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M C Scholar, Esq
Private Secretary to the
Prime Minister
10 Downing Street
London SW1

13 September 1983

Dear Michael

I attach some positive points to make on the petroleum licensing aspects of the BP Forties Farm-out for the Prime Minister's use at the Magnus Inauguration tomorrow. I understand that the Chancellor's office is providing you with separate briefing which covers taxation matters. I am sending copies of this letter to John Kerr, Muir Russell, and Jonathan Spencer, Martin Donnelly and Neil McMillan.

Yours sincerely

C E Brooks

MISS C E BROOKS
Private Secretary

BP Forties Farm Out proposals

Positive points to make

i. The change announced by the Chancellor is wholly consistent with the generous incentives given by the 1983 Budget package to engage in new exploration and development activity in the UKCS. Thus companies farming into mature fields will still be able to set new drilling expenditure against income from such fields.

ii. Moreover companies will still be able to set off past abortive exploration expenditure against income from fields in which they have held licence interests since before those fields reached maturity. (Maturity is defined as the end of the first PRT chargeable period - roughly the point at which significant production is established. PRT will not normally be paid until 2 - 3 years later).

iii. In other words, the change is fair to the companies and to the taxpayer. It should encourage new exploration at a price which both the companies and the taxpayer can afford.

iv. The Dept will be concerned to ensure, in the case of licence assignments arising from transactions on the lines proposed by BP that the new licensees satisfy the licensing criteria such as technical competence, financial capability etc. This is what always happens. No change.

v. If the BP Forties sale goes ahead, small UK companies will still be able to secure PRT income to set against their new exploration expenditure.

Defensive

i. The right way to deal with a problem of this kind, which arises from the structure of the UKCS fiscal regime, is through fiscal legislation. Discretionary licensing powers are there to ensure that exploration, development and production activities are carried on efficiently and safely.

ii. Companies developing sophisticated tax avoidance schemes should always expect an appropriate Government response.

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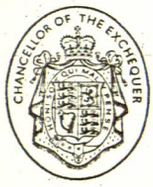
(1)

Prime Minister

Worth a quick glance.

MCS 13/9



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

13 September 1983

Michael Scholar Esq
10 Downing Street
London SW1

MS

Dear Michael

MAGNUS INAUGURATION: 14 SEPTEMBER

You have already received extensive briefing from the Department of Energy. However, the Prime Minister may also like to see the enclosed brief which has just been prepared for the Chancellor about the BP share sale and today's announcement on PRT reliefs and farm-ins.

2. I am copying this to Michael Reidy at the Department of Energy.

Yours sincerely,

Margaret O'Mara

MISS M O'MARA
Private Secretary

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BP SHARE SALE: BRIEFING FOR MAGNUS INAUGURATION

Background

The Chancellor announced on 25 July that he expects to raise up to £500million of the asset sales he is seeking this financial year from an offer for sale of a further tranche of the Government's holding of BP shares. The Bank is acting as the Government's agent in the sale.

2. The precise number of shares to be offered is still to be settled. This will depend on the price expected to be got for them. Very roughly, at the current market price of 428p (close 13/9/83) raising £500 million would reduce the Government's holding from about 39% to 32% of the company.

3. No further details have been announced. [NOTE: it is important not to be drawn on timing or method of sale.] The markets had been anticipating a sale this week but now appear to have learned that it has been delayed because of BP's proposed sale of up to 12% of its Forties field. Separate briefing is attached on BP's Forties sale and the Government's response.

Defensive

Has the sale been postponed because of BP's proposed Forties sale?

It is not Government policy to comment on the details of any of its market operations. A sale is expected this financial year.

What effect will BP's proposals and the Government's response have on the sale?

BP's proposals are one factor among many affecting the value of BP shares. But they should not prevent a sale this financial year.

Interaction between the two sales?

Are being offered to different markets - Forties stake to companies interested in the North Sea; BP shares to the capital market. Not competing with one another.

Reason for sale?

It is part of the expanded programme of asset sales announced on 7 July.

Will the sale be underwritten? Fixed price or tender? Special provisions for employees/small investors?

Decisions on these matters will be announced at the time of the offer.

What are the Government's intentions on subsequent sales of BP shares?

Wait for the prospectus.

How will the sale affect the Government's relationship with BP?

The sale will not affect the Government's traditional relationship with BP nor will it affect the Government's rights under the Articles of Association including the power to appoint directors.

What other asset sales are planned?

A number of options are being considered but no decisions have yet been taken.

What is the size of the asset sale programme in 1983-84 and how much has been raised so far?

The increase of £500 million increase announced on 7 July takes the total being sought in 1983-84 to £1,250 million. So far £290 million has been raised through the second payment on Britoil.

Why sell off assets if only another way of raising finance from the institutions?

The Government's funding programme is heavily reliant on gilt sales. Asset sales provide diversification taking pressure off gilts.

[Until 4.30 Tuesday 13 September]

BP's PROPOSED FORTIES SALE: BRIEFING FOR MAGNUS INAUGURATION

Background

BP announced on 7 September that it was proposing to farm out up to 12½% of its interest in the Forties field to raise about £260 million. 2 stakes of 1% are to be disposed of and 40 stakes of ¼%.

2. The proposal is expected to appeal to companies who have incurred exploration costs on the UKCS but do not have revenues from producing fields against which to set these costs for tax relief. Under the present regime relief could be gained for exploration expenditure that has already been incurred as well as oil future exploration and appraisal expenditure.

3. The Government has made it clear that BP's proposals are being considered very carefully. An announcement is planned for 4.30pm this afternoon when Inland Revenue will issue a Press Notice saying that in this context the Government has decided to legislate so that relief is only allowed for expenditure incurred after a farm in except where the farm in takes place before the end of the first chargeable period (this is roughly equivalent to the date of first production). This is broadly in line with corporation tax practice.

4. Expenditure incurred before a farm in takes place is to be refused relief against prt on the field which is to be bought into because it is the Government's intention to concentrate reliefs on encouraging new expenditure.

5. Under the Government proposals only current exploration expenditure can be offset against income acquired through a farm in. This will substantially reduce the ultimate cost of transactions of this type. The effect of BP's proposal on revenue depends on the amount of drilling activity which is going on and the extent to which they find purchasers with sufficient unrelieved current

exploration expenditure to take up the offer. It is for BP to decide whether to proceed or whether to modify the terms. No comment should be offered on this.

6. The Secretary of State for Energy will consider any proposals for licence assignments in the normal way once prospective purchasers have been identified. [Not for use: he is writing to BP to indicate that he does not object in principle to deals of this kind. BP may decide to publish the letter.]

Points to make

(i) Effect of Treasury proposals is to prevent the very large amount of past unrelieved expenditure from being set against income acquired through a farm in. Incentives for current and future exploration are maintained.

(ii) If BP decides to proceed, its application for assignments of its licence interests will be considered in the normal way when firm proposals are put to the Secretary of State. But the Government does not see any objection in principle to transaction of this type within the revised tax framework.

Defensive briefing

How much revenue will the measure save?
Impossible to quantify but the measure is to protect the existing forecast revenue not to raise new revenue. We estimate there is currently around £1,200 million of unrelieved expenditure. The measure prevents this expenditure being relieved.

If BP go ahead what is the cost?
Cannot quantify. That depends on how much drilling expenditure is currently going on which is not relieved and how closely BP are able to match sales of interests in Forties to the companies who have this unrelieved expenditure.

What vehicle will be used to enact the legislation?
The 1984 Finance Bill.

What effect will this have on BP's plans?
This is a matter for the Company.

Is the Government going back on 1983 Budget concessions?
No. Fully consistent with 1983 Budget measures which were designed to encourage future exploration and appraisal. Tax measure ensures that cost does not become very much greater through these new transactions. Budget provisions not being withdrawn.

Do the proposals discriminate against small companies, many of which are British?
No company is in a worse position than it was before. The measures are to prevent companies obtaining relief for expenditure incurred in the past. There is no discincentive for farm ins generally. Relief is still available for future expenditure.

Why did not the Government anticipate this type of loophole at which this prime measure is directed on framing this year's Budget proposals?
Proposals to farm out interests in mature PRT-paying fields are a relatively new phenomenon, and it is not possible or desirable to stop all forms of tax minimisation until they seem likely to be adopted.

How does the Government justify this measure and why announce it now when Parliament is in Recess?
The measure and the need to act quickly are justified to prevent an unacceptable loss of revenue from what amounts to the buying and selling of PRT relief.

Doesn't the measure offend the normal tax principle of being able to offset expenditure against income?
No. it is analogous to the corporation tax rules where a company begins a new trade. Any past losses of the old trade are available to be set off against future profits of that trade but not against profits of the new trade.

Does the action taken remove all tax incentives for farming into mature fields?
It considerably lessens the tax advantages there can be though there may still be tax advantages both in terms of PRT relief for future exploration and appraisal expenditure, which is consistent with the spirit of the Budget proposals, and on the Corporation Tax side.

INLAND REVENUE
Press Release

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13 September 1983

PRT - RELIEFS AND FARM-INS

The Chancellor of the Exchequer announced today proposals to change the PRT abortive exploration relief, appraisal and exploration relief, and allowance for unrelievable field loss as they are affected by farm-ins. He said:

"Oil companies have recently proposed selling interests in mature PRT-paying fields in the North Sea to companies without such interests. The effect of such sales would be to enable the purchasers to claim a number of PRT reliefs for costs incurred outside a field against the purchased interest. This would be extremely costly in tax revenue - we estimate that there is currently around £1200m of unrelieved expenditure. Moreover, it would not help to encourage future development to allow relief in this way for expenditure which has already been incurred.

We have therefore decided, with effect to farm-outs undertaken after today, to withdraw PRT abortive exploration relief, appraisal and exploration relief and unrelievable field loss relief against mature fields in which the claimant or an associated company became a participator after the date the expenditure was incurred or, in the case of unrelievable field loss relief, the field was accepted as finally abandoned. For this purpose, any field past the end of its first PRT chargeable period will be treated as mature. We shall be introducing legislation to this effect in the 1984 Finance Bill."

NOTE FOR EDITORS

1. BP recently announced its intention to sell about 12½ per cent of its interest in the Forties Field to other companies. It is likely that the companies who would be most interested in buying interests in such a field would be companies which have incurred expenditure on exploration and appraisal but do not have a PRT paying field against which they can set such expenditure. There is estimated to be about £1200m of unrelieved qualifying expenditure outstanding at present. The tax cost of allowing relief for such expenditure against purchased interests would be substantial and would probably largely accrue to the seller in the price. While only BP's deal has so far been publicly proposed, other companies could evidently exploit the same benefit.

2. There are three PRT reliefs which could be potentially exploited in this way: abortive exploration relief for unsuccessful exploration expenditure incurred prior to Budget Day this year; exploration and appraisal relief introduced in this year's Budget for exploration and appraisal expenditure after that date whether successful or not; and

unrelievable field loss relief for fields which are abandoned before their costs are recovered. All the expenditure available to date relates to the first two of these, and most to the pre-Budget abortive exploration relief.

3. The new and more generous exploration and appraisal relief was introduced in the Budget to encourage new activity. However, allowing this relief for past expenditure where a company buys into a mature PRT paying field does nothing to encourage new activity since the expenditure has already been spent without any expectation of relief. A company will still be able to set future exploration and appraisal against a purchased field interest. This may mean there is still some tax cost in farm-ins of this sort but there should be a corresponding increase in activity because the relief will be only available for new expenditure.

4. The proposed restriction is limited to farm-ins to mature producing fields. There is not normally any benefit to development in a farm-in at this stage in a field life since the development expenditure is already in the past. There can be positive disadvantages in increasing the number of participators in a field to an unwieldy level. Most purely commercial farm-outs are at an earlier stage when the farmer-out needs to get extra finance for development. This change in the law will not affect farm-outs prior to the end of the first chargeable period (broadly speaking, first production for the field). And even for farm-outs after this date there will be no tax disincentive; just the removal of an unjustified and costly tax incentive. At earlier stages the incentive is much less anyway, since the purchasers have to wait for relief until the field starts to pay PRT.

5. The effect of the proposed change is somewhat similar to the rules which apply for corporation tax when a trading company begins a new trade. Any past losses of its old trade are available to be set against future profits of that trade but not against the profits of its new trade. For corporation tax a company's whole oil development activities will be treated as a single trade, but for PRT each field's activity is treated separately, apart from these special reliefs for exploration, appraisal and unrelieved losses on abandoned fields. Expenditure prior to the purchase will still be eligible for PRT relief against interests in other fields which the company has held since before the start-up of production. And in the case of successful exploration and appraisal, the expenditure can, as an alternative, be carried forward and set off with a 35 per cent uplift against the income of the discovered field itself.

6. It is up to companies like BP to decide in the light of this announcement whether they wish to go ahead with proposed farm-outs. It remains for the Secretary of State for Energy to consider any proposals for licence assignments in the normal way once prospective purchasers have been identified.

7. The proposed change will take effect for farm-ins after today. The tax yield will depend on the number of such deals which would have taken place without such an announcement; in any event it is a measure to protect the existing forecast revenue not to raise new revenue.
