corresponding volume of work undertaken by the Regulator. Until end FY2020/21 the OGA will be partly funded by government, from which point on the intention is for it to be fully funded by industry via a combination of a levy and the existing charging regime. The overall additional costs of the policy therefore comprise of costs to government and costs to business from the creation and ongoing running costs of the OGA which are incremental to the current cost of regulatory activity undertaken by DECC. Internal analysis has been undertaken to map activities to pre-production and post-production licences; this will continue to be monitored following OGA's establishment as an Executive Agency on April 1st 2015, and its transition to a Government Company in summer/autumn 2016.

Other key non-monetised costs by 'main affected groups'

Costs will be incurred by Government in developing the necessary secondary legislation and strategic documents related to the creation of the OGA and establishing the levy. The costs will be absorbed within existing resources rather than being passed through to business and consequently have not been monetised.

BENEFITS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Benefit** (Present Value)
Low	-		-	**-**
High	-		-	**-**
Best Estimate	**Nil**		**Nil**	**Nil**

Description and scale of key monetised benefits by 'main affected groups'

There are no monetised benefits directly associated with the introduction of a levy to recover the costs of establishing and operating the OGA. The Wood Review presented estimates of the potential benefits that could accrue as a result of implementing MER UK, which were expanded upon in a previous Impact Assessment. The estimated benefits comprised of net additional revenues from a combination of increased oil and gas production and lower production costs on the UKCS.

Other key non-monetised benefits by 'main affected groups'

Full implementation of the Review's recommendations is expected to result in wider economic and financial benefits. Such benefits include increased capacity, capability and skills in the oil and gas sector including the wider supply chain, increased innovation and enhanced security of supply. The Impact Assessment for the Wood Review, published in Autumn 2014[2], estimated the potential net benefit to business associated with the implementation of all the Reviews recommendations of between £20.8 billion and £56.3 billion (net present value), primarily as a result of greater oil extraction from the North Sea.

[2] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/370077/Implementation_of_the_Wood_Review_proposals_for_UK_offshore_oil_and_gas_regulation_-_IA.pdf

Key assumptions/sensitivities/risks	3.5

- The NPV base year is 2015 and all values are expressed in 2015 prices. A real discount rate of 3.5% has been used with costs assessed over an appraisal period of 10 years (2015-2024).
- The levy is assumed to be first paid in October 2015, and then on an annual basis over the appraisal period of 10 years.
- The estimated range of OGA costs in each year of the appraisal period is based on internal business planning forecasts. Assumed funding streams are consistent with current committed expenditure in support of the set-up and running costs of the OGA in early years.

BUSINESS ASSESSMENT (Option 1) (2009 Prices, 2010 NPV base year)

Direct impact on business (Equivalent Annual) £m:			**In scope of OITO?**	**Measure qualifies as**
Costs: £13.4m	**Benefits:** Zero	**Net:-** £13.4m	No	Tax and spend

Evidence Base

1. Problem under consideration

1. In June 2013, the Secretary of State for Energy and Climate Change asked Sir Ian Wood to conduct an independent review of UK Continental Shelf (UKCS) oil and gas recovery, specifically looking at how economic recovery could be maximised. The Government accepted, and is committed to implementing fully, all of the Review's recommendations.

2. The Government is consequently creating a strong effective regulator – the OGA – which will be charged with effective stewardship and regulation of UKCS hydrocarbon recovery, and maximising collaboration, development and production across the industry. The OGA will be established as an Executive Agency on 1 April 2015, before transitioning to a Government Company in summer/autumn 2016 (subject to legislation being brought forward and approved by Parliament).

3. This Impact Assessment (IA) sets out the estimated costs associated with the introduction of a cost-recovery mechanism, in the form of a levy, to fund the OGA. In doing so it updates the OGA set-up and annual operating cost estimates that were presented in the IA of November 2014[3], which also set out the potential benefits associated with implementation of all the Review's recommendations. The range of benefits, which were based on the analysis in the Review, are still considered a reasonable estimation (subject to a wide range of uncertainty) and consequently have not been revisited as part of this IA.

2. Rationale for intervention

4. The Government agrees with the Wood Review's finding that delivering the objective of maximising the economic recovery of offshore UK petroleum ("MER UK") requires the OGA to be significantly better resourced than the current equivalent team in DECC. In line with the established practice across regulation and service delivery, the Government also considers it is appropriate for the body to recover its costs from companies who will benefit from its services as a Regulator.

5. The proposed approach is in line with the long-established practice and Government policy - as set out in "Managing Public Money"[4] - that Government recovers the costs of the services it provides, where this is possible. In particular it states that:

   "This [cost recovery] can be a rational way to allocate resources because it signals to consumers that public services have real economic costs. Charging can thus help prevent waste through badly targeted consumption. It can also make comparisons with private sector services easier, promote competition, develop markets and generally promote financially sound behaviour in the public sector."

6. Around 20% (c. £965,000 p.a.) of the costs of current Regulator are already recovered through fees charged for delivery of specific services to individual companies. The Gas and Petroleum (Consents) Charges Regulations 2013 (SI 2013/1138) allow for charging for the Secretary of State's energy functions, such as consent for a field development plan and for an application for a pipeline works authorisation.

7. The Government has concluded that an additional cost-recovery mechanism will be required to fully fund the OGA and a levy would provide the fairest and simplest method of achieving this aim.

[3] Impact Assessment on Implementation of the Wood Review proposals for UK offshore oil and gas regulation. https://www.gov.uk/government/publications/implementation-of-the-wood-review-proposals-for-uk-offshore-oil-and-gas-regulation
[4] HM Treasury (2013) Managing Public Money 2013 [web], available at: https://www.gov.uk/government/publications/managing-public-money.

However, in the short term, from 2016-17 for a period of five years, Government has agreed to contribute £3m per year towards the costs of running the OGA to ensure it is well-funded from the outset, and to demonstrate Government's commitment to the tripartite approach to delivering MER UK.

8. A power to raise such a levy was included in the Infrastructure Bill, which received Royal Assent on 12 February 2015 (Infrastructure Act 2015). The provision provides for the Secretary of State to impose a levy on persons holding licences for the exploitation of petroleum, the unloading and storing of gas and the storage of carbon dioxide.

Costs to be recovered under levy

9. As outlined in paragraph 6, DECC already charges companies for some services it provides in relation to licences, including consents. Current charges covered include a wide scope of services, including an application for consent to a Field Development Plan (FDP), an application for consent to a carbon dioxide storage proposal, an application for a pipeline works authorisation and consents to drilling operations. These charges recover around 20% of the costs of the current regulator at DECC.

10. The existing charging regime will remain in place but will be updated to reflect the costs the OGA incurs for providing those services. In addition, following a review of the services the OGA will undertake, and in accordance with the principles of Managing Public Money (MPM), Government considers it is appropriate to recover the costs of several additional services via direct charges (rather than through a levy). These include metering inspections, licence extensions, and area retention plans.

11. However, before these changes can be made, Government will first need to amend the provisions in section 188 of the Energy Act 2004, and intends to do so at the earliest available opportunity. Therefore, until this time, the costs will initially be recovered under the levy. The schedule of activities that the OGA will charge for directly, as opposed to fund via the levy, will be kept under review, so that the OGA's charging regime remains as costs reflective to its customers as possible.

12. Other costs, not currently recovered by DECC, encompass activity required to underpin those services (such as licencing policy, and work to prepare future licence rounds), and activities that benefit, to greater or lesser degree, all licence holders. DECC also does not recover the costs of activity to support the supply chain, research and development work (for example on innovative techniques for extraction of hydrocarbons) and costs related to collection and dissemination of data (for example surveys in relation to geological work). The OGA will also incur costs in the course of developing the MER UK strategy and implementing the Sector Strategies to maximise recovery of hydrocarbons from the UKCS.

13. As set out in the Call for Evidence[5], it is the Government's intention to recover all of these costs from petroleum licence holders via the levy. Table 1 below lists the activities the OGA will perform and which mechanism (levy or direct charges) the costs will be recovered through. These activities and cost mapping will continue to be monitored following OGA's establishment as an Executive Agency on April 1st 2015, and its transition to a Government Company in summer/autumn 2016.

[5] Implementing the Wood Review Recommendations: Call for Evidence.
https://www.gov.uk/government/consultations/implementing-the-wood-review-recommendations

Table 1: Additional regulatory activities and cost-recovery mechanism

Activities currently charged for	Activities to be recovered by levy	Additional Activities proposed to be charged for directly (but in the short term recovered via the levy)
Approval of an onshore or offshore Field Development Plan (FDP) - including approval to revisions and addenda.	Developing UKCS Strategy (PILOT / MER UK)	Inspecting metering systems on offshore platforms and onshore production sites.
Approval of an offshore Gas Storage Development Plan including approval to revisions and addenda.	Responding to non-licence related / public correspondence and FOI requests	Licence extensions
Approval of an offshore carbon dioxide Storage Permit including approval revisions and addenda.	Data: Production returns & projections	Approval of Retention Area Plans
Pipeline Works Authorisations and variations thereto.	Operational Licensing Policy	
Pipeline deposit consents.	The Field Teams (Non FDP approval work)	
Consent to drilling operations To drill a new well To drill a sidetrack To complete (perforate) a well To suspend a well To re-enter a well To abandon a well	Exploration Team (e.g. Fallow Work)	
Consent to Licence Changes Change of licensee Change of the beneficiary of a petroleum field or subarea Change of the operator of a petroleum field or subarea	Upstream Emergency Planning	
Production/Flaring /Vent consents.	Upstream Petroleum Infrastructure Third party access dispute resolution procedures and sanction processes	
Methodology proposed for the measurement of petroleum (PON6 approval)	Metering inspections, licence extensions, approval of area retention plans (in the short term)	
Extended Well Tests	Other (including Oil Price and special commissions)	

3. Policy objective

14. The challenge of delivering MER UK requires the OGA to be significantly better resourced than the current equivalent team in DECC. The policy objective is therefore to implement a levy to ensure that the OGA is both adequately funded and that it recovers its costs from companies who will benefit from the services of the Regulator. The intended effect is to enable the OGA to fulfil its remit of being a strong, effective steward and regulator, using its influence as a last resort for the good of the UK.

15. The levy design must comply with Managing Public Money guidelines, whereby the charges recovered from particular groups of payees reflect the costs which they trigger in relation to activities undertaken for their benefit by the Regulator.

4. Description of options considered

16. The policy options assessed in this IA relate to the design of the levy i.e. the allocation methodology for apportioning costs amongst the market participants benefiting from regulatory activities. The total sum to be recovered from industry as a whole each year would be of equal value under each levy design option, but the distribution of the costs to particular companies or groups of companies would vary as explained further below.

17. A ‘Do Nothing’ option **(Option 0)** was ruled out on the basis that it would not achieve the policy objectives. This approach would have constituted a continuation of current arrangements where around 20% of regulatory costs are recovered through the existing regime of charges for services, and all other costs are paid through general taxpayer contributions / government funding. Delivering the overarching objective of MER UK requires the OGA to be significantly better resourced than the current regulatory function.

<u>Options considered for allocating the levy</u>

18. The Government published a Call for Evidence in November 2014[6]. Industry feedback to that exercise called for the levy design to be simple to administer, transparent and cost-reflective. The Government agrees with these suggestions, and also that the levy should be predictable and stable to aid planning for industry and the OGA.

19. However, in common with other organisations delivering public services in the UK, the OGA needs to comply with the principles of Managing Public Money (MPM). These principles set out demanding standards expected of public services and include: transparency, accountability, accuracy and fairness.

20. Schedule 7 to the Infrastructure Act 2015 illustrates how the levy power may be used. As with fees and charges, levies should be designed to recover full costs. However, to ensure the levy is cost-reflective of the work carried out on behalf of licence holders, it may be appropriate to charge different levy rates to different kinds of licensees.

[6] Implementing the Wood Review Recommendations: Call for Evidence. https://www.gov.uk/government/consultations/implementing-the-wood-review-recommendations

Option 1a – Allocate levy based on costs incurred as a result of activities undertaken for pre-production and production licensees and divide the costs equally between the number of licences in each group.

21. Based on the current DECC team's activity and focus, the Government believes the most cost-reflective method, compliant with the MPM principles, is to allocate the levy according to the proportion of costs incurred in relation to work undertaken for the benefit of pre-production and production stage licensees. The total cost to be recovered from the two groups would then be divided equally according to the number of licensees in each. **This is the preferred option** as it will ensure, so far as practicable, that the costs to industry licence holders fall to those that impose the costs on the OGA i.e. cost-reflective charging.

22. As part of the assessment process, the future costs of the OGA were estimated and mapped across licence holders. This assessment used estimations of the costs the OGA would incur in carrying out activities to be funded by the industry, and the split of how much of this work would be carried out on behalf of the two different groups of licence holder based on internal analysis. For the purposes of the analysis, all types of licence were considered – Promote, Traditional, Frontier and Exploration. Cost mapping was undertaken on UKCS and developing sector strategies, upstream emerging planning, third party access dispute resolution procedures, exploration, operational licensing, metering inspections, production returns and projections, etc. Exploration licences, granting no rights to produce, and other licences at terms 1 and 2 are grouped within "pre-production". All licences in their 3rd term are included in "production". This analysis suggests that 11% of the OGA's costs should fall on pre-production, and 89% on production licences. This cost mapping will continue to be monitored following OGA's establishment as an Executive Agency on April 1st 2015, and its transition to a Government Company in summer/autumn 2016.

23. We acknowledge that some licences produce petroleum in their initial or second term. Similarly, some licence holders may not be producing in their third term. DECC is aware of this and will continue to work on the levy design to ensure it correctly reflects the activities taking place in each term of the licence.

24. However, the Government recognises that, as the OGA matures, this apportionment of costs will be subject to change. Therefore, the costs of the OGA and their allocation will be monitored on an ongoing basis and will be subject to review at least on a financial year basis.

25. This allocation methodology is designed to deliver an outcome which minimises unintentional cross subsidisation between classes of licence holders and provides an approach that is transparent, cost-reflective and administratively simple for the OGA and industry. It will also help with predictability of the OGA's cash flow as the levy rate is unrelated to variables such as acreage and production. Unlike acreage, it is also an approach that could easily be replicated to carbon dioxide storage and gas storage licences should the levy be imposed on holders of those licences in future.

Option 1b – Allocate levy based on costs incurred as a result of activities undertaken for pre-production and production licensees and divide these costs between licence holders in proportion to the size (acreage) of each licence.

26. An alternative approach to option 1a (the preferred option) was considered whereby, having estimated the costs the OGA is expected to face in relation to work undertaken for pre-production and production licences, the costs for each licence are split in proportion to their size (acreage).

27. In deciding between which of the two approaches to take, DECC considered which would lead to the most cost-reflective apportionment of the OGA's costs. The approach taken to determine this was,

for each activity to be funded by the levy, consider whether the OGA's costs would be more closely related to the size or the number of licences.

28. The analysis showed that the costs of the bulk of the levy-funded work would not be significantly affected by changes (within a reasonable range of variation) in either metric. This would be true of all operational licencing policy, the development of sector strategies, responding to FOI requests, Upstream Emergency Planning, as well as any work to promote the UKCS and the supply chain. As a result, we deem it more appropriate to split these costs equally by licence holder, rather than in proportion to the size of licences. This is because the range of costs paid by licence holders under the latter approach would vary by a very large degree but with no compelling evidence to suggest that the same parties trigger equivalent costs on the Regulator.

29. For other work, for example resolving Third Party Access disputes, non-FDP work of Field Teams, and the work of the Exploration team, the argument was finely balanced as to which metric would more accurately reflect the cost of the OGA's work. Therefore, the evidence suggested that it would be more appropriate to split the costs equally by licence, rather than in proportion to the size of licences, for the reasons outlined in the preceding paragraph. It was also judged that this approach would be simpler to administer.

Option 1c – Allocate levy based on production levels.

30. Production levels attained by licence holders were initially considered as an appropriate metric for the levy. However, after discussion with industry it emerged that this method is not appropriate. It could not be applied to holders of production licences which are not producing, exploration licence holders or gas storage and carbon dioxide storage licences. And although we have decided to initially exempt holders of unloading gas and storage licences and carbon dioxide storage licences from paying the levy, the metric chosen to calculate the levy rate needs to be fit for purpose in the future to include these types of licence holders (including onshore licensees). It would therefore not be an equitable metric as all of the costs would fall only upon those licence holders producing petroleum. There are also various technical challenges to deal with, such as how to account for different compositions of output (e.g. proportion of oil versus gas), which means that this is also not a simple way of allocating the levy.

Option 1d - Allocate levy based on acreage.

31. Acreage was also considered as a possible allocation metric. However, upon further examination the practice of acreage being relinquished means that holders of production licences who are not producing petroleum could pay the vast majority of the costs. This would not therefore reflect the actual costs the OGA expects to incur in relation to those licences and therefore would not be cost-reflective and non-compliant with the MPM principles. This would also not be a stable and predictable method for both the OGA and the industry. Finally, this method would not be fit for purpose in the future as it would not be applicable to gas and carbon dioxide storage licence holders, should we decide to levy them in the future.

Option 1e - Allocate levy based licence rentals.

32. A further option suggested by industry was to make levy payments proportionate to licence rental payments. The foremost attraction of this approach is its simplicity. However, several issues emerged with this option. The most significant of these is that the amount each licence holder is required to pay per acre was determined when the licence was awarded. Over time the amount per acre has increased and this would result in an inequitable allocation of costs between licence holders, with holders of older licences paying significantly less than holders of newly-granted licences. This option also raises administrative challenges as licence areas often change during the

course of the year. This would result in a somewhat unstable and unpredictable levy for industry and the OGA.

5. Monetised and non-monetised costs and benefits

33. The levy will initially be targeted only at offshore petroleum licence holders. This is compliant with MPM principles, whereby the charges recovered from particular groups of payees reflect the costs which they trigger in relation to activities undertaken for their benefit by the Regulator.

34. Holders of unloading and storage of gas and carbon dioxide licences will, in the short term, be exempt from paying the levy as it is not envisaged the OGA will incur costs for those categories of licence that cannot be recovered via direct charges. Similarly, it is envisaged that the OGA will recover all of its costs in relation to onshore licences via direct charges for services and therefore onshore licensees will also be exempt from paying the levy.

35. However, as the OGA's role develops, it may undertake work that should be funded under the levy by these other categories of licence holder. Any need to extend the scope of the levy would be signalled through the OGA's annual business planning process and the OGA will communicate its intentions to affected groups.

36. All licence holders will continue to pay direct fees for costs associated with issuing permits and consents via the extant fees and charges regime, which will be extended to include the relevant activities outlined in Table 1 above.

COSTS

Baseline costs

37. For the purposes of this analysis, the counterfactual for estimating the net additional costs of establishing the OGA is an assumed continuation of the arrangements in place prior to publication of the Wood Review i.e. the same level of regulatory activity would continue to be administered within DECC. As reported in Table 2, the total baseline resource cost of that activity in 2014 was around £5.7 million, comprised of DECC administrative costs of around £4.7 million and additional costs recovered from industry via the existing fees and charges scheme of £965,000 (2015 prices).

Table 2: Baseline costs of regulatory activity in 2014, £m, 2015 prices

£m	Baseline Costs
DECC administrative budget	£4.745m
Costs recovered via fees and charges	£0.965m
Total resource cost	**£5.71m**

38. As set out in the consultation document and summarised in Table 3 below, the amount of the levy on industry is forecast to be in the range £7.4-12 million (mid-point of £9.7m) for the period 1 October 2015 to 31 March 2016. This reflects total forecast OGA costs in the range £18.1-22.7 million (central estimate of £20.4m) for FY2015/16, minus government funding of around £9.7 million plus income from existing fees and charges of £965,000.

39. While there is significant uncertainty around OGA costs from financial year 2016/17 onwards due to the early stage of business planning, costs are currently forecast to increase to between £19.4 million and £24.0 million. For the purposes of presenting indicative Net Present Value (NPV) calculations, this analysis makes reasonable assumptions about OGA costs, funding streams and consequently the value of the levy to be recovered from industry annually from 2016/17 to end 2024/25 (i.e. an

appraisal period of 10 years). The range of indicative estimates reported in Table 3 below is intended to capture the uncertainty at this stage.

40. In summary, over the appraisal period it is assumed that:

- The range of OGA costs increases between 2015/16 and 2016/17 and then remains flat in real terms;

- Government funding streams vary in line with committed expenditure in support of the set-up and running costs of the OGA in early years. The costs of regulatory activity currently recovered via the existing charging regime is assumed to remain flat in real terms;

- Levy requirements reflect the difference between OGA costs and funding streams. The estimated levy therefore increases over the period in line with the phased tapering off in government funding and the transition towards 100% cost recovery from industry, which is assumed to commence in 2021-22.

Table 3: Estimated OGA costs and levy requirements 2015/16-2024-25, £m, 2015 prices

£	2015/16	2016/17-2020/21	2021/22-2024/25
Total OGA costs			
Low	£18.1m	£19.4m	£19.4m
Central	£20.4m	£21.7m	£21.7m
High	£22.7m	£24.0m	£24.0m
Funding; of which*	**£10.7m**	**£4.0m**	**£1.0m**
HMT	*£5.0m*	*£3.0m*	-
DECC	*£4.7m*	-	-
Fees and charges (recovered from industry)	*£0.965*	*£0.965*	*£0.965*
Residual levy requirements			
Low	£7.4m	£15.4m	£18.4m
Central	£9.7m	£17.7m	£20.7m
High	£12.0m	£20.0m	£23.0m

<u>*Societal Costs*</u>

41. As reported in Table 4 below, on the basis of the assumed profile of annual costs, the additional resource cost (societal level) associated with implementing the policy is estimated to be in the range of £116.5 million to £156.2 million, with a central estimate of £136.4 million (NPV, 2015 prices) over an appraisal period of ten years. This incremental resource cost reflects the difference between the discounted value of cumulative OGA costs (£165.7m-£205.4m) and the baseline costs in the counterfactual scenario (£49.1m), which comprise DECC funding and fees and charges paid by industry (NPV, 2015 prices).

Table 4: Estimated net societal costs, £m NPV 2015, 2015 prices.

		NPV	
	Low	**Mid**	**High**
OGA costs	£165.7m	£185.5m	£205.4m
Minus baseline costs	£49.1m	£49.1m	£49.1m
Net resource cost	**£116.5m**	**£136.4m**	**£156.2m**

Business costs

42. As reported in table 5 below, the additional net cost to business from levy payments over the appraisal period is estimated to be in the range of £134.1 million to £173.8 million, with a central estimate of £153.9 million (NPV, 2015 prices). Of this, £36.1 million is effectively a transfer of costs from the government to business relative to the counterfactual, based on the assumption that, without the creation of the OGA, DECC would have maintained annual funding of £4.745 million from 2016/17 for the remainder of the appraisal period. The remainder of the additional cost to business is a result of increased regulatory activity by the OGA and the commensurate increase in costs to be recovered from industry via the levy.

43. In summary, it is therefore assumed that without the levy, the regulator's costs would not increase and would be funded, as at present, mainly by DECC, with around 20% of the costs recovered by direct fees and charges. Following the creation of the OGA and implementation of the levy, the cost of operating the regulator will increase significantly as it becomes better resourced and increases capability. The cost to industry will therefore increase as OGA costs increase and as current DECC funding is withdrawn after FY 2015/2016, but the rate of increase will be offset in the early years of operation as a result of transitional funding from HMT.

Table 5: Estimated net cost to business, £m NPV 2015, 2015 prices.

		NPV	
	Low	**Mid**	**High**
OGA costs	£165.7m	£185.5m	£205.4m
Minus Funding	£31.6m	£31.6m	£31.6m
Net cost to business (levy required);of which	**£134.1m**	**£153.9m**	**£173.8m**
Transfer of costs from government to business	£36.1m	£36.1m	£36.1m
Increase in OGA costs net of funding	£98.0m	£117.8m	£137.7m

Analysis on Levy Allocation Options

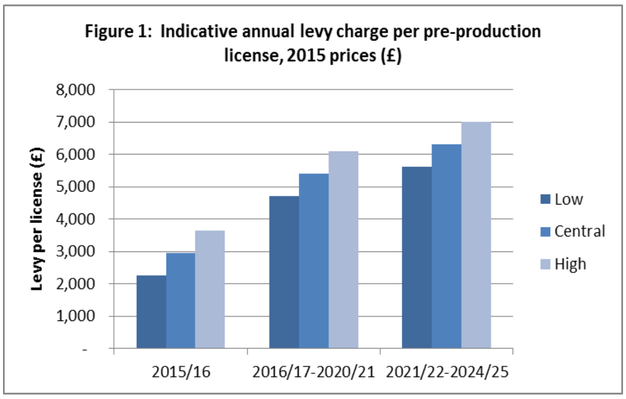
Option 1a (preferred option) – Allocate levy based on costs incurred as a result of activities undertaken for pre-production and production licensees and divide the costs equally between the number of licences in each group.

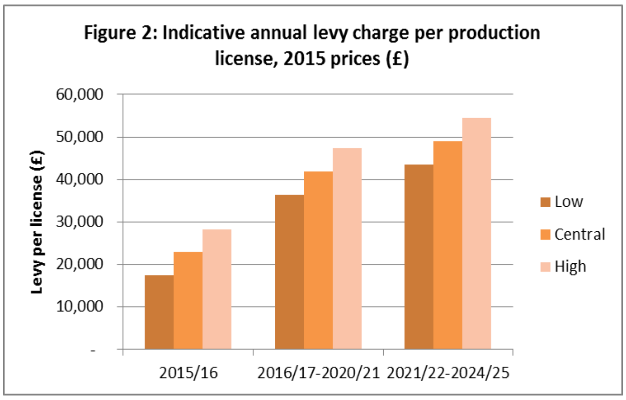
44. Based on the approach set out in paragraphs 21-25 above and the estimated levy between 1 October 2015 and 31 March 2016, the projected levy rates for licence holders are set out in Table 5 below. This shows that for FY2015/16 with a total levy of around £7.4 million (low estimate) the levy rate would be £2,250 for pre-production licences and £17,450 for production licences. In FY2015/16 with a total levy of £12.0 million (high estimate), the levy rate would be £3,660 for pre-production licences and £28,330 for production licences.

Table 5: Estimated levy by licence type in 2015/16, £'000k 2015 prices.

	Low	Mid	High
Total levy (£k)	£7,400	£9,695	£12,000
Pre-production share		11%	
Production share		89%	
Total levy pre-production (£k)	£813	£1,066	£1,320
Total levy production (£k)	£6,577	£8,629	£10,680
Pre-production licences		361	
Production licences		377	
Cost per pre-production licence (£k)	£2.25	£2.95	£3.66
Cost per production licence (£k)	£17.45	£22.89	£28.33

45. For pre-production and production licences respectively, Figures 1 and 2 below illustrate how the levy per licence would increase based on the indicative range of OGA costs and the expected reduction in government funding over the appraisal period. The estimates are consistent with the total levy estimates reported in Table 3 above.





46. The allocation of levy charges between pre-production and production licences on a 11% and 89% basis respectively is informed by an assessment of the current proportion of regulatory activity undertaken with respect to each group of licences. For the purposes of this analysis, as a simplifying assumption the split is held constant over the appraisal period. As outlined above, in practice the level of regulatory activity undertaken in respect of pre-production and production licences could change to some extent once the OGA is fully operational and thereafter vary to some degree on an annual basis. The cost profiles beyond 2015/16 for each group should therefore be viewed only as indicative.

Option 1b – Allocate levy based on costs incurred as a result of activities undertaken for pre-production and production licensees and divide these costs between licence holders in proportion to the size (acreage) of each licence

47. As outlined above, the first step of this option is the same as under option 1a, in that costs are allocated between pre-production (11%) and production licences (89%). The second step would then see costs for each licence in the two groups split in proportion to their size (acreage). Following consideration of this option it was deemed more appropriate to split the costs equally by licence, rather than in proportion to the size of licences. It was also judged that this approach would be simpler to administer.

48. In FY 2015/16 with a total levy of £7.4 million (low estimate) the levy per pre-production licence would vary in the range £34.0 to £20,924, and for production licences in the range £77.0 to £121,894. In FY 2015/16 with a total levy of £12.0 million (high estimate), the levy per pre-production licence would vary in the range £55 to £33,930 and for production licences in the range £124 to £197,665.

Option 1c – Allocate levy based on production levels.

49. Production levels attained by licence holders were initially considered as a possible metric for the levy. However, following discussion with industry it emerged that it could not be applied to holders of production licences that are not producing, exploration licence holders or gas storage and carbon dioxide storage licences. It would therefore not have been an equitable metric as all of the costs would fall only upon those licence holders producing petroleum. There would also be various technical challenges to deal with, such as how to account for different compositions of output (e.g. proportion of oil versus gas), which means that the approach would have been complex to administer.

Option 1d - Allocate levy based on acreage.

50. Acreage alone (i.e. without a split between pre-production and production licenses as in Option 1b) was also considered as a possible allocation metric. However, upon further examination the practice of acreage being relinquished means that holders of production licences who are not producing petroleum could pay the vast majority of the costs. This would not therefore reflect the actual costs the OGA expects to incur in relation to those licences and therefore would not be cost-reflective and non-compliant with the MPM principles. This would also not be a stable and predictable method for both the OGA and the industry.

51. The approach would have resulted in every licence holder paying a levy based on the acreage they held. This option disadvantages exploration licence holders, who would pay 72% of the levy as they hold the largest acreage in the basin. In this option, producing licence holders pay only 17% of the levy, while those in development pay 11%.

52. In FY 2015/16 with a total levy of around £7.4 million (low estimate), the licence rate would vary under this option in the range of £14.0 to £158,448. In FY 2015/16 with a total levy of £12.0 million (high estimate), the levy per licence would vary under this option in the range of £23 to £256,942.

Option 1e - Allocate levy based on licence rentals.

53. A further option, whereby the levy would be allocated based on licence rental payments was also considered. However several issues emerged with this option. The most significant of these is that the amount each licence holder is required to pay per acre was determined when the licence was awarded. Over time the amount per acre has increased and this would result in an inequitable allocation of costs between licence holders, with holders of older licences paying significantly less than holders of newly-granted licences. This option also raises administrative challenges as licence areas often change during the course of the year. This would result in a somewhat unstable and unpredictable levy for industry and the OGA.

54. In FY 2015/16 with a total levy of £7.4 million (low estimate) the levy per licence would vary under this option in the range £7.0 to £181,336. In FY 2015/16 with a total levy of £12.0 million (high estimate), the levy per licence would vary under this option in the range of £12.0 to £294,058.

BENEFITS

55. There are no monetised benefits directly associated with the introduction of a levy to recover the costs of establishing and operating the OGA. However, the creation of the levy will ensure that the OGA is both adequately funded and that it recovers its costs from companies who will benefit from the services of the Regulator. This will enable the OGA to fulfil its remit of being a strong, effective steward and regulator, using its influence as a last resort for the good of the UK.

56. The Wood Review presented estimates of the potential benefits that could accrue as a result of implementing MER UK, which were expanded upon in a previous Impact Assessment[7]. The estimated benefits comprised of net additional revenues from a combination of increased oil and gas production and lower production costs on the UKCS. The benefits were based on a combination of the value from the incremental production of 3-4 billion boe and the additional value resulting from assumed reductions of between 5-15% in the baseline production costs. Taken together, the benefits were estimated to be in the range £20.9 - £56.5 billion, with a central estimate of £40.8 billion. The analysis is still considered a reasonable estimation of the potential benefits based on the finding of the Review (subject to a wide range of uncertainty) and consequently has not been revisited as part of this IA. Full implementation of the Review's recommendations is also expected to result in wider economic and financial benefits. Such benefits include increased capacity, capability and skills in the oil and gas sector including the wider supply chain, increased innovation and enhanced security of supply.

Assumptions

The key assumptions used in the analysis are detailed above and in Annex A. In summary:

- The NPV base year is 2015 and all values are expressed in 2015 prices. A real discount rate of 3.5% has been used with costs assessed over an appraisal period of 10 years (2015-2024).

- The levy is assumed to be first paid in October 2015, and then on an annual basis over the appraisal period of 10 years.

- The estimated range of OGA costs in each year of the appraisal period is based on internal business planning forecasts. Assumed funding streams are consistent with current committed expenditure in support of the set-up and running costs of the OGA in early years.

- On the allocation of levy charges between pre-production and production licences, the respective 11% and 89% split of the total annual cost is based on an assessment of the current proportion of regulatory activity undertaken with respect to each group of licences. For the purposes of this analysis, as a simplifying assumption the split is held constant over the appraisal period. In practice, the level of regulatory activity undertaken in respect of pre-production and production licences could change to some extent once the OGA is fully operational and therefore vary to some degree on an annual basis. The cost mapping will continue to be monitored following OGA's establishment as an Executive Agency on April 1st 2015, and its transition to a Government Company in summer/autumn 2016. The cost profiles beyond 2015/16 for each group should therefore be viewed only as indicative.

- As discussed, the existing charging regime currently administered by DECC will remain in place but will be amended at the earliest opportunity to reflect the costs the OGA incurs for providing the services to industry and to expand the scope to recover several additional services via direct charges (rather than through a levy). Until these changes can be made, the costs of these activities will be recovered via the proposed levy. The estimated costs of the levy in this IA will therefore overstate the costs that will be recovered in future via this mechanism as some of the services provided by the OGA to industry will transition to the direct charging regime. The analysis therefore provides indicative estimates of the overall costs to business going forward based on the OGA assumed costs, but the distributional impacts between groups of companies

[7] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/370077/Implementation_of_the_Wood_Review_proposals_for_UK_offshore_oil_and_gas_regulation_-_IA.pdf)

(pre-production and production) and specific companies will in practice vary following the planned changes to the charging regime.

Risks

Appraisal assumptions and estimates

57. It should be recognised that there is significant uncertainty around the forecast operating costs of the OGA and consequently the outturn levy on industry over the appraisal period of 10 years. As outlined above, there is particular uncertainty around costs from 2016/17 onwards and a flat profile in real terms has been assumed as indicative of the magnitude of possible costs over the next ten years. While the estimated range of costs to business presented in this IA is intended to reflect the degree of uncertainty over future costs, it is possible that outturn costs could be greater or less than is currently anticipated. Further information is provided below on the proposed approach to managing accidental deficits and surpluses in the amount recovered annual via the levy.

Managing accidental deficits and surpluses

58. Our intention is to avoid burdening industry and the OGA is committed to keeping costs and administrative burden to a minimum whilst ensuring it is adequately resourced to deliver its remit. If the OGA underspends (i.e. the levy collected exceeds its running costs), it would calculate the amount owed to each licence holder and issue a credit note for that amount to each licence holder. This would be netted off against the amounts falling due the following year.

59. If the levy rate is set too low to recover the OGA's expected costs, the OGA would first attempt to work within budget by re-prioritising work. If it was not possible, the OGA will seek approvals from DECC and HMT before revising its budget and considering amending the levy rate.

Unpaid levy

60. The intention is that interest will be charged in respect of unpaid amounts of licensing levy and unpaid amounts will be recoverable as a civil debt.

61. The interest rate will be set out in regulations and will reflect the standard cost of borrowing.

Investor confidence

62. The introduction of secondary legislation to recover costs via a levy could have negative or positive effects on investor confidence. Given that the industry has been supportively involved in the Wood Review and that the Government has clearly signalled its intent to regulate and establish a levy, we do not expect the introduction of legislation to impact on investor confidence. While it is recognised that no cost increases are welcome for an industry that already faces significant challenges in the UKCS, the Government believes that the relatively modest investment that will be required will be paid back over time by improved performance, greater recovery and improved tax receipts across the basin. In line with the established practice across regulation and service delivery, the Government considers it is appropriate for the body to recover its costs from companies who will benefit from its services as a Regulator.

6. Rationale and evidence that justifies the level of analysis

63. The analysis contained in this Impact Assessment is considered proportionate at this stage of OGA business planning. The analysis sets out an indicative range of estimates of the potential costs associated with the establishing a levy over the appraisal period of ten years. These estimates will be refined in a further, final stage Impact Assessment prior to the levy coming into force.

7. Small and Microbusiness Assessment (SMBA)

64. The exact number of small or microbusinesses (defined as having up to 49 FTE and 10 FTE employees respectively, as per BIS Better Regulation Framework Manual) in the exploration or production of the UKCS is unknown, however, both types of companies operate in this sector.

65. The Government believes that including businesses of all sizes in the policy will promote a higher level and more effective co-ordination by the new Regulator and will allow extracting the maximum benefit from the implementation of MER UK principles. Small and microbusinesses will benefit from access to the infrastructure and the synergies resulting from joint field exploration and development that would not be achieved by excluding them from the policy. The intention is not to impose any disproportionate burden on companies of any size. Following the consultation, a more detailed small and microbusiness assessment will be included in the final stage Impact Assessment accompanying including a detailed assessment of the need for exemptions (full or partial) or actions to mitigate burdens on these businesses.

8. Summary and description of implementation plan

66. In summary, the proposal is to introduce a levy on industry in order to fund the activities of the OGA. The levy would be allocated based on the proportion of costs incurred as a result of activities undertaken for pre-production and production licensees. The total cost to be recovered from the two groups would then be divided equally according to the number of licensees in each. The approach is designed to ensure, so far as practicable, that the costs to industry licence holders fall to those that impose the costs on the OGA i.e. cost-reflective charging.

67. It is proposed that the new levy structure and rates will be brought into effect once the Statutory Instrument has been laid in parliament and brought into force after 40 days (negative resolution procedure). The legislation is expected to come into force in October 2015 and continue thereafter.

68. The total amount due from each company would be requested at the start of the financial year (April). Prior to that, the OGA will seek approval for its proposed budget from DECC and HMT and then consult industry. A notional timetable for this procedure is presented below: A notional timetable for this procedure is presented below. As we intend to have the levy in place in October, this timetable will be adjusted this year but will be in place for FY2016/2017.

Timeline	Activity
September	OGA to discuss business plan for year ahead with industry
October	OGA to produce business plan for year ahead and suggest required levy rate
October – December	DECC to consider business plan
December – January	DECC/HMG to approve levy rates
Mid-January – Mid-February	DECC to draft regulations
Mid-February	DECC to make and lay regulations
April	Regulations come into force. Invoices issued and levy paid

69. As with any other use of public resources, it is important to monitor performance and review the service routinely at least once a year, to check, and if appropriate revise, the charging level.