

Oil and gas taxation – UK aspects

Baku Tax Seminar



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AGENDA

1. Introduction
2. Summary of UK oil and gas tax regime
3. Update on new tax issues in the UK
4. International competitiveness
5. Typical considerations when investing overseas
6. Tax governance and risk management

1. Introduction

UKCS – current position

- Production decline:
 - Oil and gas levels reached peak in 1999
 - Now declining at rate of approximately 5% annually
 - New fields have smaller yields and decline rates much faster
- Investment decline:
 - Global competition
 - High cost structure of UKCS
 - High and constantly changing taxes
- Fiscal receipts (CT, SCT and PRT) have been in decline:
 - £12.9bn in 2008-2009,
 - Were projected before recent changes: £7bn in 2009-2010, £8.4bn in 2010-2011

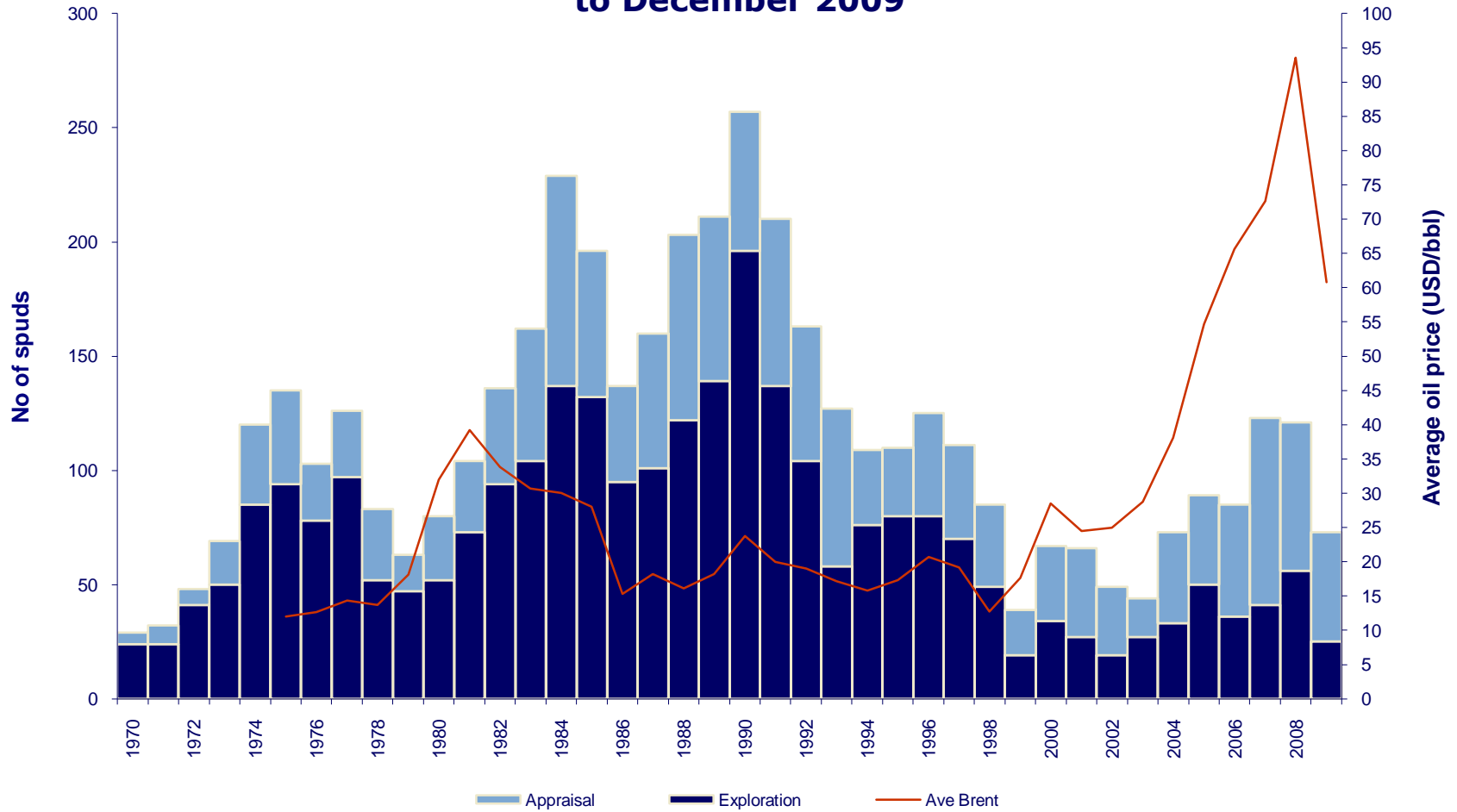
UKCS – current position (continued)

- However, there is much to play for:
 - Untapped reserves (e.g. West of Shetlands)
 - Gas (e.g. tight gas)
 - Decline not necessarily set in stone – can be influenced by policy

- It is in the national interest to extend the life of UKCS:
 - Security of supply
 - Value of the oil industry and the oil service industry to the economy

Exploration and Appraisal Drilling

UKCS exploration/appraisal wells January 1970 to December 2009



2. Summary of UK oil and gas tax regime

Oil & gas taxation

Oil and gas companies operating in the North Sea are subject to RFCT, SCT and in some cases PRT

Ring fence corporation tax ('RFCT')

- In 1975, the government introduced ring fence provisions in respect of corporation tax profits from UK oil production.
- These provisions aimed to prevent these profits being offset by losses or allowances available from other activities.
- Additionally, from 1984 capital gains arising on the disposal of field interests or field assets were brought within the ring fence.
- There is a ring fence corporation tax levied at a rate of 30% on upstream oil & gas activities. Ring fence corporation tax is levied on gross revenue remaining after the deduction of certain items, including the following :
 - petroleum revenue tax paid (if applicable);
 - general and administrative costs, deductible as incurred;
 - interest payable on sums borrowed to meet expenditure for oil and natural gas extraction activities;
 - capital expenditure;
 - plant and machinery allowances;
 - expenditure on mineral exploration and access;
 - research and development allowance;
 - abandonment costs (decommissioning all or part of an oil field); and
 - losses.

Oil & gas taxation (continued)

Main corporation tax

- The main rate of corporation tax is currently 28%, however in the recent Budget, the government announced that from 1 April 2011, the rate of corporation tax will be reduced to 26%. It is also the intention of the present government to further reduce the rate of corporation tax by 1% per annum until it reaches 23% on 1 April 2014, however these reducing rates have not yet been substantively enacted.

Oil & gas taxation

- The ring fence provisions introduced by the government to tax profits from UK oil production at 30% will continue to apply despite the changes to main corporation tax rate as outlined above.

Supplementary charge ('SCT')

- In addition to the 30% ring fence tax charge outlined above, profits generated from upstream oil and gas activities on or after 17 April 2002 are subject to supplementary charge (this was 20% and has recently changed following the Budget to 32%). The tax base for this charge is virtually identical to that for ring fence corporation tax, with the exception that financing costs are not treated as deductible in arriving at chargeable profits.

Petroleum Revenue Tax ('PRT')

- Fields that received development consent prior to 16 March 1993 are subject to Petroleum Revenue Tax ('PRT') levied at a rate of 50%. PRT is applicable to upstream oil and gas activities only.
- PRT aims to tax the 'super-profits' generated by the exploitation of the UK's oil and gas reserves.
- It is a 'field-based tax', with only the costs of developing and running a particular field being available to offset the profits generated by that field. However, any surplus losses arising can be carried forward or backwards indefinitely within that field.
- The following expenditure is specifically not allowable for PRT:
 - finance costs (e.g. interest);
 - cost of acquiring land or interests in land;
 - certain building costs (e.g. administrative premises);
 - deballasting expenditure;
 - expenditure dependent on the results of a field; and
 - certain payments to obtain an interest in oil and natural gas.

Interaction of PRT, RFCT and SCT

- PRT is treated as deductible in the calculation of the profits chargeable to ring fence corporation tax and the supplementary charge discussed above.

UK capital allowances regime for the North Sea

- Most capital expenditure incurred on any oil exploration, field development and decommissioning activities in respect of the oil and gas ring fence regime is eligible for a first year 100% capital allowance.
- However, the following expenditure will not qualify for the 100% first year allowance:
 - exploration expenditure;
 - initial costs associating with acquiring a licence; and
 - land and buildings.
- It should be noted that the exploration expenditure may be relieved in full under the research and development capital allowances regime if relating to the capital cost of oil and natural gas exploration and appraisal activities.

Decommissioning costs relief

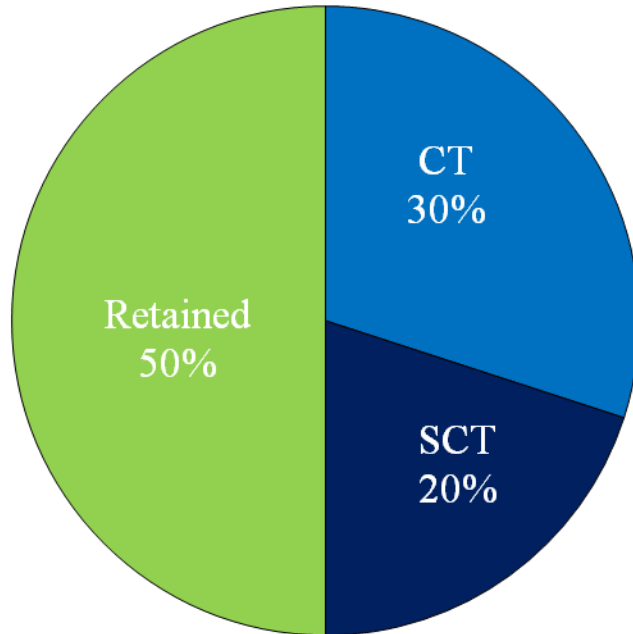
- The requirement by the Petroleum Act 1998 for licence holders to remove plant and machinery and ensure the sea bed is left safe to shipping and fishing and prevent pollution can lead to substantial expenditure.
- Relief will be available for this expenditure in respect of the cost of:
 - closing down;
 - decommissioning;
 - abandoning; or
 - wholly or partly dismantling or removing any qualifying asset.
- This relief is available at any time in the field's life, provided the expenditure has actually been incurred.

Losses

- Where on cessation of production the cost of decommissioning produces a loss, this loss may be carried back.
- If there are insufficient assessable profits in earlier periods to absorb the loss, it may be possible to claim it as an unrelievable field loss in another field.
- This is an exception to the general rule that only expenditure attributable to a particular field can be relieved in that field.

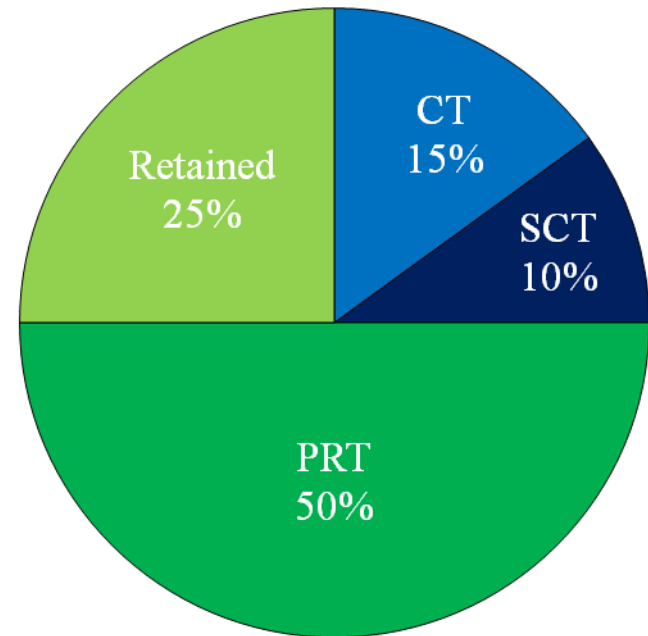
UKCS Taxation Regime before 23 March 2011

Non PRT



Effective Tax Rate = 50%

PRT



Effective Tax Rate = 75%

3. Update on recent changes to UK regime

North Sea Tax Changes - Constant Tinkering

Budget announced	
1997 – 2002	<ul style="list-style-type: none"> Major reform proposed in 2008 (SCT or broadening of PRT) but subsequently dropped due to low oil price
2002	<ul style="list-style-type: none"> Introduction of Supplementary Charge (SCT) (at 10%) on top of 30% Ring Fence Corporation Tax Enhanced FYAs (First Year Allowances), generally 100% Abolition of Royalty (from 1 January 2003)
2003	<ul style="list-style-type: none"> Tariff receipts from 'new business' exempt from PRT
2004	<ul style="list-style-type: none"> Introduction of Exploration Expenditure Supplement (from 1 January 2004)
2005	<ul style="list-style-type: none"> Alignment of corporation tax payments with PRT payments
2006	<ul style="list-style-type: none"> SCT increased to 20% (from 1 January 2006) Introduction of Ring Fence Expenditure Supplement (from 1 January 2006) Option to defer 100% enhanced FYAs on expenditure incurred in 2005 to 2006
2007	<ul style="list-style-type: none"> Ring fence corporation tax rate remains at 30%, although the rate reduces to 28% for all other large companies (from 1 April 2008)
2008	<ul style="list-style-type: none"> Carry back of decommissioning losses to 17 April 2002 100% enhanced FYAs extended to mid life decommissioning and new expenditure on long life assets No deduction for management expenses against ring fence profits (anti-avoidance)
2009	<ul style="list-style-type: none"> Introduction of field allowance for small fields, high pressure high temperature and ultra heavy oil fields Changes to capital gains legislation (reinvestment relief/swaps) Removal of fiscal barriers for change of use projects
2010	<ul style="list-style-type: none"> George Osborne considers fundamental review of the regime whilst in opposition.

2011 Budget Measures

Supplementary charge rate (SCT)

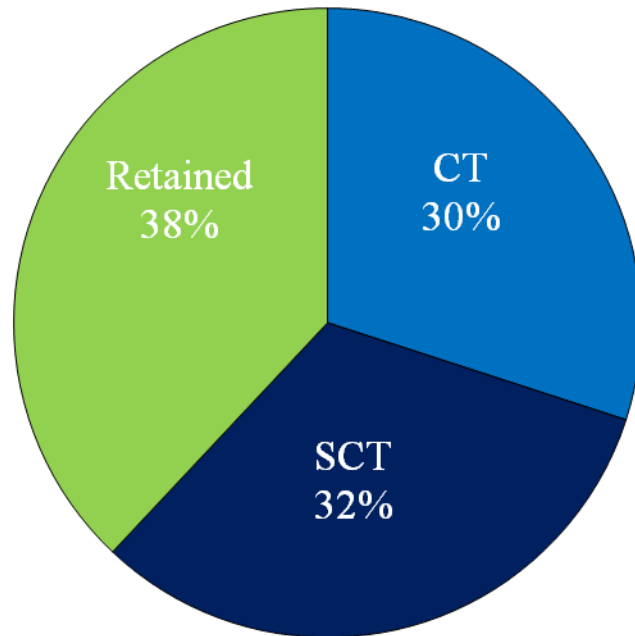
- SCT rate increased from 20% to 32% with effect from 23th March 2011.
- Intention by government to reduce rate back towards 20% on “staged and sustainable basis” in future years should the oil price fall below a set trigger price on a sustained basis.
- Linked to introduction of a “fair fuel stabiliser” whereby fuel duty will be increased by the RPI plus 1p per litre should the oil price fall below the same trigger price.
- Proposed trigger price of \$75 per barrel, but Budget forecasts for life of Parliament based on an oil price closer to \$110 !
- Effective North Sea marginal rate raised to 81% (from 75%) for fields subject to PRT and 62% (from 50%) for non-PRT fields.
- NPV impact above 20% on average. For some larger fields in development, significantly higher.

Relief for decommissioning costs

- Finance bill 2012 will introduce legislation to restrict tax relief for decommissioning expenditure to the previous 20% SCT rate.

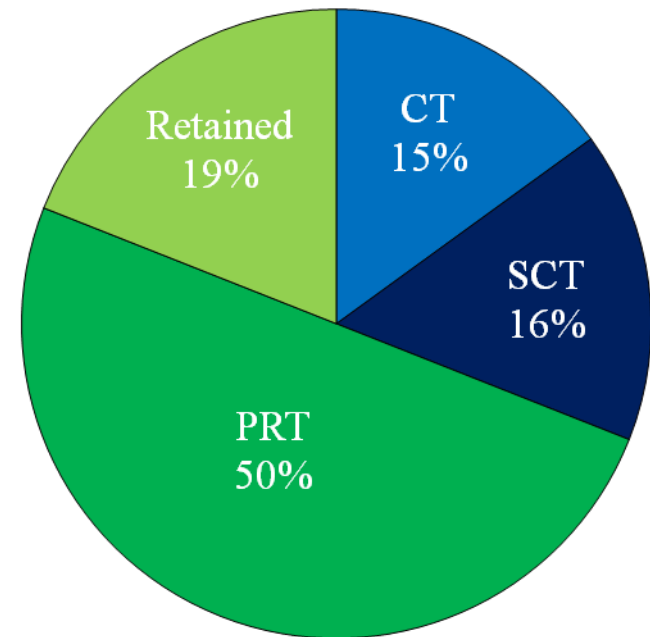
UKCS Taxation - from 23 March 2011

Non PRT



Effective Tax Rate = 62%

PRT



Effective Tax Rate = 81%

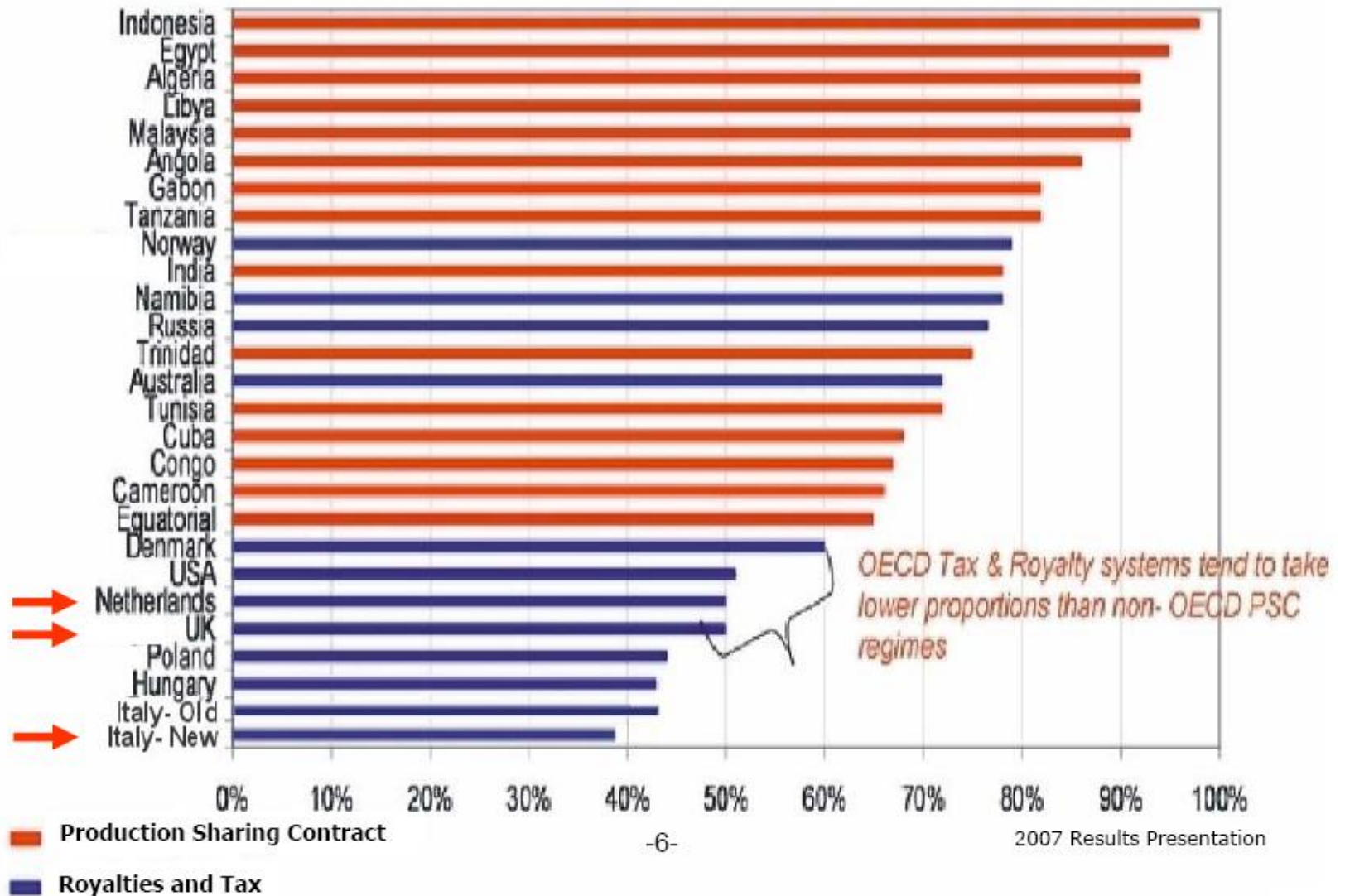
Capital Gains Taxation

- When SCT was introduced in 2002 at the rate of 10%, doubts arose whether the scope of this tax covered capital gains tax on disposals of UKCS assets.
- Since, various reforms introduced mean that disposals of UKCS assets can normally be made without any UK capital gains tax.
- Legislation to be introduced in 2012 to 'clarify' that SCT applies to capital gains tax.
- Important to have clarity around scope of capital gains taxation.

4. International competitiveness

International competitiveness (position prior to recent changes)

FISCAL FACTORS



5. Typical considerations when investing overseas

Oil & gas tax structuring

- Tax structuring is a key part of the evaluation of target assets in any given jurisdiction. Oil & gas upstream and downstream assets can be characterised by:
 - High levels of taxation
 - Government take is often in form other than taxation
 - Given high commodity prices, high cashflows & revenue generation
 - Specific capital gains taxation regimes
 - Particularly in case of downstream activities, complex flows of various commodities across many borders
- Accordingly, the key tax structuring that will need to be considered will generally focus on:
 - Reduction of local taxation as the local rate will often exceed home country rate
 - Creditability of taxes on repatriation of profits
 - Minimising withholding taxes on repatriation of profits and surplus cash management
 - Avoiding capital gains taxation on future exit (and vendors liability on acquisition !)
 - Supply chain management (including focus on jurisdiction risks and indirect taxes)
 - The level of incremental taxes (if any) that are payable when the profits/cashflows/dividends from the assets are repatriated to the home jurisdiction
 - Transfer pricing for integrated companies

Interaction with Local Law - Investment Vehicle

Foreign subsidiary with a local branch or local subsidiary?

Local subsidiaries rarely chosen for E&P activity:

- Local company law
- Directors
- Flexibility
- Expert advice
- Accounting

6. Tax Governance and Risk Management

Context

Over recent years the following trends have increased the focus on tax and, specifically, tax disclosures and tax risk management:

- Significant increase in the **level of financial regulation affecting tax**, e.g. SEC and s.404 of Sarbanes Oxley Act.
- Marked increase in the **level of attention paid to tax disclosures and reporting** from all stakeholders – tax authorities, non-governmental organisations, analysts, investors, pressure groups and the media.
- Further globalisation of business has led to more cross-border activity and **greater opportunities and risks relating to transfer pricing**.
- Tax authorities are **developing risk and system-based approaches** and working more closely with each other.
- The tax debate moving toward **ethical/moral discussion**, including environmental and wider **CSR** issues.
- Tax law is becoming **increasingly complex**, not only in the UK but **worldwide**.

Environmental trends



"Many boards are not giving tax sufficient strategic attention", Henderson Global Investors October 2005



The 12th EITI International Board Meeting, April 2010

"Seoul Declaration" on knowledge sharing by Revenue authorities, September 2006



"Tax avoidance and evasion come under fresh assault", FT December 2009

"The tax avoidance story as morality tale – does the duty to pay taxes rank with social and environmental obligations?" FT November 2004

"Tax on the Boardroom agenda", HMRC February 2006



"Tax Compliance Risk Management Guidance outlines new approach to Governance and Delivery", HMRC December 2007

"Sunlight is said to be the best disinfectant, and the area of income tax could use some more sunlight", SEC comments on s.404 of Sarbanes-Oxley Act



"Tax Justice Network Launches Initiative on African Tax Evasion", January 2007

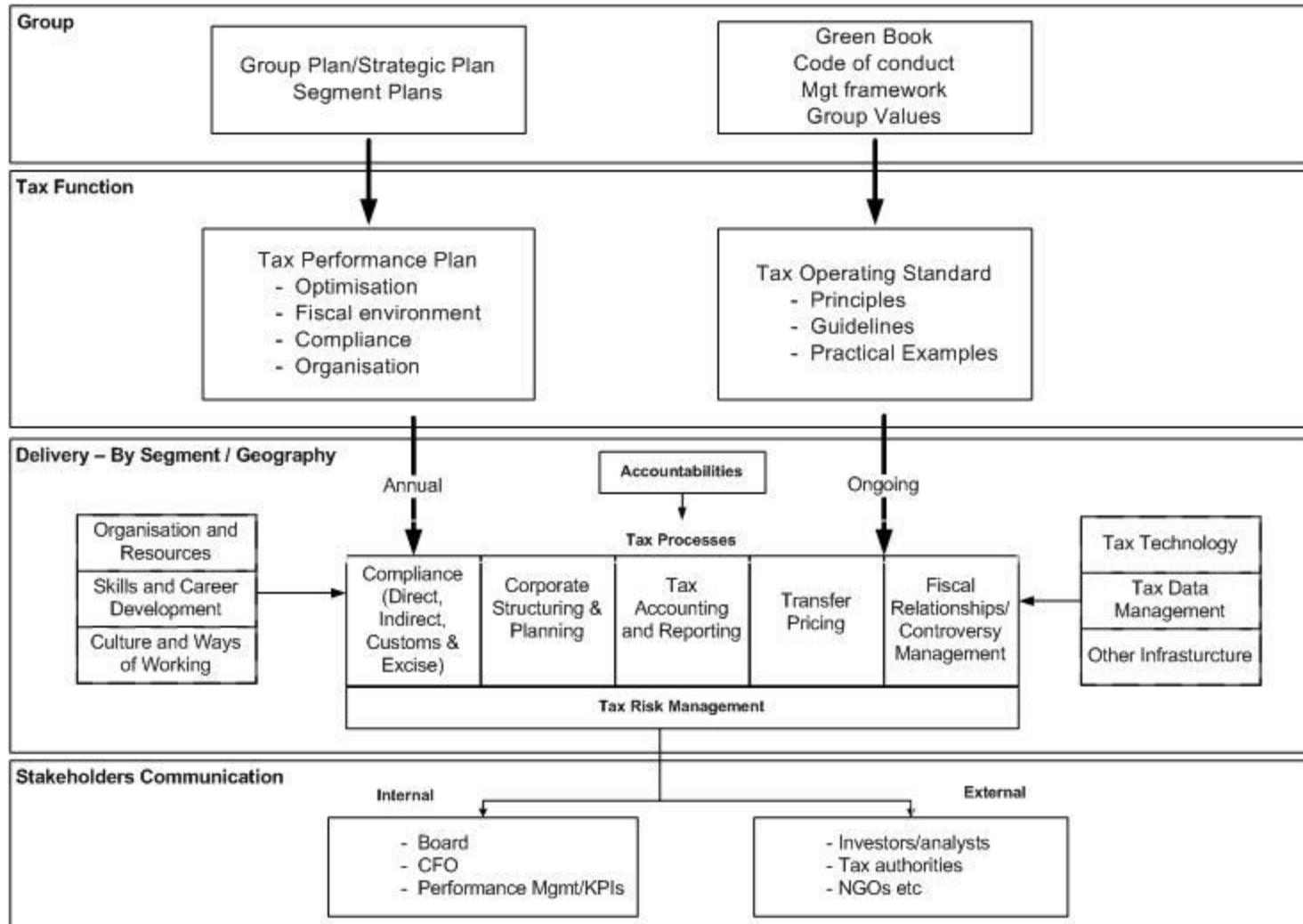
The response to this environment

- Part of the response to this changing environment has seen groups developing **formal tax strategies** which are documented and **agreed by the Board**.
- In October 2005, we undertook a **survey** to understand how many companies within the UK FTSE100 had a documented tax strategy approved by the Board. The response was as follows:
 - Yes: 46%
 - No, and this will not change: 11%
 - No, but will have within 12 months: 43%
- Based on a current understanding of the companies surveyed, we believe that at **least 85% have a formal tax strategy and underpinning tax guidelines**.
- Of those surveyed which are within the extractive industries, the above **percentage is higher**, i.e. they tend to have more fully developed tax strategies.

Stakeholders

- The following stakeholders would have an interest in your **external disclosures** on tax. However, there may be more which you would like to add:
 - Tax authorities and governments generally – compliance and reputation
 - Non-governmental organisations – compliance and reputation
 - Pressure groups - reputation
 - Media - reputation

Example - Tax Operating Framework



Key themes included in Tax Operating Standards

We have identified a number of key themes which are commonly included in a Tax Operating Standard. These themes are that the Tax Function:

1. Has agreed the Standard with the **Board**;
2. Confirms the Standard is consistent with the Group's wider **governance policy and corporate values**;
3. Is committed to **maximising shareholder return** through optimising after-tax profits;
4. Will **comply** with all applicable legislation including the prompt filing of tax returns/submissions and payment of taxes;
5. Will be **open and honest** and will provide **full disclosure** in all of its dealings with government agencies;
6. Is committed to ensuring that its tax affairs **reflect the underlying economic realities** of the Group's business;
7. Will consider the impact on its **relationships** with key stakeholders and its wider **reputation** when managing Group tax affairs;
8. Will make every effort to comply with both the **spirit and letter of the law** in the management of the Group's tax affairs;
9. Recognises its **relationship with society** and the importance of the contribution it makes through tax payments;
10. Outlines its **attitude toward taking on tax risk**;
11. Confirms that it has appropriate **risk management** and **decision-making** processes; and
12. Confirms its commitment to **transparency** in its dealings with key stakeholders.

Deloitte.