S E C R E T

Prime Minister.

F.S. Collinge
Duty Clerk
18/11/80

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

May we discuss
the timing.
MS

PRIME MINISTER

ADDITIONAL TAX REVENUE FROM THE NORTH SEA

My recent paper to Cabinet on the economic prospect and the implications for policy (C(80)59) said that I was considering a number of options for raising revenues, including the possibility of obtaining additional revenue from the North Sea. This note sets out my proposals, which I have discussed with David Howell, as well as with all my Ministerial colleagues in the Treasury, including Peter Rees - who has already borne the burden of carrying through the House several changes in the PRT regime. I hope this minute reflects his anxieties, which I certainly respect - but which do not, in the end, dissuade me from the course which I commend.

Economic background

2. The background against which we will be taking important fiscal decisions is the need to achieve our overriding aim of declining monetary growth. After the excessive monetary growth and public sector borrowing during the current financial year, it is essential that we use all available means to reduce the PSBR in 1981-82, and subsequent years, from levels that otherwise will prove uncomfortably high.

3. There are particular reasons for raising substantial additional revenue from the North Sea. The rest of the company sector is in severe trouble as a result of the recession and the high exchange rate, the latter in part the consequence of our having North Sea oil.

/In contrast,

In contrast, the companies operating in the North Sea have enjoyed in the last two years a very substantial increase in prices and profitability. In the two years to the fourth quarter of this year the world dollar real price of oil rose by 90 per cent. The rise in the exchange rate over the same period has reduced the rise in the real sterling price of oil, but this is still 60 per cent higher than at the end of 1978.

4. The world oil price continued to rise until the middle of the year, since when it has been more or less stable, and the sterling price has even fallen with the rising exchange rate. Nevertheless, during the preparation of the 1980 Budget, in which I made a significant tightening of the North Sea fiscal regime, and for a little while thereafter, the oil price rise was still taking place, It is now possible to assess the implications of this second oil price explosion for the system of North Sea taxation. The halt in the upward movement in world oil prices is the result of the current recession. The prospect over the medium term as a whole is for a further significant rise in oil prices, though no-one can predict the precise extent or timing of this rise.

Inter-departmental review

5. It is against this background that a comprehensive review of the existing tax regime in the North Sea was conducted over the last summer and early autumn by David Howell's officials and mine. The purposes of that review were to:-

(i) Consider how far the Government's share of revenues accruing to the oil companies could be substantially increased, particularly in the short term, but also in the longer run.

(ii) Judge whether such additional tax could be secured without damaging the future exploitation of the North Sea.

/ (iii)

(iii) Examine how the tax regime could be made to react with more flexibility to outside events, particularly further increases in the real price of oil.

(iv) Consider whether the existing petroleum revenue tax (PRT) needed to be tightened up to protect existing revenues.

6. After careful consideration of the issues, I have decided that it would be possible to obtain a further £1 billion in tax in 1981-82 without depriving the oil companies of a fair return on their North Sea projects. One cannot avoid some risk that this increased tax might prejudice future exploration and development, but in my view the arrangements I propose will minimise this.

Limitations of the present taxes

7. I have of course carefully considered whether sufficient additional take could be achieved by squeezing more money out of PRT. The maximum we could achieve - by increasing the advance payment rate to 40 per cent, and by tightening up the existing reliefs (which tightening I think we will have to do anyway) - would be £390 million in 1981-82, £660 million in 1982-83 and £710 million in 1983-84 (money of the day). But for a number of reasons connected with the way the reliefs are structured, that tax cannot provide anything approaching £1 billion more than the sums now expected next year. Nor can we be sure that tightening up PRT will provide us with the flexibility which we must have for the future.

8. I have therefore considered three possibilities:-

(i) Complete replacement of PRT by a new tax, which would be more flexible and capable of yielding larger revenues.

/ (ii)

(ii) A new scheme of accelerated payment of PRT to replace the present advance payment arrangements.

(iii) A second special oil tax to be paid in addition to PRT.

Replacement of PRT

9. There is at first blush an attraction in the idea of replacing PRT with an entirely new tax with progressive rates geared to the circumstances of particular oil fields. This was suggested by the Secretary of State for Energy: officials looked at it very carefully, and so have I.

10. While such a tax could certainly be designed its main difficulties are that:-

(i) It could not be introduced for two or three years, and would therefore not produce extra revenue in the short term.

(ii) It would involve maximum disruption and uncertainty for the oil companies (including complex transitional provisions).

(iii) It would, in the event, produce only an extra £350 million or so each year, compared with the present system, even with a top rate of 95 per cent.

11. Unfortunately, therefore, this does not offer a solution.

A new scheme of accelerated PRT

12. A new scheme for accelerated payments would be intended to bring forward, particularly to 1981-82, PRT which is not due to be paid until some years ahead. A scheme of this sort could probably be designed to produce extra revenues on the scale I am looking for in 1981-82.

/ 13.

13. The trouble with such a scheme is that:-

(i) It simply borrows money from the future and would have to be repaid to the oil companies.

(ii) Thus, in reality, it is only a forced loan from the companies - and does not raise new money.

(iii) It will not give the added flexibility needed in relation to any future increases in the real price of oil.

14. It is essentially a short term expedient, and I do not favour it if there is a better permanent solution.

An additional tax

15. My preferred solution is to have a new tax to be paid in addition to PRT. It would be calculated on the gross income of each field above a specified production threshold.

16. Though it is not without difficulties, the advantages I see in this approach are that:-

(i) It could be brought in quickly, and in time to raise extra revenue of about £1 billion next year.

(ii) It could also continue to raise significant extra sums in subsequent years.

(iii) It would provide a much more flexible and easily adjustable tax regime for the future.

17. This involves a difficult judgement about the possible effects on exploitation and investment in the long term.

18. We have examined this carefully, and Department of Energy officials have been fully involved. What evidence we have

/suggests

suggests that the oil companies are now prepared to accept an internal rate of return on our figures nearer to 10 per cent than the 15 per cent hitherto assumed. After the effects of the changes I am proposing, our calculations suggest that IRRs would remain above this level.

19. In these circumstances it is our best judgement that the return to companies after the imposition of a new tax bringing in £1 billion will remain sufficiently high to ensure that exploitation will not be significantly adversely affected. For example, the calculations suggest that the return on the Clyde field, one of the more marginal, would be reduced by only about 1 per cent. We know how keen the companies concerned, Shell, Esso and BNOC, are to get ahead with this field, which John Raisman described recently as a profitable new field.

20. David Howell has been particularly concerned about the effects of any new measures on marginal fields, as indeed am I, and it is our intention that the new tax should as far as possible meet this problem.

21. I have taken the precaution of asking the Law Officers to consider whether we would be open to challenge under international law if we introduced this new tax on top of the existing ones. They take the view that, subject to certain conditions, the tax ought to be defensible against the charge that it is really a disguised royalty or, in some other way, a unilateral variation of an oil company's contractual rights; and that it would be difficult for an existing licensee to establish that the arrangements I am contemplating would be confiscatory.

22. David Howell is understandably reluctant to see an additional impost on the oil companies, but he does recognise the reason for my decision.

/ 23.

23. I will not disguise the fact that this step will be resented by the oil companies, and that they will react strongly against it. They will complain that this is the fourth tax (on top of royalty, PRT and corporation tax) to which they are subject. They will throw back at us that we have raised the rate of PRT to 70 per cent, reduced the rate of uplift and free oil reliefs (upholding the proposals announced by the previous Administration) and have introduced two measures to accelerate the payment of PRT. They will add that Conservative Ministers have on a number of occasions repeated the Dell/Jenkin general assurances about stability in the regime. For example Peter Rees said in Standing Committee on 18 December 1979:

> "I do wish to emphasise [that] an assurance given by Mr. Edmund Dell, which was repeated by Patrick Jenkin, that the framework of the tax should remain unaltered and unimpaired as far as possible because stability is needed in this matter. That is not to say that there are not small areas which need to be considered from time to time. We have done that an will continue to do so."

On the other hand, in giving the most recent assurance, Peter was more guarded. He said in Standing Committee on 26 June 1980 that:-

> "I do not want to create an atmosphere of uncertainty. But, naturally, one must always keep such taxes under review and consider whether the balance and the detail are right."

24. Having said that the strictures of the oil companies will not be easy to handle, but I do not believe that the terms of the assurances rule out any change of this kind; and we shall have to argue that the Government cannot tie itself in all circumstances never to raise additional tax, and that the action is justified in the current situation. Even so Peter Rees,

/because of

because of his close involvement with these earlier assurances, is understandably concerned. I have made it clear to him that I will take the lead in presenting this latest change and he is happy with this. I think we can draw some credit from announcing the proposals (including possible changes in the PRT reliefs) in advance at this stage, and thereby allowing the industry time between now and the Budget to make such representations to us as they think fit.

25. Incidentally, the increase in take of £1 billion which I recommend would not increase the total tax take from the North Sea in 1981-82 above the level expected at the time of the Budget. For a variety of reasons (including lower production and higher capital expenditure) our latest expectation is that the 1981-82 yield from the North Sea would, as it happens, have been about £1 billion lower than expected at the Budget.

Announcement

26. If this proposal has your agreement, I should like to announce the new tax, along with the other matters mentioned in my minute to you of 4 November, in time for its implications to be taken into account in the Industry Act forecast. I shall say why we have come to the conclusion that the North Sea sector can and should shoulder a larger amount of the country's tax burden in present circumstances, and indicate the broad shape of the tax.

Conclusion

27. I seek your agreement that:-

(i) We should plan to introduce a new tax on gross profits from the North Sea sufficient to raise around £1 billion extra in 1981-82, and significant additional revenues in subsequent years.

/ (ii)

SECRET

(ii) I should announce it later this month in time for its implications to be incorporated in the Industry Act forecast.

28. I am copying this minute to the Secretary of State for Energy and to Sir Robert Armstrong.

R.I. Tolkien (Private Secretary)
for

(G.H.)

14 November 1980