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Prime Minister

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PRIME MINISTER

NORTH SEA FISCAL REGIME

Since the Budget I have been carrying out a further review, in close consultation with the Secretary of State for Energy, of my proposals for changes in the North Sea Fiscal Regime (on which I minuted you on 26 February, and on which your Private Secretary reported your comments in his letter of 1 March). The review has taken into account both the uncertain current state of the oil markets, the representations of the industry on the regime generally and my Budget proposals in particular, and your own concern that the regime might be too onerous and inhibit desirable exploration and development. I thought it right to tell you our conclusions.

2. Both Nigel Lawson and I believe that the level of development that is likely to be achieved at the present time is not likely to be sensitive to the kind of tax changes that we could sensibly make. There has been some hardening of the oil market since the Budget but there is still of course considerable uncertainty about the future of oil prices in both the short and long term. We have therefore looked at the profitability of both existing fields and likely future developments again against a wide range of oil price scenarios including a fall as steep and steeper than any that has yet occurred. The results still look generally attractive and robust.

3. It is true that there has been recent publicity given to company decisions to defer particular projects. But the companies admit, and our own evidence suggests, that other factors - such as uncertainty on oil prices or technical problems - have been as or more important than the tax regime. The Department of Energy is actively discussing with the companies concerned some projects which are expected to proceed before long. Tax concessions sufficient to produce a marked change in the pace of development would have to be very large indeed.

4. In Mr Scholar's note of 1 March it was suggested that without larger reductions in tax, companies might be encouraged to boost their production in order to maintain profits. In practice, the need to recover capital costs as quickly as possible leads companies generally to produce as fast as they can regardless of tax. Department of Energy's development controls prevent companies producing faster than good oil field practice would permit and they are already producing up to that level. So we do not fear distortions on that account.

5. We have therefore concentrated our attention, not on ways of reducing the overall level of take, but on ways of reducing the impact of APRT on some of the less profitable fields. Small fields, which are likely to predominate among the marginal fields of the future, already pay a much lower level of tax than large fields, because of the protection given to them by the PRT and APRT oil allowances. The average rate of tax on small fields is generally only about 60-65 per cent compared with 85-90 per cent for the large fields. I would propose to add to these benefits

by the following concessions:

a) APRT to be repaid after 5 years (rather than at end of field life) if it has not by then been set off against ordinary PRT.

b) No further liability to APRT for a field once 5 years have elapsed since first APRT payment.

c) APRT to be allowed as a deduction in computing "payback" for PRT (so slightly prolonging availability of certain reliefs in some circumstances).

d) A transitional provision to ease the effects of my proposals for 'smoothing' payments of PRT: this will ease cash flow problems for companies (BP in particular) in the second half of 1983.

e) Accepting the principle of an amendment put down by Sir William Clark for Finance Bill Standing Committee to make one of the technical relieving clauses (which cures an anomaly in ring fence corporation tax) retrospective for two years. The industry (including Shell and ICI) has pressed for this.

6. The overall cost of these concessions would be around £100m over the period up to 1986-87. Repayments of APRT would not arise before 1988, and the cost (perhaps around £100m in that year) will depend on oil prices between now and then.

7. We have also agreed to continue discussions at working level with the industry to explore their concerns on incremental investment and marginal fields. This will allow us to have a closer look at the analytical basis for some of their assertions, but I hope also to convince them that stability on the basis of the latest structural proposals is preferable to any further review of the tax structure as a whole. Nigel Lawson is in the meantime looking further at possible schemes for using royalty refunds to assist marginal fields.

8. I propose to make these changes by way of amendment at Committee Stage. I shall announce the proposed changes as a package later this week so that their overall effect is not lost. The whole package should help to meet some of the industry's main concerns.

9. I am copying this minute to Nigel Lawson.

GH

(G.H.)
7 June 1982