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REGULATORY IMPACT ASSESSMENT FOR CHANGES TO THE NORTH SEA TAX REGIME

Introduction

5.1 This Full regulatory impact assessment assesses the package of changes to the North Sea Fiscal regime announced in the 2005 Pre-Budget Report.

Purpose and Intended Effect

The Policy Objective

5.2 The Government is committed to maintaining an active UK oil and gas industry and to promoting the future development of the nation's gas and oil reserves. The North Sea oil tax regime must strike the right balance between oil producers and consumers, by promoting investment and ensuring fairness to taxpayers.

5.3 The objective of the changes to the North Sea tax regime announced in the 2005 Pre-Budget Report is to maintain this balance in view of the recent significant increases in oil prices and the upwards shift in expectations of the medium term outlook for future oil prices.

Background

5.4 The North Sea fiscal regime has three tiers:

- Ring fence corporation tax (RFCT), which is similar to the normal corporation tax regime but with 100 per cent capital allowances on most capital expenditure, and an enhanced exploration supplement (EES). The EES provides an annual uplift of 6 per cent in the value of unused capital allowances due to qualifying exploration and appraisal (E&A) expenditure that are carried forward each year for a maximum of 6 years. In addition, the regime is “ring-fenced” which prevents taxable profits from oil and gas extraction in the UK and UKCS from being reduced by losses from other activities;
- A 10 per cent supplementary charge (SC) levied on oil and gas companies' profits as computed for the ring fence corporation tax above, but without allowing a deduction for financing costs; and
- Petroleum revenue tax (PRT), which is special field-based tax currently levied at 50 per cent. PRT does not apply to fields given development consent on or after 16 March 1993. PRT is deductible against RFCT and SC.

5.5 The 10 per cent SC and 100 per cent capital allowances were introduced at Budget 2002. These changes were followed by the abolition of Royalty on North Sea oil and gas production from 31 December 2002.

5.6 All three components of the fiscal regime, RFCT, SC, and PRT, act effectively as cash flow taxes: all income is recognised as it is earned, virtually all expenditure is relieved as it is incurred, and the difference between income and expenditure is subject to North Sea taxes (as appropriate). Cash flow taxes target economic rents (or supernormal profits) and are generally accepted as one of the most efficient forms of

taxation for natural resources such as oil and gas, with only a limited impact on investment rates of return and associated investment decisions.

Rationale for Government Intervention

5.7 Oil prices have been rising since late 2001, and have increased particularly sharply since the beginning of 2004. At its peak in August 2005, the price of Brent, the European standard, reached over \$65 a barrel. Since Budget 2005, robust oil demand, low levels of spare capacity, and supply disruptions have meant oil prices have significantly exceeded market expectations. As a result of these developments, market forecasters have increased their expectation of the medium-term outlook. Prices are expected to moderate from current high levels, but to remain at a higher level than the average over the last 20 years.

5.8 Increased oil prices feed directly into North Sea company profits because oil companies are price takers, and as a result of the recent sustained rises in oil prices, North Sea companies are experiencing significant increases in the economic rents they derive from the exploitation of UK oil reserves. With the shift upwards in the outlook for oil prices, the increase in economic rents can be expected to continue for a number of years.

5.9 There is a similar story in the UK gas market. Due to the UK link with European gas supply networks, UK gas prices have become increasingly tied to oil prices over the last five years. This is due to the extensive use of long-term gas supply contracts in European markets that are indexed to the price of oil. Gas producers have been able to earn additional economic rent from high gas prices fed in part by the rising oil price. Natural depletion of UKCS gas reserves will reinforce the tendency for gas prices to follow the trend of oil prices and global gas prices as the world liquified natural gas (LNG) market develops.

5.10 The growth in economic rents in the oil and gas sectors means there is a strong case for increasing supplementary charge to maintain the right balance between oil producers and consumers by promoting investment and ensuring fairness for taxpayers.

Options

5.11 Four options have been identified for meeting the objectives set out above:

1

5.12 Do nothing.

2

5.13 A 10 per cent increase in SC, to take effect from 1 January 2006.

3

5.14 Option 2, plus the introduction of provisions that allow companies to defer the 100 per cent capital allowances on investment made in 2005 until 2006. This would ensure that the sunk costs of recent investment would receive relief at the same tax rate to be imposed on future income from that investment; and

4

5.15 Option 3, but with the introduction of a new Ring Fenced Expenditure Supplement (RFES). The new RFES will replace the existing EES and will provide an annual uplift of 6 per cent for a maximum of 6 years in the value of all North Sea expenditure that cannot be relieved against other North Sea profits. EES currently applies only to qualifying E&A expenditure.

Sectors and Groups Affected

5.16 The options set out above will affect the 120 or so entities undertaking oil or gas exploration and production activities in the UK or on the UK continental shelf. The replacement of the EES with the RFES will primarily affect the small sub set of those companies that are not yet trading, or that do not have a tax liability sufficient to relieve all expenditure. These are likely to be new entrant companies or others who invest heavily in the North Sea and are an important sector for the continued vitality of oil and gas production in the UK.

Benefits

Exchequer

5.17 The table below shows the exchequer benefits from each of the options described above.

Table 5.1 Exchequer Effects (£bn)

	2006 / 07	2007 / 08	2008 / 09
Option 1	0	0	0
Option 2	2.2	2.2	2.3
Option 3	2.0	2.2	2.3
Option 4	2.0	2.2	2.3

5.18 With the exception of option 1, all of the options would produce an exchequer yield and therefore help ensure that the Exchequer receives an appropriate share of the benefits accruing to oil companies from the production of North Sea oil and gas. The exchequer impacts of the RFES build up over time, and are forecast to cost the Exchequer around £25 million in 2011-12.

5.19 The introduction of the RFES in option 4 would also help level the playing field between established companies that are able to offset investment costs against profits in year, and new entrants that can only relieve the tax losses associated with investment expenditure by carrying those losses forward and offsetting them against future profits. Option 4 may therefore improve competitiveness in the sector, although the economic benefits are only expected to be marginal.

Administrative and Compliance

5.20 The replacement of the EES with the RFES in option 4 should result in some compliance cost savings for oil companies and HM Revenue & Customs as they will no longer have to identify the proportion of tax losses that are associated with E&A activity. Instead, all tax losses will now qualify for the supplement.

Costs

Economic and Investment

5.21 Because the tax base for the North Sea fiscal regime is closely aligned with economic rents, an increase in the SC tax rate to 20 per cent carries only a low risk of substantial investment loss from planned development projects. On the basis of available industry data, but adjusted for improved project viability because of current high oil prices, the increase in the supplementary charge might be expected to have some impact on a very small number of marginal investments.

5.22 However, the potential impacts on investment by companies that currently have to carry forward losses will be partly offset by the introduction of the RFES in option 4. With the exception of the “do nothing” option, option 4 therefore has the least impact on investment.

5.23 The increase in the supplementary charge is unlikely to have a significant effect on the attractiveness of the UK continental shelf for global investment. Analysis by independent industry consultants¹ indicates that the NS tax regime is currently one of the most favourable in the world in terms of Government tax take as a proportion of total Net Present Value (NPV) of NS developments. A 10 percentage point increase in the SC will increase the Government’s share, but does not substantially alter the position of the regime as being significantly more favourable for investment than most of the rest of the world’s oil provinces.

5.24 The increase in SC to 20 per cent is expected to have only a limited impact on the UK’s comparative attractiveness, measured in terms of the expected monetary value (EMV) of exploration, against other global oil regions for exploration activity¹.

Administrative / Compliance

5.25 Changes are required to HM Revenue & Customs IT systems and the corporation tax self assessment (CTSA) return. The cost of these changes is estimated at around £300,000 in system changes. Most other changes to forms etc will be undertaken as part of the normal Budget change process so no additional charges will accrue.

Small Firms Impact Test

5.26 The options described above apply equally to large and small companies, and as a result there are no specific small firm issues.

¹ Wood Mackenzie Global Oil and Gas Risks and Rewards report (2004).

Competition Assessment

5.27 The proposed changes pass the standard competition filter test for both gas and oil markets. Oil companies are price-takers, facing a globally-determined market price for their output, and so will absorb all costs. They will be unable to pass any costs on to consumers, and the impact will be distributed proportionately across producers with no adverse effects on competition.

5.28 There is no truly global market for gas, but UK gas market liquidity is considered to be high and rising due to the existence of effective gas trading. There are therefore no expected adverse effects on competition as a result of the proposed changes.

5.29 In light of the above a detailed competition assessment is not included here.

Consultation

5.30 Although consultation was not considered appropriate on the options, the Government announced in the PBR that it intended to open discussions with industry about tackling wider structural issues that affect the stability of the North Sea fiscal regime and this process has now begun. In the partial RIA published alongside the PBR the Government also requested businesses' views on the compliance cost implications of the options identified above. No responses were received from this request.

Enforcement, Sanctions and Monitoring

5.31 The normal interest and penalty provisions within the framework of the current regulations will apply to late payments. HM Revenue and Customs expects that in estimating their payments, companies will follow normal commercial practice and apply corporate governance and appropriate standards. Guidance on the HM Revenue and Custom's approach to compliance is published on the Departmental Internet site.

5.32 The corporation tax payments of oil companies are kept under constant review due to their impact on the overall tax take of the UK.

Implementation and Delivery

5.33 The Government's preferred option (option iv) was announced in Pre-Budget report 2005 and was brought into effect on the 1st of January 2006. The measures it introduces will not create any new, or increase any current, compliance burdens on companies. Therefore a detailed Implementation and Delivery plan has not been prepared.

Post Implementation Review

5.34 The Government will internally assess the economic and tax impact of these changes as information is received on the first year of the change and on an ongoing basis thereafter. As announced in PBR 2005 the Government is also conducting an open discussion with business on the North Sea fiscal regime, alongside the existing engagements with business on other North Sea issues. (Through for example the PILOT group) Government will use these forums to further discuss the effect and efficiency of these measures. In due course HMRC will also undertake a review of the compliance cost savings in this RIA in Standard Cost Methodology terms.

Summary and Recommendation

5.35 Oil prices have increased sharply since the beginning of 2004. Since Budget 2005, oil prices have significantly exceeded market expectations, and market forecasters have increased their medium term expectations accordingly. Prices are expected to moderate from current high levels, but to remain at a higher level than the average over the last 20 years.

5.36 Increased oil prices feed directly into North Sea company profits because oil companies are price takers and, as a result of the recent sustained rise in oil prices, North Sea companies are experiencing significant increases in the economic rents they derive from the exploitation of UK oil and gas reserves. This increase in economic rents can be expected to continue for a number of years, and there is therefore a strong case for increasing supplementary charge to strike the right balance between oil producers and consumers by promoting investment and ensuring fairness for taxpayers.

5.37 Option 1 would do nothing to help meet this objective. Option 2 would increase the Government share to an appropriate level, but may have a particularly adverse effect on the post-tax returns of investments made recently. Option 3 addresses this concern by allowing companies to defer allowances on investment expenditure incurred in 2005 to 2006 where they will be relieved at the new higher rate. Option 4 goes one stage further and attempts to mitigate some of the effects on investment by new entrants by replacing the existing EES with a new RFES that provides an annual uplift of 6 per cent in the value of all unrelievable expenditure rather than just the qualifying E&A expenditure that the existing EES applies to. As a result, the Government announced at PBR 2005 that it intends to take forward Option (iv).

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REGULATORY IMPACT ASSESSMENT
Changes to the North Sea Tax Regime
Statement of Ministerial Approval

I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs.

Signed by the responsible Minister:

Dawn Primarolo
Paymaster General

Dated: 14 March 2006