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Treasury Chambers, Parliament Street, SW1P 3AG
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PRIME MINISTER

Agreed MT.

OIL TAXATION PROPOSALS

1. You have asked for a note on this year's oil taxation measures. I have now, in consultation with David Howell, settled the broad lines of my proposed Budget changes; there are of course some points of detail yet to be settled.

BACKGROUND

2. You will recall that I announced my outline proposals at the time of the Industry Act Forecast last November under two heads:-

(i) a proposed new supplementary tax on gross revenues less a flat-rate oil allowance: for illustrative purposes, at a rate of 20 per cent with an allowance to 1m tonnes/year. The tax was to raise about £1 billion in 1981-82; and

(ii) a review of the PRT reliefs designed to improve their efficiency and economy in the face of changed North Sea economics. The detailed problems and possible solutions were outlined in a Revenue discussion paper issued just before Christmas.

3. The background to these proposals was set out in my letter to you of 14 November. I need not rehearse the arguments again here: nothing has happened - either to North Sea economics or to the wider economic picture - which substantially affects the conclusions we reached then.

Consultations with the industry

4. Since the November announcements Ministers and officials have had extensive discussions with the industry representative bodies and with individual companies. It is always difficult to assess the industry's response, but in my judgement the industry generally accepts that my proposals are justified on the basis of current North Sea economics. You will recall that Dr. Hammer agreed, and stressed that I was right to look for a large part of the revenue from fields which are not yet liable to PRT. The industry has however argued strongly that my objectives could be reached without introducing a permanent new tax: they suggest a "temporary levy" for 1981-82 off-settable against future North Sea tax, followed by discussions aimed at a radical reform of PRT. You will remember that this was Dr. Hammer's main point; and that he did not seriously challenge our view of the taxable capacity of the North Sea.

5. US companies have argued this line particularly strongly in favour of a temporary levy since they believe - with some justification - that the new tax might exacerbate their existing problems in obtaining effective credit for PRT against US tax. They have also argued that any changes to the PRT reliefs of the kind I have in mind might prejudice the present US credit status of PRT under the double taxation treaty.

New tax

6. Since my November announcement, my officials and those of Department of Energy have reconsidered my new tax proposals on the basis of the latest North Sea economic indications and have analysed the industry's counter-proposals; they have also carried forward the review of PRT reliefs. In the light of their conclusions, and after consulting David Howell, I propose to introduce the new tax as first announced, at a rate of 20 per cent on gross revenues with an oil allowance of 1m tonnes/year. The tax will raise about an extra £1,000 million in 1981-82; somewhat less in later years.

7. You will know that we have been looking at ways of smoothing the PSBR over the year. As one contribution to this objective, I propose to provide for advance payment of the new tax in monthly instalments over the year. David is understandably concerned that this will substantially increase the cash flow impact of the new tax on the industry, but I believe there are overriding monetary policy arguments for starting the tax off on this footing. I have however told David that I agree that the advance payment machinery should be amended - after further discussion with the industry - to reduce the burdens on particularly hard cases. My officials are already considering possible ways to do this, short of changing the proposed pattern of payments. I also propose to invite the industry to discuss the possibility of smoothing PRT: it may well, however, be impossible to develop an acceptable scheme.

8. In response to the industry's call for a "temporary levy" I propose to introduce the new tax to apply in the first instance only to mid-1982. This will give the industry ample time to show how a "reformed PRT" might replace my proposals. And if, as I rather anticipate, they do not make out the case, then our present proposals can be put on a permanent basis.

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9. As a further response to the industry's representations on the new tax, I propose to:

(i) exempt gas which is already exempt from PRT;

(ii) provide for the new tax to be repaid to fields which do not cover their development costs; and

(iii) relax the "PRT spreading" machinery - after further discussion with the industry - to ease the double taxation problem of US companies.

Review of PRT reliefs

10. My review was motivated by the belief that the PRT structure as it now exists has been overtaken by the radical changes in North Sea economics since PRT was introduced. In particular, the PRT reliefs do not now give adequate incentives to cost-effective investment. Apart from the risk of misdirection of the North Sea exploitation effort, this could lead to a substantial loss of tax in the longer run if not corrected now. More generally, the PRT reliefs in their present form are likely to give a degree of relief in the later years of some highly profitable fields that was never intended when PRT was introduced. Our consultations with the industry have, if anything, confirmed these conclusions.

11. I therefore propose the following changes to the PRT reliefs:

(i) "Uplift", which is given at 35 per cent as a proxy for interest relief, will no longer be given on expenditure incurred after a field is well into production. Such expenditure can be paid for out of current field cash-flow (to the extent that it is not paid for by immediate 100 per cent expenditure relief against CT and PRT): no proxy for interest is therefore justified;

(ii) "safeguard", which reduces the PRT charge by reference to the field's annual return on capital, will also be removed after the first few years of production. Safeguard mitigates the charge to PRT on fields which are slow to cover their costs, and insures fields generally against adverse changes in economics before the field has earned an acceptable return. There is no case on either ground for continuing the relief in later years of production long after the field has moved into profit.

I do not propose any changes to the remaining PRT relief, the oil allowance.

Yield

12. The whole package will raise about £1040 million in 1981-82 (in money-of-the-day) almost all from the new tax. This compares with a prospective yield of "about £1,000 million" announced last November. The net yield of the new tax will be substantially less than this in later years, but this fall will be partly offset by the effects of the changes to the PRT reliefs, especially in the longer term. The increased yield flowing from all these changes might be in the range £300 million to £500 million in 1983-84 (again in money-of-the-day) depending on the precise details of the PRT changes.

Industry response

13. The industry have made very little attempt to argue that my proposals are unjustified on grounds of "taxable capacity" and I do not think they will find it easy to mount such an argument after the Budget. They will no doubt continue to argue that my objectives could be better met some other way: introducing the tax initially for a limited period should effectively answer this. In the meantime, I can reasonably claim that my proposals have been significantly influenced by the industry's detailed representations.

14. I do, however, expect strong and continuing reaction from the US companies on the tax credit issues outlined in paragraph 5 above. So far as the ne w tax is concerned, I have considered the US companies' alternative - "advance PRT" - proposal carefully. But I conclude that it is distinctly inferior to the new tax, both in its immediate effects on cash flow for some fields, and in its longer-term usefulness as a tax instrument. Our response must be, I think, that any US tax credit problems are not, at bottom, of our making; they

cannot determine the shape of my proposals when the problems (which already exist) can reasonably be tackled some other way (i.e. by the "PRT spreading" provisions mentioned at paragraph 8(iii) above.

15. The US companies will also make much of the risk that the PRT relief proposals will put all PRT credit at risk: they have already enlisted the support of the State Department on this issue. There is a genuine risk that the US authorities will rule that PRT as amended is no longer a creditable tax: if and when they do so, we would be obliged to renegotiate the US/UK tax treaty, at some unquantifiable cost elsewhere.

16. David is concerned - as I am - about the possible political consequences of an adverse decision in due course (which might not be for some months) on PRT creditability from the US authorities. But I think it is clear that some quite radical changes in PRT are now unavoidable - even the industry agree on that - and therefore the credit status of PRT will inevitably come into question however we proceed. We have quite respectable arguments that the precise changes I propose do not change the basic structure of PRT. If we are to take this risk, as I think we should, the choice is between pressing ahead with legislation as planned, leaving it to the initiative of the US authorities to argue that PRT is no longer creditable; or putting the proposals formally to the US authorities for their views before any legislation, with no guarantee of a quick or favourable response.

17. David sees advantage in this latter course, with legislation - modified if necessary - following during the passage of the Bill. But I am doubtful whether the US authorities would respond in time for legislation this year; and if they gave an adverse response to my present proposals, I am not clear that it would be easy to modify them so as to retain creditability while still preserving the substance.

I therefore conclude that the alternative of immediate legislation is preferable, both because it will eliminate the distortions and loss of revenue we have identified that much sooner, and because it will allow the longer term revenue gains to score in the MTFS this year. If creditability of PRT does then become an issue we will - if the IRS rule against us - have to re-negotiate the tax treaty with the US Treasury, though possibly at a price.

Conclusion

18. I seek your agreement that we should introduce in this year's Finance Bill:-

(i) the new tax described at paragraphs 6 to 8 above, to have effect up to mid-1982 in the first instance; and

(ii) PRT relief changes on the lines set out in paragraph 11 above.

19. I am copying this to David Howell and - in view of the international implications - Peter Carrington.

P.S. Jenkins
for (G.H.)

20 February 1981

(Approved by the Chancellor and signed in his absence).

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10 DOWNING STREET

From the Principal Private Secretary 23 February 1981

Oil Taxation Proposals

The Prime Minister has seen the Chancellor of the Exchequer's minute of 20 February 1981 on the oil taxation measures to be taken in the Budget and agrees to the proposals in paragraph 18 of his minute.

I am sending copies of this letter to George Walden (Foreign and Commonwealth Office) and Julian West (Department of Energy).

C. A. WHITMORE

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John Wiggins, Esq.,
H.M. Treasury.