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CONFIDENTIAL

MR TURNBULL   8 February 1985

NORTH SEA FISCAL REGIME

Peter Walker is:

"Very alarmed indeed at the suggestion that significant reductions should be made in the allowances against Corporation Tax for expenditure on exploration and appraisal drilling in the North Sea. Such action would seem particularly insensitive and inappropriate now. The markets have been punishing sterling because they expect our national return from the North Sea to decline. We risk a "banana skin" if we invite the comment that we are taking measures in our tax policy which could accelerate any decline."

He is right to be concerned about deterring exploration, but I would question whether the Chancellor's proposal will be as harmful as suggested.

Physically, exploration is becoming more difficult and less rewarding as the search moves to the smaller and more complex structures. For the oil companies this is offset by the UK oil taxation regime with its high marginal rates of tax. The growing number of companies with production subject to PRT and CT can immediately write off exploration expenditure against taxable income. Thereby the net cost of exploration is around 17p for every £1 of gross expenditure.

The Chancellor's proposal not to make the oil industry an exception to the normal corporation tax rules covering scientific research - which successful exploration is treated as - is estimated to increase the net cost of exploration by tax-paying companies to 25p in the pound.

Of course there will be protests, but in my view the change will neither:

- markedly tip the balance against exploration;

- nor in the event of a discovery, discourage development.

In any case, there are other ways of preserving a favourable commercial climate around the UK oil and gas sector. One such was the decision not to endorse the Sleipner contract. Also, it is important that the Government clearly flags its intention of inducing the maximum recovery from the first generation of large producing fields. Timing is important because we begin to risk closing off options for increasing oil and gas recovery from fields now in sight of the point of economic abandonment under normal tax and royalty rules. Nothing can be worked out for the next Budget,but a signal would be valuable. I understand that Peter Walker now feels this in spite of the previous lack of enthusiasm on the part of his officials.

Another confidence-boosting measure would be to adopt new arrangements for valuing North Sea oil production for tax purposes. When oil is transferred from producer companies to their downstream affiliates, the transfer price is deemed to equate to BNOC's official price. Whenever markets are weak and spot prices are below the official BNOC price, this increases the producer's overall tax bill. Accordingly, producers are induced to "spin" their oil through the spot market so as to establish a genuine arm's length price. Unfortunately, spinning oil through weak spot markets reinforces their weakness. It would be better for the Oil Taxation Office to use the spot market as the principal bench mark of a fair arm's length market price.

JMW.

JOHN WYBREW

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Budget

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8/2

SECRETARY OF STATE FOR ENERGY
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The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
Treasury Chambers
Parliament Street
LONDON
SW1P 3AG

8 February 1985

Dear Nigel

NORTH SEA FISCAL REGIME

In my letter to you of 30 January, I promised to write again when I had examined further the position on incremental investment. I have now done this, and have also considered the other Budget issues raised in the Steering Group's report.

My starting position on this issue is that we should look very positively at tax concessions designed to stimulate increased production from the North Sea, so long as that production is economic. I believe that was yours too when you said in the 1984 Budget speech that "the Government is already committed to a study of the economics of incremental investment in existing fields. This is of increasing importance and, in consultation with my Rt Hon Friend the Secretary of State for Energy, I therefore proposal to review this area with the industry and to legislate as appropriate next year to improve the position".

Since your Budget announcement a great deal of work has been done by UKOOA and the oil companies. Last week UKOOA published a booklet aimed at MPs which sets out their case. Several of the major companies operating in the North Sea have seen me to communicate their anxieties that action should be taken in order to encourage incremental investment in existing fields.

My judgement is that at present we do not have an acceptable proposal which would provide incentives for a much higher level of incremental investment, whilst not also providing tax benefits to investments that would take place in any event.

I am confident however that a practical scheme could be worked out. I would therefore ask you to state in the Budget that the consultations you announced last year will be continuing and that you will come to conclusions when these consultations are completed.

I have already made clear my strong objections to any proposal to reduce corporation tax allowances for exploration and appraisal drilling in the 1985 Budget. My objections apply also to any parallel proposal to reduce corporation tax allowances for certain development drilling expenditure. Indeed, such a reduction would be particularly objectionable as it would have a direct adverse effect on incremental projects.

With respect to onshore fields, I feel that the right course is to take no action in 1985, but to ask officials to review fully the possibilities for fiscal action in 1986 and 1987. As I pointed out in my letter to John Moore of 7 November, the sums at risk over the next year or two are relatively small.

I see no difficulty with the technical amendments proposed on extended production tests, or on disposal of Head Offices, within a Budget which maintains the hope of a concession on incrementals, but is otherwise the first "no change" Budget for the North Sea since 1978.

I am copying this to the Prime Minister.

Peter

PETER WALKER

Econ Pol: Budget Pt 13.

WBPM

AT 30/1

01 211 6402

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
Parliament Street
LONDON
SW1P 3AG

30 January 1985

NORTH SEA FISCAL REGIME

I understand from my officials that you will shortly be considering possible changes that might be introduced in the 1985 Budget in respect of the North Sea Fiscal Regime. I think it is important you should have my views quickly on the main points.

I am very alarmed indeed at the suggestion that significant reductions should be made in the allowances against corporation tax for expenditure on exploration and appraisal drilling in the North Sea. Such action would seem particularly insensitive and inappropriate now. The markets have been punishing sterling because they expect our national return from the North Sea to decline. We risk a "banana skin" if we invite the comment that we are taking measures in our tax policy which could accelerate any decline.

The work that my officials have done with yours in recent weeks shows that such reductions would have a serious effect on the rate of exploration and appraisal activity. But even more damaging would be the effect on company confidence. The changes suggested would be seen as a partial reversal of one of the measures in the 1983 budget, which were expressly designed to boost confidence and activity, and which you yourself worked very hard to secure. Company confidence is now in a very fragile state on account of oil market uncertainties, and the rise in interest rates will obviously not have helped in maintaining it. Both factors could reduce prospective returns. An apparent reversal of policies now could make all the difference between companies maintaining a high level of exploration and appraisal and pushing them into drastically cutting back on such activity. This would be most damaging to offshore activity generally, and would put at risk much of what has been gained over the past two years. UKOOA, BRINDEX and individual companies have made clear their strong and genuine opposition to any reduction in allowances.

The timing would also be particularly unfortunate in regard to the Ninth Round of offshore licensing. By Budget Day prospective licensees will be in the midst of negotiating programmes of exploration drilling.

An increase in the after tax cost of such drilling would lead to delay and embarrassment to the Government whilst companies reassessed their application. The success of this and later Rounds might be thrown into doubt.

Therefore I hope that you will not consider this idea further. Its potential yield is trivial compared with the £2 billion or so of extra revenue which you would expect to derive from the oil and gas industry in 1985/86 because of the fall in sterling. And a substantial part of that amounts to an increase in the tax burden rather than reflecting a genuine increase in taxable capacity.

On incremental investment, I note that the studies by officials have led to the conclusion that no concession is economically justifiable. There is a risk that a decision to take no action, following the encouraging announcement you made in the 1984 Budget, will lead to a bad reaction from the industry and a loss in confidence. I am considering this urgently and will write to you again in the near future.

I am copying this to the Prime Minister.

PETER WALKER

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30 JAN 1985