7 Regulatory Impact Assessment for North Sea Taxation

Reform of the Nominations Scheme and Rules for Dealing with Blended Oils

Purpose and Intended Effect

The Policy Objectives

7.1 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 reduce compliance costs and provide a tax neutral environment in which commercial decisions are taken.

7.2 Changing the rules of the Nominations Scheme and thus reducing the scope for tax spinning will reduce the level of tax loss to the Exchequer. Changing the tax treatment of co-mingled oil will also reduce tax lost by preventing the opportunity to lift from non Petroleum Revenue Tax (PRT) fields, or substitute bought in oil when the oil price is high and from PRT fields when the price is lower.

Background

7.3 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% on the net income of fields given development consent before 1993.
- Ring Fenced Corporation Tax (RFCT) – charged at 30%. 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.
- Supplementary Charge (SC) – charged at 20% on ring fence profits chargeable to CT.

7.4 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% or 50% (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% or to shift income and/or assets from PRT paying fields to non PRT paying fields so they are taxed at 50% rather than 75%.

Rationale for Government Intervention

7.5 Some companies chose to try and limit their liability to PRT and RFCT by indulging in a practice known as tax "spinning". Legislation introduced in 1987 (the Nominations Scheme) and then strengthened in 1994, sought to limit scope for spinning but it has become clear that significant tax is still lost on an annual basis.

7.6 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. Not all companies take advantage of the current legislation but those who do

cause significant loss of tax to the Exchequer. This means that not only is the Government receiving less than its full share of the benefits of North Sea Oil but by allowing this behaviour to continue, it is failing to create a level playing field for all North Sea companies.

Consultation

Within Government

7.7 Consultation has taken place with:

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

Public Consultation

7.8 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 has been a general acceptance that the Government's proposals are 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

7.9 The ability to minimise tax has been recognised as a feature of the legislation as it stands. A recent review of how the nominations procedures operate indicates that manipulation of the current rules is resulting in around £45 million a year, on average, lost tax to the Exchequer, rising in line with higher prices and/or a volatile market. The tax driven opportunities for allocating oil to specific fields at terminals or even replacing delivery of equity oil with oil bought from third parties is resulting in a further £35 million a year lost tax.

7.10 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 achieving a fair share of North Sea profits and to providing a level playing field for investors. The legislation as it currently stands is not achieving these objectives.

2. Taxing all North Sea Sales at Market Value

7.11 The BFO forward market enables producers of Brent (or potentially Forties) blend to open successive forward positions, which may be many more than are required to dispose of equity oil. (BFO is a forward contract giving the seller the option to sell Brent, Forties or Oseberg crude.) They can then chose the lowest priced sale to match to their equity to minimise the value of the sale on which they will be taxed at the

full marginal rate. This is known as tax "spinning". Spinning is a phenomenon of the Brent forward market and arises from the fact that sales do not have to result in the physical delivery of oil.

7.12 The Nominations Scheme was introduced in 1987 and amended in 1994. It attempted to restrict the opportunity to spin by requiring companies to notify sales of equity crude to HM Revenue and Customs within a specified time (5pm on the next business day). If they fail to do this they are taxed to PRT on the monthly market value if this is higher than the realised price.

7.13 But in a volatile or falling market, companies can enter successive contracts and delay nominating a contract until the lowest point in the price cycle thus capturing the lowest possible price for their equity production and enabling them to be consistently taxed within the ring fence on an amount lower than the average market value for such deliveries. Not all companies engage in tax spinning but where they do so a considerable tax advantage can be achieved.

7.14 Moving to a system where all North Sea sales were taxed at a market value would solve both the scope to pick and chose between arm's length and non arm's length sales and the tax spinning issue. This approach would be controversial, as arm's length sales would be taxed on a different value to what is actually achieved in the market. It could be especially penal to those companies who do not have the opportunity to spin or to manipulate the price on which they pay tax.

3. Tax all Equity Sales on the Brent Forward Market at Market Value

7.15 This would achieve a similar result to option 2, but would represent a more focused approach.

7.16 The potential risks to the Brent market of implementing either option 2 or 3 have been considered. While the market in forward Brent paper contracts was originally mainly tax driven, once the market was up and running these contracts became instruments for speculation and hedging.

7.17 However, there are now a large range of financial instruments that perform these tasks and arguably the Brent forward market is no longer essential for this purpose, although tax driven practices are no doubt contributing to the liquidity of the Brent market. Furthermore, some producers may be reluctant to enter the forward market for sale of their production where the tax price was other than the realised price. There is therefore a risk that implementing option 2 or 3 may have an impact on the market.

7.18 Some contributors to discussions have suggested the changes would result in a scenario where liquidity in the Brent market would reduce to such an extent that the market would collapse and undermine the credibility of the International Exchange (ICE) futures contract that is settled off the forward market price. This could destabilise Brent crude's position as the world's most widely used crude marker price, with consequent movement of oil futures trade away from the UK.

7.19 Following extensive debate on this issue with market consultants and other interested parties, the Government is unconvinced of the strength of this argument but acknowledge that the risk exists. Option 4 was therefore developed to achieve the same outcome, whilst minimising commercial risk.

4. Tighten up the current nominations scheme rules and apply nominations excess to RFCT and SC

7.20 The time limit for nominating sales to HM Revenue and Customs is 5pm on the day of business following the date of the contract, where the company wants to fix the price on which it is taxed. Under the scheme rules, any equity sales volumes in a month that have not been nominated will be subject to Petroleum Revenue Tax (PRT) on both the realised price and, where higher, the excess of the market value of that oil for that month over the realised price. Such excess is known as a nomination excess.

7.21 The scheme therefore provides a simple mechanism for companies to achieve certainty on the PRT tax price on fixed price contracts in the forward market provided they deliver their oil through the contract nominated. Under current rules, a nomination excess is only chargeable to PRT so companies with field interests not liable to PRT (post 1993 fields or those where fields are covered by reliefs or allowances) are still free to tax spin on sales of oil and thus benefit from lower ring fence prices for CT and SC. The tax saving is less in these cases than for PRT paying fields but can still be considerable.

7.22 For the Nominations Scheme to achieve its policy objective of curtailing tax spinning the Government believes it is necessary to make the nominations excess liable to RFCT and SC as well as PRT. If the scope is not extended, it is still possible that companies will simply not bother to nominate where they have the ability to tax spin and pay PRT on nomination excesses from their PRT fields while enjoying the benefit of lower prices for RFCT and SC in respect of their whole production. Therefore, nomination excesses will be subject in full to the appropriate North Sea tax rates whether or not particular fields are liable to PRT.

7.23 Bringing forward the time for nominations by 24 hours to 5pm on the date of the contract would reduce the scope for choosing lower priced contracts but would not solve the problem entirely. Requiring companies to nominate immediately on entering a contract would remove the scope but could be difficult to police.

7.24 Therefore a time limit of 2 hours for nominating from entering a deal has been chosen to meet the objectives of stopping tax spinning, allowing companies sufficient time to enable them to properly nominate a deal and enabling HMRC to police the system.

7.25 The scope of the scheme will also be limited to sales made through forward contracts. This will prevent sales where there is no risk of tax spinning from being caught by the amended legislation and so will result in the need for fewer nominations overall. No risks associated with this option have been identified.

5. Introduce Rule to Address the Allocation of Oil not in line with Entitlement

7.26 This problem arises where large producers have interests in more than one field contributing to a particular blend. Although it is different from the problem of tax spinning and the options to solve this outlined above, it is part of the larger problem of tax driven behaviour, which these measures seek to address. While some fields may be liable to PRT, others may not and in these circumstances companies will allocate their lifting at the terminal point from non PRT fields when the oil price is high and from PRT fields when the price drops, thus reducing their tax liability.

7.27 In addition to this, they may buy oil from small producers under month of entitlement contracts and substitute this oil for their own equity oil when oil prices are high. Oil purchased from another producer and any subsequent sale of this oil is treated as trading in oil rather than the production of oil and is therefore outside the ring fence and only subject to 30% tax. Rules announced at PBR 05 to change the way in which oil for non arm's length disposals is valued from 1 July 2006 will go some way to reducing the tax advantage from these strategies but further action is still needed.

7.28 Introducing rules to ensure that the tax treatment of oil lifted is in accordance with field entitlement would remove the tax benefit for companies in allocating cargoes to particular fields or to substitute purchased oil out of line with entitlement in an attempt to optimise their tax position.

7.29 Large producers were paying a premium to small producers (up to $1 per barrel) in return for the flexibility of lifting additional oil at a time when oil prices are high. This premium may reduce following revised legislation to the extent that it represents a share in the tax savings derived from buying and selling oil in this way.

Sectors and Groups Affected

7.30 With the exception of options 2 and 3, the options set out above will affect only 120 or so entities undertaking oil and gas exploration activities in the UK and UK Continental Shelf. It is unlikely that other particular groups or companies would be affected. Options 2 and 3 may have a much broader impact on the workings of the Brent market and consequent ripple effect to market traders, dealers and exchanges.

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

- rural communities;
- voluntary organisations and charities;
- human rights; and
- devolved administrations.

7.32 Any impact to markets from option 2 or 3 is likely to impact London more than any other region of the UK due to the location of market traders and the Intercontinental Exchange.

7.33 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.

Costs and Benefits

1. Do Nothing

7.34 Loss of tax from tax spinning and optimisation strategies for allocating oil at terminals is estimated at up to £ 80 million a year which would be lost to the Exchequer under the do nothing option.

7.35 The do nothing option imposes no additional costs on companies. But 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. Taxing all North Sea Sales at Market Value

7.36 By imposing a market value on all equity sales of North Sea oil, companies could be taxed on quite different amounts to what they actually realise on their sales.

7.37 This option should recover 100% of the tax at risk from tax spinning, so recovering on average £45 million per year. It would remove the need for the Nominations Scheme altogether. The Nominations Scheme currently imposes a high compliance burden on companies that engage in tax spinning and also on those who fall within the scope of the scheme but do not spin. Implementing this option would therefore contribute to the Government's aim of reducing the regulatory burden on business.

3. Tax all Equity Sales on the Brent Forward Market at Market Value

7.38 Applying a market value to all equity sales through the Brent forward market would impact on any oil company engaged in this behaviour but the price of equity oil delivered under these contracts does not reflect the true value of oil for that delivery period. This difference is currently made up by the Exchequer (and hence the UK population) in terms of lost tax.

7.39 On its own, this option would recover around £45 million a year. It would also obviate the need for the Nominations Scheme as discussed above.

4. Tighten up the current nominations scheme rules and apply nominations excess to RFCT and SC

7.40 Tightening the Nominations Scheme will not involve companies maintaining any additional records from the ones they already need to keep to comply with the legislation. However, reducing the scope of the scheme greatly reduces the number of sales that require nomination so the burden of nomination will be entirely removed from a lot of companies and those who do still need to nominate will do so in much more limited circumstances.

7.41 There are currently around 380 nominations per year and it is estimated that under the new legislation this will reduce to around 40 per year. This is in line with Government's commitment to reduce the regulatory burden on companies wherever possible.

7.42 Tightening the nominations scheme would recover a proportion of the amount lost from tax spinning (£45 million a year). The shorter the time limit the less that would remain at risk. The Government would expect to recover most, if not all of the £45 million from implementing this option with a two hour time limit.

5. Introduce Rule to Address the Allocation of Oil not in line with Entitlement

7.43 Developing legislation to ensure that equity oil is taxed in accordance with the co-mingling agreements will reduce arbitrage opportunities and could lead to some of the larger companies reducing the premium they were prepared to pay smaller companies for term deals (where oil is sold at a pre-determined price for delivery over a

period extending beyond one month). But to the extent that these premiums result from tax driven behaviour the impact of their removal should be disregarded.

7.44 Companies already need to keep records to decide how to allocate their oil. In future, they will use the same information to calculate the allocation of oil for tax purposes. This will include a degree of extra work for companies with a lot of field interests and month of entitlement oil, to ensure compliance with the rules. Some of the terminal systems as presently configured would require the generation of large quantities of documentation in complying with the rules. As these documents need to be examined and signed off before the oil is loaded this could potentially impact upon terminal operators.

7.45 In the short term, it is likely that companies with a large number of field interests will need to run a separate tax allocation record in addition to the commercial one. Running parallel systems will impose an increased regulatory burden on the small number of companies involved.

7.46 The tax advantages arising from the mix of PRT and non PRT fields and the bought in oil arise from judging when it is most tax advantageous to attribute a lifting amongst the various sources of oil. The more certain you are of tax prices on different lifting dates, the bigger the tax gain.

7.47 Under the changes already announced at Pre-Budget Report to the way in which we calculate a market value for tax, it will be more difficult for companies to judge which sources of oil to attribute to their different non arm's length transactions. Accordingly, some of the £35 million a year tax at risk will already be recovered by the proposed move to value non arm's length disposals of oil on a daily rather than a monthly average price.

7.48 It is not totally clear of the extent to which allocation of lifting to fields not in accordance with co-mingling agreements takes place but the remainder of the tax estimated to be at risk should be recovered by introducing this measure. The £35 million figure is net of the estimated reduction in tax from smaller companies on the assumption that the month of entitlement premiums paid by the larger companies are reduced in light of the loss of tax benefit.

7.49 Figures below are based on 2004 analyses and reflect what could be recovered for 2006/07 in relations to each the option implemented.

Table 7.1 Option recovery if implemented

Option 1	Option 2	Option 3	Option 4	Option 5
(£80m)	£45m	£45m	£45m	£35m

Small Firms Impact Test

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

Competition Assessment

7.51 A competition assessment has been undertaken and the filter has been applied to each option. This indicated that reforming the oil tax 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.

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

7.53 Research and internal consultation to date have concluded that there may be some impact on the Brent futures market because some transactions that are purely tax driven may disappear. HM Revenue and Customs have listened to industry concerns over this issue and believe the impact of the proposed option is likely to be negligible.

Enforcement, Sanctions and Monitoring

7.54 The preferred options would be defined in primary legislation with the detail 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.

7.55 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

7.56 The legislation to be published in the Finance Bill is the result of long and detailed discussions with the oil industry representative bodies, individual oil companies and affected parties. The changes will take effect from 1 July 2006, which should allow companies the time to make the necessary changes to systems and procedures. Full instructions will be published in the Oil Taxation Manual prior to the changes taking place. In due course HM Revenue and Customs will also undertake a review of figures in this RIA in Standard Cost Methodology terms.

Post-implementation Review

7.57 Nominated prices for oil will be monitored against actual arm's length sales to note price variant and HM Revenue and Customs will repeat the analysis carried out for earlier years to see if the pattern has changed. An analysis of the amounts of oil at the terminal allocated across field interests will determine whether legislation on this issue has been successful.

Summary and Recommendation

7.58 It is recommended that options 4 and 5 are adopted. Although options 2 and 3 would achieve the same results in terms of tax, the level of risk to the stability and sustainability of the Brent market is unacceptable.

7.59 Option 4 should recover the same amount of tax without the associated risks. HM Revenue and Customs will continue to review outcomes to ensure tax spinning is limited and will take further action if necessary.

7.60 Option 5 (coupled with the move to change the way in which HM Revenue and Customs value oil for non arm's length transactions) should stop tax driven behaviour at terminals. Although there may be an impact on smaller oil companies, this will be through the removal of a subsidy paid to them by larger companies for the purposes of lowering their tax bills. This means that the Exchequer is receiving less than its full share of the benefits of the North Sea.

Table 7.2 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	£45 million tax	Nil
3	£45 million tax	Nil
4	£45 million tax	Nil
5	£35 million tax	Nil

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REGULATORY IMPACT ASSESSMENT

North Sea Taxation – Reform of the Nominations Scheme and Rules for Dealing with Blended Oils

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