The Oil and Gas Taxation Regime

The UK Oil and Gas Taxation Regime: A ‘Smash and Grab’ Approach?

PETER RIPLEY*

1. Introduction

Oil and gas taxation regimes aim to acquire for the State

a fair share of the wealth accruing [from the extraction of the resources] whilst encouraging investors to ensure optimal economic recovery of those hydrocarbon resources.¹

The problem is that these aims are ‘often competing rather than complementary’.² If the State gets too greedy and imposes an excessive tax burden then the effect is to discourage investment. Maximising government revenue in the long term involves

balancing the possibility of revenue loss on highly profitable projects through an over-liberal approach against the possibility of setting rent charges so high that there is revenue loss through deterrence of projects.³

This is a difficult balance to strike given the unique geology of each field, cost uncertainties, and oil price volatility. In fact it is

impossible to conceive a fiscal regime that meets all the required characteristics at all prices, at all times for all sizes of fields and cost structures likely to be encountered in a given basin.⁴

Alex Salmond recently accused the Chancellor of the Exchequer of making a ‘smash and grab raid’ on the profits of oil and gas companies operating in the

---

² ibid at p. 6.
⁴ Nakhlé, Sharing the Oil Wealth (n 1) at p. 28.
The accusation was based on the Chancellor’s decision to increase the supplementary tax on oil and gas production in order to fund a cut in fuel duty. The UK oil and gas tax regime has always contained distortions of the rules ordinarily applicable in the case of UK corporation tax and this is justified by a need to accommodate the aims of oil and gas taxation and the special circumstances of the industry. However, there is some substance to Alex Salmond’s criticism because the current regime fails to strike a balance between oil company profitability and Government take. The regime now imposes an excessively high tax burden without offering meaningful incentives for investment. This may boost Government revenue in the short term but could render recovery of significant reserves uneconomic. The life of the industry could be cut short and the Government’s revenue stream would dry up altogether.

2. The Need for Distortions

The exploitation of finite hydrocarbon reserves generates significant economic rent. Economic rent represents

the true value of the natural resource, the difference between the revenues generated from resource extraction and the costs of extraction.

Costs of extraction include the minimum return necessary to attract the investment in the first place. Therefore economic rent is ‘equivalent to excess profits’ and so it is considered to form the base for an ideal tax. Kemp and Stephen remark that

7 Nakhle, Sharing the Oil Wealth (n 1) at p. 16. Kumar defines economic rent as that part of the value of the output of industry which is a gift of nature and not produced by man: R Kumar, ‘Taxation for a Cyclical Industry’ (1991) Resources Policy 133 at p. 134. Kumar adds that economic rent is both cost and price determined, it changes with market prices that move in a cyclical fashion.
8 This is referred to as the supply price of investment.
The Oil and Gas Taxation Regime

the purpose of the special taxation arrangements for the UKCS is to collect a ‘reasonable’ share of the economic rents emanating from oil and gas exploration.\(^\text{10}\)

A fiscal regime which captures pure economic rent satisfies the equity principle of taxation.\(^\text{11}\) Vertical equity requires that taxpayers with a greater ability to pay should pay more tax. It follows that oil companies exploiting valuable resources and generating supernormal economic rents have a greater ability to pay and so their tax liabilities should be greater.\(^\text{12}\) Furthermore, extracting and consuming natural resources now will reduce the stock available for future generations. It has therefore been argued that to satisfy an ‘intergenerational equity criterion’ the tax system should discourage rapid depletion of resources at times when prices are low.\(^\text{13}\) Higher tax rates have this effect and ensure that future generations get a fair share of the resources or compensation for those that are depleted.

Equity considerations also arise from the assumption that the Crown should receive a fair and equitable payment for all concessions as the basic owner of the UK’s natural resources.\(^\text{14}\) There exists a deeply embedded popular notion that all natural resources, and oil in particular, belong to the nation . . . and that proceeds from their extraction should go mainly to the owners.\(^\text{15}\)

This underpins much of the policy behind petroleum tax regimes and is felt to justify a far higher government take from the profits oil companies generate.


\(^{11}\) Such a regime also satisfies the principle of neutrality which, in the context of the oil and gas industry, requires that a tax neither causes over-investment nor affects the decision to invest. A tax aimed at collecting economic rent is considered to be optimal in this regard because the rent represents a return not required to motivate investment in extraction. See A Raja ‘Should Neutrality be the Major Objective in the Decision-Making Process of the Government and the Firm?’ Centre for Energy, Petroleum and Mineral Law Policy 1999 Annual Review 3 – Article 2 available at <http://www.dundee.ac.uk/cepmlp/car/html/car3_article2.htm> (accessed 22 November 2010).


\(^{13}\) Nakhle, Sharing the Oil Wealth (n 1) at p. 12.

\(^{14}\) Strictly speaking the Crown does not own the hydrocarbons situated on the UKCS. Section 1(1) of the Continental Shelf Act 1964 simply refers back to the UK’s ‘sovereign right’ under international law to exploit natural resources on its continental shelf. This is not a right of full ownership. Oil and gas in strata on the UKCS is therefore res nullius. Ownership is created in favour of the licensees at the wellhead.

\(^{15}\) Nakhle, Sharing the Oil Wealth (n 1) at p. 149.
than is the case with other forms of production or income creating activities. The profit sharing calculation between the State and oil companies becomes one of deciding what to leave, rather than what to take. The Alberta Royalty Review Panel assert that ‘the resources do not belong to the developers; they belong to the people’, and so it follows that

the design of a royalty and tax system for energy resources...must justify every dollar that does not go to the owners.  

This is an expression of the principle that the country should be adequately compensated for the depletion of what is a nationally owned resource. This principle also underpins the UK Government’s objectives

to promote investment and production whilst striking the right balance between producers and consumers and ensuring a fair return for the UK taxpayer from our national resources.  

Principles of taxation and equity justify the appropriation of economic rent. However, the economic rent only arises because of the entrepreneurial efforts of the oil companies. Therefore petroleum tax regimes must also facilitate and encourage investment from oil companies through distortions of the ordinarily applicable tax system which recognise the special characteristics of the oil industry, including the high levels of risk involved. The tax regime plays a significant role in reducing both exploration and political risk in order to incentivise investment and unlock economic rent from the resource.

Exploration risk is the risk of losing large sums of money on projects that produce no commercial discoveries. A good tax regime should achieve a fair sharing of this risk between the Government and the oil companies. There is no equity participation from the Government in UKCS operations and so risk sharing is instead achieved through a system of reliefs and allowances different to those ordinarily applicable. The Government shares the risk through lower tax revenue. Kumar observes that

the Government becomes a sleeping partner, taking a share when profits are made and sharing the risks through loss offsets.  

---


18 Kumar (n 7) at p. 143.
The Oil and Gas Taxation Regime

The more extensive reliefs and allowances available to oil companies can mitigate the effect of the higher tax rates they pay.

Political risk arises in the UK due to instability in the fiscal regime. Investors add a risk premium when faced with greater fiscal instability and so oil states should strive to put in place a stable regime. Unfortunately the UK Government has made many changes to the regime since 1975 and

[m]ost, if not all the changes have occurred to change the risk reward balance between the oil companies and the State, as the general economic environment has changed.

This incessant tinkering has significantly increased political risk.

3. The Current Distortions

A. Petroleum Revenue Tax

Petroleum revenue tax (PRT) was introduced under the Oil Taxation Act 1975 but was later abolished for all fields given development consent on or after 16 March 1993. However, a number of fields remain liable to PRT and the tax continues to contribute significantly to the Government’s revenue from the North Sea.

PRT is an ‘additional profits’ or ‘windfall’ tax which seeks to ‘cream off a large proportion of the very high profits’ earned by oil companies at the peak of the oil price cycle or from particularly low cost fields. It is charged on each

---

19 Nakhle, *Sharing the Oil Wealth* (n 1) at p. 64.
21 Finance Act 1993 s185. Since 1 July 2007 PRT also no longer applies to re-commissioned fields. See Finance Act 2007 s102 which amends the Finance Act 1993 s185.
23 Kumar (n 7) at p. 143 referring specifically to additional profits taxes in the context of mining taxation. PRT is similar to the resource rent tax (RRT) advocated by Garnaut and Ross insofar as it is a profit tax that begins to be collected when a certain threshold internal rate of return on total cash flow has been realised. See Garnaut & Ross (n 3) at p. 277 et seq. The difference is that RRT allows expenditure to be carried forward in real terms, together with an interest mark up, for offset against future profits. This relief is absent from PRT but is compensated for by the ‘uplift’ allowance. Note also that the ‘safeguard’ relief under PRT is equivalent to a 15% return allowance under an RRT scheme. On uplift and safeguard see below.
participator’s share of profits from each individual taxable field.\textsuperscript{24} The high PRT tax rates are a distortion of the ordinarily applicable rules aimed at increasing the Government’s share of oil profits. The tax is currently levied at a rate of 50\%.\textsuperscript{25} Some of the means by which the tax is calculated and administered also favour the State at the expense of oil companies. The tax intends to collect excess profits but the stock adjustment included in the calculation of assessable profits incorporates an element of production taxation.\textsuperscript{26} In effect, oil companies are taxed on production at half of market value before profit of sale. To ensure that tax due is paid as early as possible PRT is collected twice a year.\textsuperscript{27} Losses are not usually allocated in the period charged because they must be approved via an administrative procedure.\textsuperscript{28} Therefore profits are paid up front. A number of commentators view PRT as a barrier to investment. Following its abolition for fields given development consent on or after 16 March 1993 there was a marked increase in North Sea activity. A study by Martin suggested that the 1995 peak in oil production would not have happened without the abolition of PRT.\textsuperscript{29} Bartlett remarks that,

\begin{quote}
the major shift in the balance of risk and reward introduced in 1993 was clearly the spur for investors to increase activity levels and improve profitability, ultimately generating more revenue from [corporation tax].\textsuperscript{30}
\end{quote}

\textsuperscript{24} Note that PRT profit and losses are therefore calculated using the statutory procedure set out in the Oil Taxation Act 1975 rather than by reference to profits shown in the company’s accounts. The Oil Taxation Act 1983 brought tariff and disposal receipts arising from the use of field assets directly into the PRT charge. However, the Finance Act 2004 inserted a new s6A into the 1983 Act with the effect that tariffs relating to new business that are tax-exempt tariffing receipts do not constitute chargeable tariffs for PRT purposes. ‘Participator’ is defined in the Oil Taxation Act 1975 s12(1).

\textsuperscript{25} Oil Taxation Act 1975 s1(2). During the period 1983-1993 the tax was levied at 75\%.

\textsuperscript{26} To be included in the computation of profits is one half of the market value of oil won but not sold/appropriated or sold but not delivered on the last business day of the chargeable period less one half of the market value of oil won but not sold/appropriated or sold but not delivered on the last business day of the preceding chargeable period. See Oil Taxation Act 1975 s2.

\textsuperscript{27} The tax has a chargeable period of six months. See Oil Taxation Act 1975 s1(3).

\textsuperscript{28} See Oil Taxation Act 1975 s7 and sch 2. Expenditure must also be claimed and allowed before it can reduce a company’s tax liability with the result that it often reduces PRT payable for the following half yearly assessment rather than necessarily for the half year period in which it was incurred. Provisional expenditure allowance mitigates the disadvantages of this by providing for a provisional allowance by reference to two components. See Oil Taxation Act 1975 s2. However, provisional expenditure allowance has been abolished in relation to any chargeable period beginning after 30 June 2009. See Finance Act 1999 s89 and sch 43 amending s2 of the 1975 Act.


\textsuperscript{30} Bartlett (n 20) at p. 267.
However, high tax rates and up-front payment of tax liabilities are not the only attributes of PRT. The tax is also characterised by an extensive system of reliefs and allowances enabling a project to rapidly recover its costs and ensuring that projects where no economic rent is likely are protected from the tax. Mommer contends that the various reliefs available ‘ensure that PRT cannot, even accidentally, cut into the normal profits to which the companies are entitled.’

In general, there is no distinction between capital and revenue expenditure for PRT purposes and the categories of allowable field expenditure are fairly generous. Finance costs do not come within the scope of allowable expenditure but as a result of this an additional relief known as uplift or supplement is available which provides for a super deduction of 135% in relation to certain types of qualifying expenditure. Uplift is available for expenditure incurred up to the end of the period in which the cumulative field cash flow turns positive. There is also an oil allowance of 250,000, 500,000 or 125,000 metric tonnes for each chargeable period depending on when the field concerned was given development consent with an aggregate allowance of twenty times the allowance per period. This is a ‘gross production relief which has the effect of reducing the effective PRT rate’. The safeguard is an overriding relief which is only applicable following deduction of all expenditure and other reliefs. In common with the oil allowance, the safeguard is designed to ensure the viability of smaller, more marginal fields. It guarantees a specific return on capital before companies have to start paying PRT.

---

32 Oil Taxation Act 1975 s3. On the scope of ‘initial storage and treatment’ expenditure see BP Exploration Operating Company Ltd v The Commissioners of Inland Revenue 2000 WL 33148483 in which BP was held to be entitled to claim expenditure of just under £60 million for the design and development of a marine vapour recovery system. The dispute arose because the Inland Revenue had taken a narrow approach to the meaning of initial storage and treatment under s3 and initially disallowed the claim. On expenditure incurred searching for oil anywhere within the area of the oil field under s3 see Amerada Hess Limited v Inland Revenue Commissioners 2001 WL 172046. Schedule 5 of the Act contains details on the procedure for claiming expenditure. Note also that oil used in petroleum operations is excluded from the scope of PRT.
33 See Oil Taxation Act 1975 ss2(9) and 3(5).
34 Oil Taxation Act 1975 s8. Any surplus allowance can be carried forward as part of the pool of oil allowance but it does not increase the allowance for a later period above the normal limit per period.
36 Oil Taxation Act 1975 s9.
37 If adjusted profits are less than 15% of the company’s accumulated capital expenditure (ACE) in the field up to the end of the relevant chargeable period then the PRT for that period is reduced to zero. ACE is the total amount of expenditure qualifying for supplement, also known as the safeguard capital base. If the adjusted profits are more than 15% of the company’s ACE then the PRT charge is the lesser of 80% of the excess or the amount of PRT charge calculated in the normal way.
To temper the field based nature of PRT a cross field allowance was introduced by the Finance Act 1987\textsuperscript{38} to give companies a financial incentive to develop smaller second generation fields by allowing a measure of relief for expenditure incurred in such developments against income from larger and more mature fields.\textsuperscript{39}

The treatment of losses under the PRT regime further mitigates the higher tax rates. Losses may be carried forward indefinitely and set off against the first available future profits.\textsuperscript{40} Losses can also be carried back indefinitely and set off against previous taxable profits from the field.\textsuperscript{41} If there are insufficient assessable profits in earlier periods to absorb the loss, it may be possible to claim it as ‘unrelievable field loss’ in another field.\textsuperscript{42} In a recent period of discussion between industry and the Government the future of PRT was considered.\textsuperscript{43} A major reason behind the ultimate decision not to abolish the regime entirely\textsuperscript{44} was concern from industry about the impact of the resulting removal of unlimited carry back of losses arising during decommissioning.\textsuperscript{45}

\begin{footnotes}
\footnote{38}{s65. See also Oil Taxation Act 1975 ss5A and 5B and sch 7 for details of exploration and appraisal relief and research relief which also allowed non-field expenditure to be set off against PRT.}
\footnote{39}{Deloitte (n 35) at p. 70. Companies can elect to surrender up to 10\% of eligible development expenditure incurred. Claiming the cross field allowance forfeits any entitlement to supplement on the transferred expenditure but as the donor fields are often small and not expected to pay PRT the supplement would be worthless in terms of tax relief anyway. The importance of this allowance is dwindling and in time it will disappear since fields given development consent on or after 16 March 1993 do not incur eligible development expenditure.}
\footnote{40}{Oil Taxation Act 1975 s7.}
\footnote{41}{Losses carried back displace the oil allowance and any safeguard restrictions.}
\footnote{42}{See Oil Taxation Act 1975 s6 and sch 8.}
\footnote{44}{Note that a power was created to allow HMRC to remove fields from the scope of PRT if they are never likely to pay the tax due to the availability of allowances. See Finance Act 2008 s107 which amended Finance Act 1993 s185. New developments can also be removed from the scope of existing PRT fields where it can be demonstrated that the application of PRT makes such exploitation uneconomic. A new return deferral scheme was also introduced.}
\footnote{45}{A number of minor adjustments were made to the regime to alleviate industry concern over decommissioning costs. Measures have been introduced to ensure that a former licence holder can obtain PRT relief where the current licensees default on their decommissioning costs (Finance Act 2008 ss103-105 and Oil Taxation Act 1975 sch 5) and ensuring tax relief for costs incurred post licence expiry (Finance Act 2009 s88 and sch 42 which amends s12 and sch 1 and 5 of Oil Taxation Act 1975).}
\end{footnotes}
The PRT regime was not a smash and grab raid on the profits of oil companies because the higher tax rates aimed at capturing economic rent were balanced by the system of reliefs and allowances. PRT favours neither the State nor the investor disproportionately. Zhang contends that, before the abolition of PRT for new fields, the regime was ‘close to being neutral and relatively efficient at collecting economic rent’.\(^\text{46}\) Zhang asserts that PRT did not distort investment decisions, stating that the ‘combination of an up-lift of 35% and a tax rate of over 80% only affect the trigger [for development] marginally, but can collect 3/4 of the rent’.\(^\text{47}\) PRT hits at economic rent because the allowances and reliefs available ensure that it is only payable after the company has achieved a normal rate of return. There is no doubt that the 1993 changes encouraged investment but this is only because new fields benefited from very low tax rates.\(^\text{48}\) There was nothing inherently wrong with the PRT regime itself. Rutledge and Wright contend that there is considerable evidence to suggest that the majority of new investment would have been made even without the 1993 changes.\(^\text{49}\) The additional production may have come later and been triggered by a factor other than a liberal fiscal regime, such as a rise in oil price or improved technology, but it would have come. The Government was not willing to wait and so employed a liberal fiscal regime to incentivise immediate production. This damaged overall revenue take and violated the intergenerational aspect of the principle of equity.\(^\text{50}\)

B. Ring Fence Corporation Tax

Ring fence corporation tax (RFCT) is the same as the standard corporation tax that all companies are liable to pay except for the fact that it applies within a ‘ring fence’. The ring fence severs a company’s ‘oil related activities’ in the UK

\(^{47}\) ibid at p. 1116.
\(^{48}\) Rutledge & Wright ((n 12) at pp. 802-803) remark that following the 1993 changes the State share of profits became exceptionally low and was inequitable from historical and international perspectives. Oil companies had the opportunity to make super profits on the UKCS as the fiscal regime was failing to capture economic rent.
\(^{49}\) Rutledge & Wright (n 12) at p. 807.
\(^{50}\) Mommer asserts that the removal of PRT resulted in a net loss in fiscal revenues of £3.3 billion in relation to the increased production that followed, and that a ‘property conscious’ government would not have been very pleased with this. See B Mommer, ‘Fiscal Regimes and Oil Revenues in the UK, Alaska and Venezuela’ (2001) Oxford Institute for Energy Studies 10.
from all of its other trading activity for tax purposes.\textsuperscript{51} This prevents profits from the ring fence trade (RFT) being reduced by expenses not incurred wholly and exclusively for the purposes of the RFT or by losses not connected with, or arising out of, the RFT.\textsuperscript{52} The restriction does not apply in reverse and so ring fence losses can still be set off against non ring fence profits of the company.\textsuperscript{53}

Since 2008 the RFCT rate has been set independently of the normal corporation tax rate and it is currently set at 30\%, which is 2\% higher than the normal rate.\textsuperscript{54} The RFCT rate is set to remain at 30\% despite the cut in the normal rate of corporation tax from 28\% to 23\% over four years from 2011 to 2014 that was announced in the 2011 budget.\textsuperscript{55} Therefore by 2014 RFCT will be 7\% higher than the normal rate. This higher rate, and the ring fencing of an oil company’s profit from its petroliferous trade, can be viewed as distortions of the ordinarily applicable rules aimed at increasing the State’s share of the profits from oil production. The supplementary charge (SC) has the same purpose. The 2011 budget announced a 12\% increase in the rate of the SC from 20\% to 32\%.\textsuperscript{56} The SC is computed on a similar, but not identical, basis to RFCT.\textsuperscript{57} It applies to a company’s ‘adjusted ring fence profits’ which excludes financing costs.\textsuperscript{58} Bartlett asserts that ‘the denial of relief for interest against the new supplementary charge is a major disincentive for investment’ because it increases the cost of debt finance.\textsuperscript{59} The Government’s stated objective for the denial of relief was to prevent oil companies manipulating their levels of borrowing between ring fence and non ring fence activities to minimise the

\textsuperscript{51} Corporation Tax Act 2010 ss277 and 279. Section 274 defines oil related activities as oil extraction activities and any activities consisting of the acquisition, enjoyment or exploitation of oil rights. Section 272 defines oil extraction activities as activities in searching for oil and natural gas, transporting oil and natural gas to dry land in the UK, or effecting initial treatment or initial storage of oil and natural gas. Section 273 defines oil rights. Section 291 provides that the activities of a participator in an oil field (or a connected person), in making available an asset in a way that gives rise to tariff receipts, are also to be treated as oil extraction activities.

\textsuperscript{52} See Corporation Tax Act 2010 ss37, 45 and 304. The RFCT rate has been the same ever since it was set separately from the normal rate. See: Finance Act 2008 s6(2)(b); Finance Act 2009 s7; Finance Act 2010 s2.

\textsuperscript{53} See Corporation Tax Act 2010 ss304. s305 prohibits group relief from losses allowances or expenditure from outside the ring fence trade from being set off against profits of a ring fenced trade.

\textsuperscript{54} The RFCT rate is set to remain at 30\% despite the cut in the normal rate of corporation tax from 28\% to 23\% over four years from 2011 to 2014 that was announced in the 2011 budget. Therefore by 2014 RFCT will be 7\% higher than the normal rate. This higher rate, and the ring fencing of an oil company’s profit from its petroliferous trade, can be viewed as distortions of the ordinarily applicable rules aimed at increasing the State’s share of the profits from oil production. The supplementary charge (SC) has the same purpose. The 2011 budget announced a 12\% increase in the rate of the SC from 20\% to 32\%. The SC is computed on a similar, but not identical, basis to RFCT. It applies to a company’s ‘adjusted ring fence profits’ which excludes financing costs. Bartlett asserts that ‘the denial of relief for interest against the new supplementary charge is a major disincentive for investment’ because it increases the cost of debt finance. The Government’s stated objective for the denial of relief was to prevent oil companies manipulating their levels of borrowing between ring fence and non ring fence activities to minimise the

\textsuperscript{55} HM Treasury, ‘Budget 2011’ (n 6) at paras. [1.74] and [2.66].


\textsuperscript{57} Corporation Tax Act 2010 s330. The charge was introduced by the Finance Act 2002 s91 at a rate of 10\% for accounting periods beginning on or after 17 April 2002. The rate was then increased by the Finance Act 2006 s152 to 20\% with effect from 1 January 2006.

\textsuperscript{58} Corporation Tax Act 2010 s330. Financing costs are widely defined in s331.

\textsuperscript{59} Bartlett (n 20) at p. 270.
The Oil and Gas Taxation Regime

impact of the SC. But as Bartlett remarks, ‘this area is already policed very strictly’ through detailed provisions which restrict the deduction of interest against ring fence profits

unless the debt is specifically used to meet expenditure in carrying on oil extraction activities or in acquiring oil rights other than from a connected person.

There are some special reliefs and allowances in relation to RFCT and the SC but unlike those available in relation to PRT they fail to mitigate the effect of the higher tax rates imposed. PRT paid is deductible for RFCT. General and administrative costs incurred wholly and exclusively for the purposes of the RFT are usually deducted in full as incurred in line with the ordinary corporation tax rules. However, any deductions for expenses of management of an investment business against profits from a RFT are expressly prohibited. And as noted above, there are limits placed upon when interest can be deducted. To take account of the investor’s decommissioning liabilities costs associated with abandonment are allowable as deductions from ring fence profits. This includes expenditure incurred in obtaining an abandonment guarantee, reimbursement expenditure, expenditure incurred by a participator in meeting a defaulter’s abandonment expenditure and expenditure incurred by the defaulter in subsequently reimbursing the contributing participator. With regard to the SC, the 2011 Budget indicates

60 ibid.
61 ibid. See the provisions in relation to loan relationships contained in the Corporation Tax Act 2010 ss286-287.
62 Corporation Tax Act 2010 s299. See ss299 and 300 for rules governing the situation in which PRT is subsequently repaid to the taxpayer.
63 Corporation Tax Act 2010 s303.
64 Corporation Tax Act 2010 ss286-287. Special provision is also made in relation to sale and lease-back under s288 which prohibits a deduction from expenditure from ring fence profits for sale and lease-back financing unless certain conditions are met.
65 Corporation Tax Act 2010 s292. The provision provides that expenditure is allowable as a deduction in calculating the participator’s ring fence income if it would be so allowable for PRT purposes under the Oil Taxation Act 1975 s3. ‘Abandonment guarantee’ is defined in the Finance Act 1991 s104.
66 Corporation Tax Act 2010 s293. This is relief by way of a deduction in the calculation of the relevant participator’s ring fence profits for expenditure incurred by a participator who has become liable to the guarantor following the making of the guarantee payment under the abandonment guarantee. See also ss294-295.
67 Corporation Tax Act 2010 s297. This is relief by way of capital allowance or deduction in calculating ring fence profits to a current or former participator in relation to additional abandonment expenditure paid as a result of the current or former participator’s default as the case may be.
68 Corporation Tax Act 2010 s298. The contributing participator having incurred expenditure in making up the shortfall as result of the default.
that the Government will restrict tax relief for decommissioning to the 20% rate. Therefore the reliefs will not be available against the 12% increase. The aim of this measure is to avoid incentivising accelerated decommissioning. Losses attributable to decommissioning are also given special treatment. If incurred in accounting periods beginning on or after 12 March 2008 they may be carried back as far as 17 April 2002, otherwise they can only be carried back three years. In respect of a ring fence trade that ceases on or after 12 March 2008 costs incurred in the decommissioning of fields after cessation of trade can be claimed for tax purposes until such time as the decommissioning has been properly completed.

A 100% first year allowance (FYA) applies to capital expenditure on oil and natural gas extraction activities incurred on or after 17 April 2002. This allows the costs to be written off for tax purposes in the accounting period in which the expenditure is incurred. Expenditure incurred in acquiring mineral rights or deposits also qualifies for mineral extraction allowance but only at a rate of 10%. The research and development allowance regime permits the cost of most exploration and appraisal activity to be relieved in full in the year incurred. With effect from 17 April 2002 expenditure on plant and machinery with an economic life of less than 25 years qualifies for the immediate 100% FYA. With effect from 12 March 2008 the 100% FYA was extended to expenditure on long life assets and expenditure on mid-life decommissioning. These accelerated rates at which expenditure can be written off do help to increase the front-end liquidity of the investor and hence generally raise the net rate of return.

---

69 HM Treasury, ‘Budget 2011’ (n 6) at paras. [1.149] and [2.103]. The Government added that there would be no further restrictions to decommissioning relief for the life of the current Parliament and that the Government is committed to working with the industry with the aim of announcing further, longer term, certainty on decommissioning at Budget 2012.
70 Corporation Tax Act ss40, 42 and 43; Capital Allowances Act 2001 ss163-165.
71 Capital Allowances Act 2001 ss416B and 416D. Exploration expenditure, the initial cost of acquiring a licence, and expenditure on land and buildings do not qualify for the 100% FYA. Persons carrying on a ring fence trade are entitled to elect to have a special allowance made to them for expenditure incurred on decommissioning plant and machinery. See Capital Allowances Act 2001 ss163-165.
72 Capital Allowances Act 2001 ss403 and 418.
74 Capital Allowances Act 2001 ss45F and 52. Prior to 17 April 2002, relief for expenditure on qualifying plant and machinery was available on a 25% reducing balance method.
75 Assets with a useful economic life of at least 25 years.
76 Prior to 12 March 2008 and with effect from 17 April 2002, a 24% allowance, given in the first year of acquisition, applied to expenditure that would otherwise have qualified for the 6% long-life asset allowance. In the second and subsequent years, the balance was relieved at 6% per annum on a reducing balance basis. With effect from 12 March 2008, the rate of writing down allowance for existing long-life assets was increased from 6% to 10%. See Capital Allowances Act 2001 ss102, 104A and 104D.
77 Kumar (n 7) at p. 140.
A ring fence expenditure supplement was introduced with effect from 1 January 2006. It allows companies that do not yet have any taxable income against which to set off their exploration, appraisal and development costs and capital allowances to claim a supplement which increases the value of unused expenditure carried forward from one period to the next by a compound 6% per annum for a maximum of six years. It includes all deductible expenditure (both revenue and capital) incurred in the course of oil extraction activities. The supplement was introduced as a sweetener to industry following the increase in SC but it is ‘almost illusionary’ because the cost of the supplement is miniscule in comparison to the increase in tax take secured by the increase in SC.

The most recent fiscal incentive to be introduced is the field allowance which seeks to reduce the SC for licensees in certain new fields given development consent on or after 22 April 2009. The ‘pool of field allowances’ is subtracted from the adjusted ring fence profits for an accounting period. This has the effect of reducing the profits that the SC applies to. However, the field allowance is unlikely to mitigate the effect of high tax rates in practice because it applies only to fields meeting onerous criteria to qualify as small, ultra heavy, or ultra high pressure/high temperature. The House of Commons Energy and Climate Change Committee found that the criteria for qualifying for the allowance are so stringent (especially with regard to HPHT) that its effect will be minimal; and its modest scale is such that it will not provide a significant incentive for investment even in new fields.

Usenmez asserts that ‘[l]ong term fiscal instability may soak up the intended effect of the new allowance system’.

---

78 See the Corporation Tax Act 2010 pt 8 ch 5.
79 The ring fence expenditure supplement replaced the exploration expenditure supplement (EES) which had been introduced by the Finance Act 2004. EES was only available in respect of exploration and appraisal costs.
81 See the Corporation Tax Act 2010 pt 8 ch 7.
82 Corporation Tax Act 2010 ss333, ss334 and 335 outline the manner in which allowances are to be calculated and carried forward.
83 See the Corporation Tax Act 2010 ss353, 354 and 355 respectively for definitions of these qualifying fields.
84 House of Commons, Energy and Climate Change Committee, ‘UK Offshore Oil and Gas’ (2008-09) at para. [71].
4. Conclusion

The UK oil and gas taxation regime significantly distorts the rules ordinarily applicable in the case of UK corporation tax. Distortions are necessary to capture the larger economic rents generated by oil and gas production and to ensure that the State in control of the natural resources receives a fair share of the wealth accruing from their extraction. But distortions are also necessary to manage the high levels of risk involved in extracting and producing hydrocarbons and to encourage investment from the oil companies that make that extraction possible. Before the abolition of PRT for fields given development consent on or after 16 March 1993 the regime was close to being neutral and relatively efficient at capturing economic rent. PRT’s extensive system of reliefs and allowances ensures that the tax cannot cut into the normal profits to which the company is entitled. It may have been wiser to simplify PRT and reduce costs associated with its collection than to remove it outright because for a period after the abolition of PRT new fields enjoyed excessively low tax rates under RFCT alone. The introduction of the SC increased these tax rates but came at the wrong time and imposes an excessive tax burden for the now mature North Sea province. The reliefs and allowances available do not incentivise investment to ensure maximum economic recovery of UKCS hydrocarbons. It is therefore not surprising that the most recent hike in supplementary charge has attracted criticism as a smash and grab raid on profits. The tax regime lacks coherency and arbitrary increases in supplementary charge are a crude method of increasing Government take in the short term. The cost of this in the long term will be measured in barrels of oil left in strata, never to be recovered or taxed at all.