SEEC

UNIVERSITY OF SURREY

North Sea Consultation

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The Consultation document published by the Treasury in December 2007 is a welcome contribution to the further reform of the UKCS fiscal regime. The industry has complained in the past about unexpected changes in fiscal terms, and the deterring impact that the instability of the fiscal regime inevitably creates. Consultation and dialogue are the preferred framework to introduce fiscal reforms.

No one expects fiscal regimes to be cast in concrete forever; indeed the regime must evolve to reflect maturity and competitiveness as well as ensuring the nation secures the right share of its reward from the exploitation of a national resource. Conditions change and certain flexibility should be allowed to take those changes into consideration, such as the evolution of the production, oil and gas prices, cost structure, profile and basin competitiveness. But on the other hand, regime modifications should not be on too frequent a basis nor undertaken without advanced warning, as they can, and do, negatively affect investors' confidence. The process of consultation with the industry has clearly delivered positive results and this represents a material improvement in the relationship between the industry and the Government. This is best characterised as work in progress as further reform is undoubtedly required if the UK Government is to be successful in securing the maximum economic recovery from the UKCS.

It is clear the UKCS faces many challenges which have to a large extent been disguised by the rise in oil prices. It would be unwise to speculate on the future direction of prices but a return to more sustainable price level would very quickly expose the uncompetitive nature of the basin. Whilst basin production remains material at just under 3 million boepd, production comes from a growing list of ever smaller fields. The bulk of UKCS oil production now comes from fields producing under 20 mbpd. These fields have had to absorb the rapid inflation of oil industry costs, as well as bearing a cost legacy from an earlier generation of much higher oil production. Further cost pressures are in the pipeline as production continues to fall. External factors will further aggravate the challenge, for example from EU emissions trading where compliance costs will grow materially from 2013. The impact of wider environmental regulation will also become more onerous during the next decade.

The UKCS has been valuable for the UK economy and for the country's own security of supply. While there are those who think that renewable energy will save the day, the evidence is that fossil fuels will remain at the centre of the energy mix for at least the next two/three decades. Heavy subsidies are being poured into wind power with little return, but it is the transport sector which will remain one of the largest user or oil and emitter of CO_2. Given this prospect, extending the life of the North Sea province should be more of a priority for the Government. Recent Government actions led to the conclusion that the policy focus is more about maximising tax revenues than maximising economic recovery. The Government must think much harder about the competitiveness of the UKCS and the ways this can be enhanced and not weakened. The UKCS may not provide the volume potential that satisfies larger investors, but it can and arguably must provide value.

Turning to the key measures themselves:

1) **Decommissioning:**

The changes to the treatment of decommissioning expenses will help investors, particularly smaller players and new entrants, in securing effective tax relief for the increasing bill for removing North Sea infrastructure. These measures are overdue and are readily affordable; it is unlikely that there would be any material cost falling on HMG much before 2020. Clearly, the industry would prefer it if decommissioning tax relief could be provided for ongoing provisions or cash contributions into alienated funds, but this is unaffordable and will remain so. The Government is right to reject such requests from the industry as it would do little to impact on, or encourage, future basin activity. Also as many expect the Government tax take to fall materially from the current level of 58% over the coming decade it would be imprudent for HMG to lock in such a high rate of tax relief today.

2) **PRT**

The insights provided into the discussion on PRT reform are very interesting and it is encouraging to see the industry and the Government engaging on this divisive issue. However many of the conclusions are disappointing and seem to focus on ruling options out. The impression is conveyed that the future of PRT will remain unresolved, despite several years of dialogue. It is no surprise that the industry is divided in its views, that is inevitable and is largely driven by the portfolio composition of the key players. But that should not be an excuse for inaction or failure to take the critical decisions in the best interests of the nation. The author has long believed that PRT should be removed at the earliest opportunity. Doing so would simplify the regime, encourage more investment, attract new entrants, encourage asset trading and defer decommissioning. Clearly the Government has to address concerns over the near-term revenue yield from the North Sea but not at the cost of being short sighted. The author believes PRT abolition in return for a modest increase in SCT is the simplest solution. If the abolition date were to be deferred a couple of years then no corresponding increase in SCT would be required once the crossover point (future PRT receipts matched by obligation to fund decommissioning) is approached. The alternatives canvassed of a PRT buyout by companies appear creative but this approach is never going to result in a 100% solution and for some will never be an acceptable outcome. Nonetheless it would at least be a step in the right direction if the tough decisions remain elusive.

The proposals to remove never PRT payers from PRT are also welcome but the provision that the consent of prior owners must be sought seems bizarre to say the least and will undermine the effectiveness of the change. Former owners should not be given a veto on the future tax regime.

Failure to address the future of PRT today squanders an important opportunity. Speculation will continue over its future shelf life. No assurances from the Government today can ever provide sufficient comfort that once the PRT yield becomes negative then a future Government will resist the temptation simply to abolish the tax and the obligation to repay. The author encourages the Government to take a decision in the best interests of the basin and not take the easy option of inaction for fear of upsetting a few vocal lobbyists. This should never be a consideration when the Government implements tax increases.

3) Further discussions

The Government intention to extend the consultation to end June 2008 is to be welcomed. Further careful and constructive debate is necessary if the much needed fiscal reforms are to be successfully formulated and delivered.