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REGULATORY IMPACT ASSESSMENT FOR NORTH SEA OIL TAX PRICING RULES

Purpose and Intended Effect of the Measure

The Policy Objective

8.1 There is evidence of distortion to the commercial decision making process of companies for tax driven opportunities that the current legislation provides. The objectives of the proposed changes are to provide a tax neutral environment in which commercial decisions are taken, so reducing the scope for tax manipulation and reducing the level of tax loss to the Exchequer.

Background

8.2 Profits arising from the extraction of oil and gas in the North Sea are liable to a special tax regime:

- Petroleum Revenue Tax (PRT) – charged at 50 per cent on the net income of fields given development consent before 1993;
- Ring Fenced Corporation Tax (RFCT) – charged at 30 per cent. The ring fence is a concept that retains the profits from the extraction of oil and gas in the North Sea inside the “fence” and prevents them being diluted with losses etc from other activities; and
- Supplementary Charge (SC) – charged at 20 per cent on ring fence profits chargeable to CT (before finance charges).

8.3 The normal logic of business is to realise the highest possible price for a product but because ring fence profits are taxed at a marginal rate of 75 per cent or 50 per cent (dependant on whether the field is subject to PRT or not) there is an incentive to try and move profits outside the ring fence into trading operations so they are taxed at the UK standard rate of 30 per cent.

8.4 The general principle underlying the current rules for pricing UK oil for taxation purposes is that the actual realised price is taken for oil sold at arm’s length (to third parties) and a monthly market value (determined by HM Revenue and Customs) is applied to non arm’s length sales and transfers to their own refineries.

Rationale for Government Intervention

8.5 There are inherent problems with the monthly valuation in current legislation, which provides an opportunity (particularly in volatile markets) to arbitrage between arm’s length and non-arms length disposals to achieve the lowest price for tax purposes. A further arbitrage opportunity arises in a rising market, where the market value fails to keep up with the actual price of oil.

8.6 The Government is concerned that the current oil taxation legislation allows companies too much scope to select the price of North Sea oil on which they will be taxed causing significant loss of tax to the Exchequer. This means that not only is the Exchequer receiving less than its full share of the benefits of North Sea Oil but by allowing this behaviour to continue, the Government is failing to create a level playing field for all North Sea companies.

Consultation

8.7 Within Government, consultation has taken place with:

- HM Revenue and Customs sector specialists and analysts;
- HM Treasury; and
- Department of Trade and Industry

Public Consultation

8.8 As oil is such a specialised industry and has a specific system of taxation, full consultation was deemed inappropriate. A discussion document was sent to the oil industry and other interested parties in July 2005. Following on from this, a series of meetings have taken place with representative bodies, individual oil and gas companies, oil traders and price reporting agencies. Written representations have also been received. There was a general acceptance that the Government's proposals were a proportionate and workable response and a number of helpful suggestions on the details of the new rules have been adopted.

Options

1. Do Nothing

8.9 The ability to minimise tax has been recognised as a feature of the legislation as it stands but the amount of tax being lost was not deemed to be significant. However, a recent review of the way the valuation procedures operate indicates that manipulation of the current rules is resulting in around £80 million a year, on average, lost tax to the Exchequer, rising in line with higher prices and/or a volatile market.

8.10 The fact that transactions of some oil companies appear to be tax driven rather than made for pure commercial reasons leads to the conclusion that there is a sound case for seeking to eliminate or substantially reduce the amount of tax currently being lost. The Government is committed to ensuring oil companies receive a fair post-tax return for their risk and investment in the North Sea and the UK gets a fair share of the revenues derived from what is a national resource. The Government is also committed to providing a level playing field for companies investing in the North Sea. The legislation as it currently stands is not achieving these objectives.

2. Change the basis of calculation for the market value from a month based on a 6 week reference period to a daily value based on 5 days around the bill of lading

8.11 Under current rules, a monthly market value is applied to all non arm's length sales of oil. It is calculated by averaging a daily average of all sales over a six week period (the valuation reference period) beginning at the start of the month prior to delivery and ending in the middle of the month of delivery.

8.12 Setting a market value for a one month period means that the price is rarely likely to reflect the actual value of oil at the time of delivery, especially in a volatile market. It also means that companies can predict with some accuracy what the market value is likely to be and to decide whether to sell their oil at arm's length or non arm's length according to which will produce a lower tax bill. They will sell arm's length when

they expect the monthly market value to be higher than their realised price and non arm's length when they expect the monthly market value to be lower than the realised price.

8.13 To make the system tax neutral it is necessary to ensure that the amount taxed for arm's length and non arm's length sales are similar, especially as the general taxation principle of arm's length sales is that the market value of goods for delivery at any given time should reflect prices for sale on the open market at that time. The reason for the divergence of prices in the North Sea is due to the fact that a monthly average value cannot reflect the price of specific cargoes unless the price of oil is static. This means that there can be significant tax loss in volatile, rising and falling markets.

8.14 A daily value for oil could be achieved by taking an average of the daily prices for the actual date of the bill of lading (the document issued by the carrier which is evidence of the receipt of goods and a contract of carriage) and two days either side. This would provide a more realistic market price and remove the opportunity for companies to choose whether to sell arm's length or non arm's length by "second guessing" what the monthly value would be.

3. Change the basis of calculation for the daily market value to a period greater than 5 days but less than 6 weeks or use a different 5 day period

8.15 As in option 2 but using a longer reference period than 5 days to calculate an average, for example 0-0-10 or a different 5 day period 0-0-5.

Sectors and Groups Affected

8.16 The options set out above will affect only 120 or so entities undertaking oil and gas exploration activities in the UK or UK Continental Shelf. It is unlikely that any other particular groups or companies would be affected.

8.17 There are no environmental or social cost impacts to any of the options. There are no specific impacts on:

- rural communities;
- voluntary organisations and charities;
- human rights;
- devolved administrations; and
- particular regions of the UK.

8.18 There are no specific equality issues, but the need for change is driven by the desire to create a level playing field for all companies investing in the North Sea.

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8.19 UK citizens generally will be affected by the continuing loss of tax to the Exchequer from the do nothing option and the North Sea playing field will remain uneven.

2

8.20 This option reduces the scope to choose between arm's length and non arm's length sales for tax driven reasons and so produces a tax neutral regime. Moving to a daily market value means that the market value reflects the actual value of oil at any given point. As such, the regulatory impact on oil companies should be negligible or even reduced and they will be able to hedge any risks with certainty.

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8.21 This option would also produce a daily value based on a shorter period, as such the impact would be similar to option 2. Companies might find it easier to hedge 0-0-10 or 0-0-5 if the delivery date is unknown but Option 2 provides the hedging certainty required and reflects the way in which most oil is sold.

Costs and Benefits

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8.22 Comparison of the monthly market value over a 6 year period 1999 – 2004 with an average of the actual arm's length nominated prices on which companies have been taxed shows an average tax loss of £80 million per year but it could be substantially more in any given year depending on market conditions and the price of oil.

8.23 The do nothing option imposes no additional costs on companies.

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8.24 Analysis suggests that around £80 million per year could be recovered by changing to a daily market value based on a 5 day reference period. Because companies already have to make a return to HM Revenue and Customs of all sales for PRT purposes, there would be no additional regulatory burden in complying with this option. Companies' administrative requirements may fall if there is no longer an incentive to engage in or resource behaviours that are causing the tax loss.

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8.25 Tax benefits are the same as option 2, although there may still be arbitrage opportunities between arm's length 2-1-2- prices and non arm's length 0-0-10 or 0-0-5 prices which could reduce the yield and are less in line with market practice.

8.26 Figures for increased tax shown below are based on 2004 analyses and reflect what could be recovered for 2006/07 and subsequent years if options 2 or 3 were implemented.

Table 8.1 Option recovery if implemented

Option 1	Option 2	Option 3
(£80m)	£80m	£80m (but see comments above)

Small Firms Impact Test

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

Competition Assessment

8.28 A competition assessment has been undertaken and the filter has been applied to each option. This indicated that reforming the oil tax pricing rules should not have any adverse effects on the highly specialised activity of companies who sell oil they have won from the North Sea into the highly competitive and buoyant world market.

8.29 Not all companies have the opportunity to use planning techniques described here and of those who do, some chose not to. By implementing some of the options outlined in this document the Government is creating a level playing field for companies by removing or refining tax rules that are distorting commercial decisions.

8.30 The proposed changes would help to eliminate any unfair competitive advantage accruing to companies with integrated off-shore oil extraction and on-shore refining activities who by being able to switch between selling arm's length (to third parties) or non arm's length (into their own refineries) can reduce their exposure to tax. In so far as the changes may eliminate opportunities for switching, they will also reduce administrative costs for companies engaged in such activity. In turn, it may also be possible to reduce regulatory burdens.

Enforcement, Sanctions and Monitoring

8.31 The principles of option 2 or 3 would be defined in primary legislation with the detail contained in Regulations. The legislation will be enforced via the normal risk assessment process. Sanctions would be through the statutory interest and penalty provisions as defined in the Finance Acts.

8.32 The information returned by companies is subject to routine analysis by HM Revenue and Customs operational caseworkers to ensure the correct amount of tax is collected. The results of any legislation and any resultant changes in behaviour would be monitored as part of this process to ensure no further tax is at risk.

Implementation and Delivery Plan

8.33 Draft legislation will be issued before the Budget to allow time for further comment from industry, with changes commencing from 1 July 2006. This provides adequate time for companies to make any necessary changes. Full instructions will be published in the Oil Taxation Manual. In due course HM Revenue and Customs will also undertake a review of the figures in this RIA in Standard Cost Methodology terms.

Post-implementation Review

8.34 HM Revenue and Customs calculations of the oil price for NAL sales will be monitored against values of AL sales for comparison. We will repeat the analysis we carried out for earlier years to see if the pattern has changed.

Summary and Recommendation

8.35 It is recommended that option 2 is adopted as it mirrors the way in which oil is actually sold. Option 1 would not achieve the objective of ensuring the Government receives its' full share of the benefits of North Sea Oil and creating a level playing field for all North Sea companies. While option 3 would potentially achieve a similar outcome to option 2, it does not reflect the way in which the majority of North Sea oil is sold and still leaves open the risk of tax arbitrage opportunities for companies to exploit. HM Revenue and Customs will continue to review the pricing terms of market contracts with a view to moving the market value to either 0-0-10 or 0-0-5 should either of those become the market norm.

Table 8.2 Summary Costs and Benefits

Option	Total benefit per annum: Economic, Environmental, and Social	Total cost per annum: Economic, Environmental, Social, Policy and Administrative
1	£80 million tax loss	Nil
2	£80 million tax	Nil
3	£80 million tax	Nil

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REGULATORY IMPACT ASSESSMENT

Reform of the North Sea Oil Tax Pricing Rules

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