

Making the most of the UKCS The oil and gas fiscal framework: Is it fit for purpose?



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Methodology

In May and June 2014, Deloitte undertook a survey of United Kingdom Continental Shelf (UKCS) licence holders and selected major oilfield service companies in the North Sea to gauge their views on the current UKCS tax system.

The survey findings were originally presented at the Oil & Gas UK Industry Conference in Aberdeen on 12 June 2014.

The 30 companies that participated in the survey represent over a quarter of those approached. Of the respondents, 19 represented independent oil and gas companies (63% of the total), four oil majors and super-majors (13%), four oil field services companies (13%), and three others, including exploration and production arms of utility companies and state-owned oil companies. One questionnaire was sought from each company.

The participants' functions were predominantly within tax (65%) followed by finance (19%), operations (12%) and commercial (4%).

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Executive summary

The UK has been benefiting from its oil and gas reserves in the UKCS in terms of energy security, tax revenues and employment for over four decades. Much of the basin is now in the mature phase of its life cycle as its reserves gradually deplete. As the UKCS matures, challenges mount.

Many of these challenges were already known a decade ago, but with the window of opportunity disappearing quickly, urgent and wide-ranging industry reform is necessary. Getting the fiscal regime right is vital but the changes must be made in the context of Sir Ian Wood's *UKCS Maximising Economic Recovery Review* (Wood Review). This will require close collaboration between the government and the industry. In addition, specific sector strategies on infrastructure, exploration and regional cooperation identified in the Wood Review will also need to be addressed.

The next two years will be crucial for the UK oil and gas industry. Although the Scottish independence vote is now cast, there remain a number of macro uncertainties that will all affect the future of the North Sea. These include the general election, the shape of the new regulator, the Oil & Gas Authority (OGA), as well as the outcome of the UKCS fiscal review. While the size of the prize is still substantial, actions that HM Treasury, OGA and the industry take now will have a major impact on the pace of the basin's decline.

In this context, the Deloitte oil and gas survey was originally conducted for a presentation by Roman Webber, UK Leader – Energy & Resources Tax, at the Oil & Gas Industry Conference in Aberdeen on 12 June 2014. The results of the survey are made available to a wider audience to ensure that the findings are known as part of the government's fiscal consultation process.

The survey confirmed some of the industry's perceptions of the UKCS fiscal framework and identified areas for improvement. These perceptions include a high level of taxation and an unpredictable, unstable as well as unnecessarily complex regime. A major concern is that these factors diminish the basin's attractiveness to international investment, which is critical for the basin's future. The survey participants also believe that the current fiscal system does not support new entrants or stimulate industry collaboration.

The survey findings suggest that a set of actions could help address these issues. Respondents thought that the current tax system has many good features such as first year allowances for capital expenditure and field allowances that have driven investment to record levels. However, the survey found that companies would prefer a reduction in headline tax rates rather than new or more generous field allowances. The following measures would be helpful according to respondents: using a cash back system to incentivise exploration and appraisal in the UKCS, retaining the 100% first year capital allowances, and easing the taxation of infrastructure assets to facilitate changes in ownership. The argument of whether oil and gas should be taxed differently has also been considered. Most respondents favoured taxing both commodities on the same basis to avoid further complicating the system though this view was not unanimous.



Introduction



Upstream oil and gas taxation in the UK – time for change

The North Sea is facing a number of challenges. While some of these are symptomatic of a brownfield environment, others are specific to the UKCS. The UKCS is a diverse basin with areas ranging from those close to the end of their economic life to new frontiers and new plays. As a general trend, discoveries are getting smaller and deeper, requiring more innovative and costlier technologies to develop.

According to the *BP Statistical Review of World Energy 2014*, UKCS oil and gas production has been gradually falling since 1999 and 2000 respectively. UK oil production in 2013 was less than a third of its peak in 1999. While production is anticipated to recover somewhat in 2014, direct North Sea tax revenues have more than halved between 2011 and 2013.

The level of exploration and appraisal (E&A) activities has also been falling since 2009. There was a sharp decline in 2011, the year the Supplementary Charge Tax (SCT) was introduced. If the current low activity levels continue, this will have a negative impact on the future recovery of resources.

On the positive side, at £14.4 billion, 2013 was a year of record investments into the UKCS driven in large part by specific field allowances. However, a significant part of this investment related to a handful of large projects. Oil & Gas UK expects a steep fall in future capital investments in the basin once these are completed. If returns are more promising elsewhere in the world, it will be more difficult to secure the investment necessary for prolonging the basin's mature phase.

High costs associated with the UKCS are just one of the factors that could impair the basin's attractiveness to international investment. With crude oil prices flat for a number of years, company margins are coming under significant pressure. New taxes introduced in recent years created a sense of fiscal instability that has added to the pressure.

These factors led many companies to decide to put some of their North Sea assets up for sale. However, many of them are finding it difficult to attract a buyer in the current environment.

Both the government and the industry have known about this for a decade, yet previous attempts to make the basin more efficient have had little success. However, with rapidly falling production and ageing infrastructure, the window of opportunity to act is limited.

It is against this backdrop that Sir Ian Wood published the Wood Review in February 2014. The report recommends a tripartite approach to addressing the basin's issues involving the government (HM Treasury and OGA) and the industry.

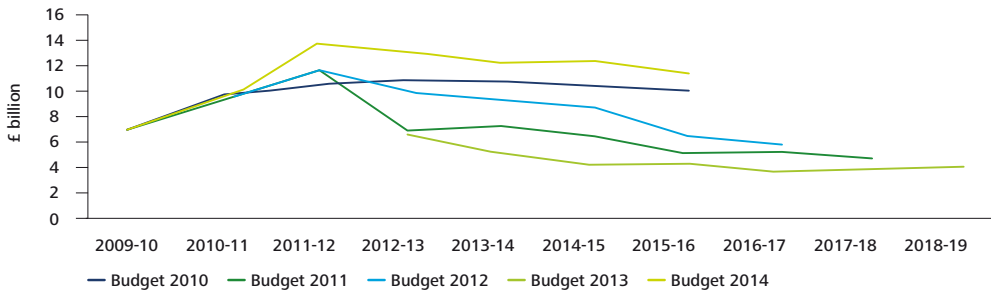
The Wood Review has four main recommendations:

1. A new strategy for Maximising Economic Recovery (MER UK) by the government and the industry
2. Creation of a new arm's length regulatory body, the Aberdeen-based OGA. It is to be charged with the stewardship and regulation of the UKCS resource recovery, and maximising collaboration in exploration, development and production across the industry
3. Additional power to the regulator to facilitate implementation of the MER UK
4. Development and implementation of sector strategies on exploration, asset stewardship, development of regional hubs, sharing of infrastructure and decommissioning.

While the Wood Review did not make recommendations on tax, it highlighted the importance of a stable fiscal regime that is appropriate for the realities of a mature basin. This was acknowledged in the 2014 Budget, which also promised an immediate, full review of the tax regime “to make sure it is fit for the purpose of extracting every drop of oil we can” (Chancellor George Osborne, Budget 2014 speech).

HM Treasury is gradually realising the magnitude of the problem as it has reduced its forecast revenues from the North Sea every year since 2011. For example, as Chart 1 shows, it expects that revenues from the basin will be in the region of £3.7 billion in 2014-15 instead of the £12.1 billion forecast in the 2011 Budget, less than a third of the original figure.

Chart 1. Expected UKCS tax take at 2010-14 Budgets



Source: ‘Red Books’, Deloitte analysis

The revenue reduction led Danny Alexander MP, Chief Secretary to the Treasury, to assure the audience at the Oil & Gas Industry Conference in Aberdeen in June 2014 that the broader contribution the oil and gas industry makes to the UK economy will be recognised as part of the review and that the UKCS will be seen more as an ‘economic asset’ rather than a ‘fiscal asset’.

The UK has a three-tiered taxation system of Petroleum Revenue Tax (PRT), Supplementary Charge Tax (SCT) and Ring Fence Corporation Tax (RFCT). It is counterbalanced with various reliefs including field allowances and Ring Fence Expenditure Supplement, which has created a framework where the effective tax rate can range from 30% to 81% (or even beyond at the extreme).

The field allowances, the Ring Fence Expenditure Supplement and the Decommissioning Relief Deeds were generally welcomed by the industry when they were brought in over the last few years. The measures were responsible for boosting capital investment to record levels in 2013. However, these changes have been introduced in part due to recognition that headline tax rates are too high for many projects and to concerns over dead weight costs. In addition, they created a complex tax system that makes international comparison and investment decisions challenging. The capital investment into new commercially marginal fields, increasing costs and production interruptions have also led to a large pool of players that are currently not paying tax. This significantly alters the economics of their investment decisions and makes them less sensitive to any ‘tax levers’.

At the end of July 2014, HM Treasury launched a ‘Call for evidence’ that will shape the principles of the UKCS fiscal system for the foreseeable future. At the same time, there is consultation on the ultra-high pressure high temperature (uHPHT) cluster allowance.

The results of the consultation will set out the ‘road-map’ for the future of the North Sea regime, with more details expected in the Autumn Statement in December 2014.

A challenging fiscal environment



The results from the Deloitte oil and gas tax survey confirm the general perception of the North Sea as a difficult fiscal environment where companies find it challenging to operate. Respondents identified the high levels of taxation, unpredictability and complexity of the regime as the most pressing issues that the fiscal review needs to address. These issues, combined with the high cost environment and the maturity of the basin, cast doubt on international competitiveness of the UKCS. Furthermore, the fiscal regime does not encourage new entrants or collaboration across the industry.

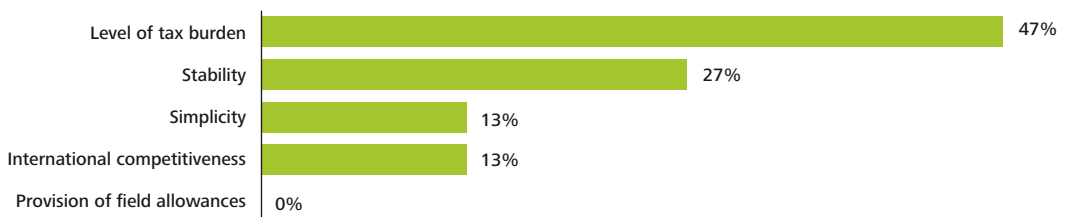
1. High level of taxation, unpredictability and complexity leads to ...

The high tax rate is considered the most important area for reform. In fact, respondents prefer lowering the overall rate of taxation to the provision of new field allowances.

The second most pressing concern is the lack of a predictable and stable tax regime. Considering the introduction of new oil and gas taxes in the basin in recent years, it is not surprising that companies are losing trust in the regime. The UK has also had three Secretaries of State for Energy and Climate Change and five Energy Ministers since 2008, which could also contribute to the sense of instability.

The complexity of the fiscal regime and the impact of the above issues on international attractiveness are also major concerns for companies in the basin.

Chart 2. What part of the fiscal system needs addressing most?



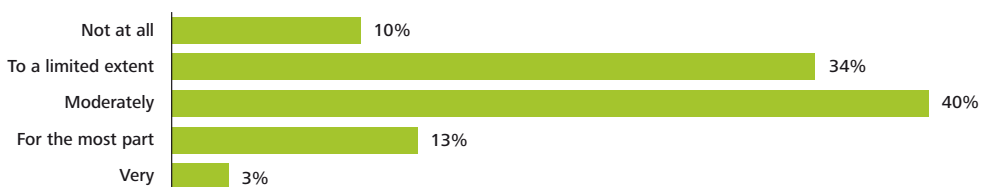
Source: Deloitte oil and gas tax survey; Deloitte analysis

2. ... an uncompetitive UK fiscal regime by international standards ...

The UKCS fiscal regime is not perceived as being competitive by international standards. The findings of the survey support this perception with only 16 per cent considering it “very” competitive or competitive “for the most part”. These views were particularly strong among oil majors and super-majors with large international portfolios.

The lack of new investment will not only lead to precipitous decline in recovered resources but lower government tax revenues.

Chart 3. Is the UK fiscal regime competitive by international standards?



Source: Deloitte oil and gas tax survey; Deloitte analysis

“The fiscal regime is complex, ever changing, highly taxed and as a mature province all these things together prove unattractive.”

Anonymous respondent

3. ... which also fails to support new entrants and industry collaboration

Chart 4 shows that three-quarters of survey respondents believe that the UK fiscal regime fails to encourage new companies to enter the UKCS.

New entrants are crucially important for the basin because they bring new capital, innovative technologies, cost-effective solutions and increased risk appetite. These factors are vital for advancing MER UK.

However, this will be challenging under the current UK fiscal system. There are few, if any, specific incentives for new entrants. The ‘Ring Fence Expenditure Supplement’, which was originally created to support new entrants, has lost its effectiveness as a result of the record levels of investment and new field allowances in recent years.

Chart 4. Does the current UKCS regime encourage new entrants?



Source: Deloitte oil and gas tax survey; Deloitte analysis

The survey findings also confirm the general perception that the fiscal regime does not encourage collaboration in the UKCS (Chart 5).

Currently, there is only one proposal to encourage collaboration around cluster areas in the UKCS. However, any project seeking to qualify for the allowance needs to have some element of uHPHT potential. Other than this allowance, there are no provisions encouraging collaboration in the UKCS fiscal system.

Addressing this issue stands at the heart of MER UK. Therefore, further financial incentives to encourage collaboration would advance the better recovery of resources.

Chart 5. Does the current UKCS fiscal regime encourage collaboration?



Source: Deloitte oil and gas tax survey; Deloitte analysis

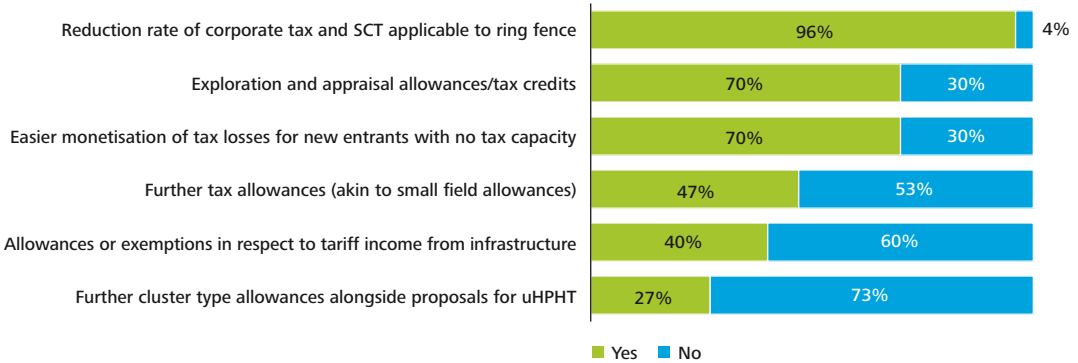
Potential fiscal levers



What are the potential fiscal levers that would help address the issues highlighted in the previous chapter? The survey results show some of the potential actions that could bring material benefits to both HM Treasury and the companies operating in the UKCS.

Respondents believe that an overall reduction in headline taxes would bring more benefits to the sector than increasing the breadth and wealth of field allowances. Lower taxes would improve investor confidence, it could also lead to the simplification of the overcomplicated tax system. Falling E&A figures continue to cause concern for HM Treasury, the regulator and the industry. A cash back tax credit has been identified as an effective fiscal incentive to stimulate E&A, which has been successful in Norway. Considering keeping 100% first year capital allowances would also make the UKCS more attractive for new entrants. In terms of infrastructure, considering removing taxation of pipeline tariffs from the Ring Fence could facilitate change in asset ownership. Respondents also believe that oil should continue to be taxed at the same rate as gas for simplicity and because of concerns over an increase in oil taxation if gas tax revenues were to fall.

Chart 6. Which of the following changes would be received best by industry?

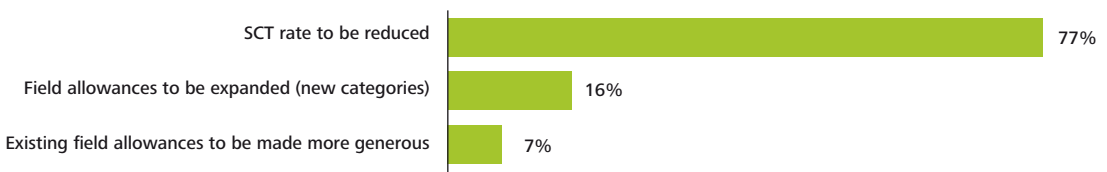


Source: Deloitte oil and gas tax survey; Deloitte analysis

1. Reduce the headline tax rate

Respondents prefer a reduction in the headline rate of SCT to generating new bespoke micro-regimes for certain types of fields or making field allowances more generous (Chart 7). Even though the headline tax rate for UK North Sea operations ranges from 62 per cent to 81 per cent, in practice field-specific allowances and other incentives make the effective tax rate much lower for many companies. However, this bespoke regime creates complexity and a perceived barrier to international investment.

Chart 7. Which would you prefer to see as part of the fiscal review?*



*Assuming grandfathering of currently activated field allowances

Source: Deloitte oil and gas tax survey; Deloitte analysis

2. Use cash back to incentivise exploration and appraisal

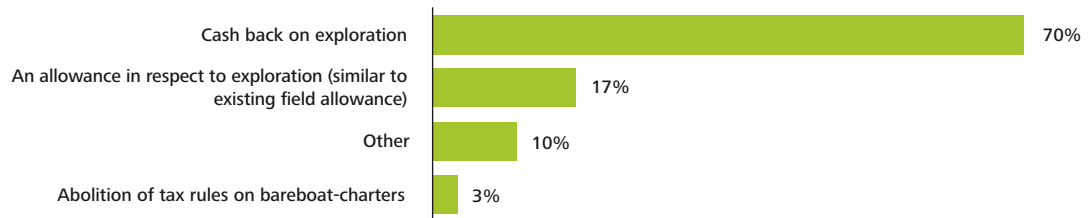
Eleven E&A wells were drilled according to the *North West Europe Third Quarter Review 2014* by Deloitte's Petroleum Services Group. This is higher than the seven wells drilled in the second quarter of the year and the same as in Q2 2013.

Low drilling figures are a particular concern for the industry because the lack of E&A activity will inevitably lead to a decline in future production as well as a reduction in the need for oilfield services.

Currently, there are no exploration-focused tax incentives compared to other parts of the field-life-cycle. While there are a number of non-tax reasons for the low exploration activity, such as prospectivity, and availability and cost of drilling rigs, introducing exploration tax incentives could have a major impact on exploration activities in the UKCS.

The survey suggests that cash back (or something that would create a similar result) is the industry's preferred financial mechanism for stimulating E&A. This would be similar to the model successfully used in Norway. While there are a number of differences between the UK and Norwegian markets, the industry would welcome measures specific to E&A.

Chart 8. Which would best increase levels of exploration and appraisal?



Source: Deloitte oil and gas tax survey; Deloitte analysis

“A step change reduction in the headline tax rate would assist overall activity, and E&A would be further boosted if a payable tax credit was available for E&A.”

Anonymous respondent

3. Consider keeping 100% first year capital allowances

The current tax regime has many attractive features. These include specific incentives for developing fields, capital gains exemptions and decommissioning relief deeds.

However, Chart 9 shows that over two-thirds of respondents would like to see 100% first year capital allowances to be kept as a key feature of the regime. These provide immediate write-off of most capital expenditure for tax purposes. More importantly, they align cash flow generation with taxable profits. 100% first year allowances for the oil industry were introduced at the same time as SCT in April 2002. If the oil and gas industry wishes to see the SCT rate reduced, it may have to accept giving something back, such as a change in the rate of capital allowances.

Chart 9. Which would you like to maintain?*



*Assuming that there will be no substantive changes in the Decommissioning Relief Deed regime

Source: Deloitte oil and gas tax survey; Deloitte analysis

4. Consider removing taxation of pipeline tariffs from the Ring Fence regime

Infrastructure is another area that the Wood Review identified as requiring attention. Preservation of ageing pipelines and terminals, as well as access to these by third parties for maintenance, production and for new field developments, are major issues for the industry.

With financial investors entering the market, we are seeing new ownership models for infrastructure. Taxation of infrastructure is a very complex area, but tax is only part of the challenge. Respondents felt that taxation of pipeline tariffs should be removed from the Ring Fence and rules eased to remove barriers to changes in infrastructure ownership. The Wood Review considers that changes in infrastructure ownership are required to improve investment and maintenance.

Preservation of ageing pipelines and terminals, as well as access to these by third parties for maintenance, production and for new field developments, are major issues for the industry.

5. Keep tax rates for different commodities (i.e. oil and gas) at the same level

Prices for oil as opposed to gas are driven by different factors and for some time gas prices have been perceived in relative terms to be lower than oil prices. Therefore, it has been suggested that oil and gas should be subject to different levels of taxation.

Chart 10. Should oil and gas profits be taxed at the same rate?

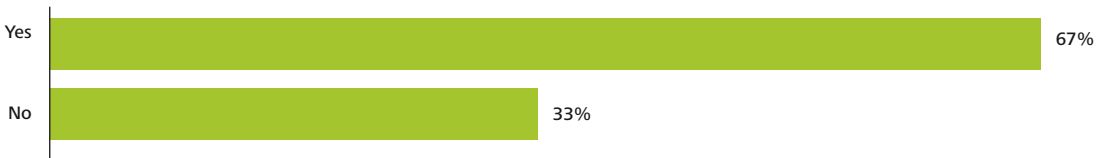


Chart 10 suggests that two-thirds of respondents are in favour of keeping gas profits subject to the same tax rules as those of upstream oil. A number of respondents with both oil and gas portfolios indicated that to disaggregate gas profits would add an additional layer of complexity to an already complicated system. Some were also concerned that a reduction in gas tax rates would lead to a rise in oil tax rates to preserve the tax value for the government. However, others had a clear preference to treat gas separately.

“Gas is suffering from relatively low prices and high costs driven by oil price. It is not unreasonable to tax (marginal) profits from gas at the same rate as oil, but the lack of incentives to risk new capital on gas, will result in earlier abandonment of infrastructure and ultimately a lower tax take.”

Anonymous respondent

Conclusion

The review of the UK oil and gas fiscal regime is timely following the publication of the Wood Review, which highlighted the main issues of the complex hydrocarbon basin. The OGA, which is currently being established, should provide sector expertise to assist HM Treasury in better understanding both the risks and opportunities in managing the basin.

The results of the survey are clear: the industry wants a stable and simple fiscal regime that is appropriate for a mature market. This will also make the basin more competitive internationally.

This is a tall order for any fiscal review. HM Treasury is under immense pressure to deliver as this could be the last chance to get the fiscal regime right. Success in restoring investor confidence and international competitiveness of the UKCS would mean another two or three decades of sustainable production and equally important tax revenues. Failure to make radical changes to the system would result in the steeper decline and decommissioning of assets, reduced energy security, lost tax revenues and a loss of thousands of jobs.

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Designed and produced by The Creative Studio at Deloitte, London. 38565A