North Sea oil taxation

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Companies operating in the North Sea pay three separate profit-based taxes on oil and gas production: corporation tax, petroleum revenue tax (PRT), and a supplementary charge.[1] Total receipts from these taxes were £4.7 billion in 2013/14. By comparison receipts from 'onshore' corporation tax were forecast to be £36.7 billion in the same year.[2]

Revenues from North Sea oil and gas production have fluctuated dramatically over the last twenty years, following peaks and troughs in world oil prices.[3] From the late 1990s revenues grew consistently, before falling dramatically with the world economic recession in 2009. Although revenues grew strongly in the next three years, they have fallen sharply since 2011/12, and are projected to *continue* to fall in future years. In March 2015 the Office for Budget Responsibility revised its forecasts for annual revenues significantly, from around £2.6bn from 2015 to 2020, to £0.7 billion over the same period.[4]

Over this period there have been three major reforms to the fiscal regime.

First, in its 2002 Budget the Labour Government introduced the 'supplementary charge' on ring fence profits. The charge was first set at 10%. Subsequent increases in oil prices and industry profits led to the then Chancellor, Gordon Brown, announcing that the charge would be set at 20% from January 2006.[5]

Second, in his 2011 Budget the Chancellor, George Osborne, announced that the supplementary charge would be set at 32%, while tax relief for companies' expenditure on decommissioning would be restricted. At the time Mr Osborne proposed that the extra receipts would be used to cut excise duties on road fuel: specifically, an immediate 1p cut in the main duty rate, a suspension in the duty 'escalator' – the commitment to increase duty rates in real terms each year – introduced by the Labour Government in 2009, and a delay in the two inflation-only increases set for April 2011 and April 2012. Mr Osborne went on to

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1 Until January 2003, some oil fields were also subject to licence royalties, a revenue-based tax.
2 Office for Budget Responsibility, *Economic & fiscal outlook* Cm 9024, March 2015 (Table 4.5)
3 HM Revenue & Customs, *Statistics: Government revenues from UK oil and gas production*, April 2014. For data on prices see, *Petrol and diesel prices*, Commons Briefing Paper SN4712, 29 January 2014.
4 *Economic & fiscal outlook* Cm 9024, March 2015 (Table 4.12)
5 *Budget 2002* HC 592 April 2002 para 5.81-2; *Pre-Budget Report*, Cm 6701, December 2005 para 5.129-130

explain that if oil prices fell back down 'on a sustained basis', the extra supplementary charge would be removed, and the duty escalator would be re-imposed.[6]

In his Autumn Statement in December 2014 the Chancellor announced a number of changes in the wake of the reductions seen global oil prices, including "an immediate reduction in the rate of the supplementary charge from 32% to 30%." Mr Osborne also withdrew the commitment to raise excise duties on road fuels in the event of lower oil prices: "despite falling fuel prices, let me make this absolutely clear: we have cut fuel duty and we will keep it frozen."[7] As oil prices continued to fall, Mr Osborne announced a second series of measures in his Budget four months later, including a cut in the supplementary charge to 20%, backdated to January 2015, and a reduction in the rate of petroleum revenue tax, from 50% to 35%, from 1 January 2016.[8]

This note gives a short description of the way North Sea oil is taxed, before discussing the main changes in the fiscal regime since 2000. A second briefing paper looks at the related issue of road fuel taxation.[9]

Contents

1 Introduction

In their survey of the UK tax system, the Institute for Fiscal Studies give a short description of the fiscal regime, prior to the most recent changes made over 2014-2015:

> The current North Sea tax regime has three layers of tax: petroleum revenue tax (PRT), corporation tax and a supplementary charge. All of these taxes are levied on measures of profit, but there are some differences in allowances and permissible deductions.
>
> Corporation tax on North Sea production is ring-fenced, so that losses on the mainland cannot be offset against profits from continental-shelf fields. Until recently, corporation tax was otherwise the same as on the mainland, but important corporation tax reforms announced in the 2007 Budget and subsequently do not apply to ring-fenced activities:

6 HC Deb 23 March 2011 cc964-5
7 HC Deb 3 December 2014 c312. The cut in the supplementary charge was estimated to cost around £60m a year from 2015/16 (*Autumn Statement*, Cm 8961, December 2014: Table 2.1 – item 21).
8 HC Deb 18 March 2015 c775. These two measures, along with a new investment allowance, were projected to cost £395m by 2016/17 (*Budget 2015*, HC 1093, March 2015: Table 2.1 – items 11 & 12).
9 *Taxation of road fuels*, Commons Briefing Paper SN824, 10 January 2014

the rate of corporation tax on these activities remains at 30% (or 19% if profits are below £300,000), while capital allowances are more generous than on the mainland.

The supplementary charge is levied on the same base as corporation tax, except that certain financing expenditure is disallowed. The charge was introduced in the 2002 Budget at 10% (raised to 20% from 1 January 2006), and was increased to 32% in Budget 2011, effective immediately. The government has announced that if the price of oil falls below $75 a barrel, it will reduce the rate towards 20%.[10]

There are a number of allowances and reliefs available for North Sea companies, including a 100% first-year allowance for most capital expenditure and decommissioning relief which allows the losses from decommissioning a field to be carried back, carried forward or offset against profits from another field.

Overall, corporation tax receipts from the North Sea (including the supplementary charge) are forecast to be £2.5 billion in 2014/15. PRT is only payable on oil fields approved before 16 March 1993. It is assessed every six months for each separate oil and gas field and then charged at a rate of 50% on the profits (less various allowances) arising in each chargeable period. It is treated as a deductible expense for both the corporation tax and the supplementary charge. PRT is forecast to raise £1.2 billion in 2014/15.[11]

Although these taxes continue to raise substantial amounts of money, their relative importance to the Exchequer has declined substantially over the last 25 years. At their peak North Sea taxes raised just over £12 billion in 1984/85, which at that time accounted for just under 9% of all tax receipts.[12] By comparison these taxes accounted for about 0.7% of total receipts in 2013/14, whereas the share of total receipts from duties on road fuel was 4.3%.[13]

In July 2014 the Coalition Government launched a consultation on the future of the fiscal regime, which reviewed the historical pattern to tax revenues:[14]

Oil and gas tax receipts have fluctuated over time, as a result of changes in prices, costs, production levels and the fiscal regime … The early 1980s saw revenues peak as production ramped up during a period of high prices. In the late 1980s revenues fell driven by falling prices and production.

The 1990s were a period of relatively low revenues due to low oil prices and a comparatively low tax rate. But as prices rose significantly in the 2000s, the tax rate was increased to ensure the nation took a fair share of the benefits. This period also saw significant rises in investment by the industry from an historic low in 2000 to a record high in 2013, partly in response to the introduction of field allowances.

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10 see para 2.102 of *Budget 2011*, HC 836, March 2011 (p59). In addition, some new allowances for the supplementary charge were introduced in 2012, notably for income from new investments that increase production from existing fields.

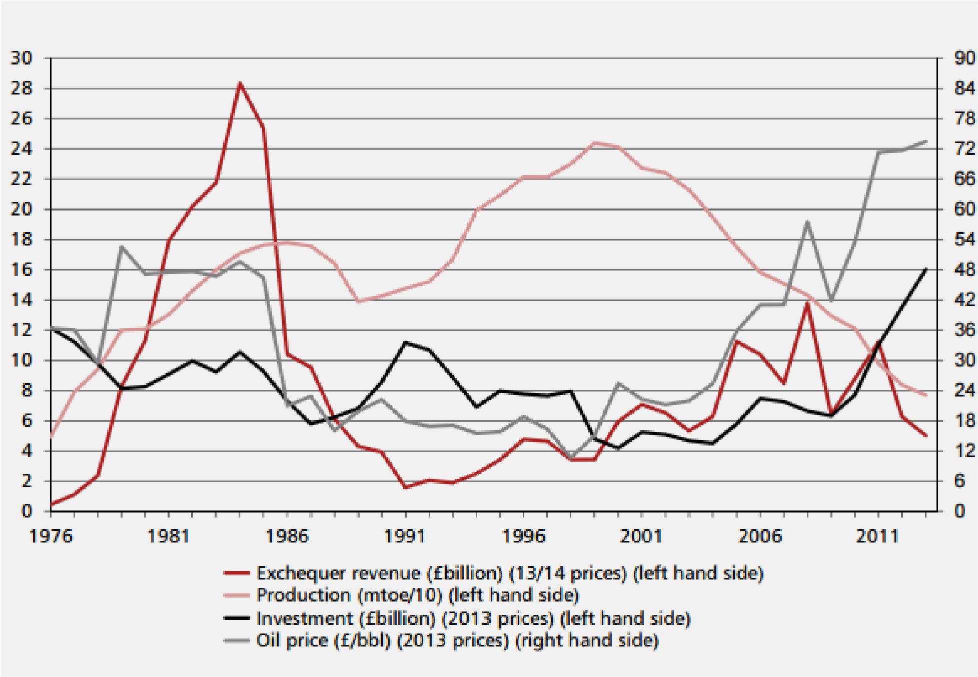
11 IFS, *A Survey of the UK Tax System*, November 2014 pp32-3. See also, "Appendix B: Key elements of the fiscal regime", in, HM Treasury, *Review of the oil and gas fiscal regime: call for evidence*, July 2014 pp23-27

12 *Financial Statement & Budget Report* HC 265 March 1985 p9 (Table 2.3). Total receipts in 1984/85 were £140 billion.

13 In 2013/14 total receipts were just over £624bn. Receipts from fuel duties were £26.9bn. *Economic & fiscal outlook* Cm 9024, March 2015 (Table 4.5)

14 HM Treasury, *Review of the oil and gas fiscal regime: call for evidence*, July 2014 pp13-14

Chart 2.A: Exchequer Revenue, Oil and Gas Production, Investment and Brent Oil Price



Figures for investment are the total of development capital expenditure (£14.4bn in 2013) and exploration and appraisal expenditure (£1.6bn in 2013)

Source: DECC

The paper also gave a one-page summary of the changes made to the tax regime since the mid-1970s; this is reproduced overleaf. As the paper acknowledged, reforms have been driven by developments in the commercial position of the industry, but also by the wider considerations of the UK's public finances:[15]

> The government designs the fiscal regime to support its twin objectives of maximising the economic recovery of hydrocarbon resources whilst ensuring a fair return on those resources for the nation. A 'fair return' implies that a share of the profits should be retained for the nation, whilst ensuring returns on the private investment needed to exploit these resources is sufficient to make extraction activity commercially attractive. This is particularly important where ownership of companies by foreign investors means corporate profits flow overseas. Overseas ownership is increasingly common with companies operating in the UKCS.
>
> In practice, the design of oil and gas taxation involves making judgements about the combination of tax measures that will achieve the right balance in meeting these objectives. A key consideration is the degree to which a lower effective tax rate will incentivise investment in more challenging fields to increase production in future. This is important not just in ensuring a future flow of tax receipts but wider economic benefits such as employment, skills, supply chain activity, exports and security of energy supply.
>
> However, these benefits need to be balanced against the risk of incurring deadweight costs – that is, reducing the return for the nation from less economically challenging fields which would have still been commercially attractive at a higher tax rate. Another judgement is the trade-off between a simple regime which is easily understood by investors but which fails to take account of the commercial challenges of individual

15 *op.cit.* pp12-13

fields, and a more tailored regime which seeks to match tax take to the profitability of fields, but at the cost of greater complexity.

These judgements change over time as circumstances change. Some changes in tax policy are a response to changes in the commercial position of the industry, which is driven by fluctuating oil and gas prices, its cost base, and the value of future commercial opportunities. Some tax changes are a response to the wider UK fiscal position, such as the current need to reduce the fiscal deficit.

Period	Key changes in regime
Mid-1970s – UK emerging as a significant producer	• Introduction of PRT and RFCT in addition to a Royalty (12.5%) on gross production
1980s – reforms to capture share of higher prices whilst encouraging new investment	• a Supplementary Petroleum Duty (SPD) introduced briefly, replaced by an Advance PRT (APRT) which was soon phased out • PRT oil allowances increased • Royalty abolished for all oil fields developed after March 1982
1993 – changes to stimulate investment during period of low prices	• PRT abolished for new fields • PRT rate for existing fields reduced from 75% to 50%
2000s – reforms to capture higher share of rising oil prices and encourage capital expenditure	• SC introduced at a rate of 10% (2002) and increased to 20% (2006) • 100% first year capital allowances introduced for RFCT and SC for most capital expenditure • Exploration Expenditure Supplement introduced then replaced by RFES • Remaining Royalty abolished with effect from 2003
2008 to 2010 – new measures to incentivise investment in maturing basin	• Field allowances introduced to encourage investment • Relaxation of decommissioning loss carry back rules to extend period in which losses are carried back • Operators of unexploited parts of PRT fields can apply for them to be taken outside of PRT
2011 to 2014 – further action to encourage investment in marginal developments; main rate increase at time of record high oil prices and fiscal consolidation	• SC rate increased to 32% • Field allowances expanded (including brown field allowance) • Introduction of Decommissioning Relief Deeds

2 Earlier reforms to the fiscal regime (up to 2010)

The summer months of 2000 saw an unprecedented level of public outrage over the taxation of road fuels - the so-called 'fuel crisis': a campaign over pump prices resulted in blockades of oil refineries, panic buying and national shortages. In November 2000 the then Labour Government announced a major reversal of its approach to setting excise duty rates on petrol and diesel: fuel duty rates would be cut, with effect from March 2001, and the 'duty escalator' would be suspended.[16] The 'escalator' was a commitment to put up duty rates in real terms each year, a policy first introduced by the then Conservative Government in 1993 as a means of changing incentives for drivers and car manufacturers, so as to cut the growth of carbon dioxide emissions. The policy had been adopted by the new Labour Government in 1997, with the benchmark of annually increasing duty rates in real terms by 6%.

In its Green Budget in January 2001, the Institute for Fiscal Studies suggested that the strength in fuel prices and the reported profits of oil producers made it quite likely that the Labour Government would increase taxes on North Sea oil production. In its view this was a legacy of the original design of the fiscal regime, which could not respond adequately to fluctuations in oil prices:

> The history of North Sea taxation is an unfortunate example of some of the weaknesses in tax policymaking in the UK. When significant oil deposits were first discovered, the government had a clean sheet on which to design a tax system, unconstrained by the legacy of previous decisions. Rather than introducing a coherent rent tax that automatically adjusts tax liabilities to changing economic conditions, significant departures from this principle were introduced into petroleum revenue tax, in response to short-term revenue considerations.
>
> These have required successive governments to raise tax rates or introduce new taxes when profits are high and to lower tax rates or abolish taxes when profits are low. This culminated in the arguably premature abolition of PRT itself for new fields after 1993. As no government has been willing to introduce a fundamental reform of the North Sea tax system, the current government finds itself with a similar dilemma to that faced by its predecessors whenever oil price rises have led to high North Sea profits. Whether it will find a more coherent solution to this dilemma remains to be seen.[17]

In 2011 Professor Alex Kemp published his official history of the industry, and in his concluding reflections made a similar criticism of the fiscal regime:

> When seen in the round it can be concluded that by and large the North Sea tax system has procured to the state a very substantial share of the economic rents emanating from North Sea oil and gas exploitation covered by this history. But the process has been personified by very frequent changes and the introduction of devices in response to short-term Government budget problems rather than the incidence of economic rents from oil and gas production … [Frequent changes have been] a consequence of the design feature of PRT with one rate plus several allowances. This was an ad hoc mechanism to make the tax progressive in relation to price, cost and volume changes, but it proved inadequate to deal with the major variations in all three which have actually occurred.

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16 For more details see, *Taxation of road fuels: policy following the 'fuel crisis' (2000-2008)*, Commons Briefing Paper SN3016, 21 January 2011. The Labour Government reintroduced a duty escalator in its 2009 Budget.

17 IFS, *Green Budget*, January 2001 p85

> A progressive resource rent tax scheme with the tax rate related to the achieved returns would have reduced the need for discretionary changes. Many of the changes made have also resulted from consultations with the industry, but the need for such consultations would have been reduced had a progressive resource rent tax been introduced from the beginning. The continuous review and discussions with the industry is certainly appropriate as far as detailed technical matters are concerned, but semi-continuous consultation/negotiation on more fundamental issues are likely to reflect a design fault.[18]

As it transpired, the then Chancellor announced two major reforms the following year, in his 2002 Budget, in his words, to "deliver a tax regime that promotes long-term investment while giving a fair return to the British people":

- the introduction of a new 10% supplementary charge on North Sea profits, and,
- an extension of 100% capital allowances on most expenditure in the North Sea.[19]

Taken together it was estimated that these changes would raise £450 million by 2003/04.[20]

There was some criticism that the announcement had been made without any consultation. In 1998 the Labour Government had indicated it would have a formal review of the fiscal regime, and that this might include a supplementary corporation tax charge on North Sea profits – but abandoned these plans later that year, on the grounds that oil prices had fallen too much to make reform practicable.[21] As the IFS noted, "it is difficult to see why consultation as desirable in 1998 but not in 2002. If and when the Government decides to resolve the outstanding problems with North Sea taxation, it should certainly consult widely to prevent further piecemeal reform."[22] When these provisions were debated at the Committee stage of the Finance Bill the then Financial Secretary, Ruth Kelly, addressed this issue:

> In 1998, during the last Parliament, the Government proposed to consult on the choice between two options for tax reform—the extension of petroleum revenue tax and a supplementary charge on profits. That made sense at the time, but in due course, in an environment of low oil prices, it no longer made sense to proceed with any change. Four years on, the proposal to reintroduce PRT is unrealistic. It would require companies to rebuild records on income and expenditure in all fields that had come onstream since 1993. Given that oil companies may have changed hands, that would be administratively very difficult—a bureaucratic nightmare.
>
> As far as I know, no one in the industry has called for the reintroduction of PRT. We have opted for a simple, streamlined tax reform that promotes investment over the long term. We will of course continue to work with and listen to the industry as we implement the changes, and … we are consulting on the timing of the abolition of royalty.[23]

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18 Alex Kemp, *The Official History of North Sea Oil and Gas vols I & II*, 2011 pp679-80

19 HC Deb 17 April 2002 c584

20 *Budget 2002* HC 592 April 2002 p155 (Table A.1 – item 31). In comparison total receipts from North Sea taxes were £5.4 billion in 2001/02.

21 Inland Revenue Budget press notice IR15, 17 March 1998; Inland Revenue press notice, *The North Sea fiscal regime*, 7 September 1998

22 IFS, *Budget 2002: Business Taxation measures*, May 2002 p6

23 HC Deb 9 May 2002 cc365-6. In November that year the Government announced the abolition of North Sea royalty payments from 1 January 2003 (HM Treasury, Pres Budget Report press notice REV/C&E1, 27 November 2002). These payments only applied to older oil fields – licensed before March 1982 – and were based on the gross value of output, rather than profits.

A similar pattern of events led up to the Labour Government's decision in December 2005 to double the supplementary charge. Over the year the strength in oil prices, and the substantial boost in North Sea profits, led to speculation that the Government were considering a new windfall tax.[24] In his Pre-Budget statement on 5 December, the then Chancellor, Gordon Brown, argued that the recent upward trend in oil prices should be reflected in an increase in the tax charge on North Sea companies:

> Our economy has had to withstand an oil price rise from around $25 to a current price of around $55, which is also close to the level of almost all future projections. Returns in the North Sea are now nearly 40 per cent. on capital, compared with ordinary returns of 13 per cent. With the tax on new development in the North Sea now lower than in the USA, the Gulf of Mexico, Norway, Italy and Australia, and in order to strike the right balance between producers and consumers, I will raise the supplementary North Sea charge from 10 per cent. to 20 per cent., while giving new incentives to companies for exploration and development of the most difficult fields by extending the exploration expenditure supplement to all their ring-fenced activity.[25]

It was estimated that the new supplementary charge would raise £2.3 billion by 2007/08.[26] As part of this reform the Labour Government stated that it would not increase North Sea oil taxation any further for the remainder of the Parliament:

> 5.129 In striking the right balance between producers and consumers, the North Sea oil taxation regime needs to promote investment and ensure fairness for taxpayers. In response to the recent significant rises in oil prices which are now expected to be sustained in the coming years, the Government will, with effect from 1 January 2006, increase the rate of supplementary charge to 20 per cent to maintain this balance. North Sea oil companies will be able to elect to defer 100 per cent relief for capital expenditure incurred in 2005 into the following year.
>
> 5.130 The Government will also introduce a Ring Fence Expenditure Supplement to uplift all expenditure by North Sea oil companies without taxable income, to ensure that the value of tax relief is maintained over time. This replaces and extends the current Exploration Expenditure Supplement. The Government intends to open discussions with industry to examine wider structural issues which have implications for the stability of the North Sea oil tax regime. The Government is clear that there will be no further increases in North Sea oil taxation during the life of this Parliament.[27]

In January 2006 the Treasury Committee published its report on the PBR, and as part of this, was strongly supportive of this commitment: "we welcome the Treasury's promise of no further increases in North Sea oil taxation during the life of this Parliament, not least because any subsequent increases might increase uncertainty around future taxation of oil companies and might serve as a disincentive to future investment in the North Sea."[28]

Later that year the Scottish Affairs Committee undertook an inquiry on the impact of these changes on the industry. Ian Davidson MP raised this particular issue with Treasury officials at an evidence session in October:

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24 "Record Shell profit spurs windfall tax calls", *Guardian*, 4 February 2005; "Brown eyes North Sea as target for shoring up public finances", *Financial Times*, 30 October 2005.

25 HC Deb 5 December 2005 c 612

26 *Budget 2006* HC 968 March 2006 p190 (Table A2 – item q)

27 *Pre-Budget Report* Cm 6701 December 2005 paras 5.129-130

28 *Second report: the 2005 Pre-Budget Report*, 25 January 2006 HC 739 2005-06 para 89

> **Q193 Mr Davidson:** … Am I right in thinking that there is a degree of comfort for the industry in knowing that a British Chancellor would want to look again at the rate should the price collapse, yet the industry have been given a commitment that there is going to be no further increase in North Sea tax during the lifetime of this Parliament, according to your statement, so in fact from the industry's point of view there is no down, as it were, if prices go up but there is a potential up if prices go down, so they have the best of all possible worlds in the circumstances?
>
> **Ms Jo Wakeman, Head of North Sea Branch, Corporate Taxation Team, HM Treasury:** You are absolutely right in saying that the Government has made a commitment that there will be no further increases in North Sea taxation during the lifetime of this Parliament, and also the Government has an interest in ensuring that the fiscal regime continues to deliver its policy objectives and will continue to agree to ensure that that will be the case.[29]

In evidence sessions several witnesses argued that it would be difficult to assess the impact of the higher supplementary charge because of the long lead times in the industry. In its final report, published in November 2007, the Committee suggested that the fiscal regime was "unlikely to be the most important factor driving investment decisions in the major fields":

> We conclude that it is impossible to isolate with certainty the impact of tax increases from that of other factors such as price or initiatives designed to stimulate investment or increase recovery, including the PILOT programme[30] or the brown field initiatives. In our view, the fiscal regime is unlikely to be the most important factor driving investment decisions in major fields. Although tax is clearly significant, the nature of the oil and gas fields, the underlying geology and future oil and gas prices are more likely to be the dominant drivers,[31] but the fiscal regime may be a factor affecting investment in older, more marginal fields.

Nevertheless the Committee took the view that stability in the tax regime was particularly important:

> The industry made clear its view that fiscal stability was key in attracting investment. The United Kingdom Offshore Operators Association (UKOOA) argued that instability damaged the UK's competitiveness. They believed that the effect of several changes within a short space of time had earned the UK a reputation within the industry for fiscal instability. It was also clear from the evidence provided to us that these were wider concerns than just the latest change to the Supplementary Charge.
>
> Mr Dave Blackwood (Director, BP North Sea) told us that any tax increase made it harder for him to attract capital and people to the UKCS. However, while fiscal stability is important, witnesses from the Treasury suggested that the UK's fiscal regime was "broadly comparable with our main competitor regimes" despite the recent changes. While there was some disagreement about what stability meant, with industry wanting taxes to fall as the price of oil falls but not to rise when it rises, the Oil and Gas Independents Association Limited (OGIA) suggested that what was most important was predictability. **We conclude that a simple fiscal regime that is consistent and**

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[29] *First report: Effects of tax increases on the oil industry*, 30 November 2007 HC 35 2007-08 Ev 34-5

[30] [A joint government-industry forum established in 2000. There is an archived site of the forum's work maintained by National Archives.]

[31] HM Treasury, *The North Sea Fiscal Regime: a discussion paper*, March 2007, para 1.3

predictable would be of most benefit to the industry and the UK in the long term.

> The Government has made a commitment that there would be no further changes to the fiscal regime for oil and gas companies in the remainder of this Parliament. The industry seeks even greater stability and predictability than this commitment offers. Professor Alex Kemp [at University of Aberdeen, and generally recognised as the leading academic expert in this area] argued that the assurance from the Treasury that Supplementary Charge will not be increased for the rest of the Parliament was of limited benefit where investments had to be considered over a much longer time frame. However much such guarantees might be desirable, and despite industry's claims that there was greater fiscal stability in the past, no government has ever been able to make a commitment that binds its successor.[32]

Although the supplementary charge remained at 20%, the industry was disappointed when in March 2007 the Labour Government announced a cut in the main rate of corporation tax from 30% to 28% - but *retained* a 30% rate for the North Sea.[33] The Budget report set out the reasons for this decision:

> The Government recognises that the North Sea presents unique challenges and opportunities for both industry and government. In recognition of these challenges, this Government has introduced a unique capital allowance regime that encourages investment by providing full relief on cashflow outflow as it arises. This minimises the impact of the fiscal regime on investment decisions. In light of this, and of the need for stability and certainty, and given continuing high levels of profitability and investment, the reforms to business tax announced in Budget 2007 will not therefore apply to activity within the North Sea fiscal regime, which will retain its existing capital allowances regime and rate of tax.[34]

In Budget 2008 the Labour Government announced a number of changes to petroleum revenue tax, arising out of its discussions with the industry;[35] when these were scrutinised at the Committee stage of the Finance Bill, the then Exchequer Secretary, Angela Eagle, said a little about the Government's overall approach to the fiscal regime:

> The future of petroleum revenue tax is a fundamental issue for oil companies, but it is also fundamental for UK taxpayers. It is quite right, given that the UK owns the gas and oil reserves, that we should ensure that there is a reasonable return for their exploitation, especially if super-profits are made. That is why the petroleum revenue tax was legislated for in the first place.
>
> The balance that we are trying to strike through our ongoing consultations with the oil and gas industry is between having a reasonable taxpayer return on important UK assets and ensuring that we can enable and facilitate their exploitation rather than see them left in the ground.[36]

As it transpired, no further major changes were made to the North Sea fiscal regime for the remainder of the Parliament.

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32 HC 35 2007-08 paras17, 21-23
33 "North Sea oil and gas companies express 'dismay' at losing out", Financial Times, 22 March 2007
34 *Budget 2007*, HC 342 March 2007 p52
35 HM Revenue & Customs Budget Note BN09 & BN26, 21 March 2008
36 Public Bill Committee (Finance Bill) 5 June 2008 c538

3 Budget 2011

The Coalition Government set out its priorities for taxation in its agreement, published in May 2010. On its overall approach the agreement stated: "the Government believes that the tax system needs to be reformed to make it more competitive, simpler, greener and fairer."[37] Although the agreement listed a number of specific measures for the next five years, it made no mention of the North Sea fiscal regime, nor of excise duties on road fuel. However, in its first Budget in June 2010, the Government confirmed that it had asked the Office for Budget Responsibility (OBR) "to undertake an assessment over the summer of the effect of oil price fluctuations on the public finances" and that informed by this assessment, it would "examine options for the design of a fair fuel stabiliser."[38]

Some commentators have argued that the impact of rising oil prices on motorists and businesses could be mitigated by use of a 'duty stabiliser': cutting the rates of road fuel duties when prices rise, and raising rates when prices fall. Usually the case for this type of mechanism has been made on the grounds that higher oil prices deliver a windfall for the Exchequer from North Sea taxes, something which could be given back to motorists by means of a duty rate cut.

In September 2010 the OBR published its report, in which it argued that far from creating a 'windfall' for the Exchequer, a permanent increase in oil prices would have a *negative* impact on the public finances after a year, as "the detrimental effect on receipts from lower output more than offsets the boost to UK oil and gas revenues." Although higher oil prices boosted revenues from North Sea oil taxation and corporation tax, there would be "a number of offsetting effects on the public finances":

- higher pump prices will reduce the demand for fuel, lowering fuel duty receipts;
- temporarily higher inflation will push up the indexation of tax thresholds, benefits, public service pensions and index-linked gilts; and
- higher oil prices are likely to reduce real household income and the supply potential of the economy, with detrimental effects on receipts from labour and capital income as well as from consumer spending.[39]

The OBR updated this analysis at the time of the 2011 Budget, in the light of revised estimates for future oil prices. It suggested that although higher oil prices would deliver a temporary boost to the public finances, this effect would be cancelled out within a couple of years:

> In the September paper, [we] … used the example of a £10 increase in the price of oil. Since November the oil futures curve which we use to base our projections has increased by £15 in the short-term and £10 in the medium-term.
>
> In the current forecast the £15 increase in the oil price improves the public finances by around £1½ billion in 2011-12. Tax revenues from the UK oil and gas sector and VAT on fuel duty is increased by around £4 billion in 2011-12.
>
> This is only partly offset by reductions in fuel duty, as higher oil prices reduce demand for fuel; indexation effects, as higher inflation leads to higher social security and debt

37 HM Government, *The Coalition: our programme for government*, May 2010 p30

38 *Budget 2010*, HC 61, June 2010 paras 1.122, 1.121

39 OBR, *Assessment of the Effect of Oil Price Fluctuations on the Public Finances*, 14 September 2010 (Executive summary)

interest payments; and, economy effects, as higher inflation reduces real income and consumption leading to lower income tax and wider VAT receipts.

Over the forecast period, the overall effect on the public finances is broadly neutral, with an overall increase in borrowing in 2014-15 and 2015-16. The increase in revenues from the North Sea is lower in the medium term as the increase in oil prices since the November forecast is lower and because North Sea production is expected to fall over the medium term. In addition, the GDP effect is slightly higher in the medium term. The September paper highlighted the uncertainty around the estimates and this is clearly also the case for our forecast projections. The medium-term oil price and its overall impact on the economy are highly uncertain, as are the projections of future North Sea oil production.

Table A: Estimated impact of higher oil prices on public sector net borrowing

	£ billion				
	2011-12	2012-13	2013-14	2014-15	2015-16
UK oil and gas revenues	3.7	3.0	2.4	2.2	1.9
Fuel duty	-0.5	-0.5	-0.4	-0.4	-0.4
VAT	0.3	0.2	0.1	0.1	0.0
Indexation	-1.1	-1.0	-0.8	-0.9	-0.9
GDP effects	-1.0	-1.3	-1.3	-1.4	-1.5
Overall effect	**1.4**	**0.5**	**0.0**	**-0.4**	**-0.9**
Memo: Rise in sterling oil price futures since November forecast	15	14	11	10	10

Note: Negative figure implies a rise in borrowing [40]

In their Green Budget published in February 2011, the Institute for Fiscal Studies noted that "high fuel taxes in themselves help stabilise pump prices of fuel … [as] the cost of oil acquired by refineries is such a small fraction of the final pump price." The authors acknowledged that a fair fuel stabiliser could stabilise household finances, but raised a number of practical concerns about how it might work in practice:

> Trends in oil prices can be hard to forecast accurately and are probably not stable over time. For example, the large spike in prices in 2008 appears to have been temporary, though it may not have been obviously so at the time. If the government gets the trend wrong, or fails to adjust to a new trend, fuel taxes could rise or fall significantly before the 'mistake' is realised. This might then require big sudden policy adjustments, which would undermine claims to greater stability.[41]

Despite these difficulties, the continued growth in fuel prices in the weeks before the 2011 Budget saw a major campaign for the introduction of a duty stabiliser.[42]

Consequently in his 2011 Budget, the Chancellor George Osborne made three changes to road fuel duties: withdrawing the previous Government's 'duty escalator' – the baseline assumption that duty rates would rise each year in real terms; freezing for duty rates for the coming year; and, implementing an immediate 1p cut in the duty rate. These tax cuts would be funded by an increase in taxes on North Sea oil and gas production – an arrangement he characterised as a 'fair fuel stabiliser':

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[40] *Economic & Fiscal Outlook*, Cm 8036 March 2011 p111 (Box 4.1)

[41] *The IFS Green Budget 2011*, February 2011 p264, p266

[42] 48 Members signed an EDM arguing a fuel price stabiliser should be implemented "as soon as practically possible" (EDM 1241 of 2010-11, 10 January 2011).

> It is important that when shocks like the steep rise in the oil price occur, a responsible Government are able to listen and respond …Many have suggested that we should use the extra revenues we automatically get from the North sea. It is true that they go up when the oil price rises, but the OBR confirms that rising oil prices also cause other tax revenues across the rest of the economy to fall by a similar amount, and I am not prepared to undermine the public finances like that …
>
> The North Sea oil tax regime was most recently changed in 2006, when the price of oil stood at $66. It is now almost double that amount. That means that oil companies are making unexpected profits on oil prices that are far higher than those that they based their investment decisions on. Other oil-producing countries have a tax regime that automatically regulates returns when prices rise. We do not, and the North Sea is too mature to introduce such a regime now. Instead, we can do something else: we can introduce a fair fuel stabiliser.
>
> From tomorrow, the supplementary charge levied on oil and gas production will increase from 20% to 32%. Even after this, profits on a barrel of oil are forecast to be higher in the next five years than in the last five years, but this will raise an additional £2 billion of revenue, and we will use the new tax money to do this: first, we will delay the inflation rise in duty planned for next week until next year and also delay the April 2012 inflation rise until the following summer; secondly, the fuel duty escalator that adds an extra penny on top of inflation every year will be cancelled-not just for this year or next year, but for the rest of this Parliament.
>
> But I do not want important investment in the North Sea lost, so if the oil price sustains a fall below $75-and we will consult on the precise figure-we will reintroduce the escalator and reduce the new oil tax in proportion. That is how it will work: no escalator when the oil price is high; no extra tax on the profits of North Sea oil companies if the oil price falls and stays low. That is the fair fuel stabiliser … [In addition] as well as stopping [the planned fuel duty increases] … I am today cutting fuel duty by 1p per litre. This will take effect in petrol stations from 6 pm tonight.[43]

The Budget report gave more detail on how the Government would review North Sea taxes, if oil prices fell in future years:

> The Government will abolish the fuel duty escalator and replace it with a fair fuel stabiliser. When oil prices are high, as now, fuel duty will increase by inflation only. UK oil and gas production is more profitable at such times, so it is fair that companies should contribute more. The Supplementary Charge on oil and gas production will therefore increase to 32 per cent from midnight tonight …
>
> In future years, if the oil price falls below a set trigger price on a sustained basis, the Government will reduce the Supplementary Charge back towards 20 per cent on a staged and affordable basis while prices remain low. Fuel duty will increase by RPI plus 1 penny per litre in each such year. The Government believes that a trigger price of $75 per barrel would be appropriate, and will set a final level and mechanism after seeking the views of oil and gas companies, and motoring groups.
>
> As the increased rate of Supplementary Charge will only apply when prices are high, the Government will restrict tax relief for decommissioning expenditure to the 20 per cent rate to avoid incentivising accelerated decommissioning. There will be no restrictions to decommissioning relief below this level over the course of this

43 HC Deb 23 March 2011 cc964-5

Parliament, and the Government will work with the industry with the aim of announcing further, longer-term certainty on decommissioning at Budget 2012. Recognising the importance of continued investment in the North Sea, including in marginal gas fields, the Government will also consider with the industry the case for introducing a new category of field that would qualify for field allowance.[44]

The Budget report also gave estimates of the cost and yield to the duty rate changes, and those made to North Sea taxation, as follows:[45]

£ million	**2011/12**	**2012/13**	**2013/14**	**2014/15**	**2015/16**
Fuel duty: 1ppl reduction from 23 March 2011, removal of previously announced above-RPI increases and delay of RPI increases	-1,900	-1,600	-1,700	-2,100	-2,100
North Sea: increase in supplementary charge from 20% to 32% and restriction on decommissioning relief from 2011-12	+1,780	+2,240	+2,120	+2,090	+1,870

Some commentators argued that the Government had come up with a politically creative solution to the problems inherent in the type of duty stabiliser that others had called for. Writing in the *Times*, Anatole Kaletsky said:

Mr Osborne was clever to recoup the lost revenue from North Sea oil producers, which are reaping an unexpected windfall profit as a result of Middle Eastern turmoil. And he showed good economic judgment by promising that the higher fuel taxes will be automatically reinstated if and when the oil price falls back from the present $110 a barrel to below $75. Failing to make this kind of advance commitment to restoring the escalation of fuel duties once global oil markets stabilised was one of the biggest mistakes that Gordon Brown made as Chancellor, when he capitulated to fuel-tax protesters in 2000, thereby destroying one of the Treasury's most buoyant sources of revenue, as well as the Labour Government's green credentials.[46]

In an editorial the *Financial Times* observed "in future [duty rates and the supplementary charge] will sit on a sort of see-saw with one or the other kicking in as energy prices rise and fall. Like the Budget as a whole, the politics of this is perhaps more important than the economics."[47] A leader in the *Times* was more sceptical: "as things stand, the forgone revenue will be paid for by a levy on the oil companies. The potential problem is that, if oil prices do not fall, those companies may just regard it as uneconomic to continue being based in the UK and thus move abroad. How the Exchequer could get out of the scheme once it is established is far from clear."[48]

Unsurprisingly the industry was critical, arguing that the changes would deter investment in the North Sea, and hit mid-tier and smaller companies disproportionately.[49] Statoil, a Norwegian company with operations in the North Sea, announced it would suspend development work in two oil fields south-east of Shetland while it assessed the impact of the

44 *Budget 2011*, HC 836 March 2011 paras 1.146, 1.48-49
45 *op.cit.* p40 (Table 2.1: items 27 & 28)
46 "A spring in Osborne's step, but growth is the worry", *Times*, 24 March 2011
47 "Editorial : Osborne looks beyond austerity to prosperity", *Financial Times*, 24 March 2011
48 "Leader : Bad Hand, Well Played", *Times*, 24 March 2011
49 "Oil industry warns on North Sea investment" & "Investment alarm rises after tax raid on oil", *Financial Times*, 24 & 25 March 2011

new tax regime,[50] and other major oil companies also raised concerns.[51] In an editorial some days after the Budget statement the *Financial Times* suggested that the increase in tax was fair, but the way in which it had been imposed was unwise:

> Statoil and others will face a 62 per cent marginal tax rate on new projects, a good deal less than the 78 per cent they pay on the Norwegian side of the border. On old fields, the rate will be 81 per cent, just above Norway's. Such rates are sustainable because oil and gas profits largely consist of economic rent - returns due to the scarcity of the resource, not the cost of extracting it. A tighter UK regime will make up for years of undertaxing this rent, which, with Brent at $115 a barrel, is now much greater than any responsible company would rely on for its planning.
>
> As North Sea reserves are slowly depleted, companies do need better incentives to pump up the remaining, harder-to-get resources. But this change does not prevent that. The biggest tax is on fields where development took place long ago. On new fields, allowances for a normal rate of return or a government participation in exploration risk are better than low tax rates.
>
> Useful as it is, the change was carried out in the least helpful way possible. Springing populist surprises on business undermines the tax predictability the government has promised. Worse, Mr Osborne - asserting a phoney link with petrol prices voters pay at the pump - says he will lower the tax if prices fall, confirming that the policy will remain at the mercy of ministerial whim. He should limit the damage by making the tax rise permanent.[52]

In a letter to the paper, Charlie Kronick, the senior climate advisor at Greenpeace, argued that “the oil industry as a whole, is crying wolf over changes to the North Sea oil tax”:

> One week after the Budget, Edison Investment published a market analysis report. It concluded that "despite the negative sentiment around the UK government increasing the marginal tax rate from 50 per cent to 62 per cent in last week's Budget, the North Sea independents continue to offer the potential for spectacular returns".
>
> Many companies are sitting on piles of tax credits, accrued, in part, as a result of changes in the Emergency Budget. Those companies, including Premier Oil and Xcite Energy, are at least partially insulated from the tax increase. For others, the high oil prices - Brent Crude is up 31 per cent since the beginning of the year - will more than cover the tax increase. Oil is no more expensive to extract now than it was in January, but can be sold for almost a third more.
>
> Statoil's much-publicised decision to freeze its North Sea investment is not what it seems. Days after threatening to pull out of British waters, it announced a major discovery in Norway. Norway has a 78 per cent marginal rate of tax on North Sea oil - 16 percentage points higher than in the UK. If Norway's tax rate is not dissuading investment, why should we believe the oil companies when they claim that our tax regime will?[53]

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50 “Osborne tax halts North Sea project”, *Guardian*, 30 March 2011

51 “Total sounds alarm over tax swoop” & “Chevron hits at North Sea tax rise”, *Financial Times*, 31 March & 18 April 2011

52 “Editorial: Osborne squeezing, but not too hard”, 31 March 2011

53 “Letters: Oil companies have little reason to moan about tax rise”, *Financial Times*, 20 April 2011

Mark Hanafin, managing director of Centrica Energy, wrote to the paper to argue that Mr Kronick's analysis ignored two important issues:

> The suggestion by Greenpeace that oil companies will be insulated from the Treasury's Budget raid on the North Sea by rising crude prices (Letters, April 20) overlooks a crucial point - the proposed tax hike also impacts on gas production. It is simply wrong to apply a tax rise on oil, designed to help contain fuel prices for motorists through a reduction in petrol duty, to gas production. You put gas in your boiler not your car. Moreover, in the UK gas prices aren't linked to oil prices and haven't risen to anything like the same extent. Profit margins for gas are also lower ..
>
> The suggestion that the fiscal regime is tougher still in the Norwegian sector is misleading. In Norway the tax rate is indeed 78 per cent but has remained stable for at least two decades. Larger field sizes, simpler geology and higher capital allowances mean that unit costs of production and margins are more favourable than in the UK. In contrast this was the third UK tax hike in nine years and the marginal rate of tax on mature production in the UK sector is now 81 per cent.[54]

In its impact assessment for this tax increase, HMRC suggested that the impact on investment would not be significant:

> The impact of this tax change will not influence oil prices, as oil is traded globally. High commodity prices increase the profitability of oil and gas production in the UK and the UKCS. An increase in the tax burden through a higher rate of supplementary charge will reduce the post-tax profits of companies producing oil and gas, though Government still expects that average post-tax profits per barrel will be higher over the next five years than the last five.
>
> The measure may potentially affect the commercial viability of a handful of marginal investments, but the Government does not expect a significant impact on investment or production in the forecast period as a consequence of this measure. The Government will consider with the industry the case for introducing a new category of qualifying field for field allowance to support continued investment in the North Sea.[55]

As part of their enquiry into the Budget the Treasury Committee raised this issue with Treasury officials: in response Edward Troup (Managing Director, Budget, Tax and Welfare) argued that it was important to look at the prospects for this sector over the longer-term, and discussed the impact that the rise in the supplementary charge had had in 2005:

> When there is a change that does have a significant fiscal impact—and we are raising £2 billion more from the industry—the businesses affected will want to stop and think, and make sure their numbers work … our own analysis shows that, over the next five years, we expect the post-tax return per barrel of oil to be greater than the post-tax return per barrel of oil or gas equivalent over the last five years. So although this is a change parameter into the investment decisions, we do not think it will make a material difference …
>
> The analysis we did going back to 2005 and in the year before the change in 2005, there was £4.8 billion of investment in the North Sea. In the three years following, the level of investment was over £6 billion in each of those years, and that was, as most investment in this sector is, a reflection of the fact that the oil price is the key

54 "Letters: North Sea tax rise also applies to gas", *Financial Times*, 25 April 2011

55 HMRC, *Oil and Gas Taxation: Supplementary Charge* (TIIN6133), 23 March 2011

determinant to investment decisions. So in the last change, investment went up 20% plus and sustained, remained up for the next three years.[56]

Mr Troup went on to say a little about the Government's plans to consult on changing the scope of the field allowance – which reduces the rate of tax paid in respect of certain new developments – and about the relative lack of consultation prior to the Budget on increasing the supplementary charge:

> The Budget made clear, what the Chancellor did say, is we are interested in hearing from production companies about scope for extending the field allowance. The field allowance effectively allows you, for a designated type of field, to pay no supplementary charge at all on the first X barrels of units of production. That was introduced in 2009. It has already been taken up quite significantly. It is already bringing marginal fields into production and we are interested in talking to the production companies to see whether there is scope for extending that further, to help bring more marginal fields into production …
>
> on the point of talking to the industry in advance: … with a tax change like this, it is very difficult to engage … I am afraid that is part of the nature of decision-making in these circumstances, but we are now talking to the industry quite intensively.[57]

The Committee also took evidence from Paul Johnson, director of the IFS, and he was asked whether the Government's decision to fund a cut in road fuel duties this way constituted a fair fuel stabiliser. Mr Johnson said:

> The element [of the policy] that impacts on households is, you know, going to do something to stabilise the amount that they spend on petrol, and frankly is very similar to what the last Government did over a 10-year period. We continued to have announcements that fuel duty would rise next year, but it never did. This Chancellor has very much followed in those footsteps. The way he has constructed this fair fuel stabiliser is very different from what we were expecting, given previous announcements. It will have that effect on motorists, but … it rather depends on how it affects investment in the North Sea.[58]

When the Chancellor gave evidence to the Committee, he gave some figures on the impact that higher prices had had on company profits, and mentioned the OBR's work on the relationship between prices and public finances to explain why, in his view, this was the best way to mitigate the impact of rising prices on motorists:

> The profits on a barrel of oil are going to be higher in the next five years than they were in the last five years. Just to give the Committee the actual numbers, the companies were making £12.02 profit on a barrel of oil for the last five years. They are forecast to make £12.31 on the next five years on that barrel of oil, with the new tax. At the moment they are making £13.28. So their profits are going up even with the additional tax and I think you would have a very strong complaint against me if you said that I had made no allowance for the fact that the oil price might fall and that might then damage investment. But I have made a very explicit allowance for the fact that the oil price, and

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56 *Budget 2011*, 9 April 2011 HC 897 2010-11 Q401 (Ev61)

57 HC 897 2010-11 Q405 (Ev62), Q409 (Ev63). In answer to a subsequent PQ on this the Government stated, "it is not the current (or previous) Government's policy to consult on tax rate changes in advance of Budget announcements" (HC Deb 26 April 2011 c326W).

58 HC 897 2010-11 Q149 (Ev25)

> indeed the gas price, might fall. Given the judgements I had to make about who to help in the economy, I think it was a reasonable one …
>
> It is a perfectly fair line of argument to say, "You shouldn't have increased these taxes on the North Sea and you shouldn't have changed the plans for the fuel duty increases" but you can't have your cake and eat it ... One thing that has been very clearly established over the last 10 months … is it is not possible to design, if I put it like this, an automatic stabiliser based on the fact simply that revenues, increased revenues come in from North Sea oil taxation anyway when the price goes up, because as [the OBR] say on page 111 [of their Economic and Fiscal Outlook], "The overall effect on the public finances is broadly neutral over an increase in the oil price". So in order to make a stabiliser work, I had to look to an additional tax charge on North Sea oil.[59]

In its final report the Committee acknowledged that it would not "be possible or desirable to consult on every tax increase ahead of the decision being made", but it went on to suggest that in this case the Government might have undermined its credibility:

> The decision to increase the supplementary oil and gas levy by 12% without warning, less than a year after the Government had undertaken to provide a "stable" tax regime in the sector,[60] may weaken the Government's credibility in seeking to establish a stable tax regime in this and other areas. Such reversals of policy in the absence of changes of circumstances that would warrant them is bad for business confidence and the credibility of government policy making. We note that the Government "is now talking to the industry quite intensively" and urge it to make sure that industry is properly consulted on the design of the "stabiliser".[61]

Just prior to the 2011 Budget the Treasury Committee published a report on tax policy in which it set out a number of principles by which tax policy-making should be judged:

> **Tax policy should:**
>
> 1. **be fair**. We accept that not all commentators will agree on the detail of what constitutes a fair tax, but a tax system which is considered to be fundamentally unfair will ultimately fail to command consent.
>
> 2. **support growth and encourage competition**.
>
> 3. **provide certainty**. In virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.
>
> **Certainty about tax requires**
>
> i. **legal clarity:** Tax legislation should be based on statute and subject to proper democratic scrutiny by Parliament.
>
> ii. **Simplicity:** The tax rules should aim to be simple, understandable and clear in their objectives.

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59 HC 897 2010-11 Q441 (Ev70), Q443 (Ev71)

60 (The 2010 Budget report stated "the Government recognises the importance of a stable and fair UK oil and gas tax regime that provides certainty for businesses. It will take forward discussions with the industry to ensure the regime encourages continuing investment and the exploitation of remaining resources." *Budget 2010*, HC 61, June 2010 para 1.85)

61 HC 897 2010-11 para 157

iii. **Targeting:** It should be clear to taxpayers whether or not they are liable for particular types of charges to tax. When anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system.

4. provide stability. Changes to the underlying rules should be kept to a minimum and policy shocks should both be avoided. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.

5. The Committee also considers that it is important that a person's tax liability should be easy to calculate and straightforward and cheap to collect. To this end, tax policy should be **practicable**.

6. The tax system as a whole must be **coherent**. New provisions should complement the existing tax system, not conflict with it.[62]

The Committee requested the three professional accountancy bodies to consider the extent to which the Finance Bill, published after the 2011 Budget, met these criteria. It published memoranda by each organisation on 28 April.[63] In general all three were positive, but in each case suggested that the new supplementary charge failed one or more of these tests. The Chartered Institute of Taxation argued "the last minute and precipitate change in Oil tax rates for an industry that is particularly dependent on long-term planning seems wrong." The Association of Certified Chartered Accountants commented "while the measure is clear, simple and targeted, it fails on the Principles of Stability and Supporting Growth." The Tax Faculty of the Institute of Chartered Accountants of England and Wales noted "we understand the policy rationale for this decision but imposing unexpected tax charges with immediate effect is likely to cause damage to the UK's competitiveness."[64]

The Finance Bill received a second reading on 26 April 2011, and on this occasion several Members raised concerns about this particular measure: in particular, the lack of formal consultation on a higher charge before the Budget, the fact that the charge applied to gas as well as oil, and the possible impact on new investment in the North Sea.[65] Summing up for the Opposition at the end of the debate, David Hanson focused on the first of these objections:

> At the very last minute, with no consultation, the Government have made proposals to tax North sea oil still further. Oil and Gas UK has criticised the Government's decision and uncertainty has been expressed from organisations across the board about this hasty move. The Government took the decision at the very last minute with no consultation and [at the Committee stage of the Bill] we will seek to … ensure that we get further consultation.[66]

Opening the debate the then Chief Secretary to the Treasury, Danny Alexander, reiterated the Government's case for this measure:

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62 *Eighth report: principles of tax policy*, 15 March 2011 HC 753 2010-11 para 84

63 *Eleventh report: Finance (No. 3) Bill 2010–11*, 28 April 2011 HC 497 2010-12

64 HC 497 2010-12 pp 6,11,15

65 For example, Frank Doran, Stewart Hosie and Peter Aldous all discussed the issue at length (HC Deb 26 April 2011 cc85-91, cc94-97, cc 97-99).

66 HC Deb 26 April 2010 c133

> I understand that the increases in the supplementary charge are controversial, at least in the oil and gas sector. Given that the sector is benefiting hugely from the rapid rise in the world oil price, which currently stands at $124 a barrel, it was right to ask it to share some of its profits with motorists, but we are listening carefully to its concerns about specific investments. As we said in the Budget, we discussing with several firms the possibility of using the field allowance regime to continue to support investment. The industry is understandably concerned about the stability of the tax regime, given the long-term nature of investments in the North sea. That is why we committed ourselves in the Budget to working with the sector to provide certainty about the long-term future of decommissioning relief, and why we announced a fair fuel stabiliser to reduce the supplementary charge if oil prices fall below an agreed trigger level.
>
> However, we should not lose sight of the fact that this money is financing a much-needed package of support for motorists. First, it is funding the 1p reduction in fuel duty to which clause 19 refers. Secondly, it has helped to cancel Labour's inflation uprating until January next year. As a result of these two changes, fuel is 6p a litre cheaper now than it would have been under the plans we inherited.
>
> I should also remind the House that this Government inherited plans for above-inflation increases in fuel duty for 2011, 2012, 2013 and 2014. The increase in the supplementary charge has allowed us to abolish this fuel duty escalator, so that duty will not rise above inflation for the rest of this Parliament. As with fairness, so in understanding the issues facing hard-pressed motorists it is this coalition Government who are looking to share the burden of higher oil prices.[67]

When challenged about the fact that the price of gas was so much lower than that of oil,[68] the Minister underlined that the Government wished to consult further to mitigate the impact on "particular fields in the event of particular problems":

> The price of gas has also been on an upward path. However, we have discussed the matter with representatives of the industry, including Centrica, which has raised it directly with me and with other Ministers. We said in the Budget that we were willing to consider extensions of the field allowance regime to provide breaks for particular fields in the event of particular problems, and we are doing that at the moment. Existing rules allow breaks for very deep oil wells and heavy oil, for example. The discussion continues.[69]

4 Debate on the impact of the 2011 Budget

Provision to impose the new supplementary charge was made in clause 7 of the *Finance (No3) Bill 2011*, and this was debated on the floor of the House on 3 May. Speaking for the Opposition Kerry McCarthy MP argued that the charge was "poorly targeted, has potentially serious unintended consequences for the industry, and is certainly not a policy that [the Government] got "right first time", and all because [it] did not consult on their decision." Ms McCarthy moved an amendment to require the Government to produce an impact assessment of this change, while Stewart Hosie MP, speaking for the SNP, argued the new

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67 HC Deb 26 April 2011 cc72-3

68 During the debate Stewart Hosie noted that "Brent crude trades at about $120 per barrel, whereas UK wholesale gas trades at about $57 per barrel equivalent" (*op.cit.* c96).

69 *op.cit.* c70.

charge should be reversed on the grounds that "this is the most damaging measure in the Budget for economic growth."[70]

In response the then Economic Secretary Justine Greening argued that the rise in this charge was "the second part of the [fair fuel] stabiliser, which ensures that when oil prices are high, as they are now, and oil and gas production is more profitable, the companies that benefit more than that are asked to pay more." The Minister rejected the case for a separate impact assessment, but went on to mention the Government's ongoing discussions with the industry, and the purpose of certain technical amendments that were being made to the supplementary charge:

> The Government published our assessment of the impact of the measure in a tax information and impact note at the time of the Budget. Although we do not expect the measure to have a significant impact on investment or production in the forecast period … we are working closely with the industry. First, we want to look at field allowances to see how we can unlock those more marginal fields, and secondly, we want to look at the longer-term issues that the industry is keen to address, including, for example, achieving more certainty on decommissioning …
>
> The legislation provides for how profits in an accounting period that straddles the date of the rate increase are to be split, so that the two tax rates can be applied to the appropriate amounts of profits. Government amendment 11 provides that a company may elect for a just and reasonable basis to be used where a time apportionment would give an unjust or unreasonable result ... The amendment has an Exchequer cost of £40 million in 2011/12 only. We feel that the change is worthwhile because it ensures, for example, that the tax change does not affect the tax liability due in respect of transactions that were wholly completed before the Budget and that should not, therefore, have been affected by the rate change …
>
> The Government are also seeking the views of oil companies and motoring groups about the level of the trigger price for the supplementary charge, and how the oil price for that purpose is to be determined. That informal consultation will be take place shortly, and we expect to be able to clarify the policy mechanism in the autumn.[71]

At this time the Energy & Climate Change Committee held evidence sessions with industry representatives and with Ministers. In a memorandum following these sessions, the Government gave more details of its assessment that the tax increase would not have a significant impact on investment or production. An extract is reproduced below:

> The Government recognised at the Budget that the tax increase could have an effect on marginal projects, and announced that it would consider the case for a new category of field qualifying for field allowance to address this issue. However, it is important to note that, since the introduction of and extensions to field allowances in 2009 and 2010, most marginal new fields already qualify for a field allowance. That means that the impact of the increase in rate of supplementary charge for such fields on a post-tax income basis is often less, or much less, than the headline reduction of 24%. In some cases, the impact is zero or even positive.
>
> The latest Oil & Gas UK activity survey published in May shows that very few, if any, projects have been cancelled as a consequence of the tax rise, though some projects have been identified as less likely to proceed. The survey also shows that investment

70 HC Deb 3 May 2011 c600, c605
71 HC Deb 3 May 2011 cc624-5, c627

> in the years to 2014 will be higher than in 2010, despite the general declining trend in a mature basin. Companies expect to proceed with billions of pounds of investment that have yet to be sanctioned, which demonstrates that the North Sea is still a very attractive place to attract future investment.
>
> The Government's assessment is further corroborated by the fact that activity is continuing on almost all of the many new field and incremental projects which were being worked up and discussed with DECC prior to the Budget in preparation for development approval. Indeed, discussion on some projects started only after the Budget. Where projects have been put back, the reasons are predominantly technical rather than economic, though there are a few cases where companies are arguing that the commercial viability of their project is threatened. Discussions on these projects are underway with Government in line with the announcement on field allowances.
>
> The Government's assessment, and the evidence to date, is also in line with the findings recently published by Professor Alex Kemp and Linda Stephen of the University of Aberdeen.[72] Their analysis of the impact assuming high oil and gas prices ($90/barrel, 70p per therm) and the screening hurdle most commonly reported to us by active investors shows a loss of only 2% of new fields and 2% of incremental projects—a reduction from 1,099 projects to 1,074. These effects are much smaller than the effect of re-running the analysis at different levels of oil and gas prices or of re-running it with a different screening hurdle. This analysis also does not take into account any future policy on field allowances.[73]

The industry continued to lobby strongly against the new charge,[74] although in an editorial at this time the *Financial Times* suggested that, even if the Government's policy had been "handled clumsily" it was "long overdue":

> UK gas producers are protesting that gas has not seen the same windfall as oil … But this is a weak argument. First, it would be strange if oil and gas prices stayed apart for very long. After all, these are energy sources that can to some extent be substituted for one another. The price divergence will prompt users to shift to gas where possible, which will narrow the price gap.
>
> More fundamentally, gas shares with oil (and mined metals) the feature that justifies higher tax rates on extraction than on other industries: profit in excess of the level needed to attract capital into these sectors. This excess is due to the natural scarcity of the product, not any particular talent or effort expended. These "superprofits" - or economic rents - ought to be captured in their entirety for the benefit of the public. This is what "supertaxes" on oil, gas and mining achieve, provided companies are allowed to make a normal return on capital before the higher rate kicks in. This - not a low headline tax rate … is the best response to legitimate worries about keeping incentives in place as fields become more marginal.[75]

However, on 5 July 2011 Ms Greening made a written statement, confirming that the Government had agreed to increase the 'ring fence expenditure supplement' (RFES) to mitigate the impact of the new charge on new investment. This is reproduced in full below:

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72 *The Effects of Budget 2011 on Activity in the UK Continental Shelf* (April 2011)

73 "Memorandum submitted by DECC & HMT", June 2011, *Implications for the North Sea oil and gas industry of the Budget 2011*, 18 January 2012, HC 1018-I of 2010-12 Ev35

74 "Charge on profits pits angry industry against Treasury" & "Warning over energy sector tax increase", *Financial Times*, 9 May 2011; "CBI chief takes gloves off in energy tax fight", *Financial Times*, 2 June 2011

75 "Editorial: Big Oil protests too much on tax", *Financial Times*, 13 May 2011

I can announce today that the annual rate of the ring fence expenditure supplement (RFES) for the North sea fiscal regime will be increased from 6% to 10%, following discussions with industry initiated at Budget 2011. This provides extra support for investment in the North Sea, including in marginal fields that qualify for the current field allowance, and will also support the ongoing considerations on new categories of field allowance.

In the March Budget, as part of a package of measures to help motorists cope with high petrol prices, the Government announced a fair fuel stabiliser that would be funded by higher taxation of the profits from oil and gas companies when oil prices are high. The Government said at that time that they would consider with the oil and gas industry the case for a new category of field that would qualify for field allowance to support investment in marginal fields. In the course of those discussions with industry, the Government have identified that the ability of a company to benefit fully from the field allowance is dependent on whether a company has sufficient current taxable income against which to off-set expenditure. This is addressed to some extent by the ring fence expenditure supplement, which currently allows companies with insufficient taxable income to uprate losses by 6% for six accounting periods.

The increase to 10% will help ensure existing field allowances work more effectively and equitably to support investment in marginal fields. It also brings RFES in line with the discount rate typically used by the sector. Increases in the rate of supplement may be made by order. The Government intend to lay the necessary order before the House of Commons in the autumn, with the increase in RFES effective from 1 January 2012. The OBR will publish the full scorecard costings of this measure over the forecast period at the time of its autumn forecast. Initial estimations are that the change is expected to cost around £50 million a year by the end of the forecast period (2015/16).

The Government will continue to engage with oil and gas companies on the case for new categories of field qualifying for field allowance, and will provide further updates to Parliament in due course.[76]

The announcement was widely welcomed by the industry,[77] and two companies which had been particularly critical of the tax rise, suspending certain operations, stated that they would resume these activities:

Statoil, the Norwegian oil company, is to resume work on a large North Sea project and Centrica, the UK utility, said that it had reopened Britain's biggest gas field following concessions by the government on taxation. The Treasury has said it will increase the ring fence expenditure supplement from 6 to 10 per cent, a measure that allows energy companies to offset the losses they make from investments against tax payments from future profits.

The change was enough for Statoil to say that it would resume developing the Mariner oilfield, south-east of the Shetland Islands, which might hold 430m barrels. All work had been suspended after George Osborne, chancellor, raised the supplementary tax on oil and gas production in British waters at prices exceeding $75 per barrel from 20 to 32 per cent in the last Budget. "The negative impact from the tax increase proposed

[76] HC Deb 5 July 2011 cc81-2WS; see also, HM Treasury press notice 72/11, 5 July 2011. The RFES was introduced by the Labour Government in Budget 2006 – at an estimated cost of £5m per year, by 2008/09 (*Budget 2006*, HC 968 March 2006 p190: Table A2 : item r).

[77] Oil & Gas UK press notice, *Oil & Gas UK Responds to Treasury Announcement*, 5 July 2011

in March has been neutralised for the Mariner investment and the project is now back on track," said Statoil. "We will resume technical and commercial work with full speed."

Centrica has reopened the UK's largest gas field after choosing to leave it dormant for a month, a move that it linked to the tax increases in the Budget. Production from South Morecambe resumed last Friday. A Centrica spokesman said this was because of "commercial optimisation" and the need to use the field in order to complete the maintenance process.[78]

In its 2012 Budget the Government announced a number of changes to field allowances, and its plans to bring forward legislation giving it statutory authority to sign contracts with companies, to provide assurance of the relief they would be entitled to when decommissioning assets.[79] Both announcements were welcomed by the industry, though, compared with the amounts raised by the 2011 Budget changes, the sums of money at stake for the medium term were relatively small.[80] Consultation on decommissioning relief was launched later that year;[81] provisions for these 'Decommissioning Relief Deeds' were announced in the 2013 Budget.[82] Further to this, in September 2012 the Government announced a new allowance to encourage investment in brown fields.[83]

In February 2013 Helen Miller of the IFS gave an overview of the fiscal regime in the IFS Green Budget, in which she was critical of the uncertainties created for corporate investment by this pattern of events:

In the March 2011 Budget, the supplementary charge was increased to 32%. Part of the rationale for the increase was to transfer to the government some of the benefits that North Sea companies can expect to gain as a result of high oil prices over the next five years.[84] However, using the supplementary charge for this purpose means that at least some North Sea investment decisions were distorted ...

Partly in order to offset the impact of the increased rate of supplementary charge, the government has since increased the scope and generosity of Field Allowances, which work to reduce the amount of profit on which firms are liable to pay tax. Notably, they have been extended to encompass brown field sites.[85]

Even if the government has reached a set of policies that work to raise revenues while limiting investment distortions, the process of getting there – i.e. of increasing the rate and later trying to offset some of the effect through changes in allowances – could have been better managed …

That the supplementary charge was introduced and increased twice in the last decade raises concerns of further surprise tax increases. The lack of stability in the tax burden

78 "Statoil to restart North Sea project after concessions by UK over tax", *Financial Times*, 6 July 2011; see also, "BP plans to push ahead on North Sea projects", *Financial Times*, 14 July 2011

79 *Budget 2012*, HC 1853, March 2012 para 2.125-6

80 "Premier sees deals on N Sea horizon" & "Operators welcome Budget changes", *Financial Times*, 23 March 2012. Taken together, these measures were projected to cost up to £335m by 2013/14, before boosting receipts by £300-£400m in successive years (*Budget 2012*, HC 1853, March 2012, Table 2.1 – items 9 & 10).

81 HC Deb 9 July 2012 c1WS

82 HMRC, *Decommissioning: increasing tax certainty for oil and gas investment in the UKCS*, 20 March 2013. Take-up over the first year was reported to the House in July 2014 (HC Deb 21 July 2014 c95WS).

83 HC Deb 7 September 2012 cc37-8WS

84 "Government still expects that average post-tax profits per barrel will be higher over the next five years than the last five' (HMRC, *Oil and Gas Taxation: Supplementary Charge* (TIIN6133), 23 March 2011).

85 specifically, a Brown Field Allowance will be available for the development (after 7 September 2012) of previously unaccessed reserves in an existing field. See Finance Act 2012.

> and the expectation of further rises in future may work to deter investment (although we do not know how important this effect is empirically). In the June 2010 Budget, the government recognised 'the importance of a stable and fair UK oil and gas tax regime that provides certainty for businesses' and set out its intention to 'take forward discussions with the industry to ensure the regime encourages continuing investment and the exploitation of remaining resources'.[86]
>
> The increase in the supplementary charge was then announced without warning just nine months later. This is not the first government to have openly acknowledged the importance of a stable tax regime, only to increase taxes later without warning.[87] In fact, the taxation of North Sea companies has been subject to many changes since the regime began in the 1970s. Companies, especially those undertaking large long-term investments, value certainty.[88]

Ms Miller went on to highlight the different approach taken toward future decommissioning relief, as "a good example of how additional certainty can improve investment incentives":

> The rate against which tax relief for decommissioning expenditure is granted has been restricted to 20% (ie, not increased to 32% in line with the rate of supplementary charge). The rationale given was that allowing relief against the higher rate would incentivise accelerated decommissioning. That is, if relief were granted at the new rate, then – to the extent that firms did not think this new higher rate was permanent – they would face an incentive to bring forward decommissioning costs.[89] However, because the increased rate of the supplementary charge looks permanent, this effectively acts to reduce the relief available for decommissioning costs. There is no clear reason why the relief for decommissioning should be given at a lower rate than that at which the related returns are taxed.
>
> In a positive move, legislation will be introduced in 2013 under which the government will be able to sign contracts with companies that provide certainty over the future relief they will receive when decommissioning assets.[90] Providing companies with such certainty is forecast to raise revenue solely by increasing investment in and production of oil and gas (i.e. raising revenue without directly imposing a higher tax burden on firms) …
>
> The taxation of North Sea companies has undergone many incremental changes by many governments. The result is a system that incorporates distortions, is unduly complex and lacks a clear design … In considering policy change, any benefits (for example, additional revenue) should be weighed against the costs of reducing stability and certainty and possibly additional complexity. The introduction of contracts that specify future decommissioning relief is a good example of how additional certainty can improve investment incentives and, as a result, strengthen the public finances.[91]

86 Se para 1.85 of HM Treasury, *Budget 2010*, June 2010

87 For example, following a number of changes in 2002, including the introduction of the supplementary charge, the government of the day stated that it felt it had established a system with the right balance between revenues and investment incentives (paragraph 5.82 of HM Treasury, *Budget 2002: Economic and Fiscal Strategy Report*, April 2002. However, the same government changed the timings of ring fence corporation tax payments in 2005 and doubled the supplementary charge in 2006.

88 "Chapter 10: Corporate tax revenues & avoidance", *IFS Green Budget*, February 2013 pp307-8

89 See paragraph 1.149 of HM Treasury, *Budget 2011*, March 2011

90 The government plans to consult on the precise form of such contracts with a view to introducing legislation in Finance Bill 2013. See paragraph 2.125 of HM Treasury, Budget 2012, March 2012

91 *IFS Green Budget*, February 2013 pp308-9

5 Autumn Statement 2014 & Budget 2015

Following a review of the UKCS by Sir Ian Wood, in the 2014 Budget the Chancellor, George Osborne, announced the Government would "review the UK's tax treatment of the North Sea to ensure that it continues to incentivise economic recovery as the basin matures."[92] In July the Government launched a call for evidence, asking for views on how the tax regime should be reformed in the light of the challenges facing the industry in future years:

> The government estimates that there are between 11 and 21 billion boe remaining in the UKCS that could be economic to recover (DECC estimates). This is a significant resource, and has the potential to support employment, skills, economic growth and tax revenues for several decades to come. A record £14.4 billion was invested in the UKCS in 2013, demonstrating confidence that this potential can be realised ('Activity Survey 2014', Oil & Gas UK, 2014).
>
> However, as the basin matures recovering the remaining oil and gas is becoming more difficult. In recent years, the UK oil and gas industry has faced a growing challenge to maintain production – which has fallen 37% since 2010 (DECC figures) – and production efficiency[93] – which is down to near 60%, having averaged around 80% a decade ago ('Activity Survey 2014', Oil & Gas UK, 2014).
>
> A number of factors are contributing to these outcomes, including:
>
> - New fields are generally smaller, harder to find and more technically challenging to exploit. This means that the potential benefits from exploration are less attractive. Exploration rates have been relatively low since 2009.
>
> - Extending the production of old fields often entails making significant investment in existing infrastructure to extend their lives. This is also an issue for many new small fields, which require access to existing infrastructure if they are to be economic to develop.
>
> At the same time, the UKCS has to compete for global investment capital. Numerous less mature basins overseas offer commercial opportunities, such as Norway, West Africa and North America.[94]

Writing in the *Tax Journal*, Derek Leith, head of oil and gas taxation at Ernst & Young, wrote, "we believe that conditions in the UKCS have reached a tipping point in the eyes of many investors. Whether it is grounded in perception or reality, the combination of rising costs, falling production, deteriorating efficiency, reducing and disappointing exploration results and the impact of tax increases are all having a negative impact on investor sentiment, at a time when the US onshore hydrocarbon revolution has and continues to attract significant interest."[95] Just prior to the Autumn Statement the *Financial Times* reported Malcolm Webb, head of Oil & Gas UK (the industry's trade association), as arguing, that without tax reductions, "swaths of the UKCS will be pushed into terminal decline":

> The warning from Malcolm Webb, chief executive of the industry's leading lobby group, comes in spite of two years of record investment in UK waters. This year the UK's continental shelf is expected to attract £13bn in capital investment, after £14.4bn was committed in 2013. Another £39bn has been approved, much of it sanctioned during a sustained period of high global oil prices. However, Mr Webb and other observers point

92 *Budget 2014*, HC 1104, March 2014 para 1.114
93 The ratio of a field's actual production performance against its maximum capability.
94 HM Treasury, *Review of the oil and gas fiscal regime: call for evidence*, July 2014 p6
95 "The Q&A: North Sea fiscal refresh: the government's new consultation", *Tax Journal*, 25 July 2014

out that increases in operating costs, a collapse in exploration drilling and sharp falls in production of oil and gas in British waters threaten to extend a collapse in cash flows from the once-prolific basin.

> He says the recent fall in the benchmark Brent Crude price index to $80 a barrel has strengthened arguments for a more benign fiscal environment for operators at the expense of short-term tax yields. In particular, they want the chancellor to reverse a 12 percentage point increase in the supplementary charge in his 2011 Budget, which raised their top marginal tax rate to 81 per cent.[96]

As it turned out, the Chancellor announced a cut in the supplementary charge, as well as the withdrawal of the so-called 'fair fuel stabiliser', in his statement on 3 December:

> The fall in the global oil price has meant a welcome boost to much of the British economy and to families. There is record investment this year in the North Sea, but the lower oil price clearly presents a challenge to this vital industry. My right hon. Friend the Chief Secretary to the Treasury will set out our full proposals in Aberdeen tomorrow, but I can tell the House today that we will go ahead with an immediate reduction in the rate of the supplementary charge from 32% to 30%; we will expand the ring-fenced expenditure supplement from six to 10 years; and we are introducing, with immediate effect, a new cluster area allowance. That demonstrates our commitment to the tens of thousands of jobs that depend on this great British industry.
>
> Despite falling fuel prices, let me make this absolutely clear: we have cut fuel duty and we will keep it frozen—with my hon. Friend the Member for Harlow (Robert Halfon) sitting right behind me, I would not dare do anything else.[97]

As Mr Osborne said, further details of the Government's proposals were given by the then Chief Secretary the next day,[98] and in document summarising the responses made to the call for evidence.[99] The document noted that the 'key findings' from this exercise had been as follows:

> 1. The fundamentals of the fiscal regime remain sound, but now is the time for significant change within the ring fence in order to attract investment.
>
> 2. UKCS operators are facing strong competition for scarce investment whilst the economics of the basin have changed fundamentally, with implications for the overall level of tax
>
> 3. There are opportunities to simplify the fiscal regime to provide greater certainty, less administrative burden, and fewer distortions.[100]

The document gives a little more detail on the Government's conclusion that 'the fundamentals of the fiscal regime remain sound':

> Countries around the world take very different approaches to sharing the profits of natural resource extraction. The government's view when establishing this review was that the UK's approach, based on taxation of ring fenced profits, remained sound. The UK's approach is similar to many other developed nations though each tax regime

96 "Osborne pressed to reform taxes or see UK oil and gas decline", *Financial Times*, 24 November 2014
97 HC Deb 3 December 2014 c312
98 HM Treasury press notice, *Radical reforms for oil and gas industry*, 4 December 2014
99 HM Treasury, *Driving investment: a plan to reform the oil and gas fiscal regime*, December 2014. See also, "Analysis: oil and gas fiscal regime – the plan for reform", *Tax Journal*, 12 December 2014
100 *Driving investment: a plan to reform the oil and gas fiscal regime*, December 2014 pp15-16

> differs in its detail. The government has not received evidence that would suggest the UK should radically change its approach. The review has therefore focused on what would be the most appropriate structures and tax rates within the ring fence regime.
>
> Within the regime, there are clearly some aspects that are working well. Oil and gas production is highly capital intensive and so the tax treatment of capital expenditure is a key element of the regime. 100% first year capital allowances are available for virtually all capital expenditure, and it is clear that this remains a vital element of the regime. Tax relief is also available for expenditure on decommissioning, and the introduction of Decommissioning Relief Deeds from 2013 was a welcome move to ensure uncertainty over future tax relief for decommissioning does not tie up capital which would otherwise be available to invest.
>
> The introduction of field allowances, which reduce a company's liability to the Supplementary Charge if certain qualifying criteria are met, has supported significant investment in commercially marginal developments (though as explained below there is a case for making changes to the current field allowance model). More generally, stakeholders have also welcomed the level of engagement they have had with the Treasury and HMRC on fiscal issues in recent years.
>
> **The government's position is that the structures of the ring fence regime remain sound. The government intends to make radical reform but within the ring fence structure.**[101]

The cut in the supplementary charge was estimated to cost around £60m a year from 2015/16.[102] In his presentation on the Chancellor's statement, Paul Johnson at the IFS noted the quiet demise of the Government's commitment on excise duties:

> It is also worth mentioning the reduction to the supplementary charge levied on North Sea Oil production. This is notable less for the reduction itself than for the quiet abandonment of the so called fair fuel stabiliser introduced when the supplementary charge was increased back in 2011. The idea was supposed to be that when oil prices were high oil producers would pay more tax on their profits while motorists wouldn't see excise taxes exacerbate the effect of high prices. Low oil prices should have seen cuts in the tax on oil producers but rises in fuel duties. The latter is not happening. This does little for the credibility of such commitments.[103]

Despite the Chancellor's announcement, many companies started the New Year by announcing significant redundancies.[104] At this time the Scottish Affairs Committee was undertaking an inquiry into the Smith Commission, and its recommendations for further devolution of powers to the Scottish Parliament. When David Phillips, from the IFS, and Professor John McLaren, gave evidence, they were asked for their views on how the Government should respond to these developments; notably both witnesses underlined the point that huge volatility – in prices, profits and jobs – was a permanent feature of the industry:

> **Professor McLaren:** In terms of helping the industry at the minute, what you do not want to do is rush in. This industry is used to big changes in price and huge political,

101 *op.cit.* p16

102 *Autumn Statement*, Cm 8961, December 2014 (Table 2.1 – item 21). The cost of the extension to the ring-fenced expenditure allowance, and the new cluster area allowance, were estimated to be £10-15m pa from 2016/17 (Table 2.1 – item 22).

103 "Introductory remarks", *IFS Autumn statement briefing*, 4 December 2014 p8

104 "Urgent review of North Sea oil risks ordered as axe falls on jobs", *Financial Times*, 19 January 2015

> economic and price volatility. It is asking for help at the minute, as it would—as all industries would in these circumstances—but if the UK or Scottish Governments are going to offer help it should not be along the lines of what will help the big oil companies, which make reasonable profits, but what will help the UK in the longer term, for example keeping the infrastructure in good condition so that later on, when things pick up, the industry can carry on and gain more export markets for onshore industries …
>
> **David Phillips:** I would agree with everything John McLaren said. Although the oil industry is used to dealing with uncertainty in the policy environment, in price and in the political environment, it still likes certainty where possible. Some of the changes we have seen in the UK oil and gas tax regime over the last few years have not contributed to that. For example, back in 2011 a fair fuel stabiliser was announced, whereby when oil prices were high there was a higher tax rate on oil firms and the petrol duty was cut for consumers, and if the oil price fell again to below $70 a barrel—I think that was the level set—you would start to increase fuel duties to consumers and cut down the charge to oil companies, back to the 20% surcharge that used to apply.
>
> That policy has been, quietly, largely abandoned. There has been a small cut in the surcharge—it was announced in the autumn statement—but it is still 30% as opposed to 20%, so it has not gone back down. They have completely cancelled the fuel duty increases that were meant to take effect. IFS never thought it was a sensible policy in the first place, but it is even less sensible to announce the policy and then cancel it at the last minute, because you create uncertainty in the meantime.
>
> I think there are lessons to be learned from this. If you are going to announce policies that can smooth, stabilise or help an industry in certain circumstances, don't announce them and then cancel them, because that affects the expectations of companies and has a negative knock-on effect in future. If they know that in the past the Government have not kept to their pledges, they might doubt them in future.[105]

Oil prices continued to fall in early 2015, with suggestions that quite a number of smaller companies were likely to go bust, or would be bought by larger concerns.[106] Continued job losses and reports of a significant decline in investment over the previous year,[107] led the one-time CEO of BP, Lord Browne, to argue for a much more radical change to the tax system: the *Financial Times* quoted him as saying, "frankly, why don't we put the whole thing on a corporation tax basis? It all needs to be simplified … it's not appropriate to have so many detailed regimes. I don't know of anywhere else in the world that does it like that."[108] An editorial in the paper agreed that cutting marginal tax rates on profits "could have some impact on behaviour, as could the simplification of the allowances system", although it recommended direct state subsidy for new exploration, as part of a risk-sharing approach between government and the industry, akin to that used in Norway.[109]

In his 2015 Budget speech Mr Osborne announced a second series of measures, including a cut in the supplementary charge to 20%, and a reduction in the rate of PRT:

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105 "Oral evidence: Wednesday 14 January 2015", *The Smith Commission: Proposals for Further Devolution to Scotland*, 10 March 2015, HC 835 of 2014-15, Q333. The issue was the subject of a debate in Westminster Hall at the time (HC Deb 20 January 2015 cc32-55WH).

106 "That sinking feeling", *Financial Times*, 26 February 2015

107 "Oil and gas industry in 'bleak' 2014, finds survey", *BBC news online*, 24 February 2015. For details see, Oil & Gas UK, *Activity survey 2015*, February 2015

108 "Browne urges end to extra North Sea oil tax after plunge in the price of crude", *Financial Times*, 12 February 2015

109 "Editorial: A new deal to keep North Sea oil flowing", *Financial Times*, 12 March 2015

> Although the falling oil price is good news for families across the country, it brings with it challenges for hundreds of thousands whose jobs depend on the North Sea. Thanks to the field allowances we have introduced, we saw a record £15 billion of capital investment last year in the North Sea. But it is clear to me that the fall in the oil price poses a pressing danger to the future of our North Sea industry, unless we take bold and immediate action. I take that action today.
>
> First, I am introducing, from the start of next month, a single, simple and generous tax allowance to stimulate investment at all stages of the industry. Secondly, the Government will invest in new seismic surveys in underexplored areas of the UK continental shelf. Thirdly, from next year, the petroleum revenue tax will be cut from 50% to 35% to support continued production in older fields. Fourthly, I am, with immediate effect, cutting the supplementary charge from 30% to 20%, and backdating it to the beginning of January. It amounts to £1.3 billion of support for that vital industry in the North Sea. The OBR assesses that it will boost expected North Sea oil production by 15% by the end of the decade.[110]

The Budget report gave more details of these measures, the cost of which was projected to be £230m in 2015/16, rising to £395m in 2016/17:

> 2.139 Ring Fence Expenditure Supplement (RFES) – As announced at Autumn Statement 2014, the government will extend the RFES from 6 to 10 accounting periods for all ring fence oil and gas losses and qualifying pre-commencement expenditure incurred on or after 5 December 2013. (Finance Bill 2015)
>
> 2.140 High pressure, high temperature cluster area allowance – As announced at Autumn Statement 2014, the government will introduce an allowance to support the development of high pressure, high temperature projects and encourage exploration and appraisal activity in the surrounding area or 'cluster'. The allowance will exempt a portion of a company's profits from the Supplementary Charge. The amount of profit exempt will equal 62.5% of the qualifying capital expenditure a company incurs in relation to a cluster from 3 December 2014 onwards. (Finance Bill 2015)
>
> 2.141 UK Continental Shelf Investment Allowance – The government will introduce a basin-wide allowance to support investment on the UK Continental Shelf, replacing the existing offshore field allowances and simplifying the existing regime. The allowance will exempt a portion of a company's profits from the Supplementary Charge. The amount of profit exempt will equal 62.5% of the investment expenditure a company incurs in relation to a field from 1 April 2015 onwards. (Finance Bill 2015)
>
> 2.142 Reduction to Supplementary Charge – Further to the 2 percentage point cut in the Supplementary Charge announced at Autumn Statement 2014, the government will reduce the rate of the Supplementary Charge from 30% to 20% with effect from 1 January 2015. (Finance Bill 2015)
>
> 2.143 Petroleum Revenue Tax (PRT) – The government will reduce the rate of PRT from 50% to 35%, taking effect for chargeable periods ending after 31 December 2015. (Finance Bill 2015).[111]

The OBR's *Economic & Fiscal Outlook* published alongside the Budget says a little more about its impact assessment of these changes:

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[110] HC Deb 18 March 2015 c775. These two measures, along with a new investment allowance, were projected to cost £395m by 2016/17 (*Budget 2015*, HC 1093, March 2015: Table 2.1 – items 11 & 12).

[111] *Budget 2015*, HC 1093, March 2015 p85, p64 (able 2.1 – items 11 & 12). See also, HMRC, *Corporation tax: oil and gas companies: investment allowance and reduction in supplementary charge – tax information note*, 18 March 2015

The policy measures announced in the Budget to introduce a new investment allowance, cut the supplementary charge (SC) from 30 per cent to 20 per cent and a 15 per cent cut in the rate of petroleum revenue tax (PRT), reduce receipts by a further £0.3 billion a year on average. The costing of these measures involved a relatively simple static effect of changing rates, but a highly uncertain set of judgements about the effect on capital expenditure and production, which offset some of the pre-behavioural cost.

The investment allowance will provide companies with an allowance of 62.5 per cent of capital investment to offset against profits subject to the SC. The allowance replaces existing field allowances and can be offset against profits (chargeable to the SC) arising from all operations in which companies are involved, not just the project or field from which the allowance is generated. The SC and PRT cuts also raise the post-tax returns on oil and gas extraction. In reaching a judgement on the extent to which these measures would lead to increased production and investment, we considered both bottom-up evidence of the possible impact on representative project profit-to-investment ratios and top-down evidence of the impact of the policy change relative to the oil price falls already witnessed.

The judgements we have made are subject to considerable uncertainty, as it is not possible to know the precise hurdle rates or cost and price assumptions that firms will make, or the speed with which any new investment will deliver additional production. With those caveats in mind, Table 4.11 presents our pre- and post-measures forecasts of production and expenditure. We have assumed for our central forecast that the policy measures will boost oil production by 14 per cent, capital expenditure by 23 per cent and operating expenditure by 6 per cent.

Table 4.11: Oil and gas production and expenditure forecasts

	£ billion (unless otherwise stated)					
	2014	2015	2016	2017	2018	2019
	Pre-measures					
Oil production (million tonnes)	39.7	38.1	35.9	33.0	30.8	27.1
Gas production (billion therms)	13.1	12.5	11.5	10.8	10.1	9.3
Capital expenditure	14.8	10.5	8.0	6.0	5.0	4.0
Decommissioning expenditure	1.0	1.4	2.0	2.0	2.0	2.0
Exploration and appraisal expenditure	1.1	0.8	0.5	0.5	0.5	0.5
Operating expenditure	9.6	9.0	8.5	8.0	7.5	7.0
	Post-measures					
Oil production (million tonnes)	39.7	38.3	36.7	34.9	33.4	30.9
Gas production (billion therms)	13.1	12.6	11.9	11.4	10.9	10.3
Capital expenditure	14.8	10.8	8.3	6.6	5.9	4.9
Decommissioning expenditure	1.0	1.4	2.0	2.0	2.0	2.0
Exploration and appraisal expenditure	1.1	0.8	0.8	0.8	0.8	0.8
Operating expenditure	9.6	9.0	8.6	8.2	7.8	7.4

Different assumptions would not be unreasonable and … it is likely that outcomes will be different to our forecasts. But we do consider the risks to be both to the upside and the downside.[112]

As noted in this extract, legislation to give effect to these changes was included in the *Finance Act 2015*, passed after the Budget (specifically ss471-51). Due to the timing of the Dissolution of the House, the House's scrutiny of the Bill was taken, in all its stages, in a single day, so that there was no detailed discussion of these provisions, or the North Sea tax

[112] Economic and Fiscal Outlook, Cm 9024 March 2015 pp115-6

regime generally.[113] Similarly the timing of the General Election saw most commentary on the Budget focused on other issues, though, in a technical summary of the measures in *FA2015*, two practitioners writing in *Tax Journal* made these concluding remarks:

> The changes enacted by *FA2015* have been well received by the UK oil and gas industry. By HM Treasury's own figures, the cost of the package of measures is surprisingly modest – approximately £1.4bn over the next five years. This probably reflects that future tax revenues over that period were estimated to be low because of the current challenges facing the sector. However, HM Treasury also anticipates the changes should facilitate upward of £4bn of incremental investment in the UKCS over the same period, lifting production by 15%. If the turn-out achieves this bold prediction, one would imagine both industry and government would be extremely pleased.[114]

[113] HC Deb 25 March 2015 cc1437-1537. Speaking for the Opposition on the Bill's second reading, Chris Leslie said, "We welcome the measures that will cut the supplementary charge and petroleum revenue tax … However, we have also consistently called for greater certainty for the sector, particularly because of the long-term nature of much of its investment." (*op.cit.* c1454).

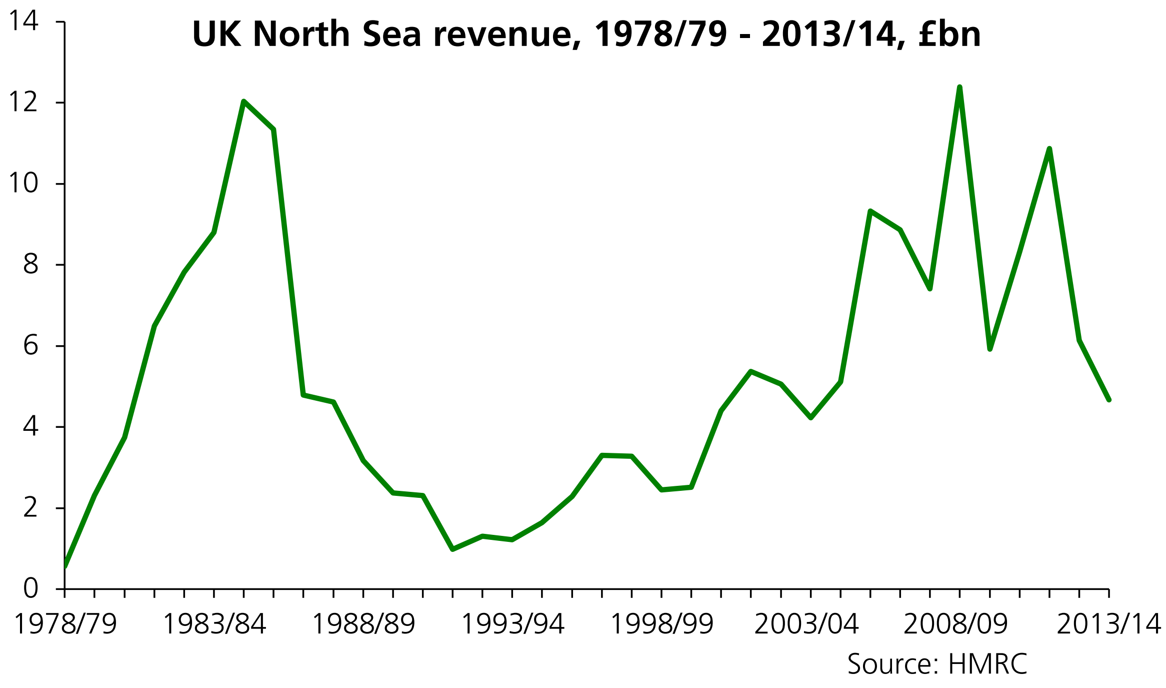
[114] "FA2015 analysis: oil & gas measures", *Tax Journal*, 24 April 2015

Appendix : North Sea revenues - statistics & forecasts

North Sea revenues are volatile and hard to predict. This section discusses the size of North Sea revenues up to 2013/14 and future forecasts.

How large are North Sea revenues?
UK revenues from the North Sea were £4.7 billion in 2013/14,[115] down from close to £11 billion in 2011/12. For the UK as a whole, they accounted for around 1% of government receipts in 2013/14. Since 1999/00 North Sea revenues have averaged £6.7 billion a year.

The chart below shows that revenue from the North Sea can fluctuate greatly from one year to the next. For example, revenues roughly halved between 2008/09 and 2009/10.



What are the forecasts for North Sea revenues?
The section above looked at North Sea revenues in recent years. An important issue is how great these revenues will be in the future. The Office for Budget Responsibility (OBR) forecasts UK North Sea revenues of £4.7 billion in 2013/14 falling to £2.6 billion the following year, and then fluctuating between £0.6 billion and £0.8 billion a year until 2019/20.[116,117] Forecasts of North Sea revenue are subject to considerable uncertainty as they depend on a range of factors, such as oil prices and exchange rates, which are themselves hard to predict.

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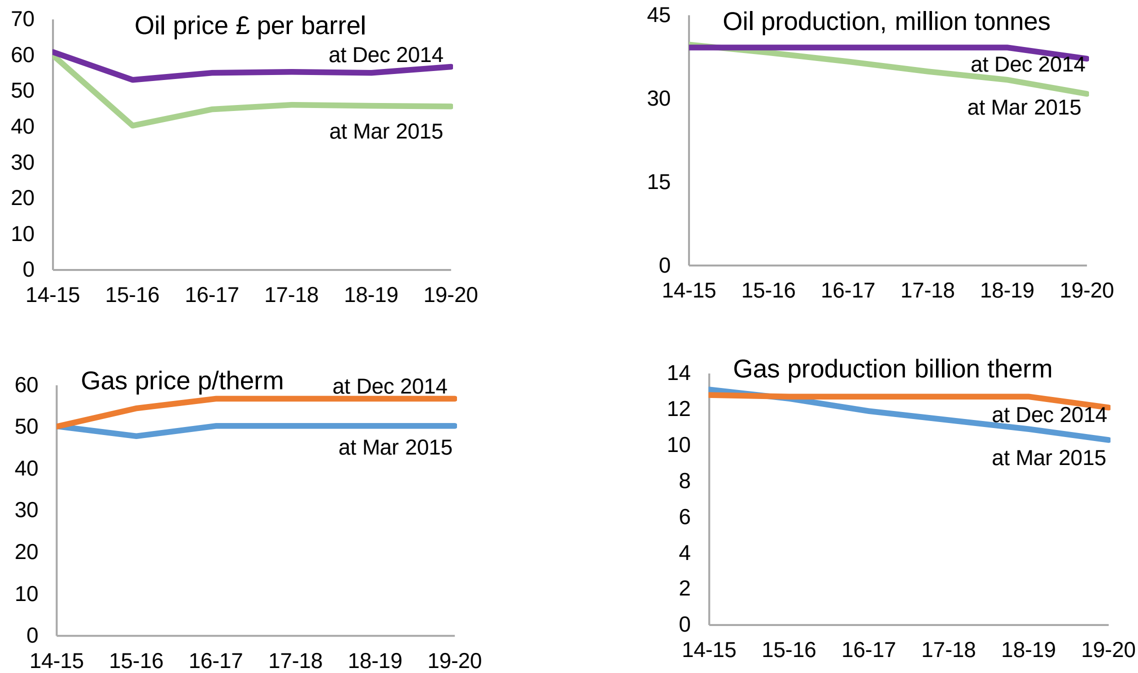
115 Figures from HMRC Table 11.11. *Government Expenditure and Revenue Scotland 2013-2014* reports a figure of £4.8bn.

116 OBR, *Economic and Fiscal Outlook,* March 2015, Table 4.5

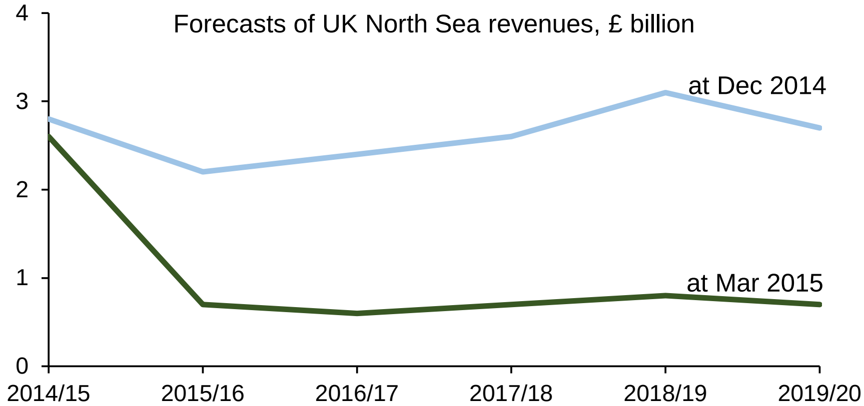
117 In May 2014 the Scottish Government published projections of North Sea revenue. These were produced before the price of oil fell significantly so are not included here but can be accessed from the following source: Scottish Government, *Oil and Gas Analytical Bulletin*, May 2014

As with all forecasts, forecasts of North Sea revenues are subject to revision. For example, in December 2014 the OBR forecast North Sea revenue to average £2.6 billion per year between 2015/16 and 2019/20; by March 2015 this figure stood at £0.7 billion a year.[118] The downward revisions were largely due to lower forecasts of oil prices and production, as shown in the charts below.

OBR Forecasts of North Sea revenue determinants changed significantly between December 2014 and March 2015…



...causing forecasts of North Sea revenues to fall



source: Office for Budget Responsibility (OBR)

118 OBR, *Economic and Fiscal Outlook*, March 2015, Table 4.6

Over the longer term, the OBR expect oil and gas receipts to fall but emphasise that the speed of the decline is very difficult to predict with confidence:

> …in considering these projections, it is important to note that oil and gas receipts are the most volatile revenue streams in the UK public finances and forecasting them over even short horizons is extremely difficult. The same factors that make North Sea receipts volatile on a year-to-year basis make it very hard to predict the pace of the long-term trend decline with any confidence.[119]

[119] OBR, *Fiscal Sustainability Report*, July 2014, para 35