

The UK Budget Proposals and North Sea Oil and Gas

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In the UK Budget it is proposed to raise the Supplementary Charge (SC) on the profits from oil and gas exploration in the UK Continental Shelf (UKCS) from 20% to 32%. This will result in the overall rates of tax being increased from 75% to 81% on the mature fields subject to Petroleum Revenue Tax (PRT) and from 50% to 62% on those fields not subject to PRT. This is a relatively large increase and the rather odd resulting rates probably emanate from the finding that the estimated increased yield over the next few years broadly matches the reduced yield from the lower duties on petroleum products which would otherwise have prevailed. The estimated increased yield from the UKCS averages nearly £2 billion annually over the next 5 years.

To compensate for a reduced yield in this way may appear neat from an accounting viewpoint but is unsatisfactory when viewed as determining the appropriate tax arrangements for the UKCS. Broadly, the system has been proportional in relation to profits for some years and thus not progressive in relation to the wide range in the profitability of projects, whether they be new fields or substantial incremental projects in mature ones. There are many fields and projects which are regarded as marginal by their operators, even at the relatively high oil prices currently ruling. Thus there are over 300 undeveloped discoveries many of which have lain fallow for many years because of their doubtful economic viability.

It is inevitable that the reassessment which will be made by investors for all unsanctioned projects will result in some failing their financial hurdle and thus being deferred, with a consequent reduction in new investment and employment. The UKCS is a mature petroleum province, and the main priority should be to maximise economic recovery while there remains a viable infrastructure to keep down the costs of new developments. The increased tax is unhelpful in this respect. In PRT-paying fields costly enhanced oil recovery schemes are certainly not encouraged when the tax rate is 81%.

There is an acknowledgement in the Budget documents that the current oil price might not prevail and the suggestion is made that the rate of extra SC

could be reduced if the price falls. A possible threshold price of \$75 below which the new charge would not apply is mentioned. But the statement is quite vague and cannot be relied upon when making investment decisions. At the very least a clear formula is necessary to provide guidance to investors. But designing such a formula is by no means straight-forward in practice. Thus there is scope for debating the appropriate price below which the extra charge should not apply in order not to discourage new developments. It should be noted that many new developments are gas fields and the question of the appropriate gas price below which the extra charge should not apply arises. But gas prices on an energy equivalent basis are much lower than oil prices. This clearly needs to be taken into account in the design of any scheme.

It is also manifestly clear that oil and gas prices are quite volatile. Thus it is very possible that during a year (or six month period) the price could fluctuate above and below the threshold price. To deal with this in the tax arrangements is difficult but not impossible. The scheme just becomes more complex.

The Budget document recognises that additional reliefs for some new investments will be necessary as a consequence of the tax increases. Over the last 2 years field allowances have been given against the SC for small fields, heavy oil fields, remote, deep water gas fields, and HP/HT fields. The reliefs are in effect a proxy for the high investment costs (per barrel) in these categories of fields. It can be expected that the consequence of the Budget announcement will be much discussion between the government and industry regarding the eligibility of other categories of fields and projects for a new allowance. Thus it is known that the exploitation of tight gas (in both old and new fields) is very expensive and enhanced oil recovery schemes can also be very expensive. The result could be prolonged discussions resulting in a further proliferation of allowances based on the physical characteristics of projects. Anomalies and complexity may well be increased as a consequence.

As these physical characteristics are in essence a proxy for costs a more satisfactory arrangement would be one where liability to the SC and/or the new additional SC is triggered only when a specified return on the investment has been achieved. This would make the whole tax system progressive in a neater manner free from the inevitable anomalies and complexities of the

current arrangements. But these current arrangements have (nearly) become familiar and this may deter the introduction of more radical changes.

The Budget proposals will have several other effects. Industry net cash flows will be significantly reduced. This will impact adversely on the willingness and ability of the industry to engage in exploration which is essentially financed from cash flows. The willingness is reduced because the expected returns are reduced by the higher tax. Exploration has been relatively low in recent years even though a significant number of discoveries have been made.

The UKCS is becoming increasingly reliant on middle-sized and small companies not only for exploration but for new field developments. The tax increase will impair their ability to finance new developments whether from internal cash flows or from external funds. During the financial crisis the North Sea industry experienced some financing problems and the higher tax could reintroduce these at the very time when substantial new investments appear to be imminent. It remains to be seen to what extent financing issues will re-emerge as a hindrance to new developments.

More generally the tax increase will adversely affect investor confidence towards the UKCS. This is a less tangible effect but it is nevertheless real. In the past investors have been caught by tax increases shortly after substantial sums have been expended on new developments, and they will be wary in future. In this respect those affected have long memories.

A specific feature of the Budget proposals is that no relief for field decommissioning costs is to be permitted against the new charge. While this could be interpreted to indicate the likelihood that the new charge is very temporary it may also cause unease among investors. It is arguable that it is conceptually unsound to introduce a profit-related tax against which legitimate costs cannot be set. It may also give a further signal that the government is examining ways by which relief for decommissioning costs could be restricted. Given the very large costs involved these concerns are understandable.

In sum the proposed increase in taxation raises several concerns which affect the prospective activity levels in a mature industry which has been emerging from the effects of the recession and which can still bring much

economic prosperity to Scotland and the UK. Given the maturity of the industry it is essential that its life is prolonged rather than curtailed by inappropriate policies.