



NOTE OF A MEETING HELD IN No.11 DOWNING STREET AT 4.10 pm
ON TUESDAY, 12 FEBRUARY 1985

Those present:

Chancellor of the Exchequer
Financial Secretary
Mr Cassell
Mr Crawley - IR

Secretary of State for Energy
Minister of State
Sir Kenneth Couzens
Dr Myerscough

NORTH SEA FISCAL REGIME

Opening the meeting, the Chancellor said that he had to view changes in the North Sea fiscal regime against the background of a very tight budgetary situation. He pointed out that the North Sea oil industry had benefited substantially from the 1984 corporation tax changes, although clearly he had not been able to make this point publicly.

2. Turning to his specific proposals, the Chancellor noted that officials had undertaken an extremely thorough review of incrementals and the outcome had clearly indicated that there was no case for any Government action. On exploration and appraisal allowances, he drew attention to the direct link with his 1984 reforms. He thought there was a very strong case for saying that expenditure in this area should no longer be eligible for the Scientific Research Allowance (SRA) but should simply receive a 25 per cent reducing balance allowance. However, this expenditure had hitherto been eligible for the 100 per cent SRA and he was proposing to retain the SRA at 100 per cent for genuine scientific research. He therefore proposed that expenditure on exploration and appraisal should



receive a 25 per cent reducing balance allowance but that there should be immediate write-off if and when expenditure became abortive, or after five years if there had been no commercial decision to develop by then. He pointed out that his proposal on the SRA would in itself be of benefit to the oil industry.

3. On "New Brunswick", the Chancellor said he had been inclined to put this expenditure on a 25 per cent reducing basis too but that if the Secretary of State thought this was an issue to which the industry would attach importance, he would be prepared to agree that the existing revenue treatment should not be changed this year. Finally, the Chancellor mentioned that he was planning to remove PRT relief for onshore exploration and appraisal, pointing out that the onshore industry was very profitable so that the case for withdrawing the relief was very strong.

4. The Financial Secretary mentioned two further minor items. First, Treasury Ministers were planning to reduce relief for expenditure on extended production tests by any test income. He pointed out that only small sums were involved. Second, Ministers were proposing to make another technical change related to extended production tests. He pointed out that both the Chancellor's departments and the Department of Energy thought there were anomalies here which could be set right in the context of the other more general alterations to the regime.

5. The Secretary of State for Energy suggested that as a result of the falling dollar exchange rate and the changed prospect for the petrol and oil market in the UK, the tax burden on the North Sea oil industry had increased over the



past year. He believed that the industry had probably enjoyed a net benefit of around £55 million in 1984-85 as a result of the Budget changes. The Chancellor's proposals for 1985 would, however, amount to a net loss of £90 million. The Chancellor noted that the decline in the dollar exchange rate would, in fact, increase the industry's profits but the Secretary of State drew attention to the enormous losses suffered on downstream activities and Sir Kenneth Couzens suggested that as a result of higher profits, North Sea companies were now being pushed into the top PRT bracket. The Chancellor thought it important to consider the long-standing downstream problem separately, in the context of the industry's overall activities. He stressed that the North Sea fiscal regime was now a very favourable one, following the 1983 changes.

6. The Secretary of State for Energy noted that the Chancellor had made a very positive reference to incrementals in his 1984 Budget Speech. He therefore thought there was a need for some action this year. He believed it would suffice to say that extensive studies had been undertaken: as a result, the Government believed that no fiscal action was required at this stage, but it would continue to review the situation. The Secretary of State added that any relief would have to be targeted. All the major oil companies believed that it was possible to devise a relief of this kind and he therefore thought it would be a great tactical error to refuse to countenance any proposals which the industry might put forward. The Minister of State added that individual companies were even now examining the problem and the Secretary of State suggested that a statement on the lines he had proposed would cost the Government nothing.

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7. The Chancellor noted that the UKOOA campaign on this issue had been a relatively small one. If officials had been able to devise a properly targeted relief for incrementals, he suspected that Ministers would probably have been prepared to introduce it but no satisfactory measure had come to light despite an extensive search. He noted he had promised in last year's Budget Speech that any action introduced in 1985 would be backdated to 1984. This undertaking could clearly not apply to any action taken in a subsequent year. He would think further about the point which the Secretary of State had put to him but he stressed that he did not want to mislead the industry by appearing to promise action where none was in prospect.

8. The Secretary of State for Energy emphasised that the industry was already nervous about a potential slide in oil prices. If it believed that the Government was attempting to reverse its fiscal stance for the North Sea, confidence could be badly shaken. The Chancellor replied that if there were a complete collapse of the oil price, the Government would clearly have to look again at the whole North Sea tax regime but naturally he could not commit himself to do so publicly. Meanwhile, he had to take his 1985 Budget decisions in the light of current conditions and the pressure for exemptions to the capital allowance regime which had risen on other fronts.

9. The Financial Secretary pointed out that the changes which Treasury Ministers had in mind would not have a large impact on the industry. The Chancellor commented that these



losses would be totally overshadowed by the benefits accruing to the industry from his 1984 corporation tax reforms. Over the period 1984-85 to 1988-89, these would reduce the industry's tax burden by £1.2 billion, compared with an annual average loss under Option B of £65 million.

10. Sir Kenneth Couzens pointed out that, unfortunately, last year's benefits had gone to the developed fields such as Forties and Brent, while the adverse changes now proposed were directed towards exploration and appraisal. The Chancellor explained that this was why he was prepared to introduce immediate write-off for abortive exploration and appraisal expenditure which in practice represented a significant concession. However, he stressed that he had to take some action on these allowances in order successfully to resist pressure from other industries, such as shipping, which were also seeking exemptions to the general capital allowance regime.

11. The Secretary of State for Energy noted that the figures which the Chancellor had quoted for the benefit to the oil industry of the 1984 corporation tax changes were higher than those which he himself had seen. He asked the reason for this. Mr Crawley explained that these were the figures which had emerged from the latest forecast. Part of the change could be accounted for by different estimates of company expenditure supplied to the forecasters by the Department of Energy. The Chancellor suggested that his officials should supply the Department of Energy with a detailed breakdown of the new forecast. Nevertheless, the Financial Secretary pointed out that the changes advocated by the Treasury and Inland Revenue had been proposed before the latest figures were available and the Chancellor noted that despite the changes now proposed, the North Sea fiscal regime was still a good one compared with that in place in other countries.

BUDGET CONFIDENTIAL



12. The Secretary of State said that following the Budget changes in 1983 and 1984, his concern was that the action proposed for 1985 might look like a reversal of policy. The Chancellor stressed that he had never claimed publicly that the 1984 changes would benefit the oil industry and that the action he was proposing for 1985 would clawback only some of the improvements in the regime. He had said last year that he would be examining the SRA and it had been clear from his remarks that any change would be bound to amount to a reduction in the relief. Sir Kenneth Couzens suggested that there would be greater value in continuing the allowance for exploration and appraisal at 100 per cent than maintaining a 100 per cent SRA. The Chancellor replied that this was perhaps an argument for reducing the SRA too.

13. Sir Kenneth Couzens referred to the weakness of sterling. He believed that this could in part be attributed to the fact that the markets had written down the value of the North Sea to the UK economy. He thought that the recent Sleipner announcement and the publicity given to the Ninth Round should have gone some way to counteract this. But it was also vital to rebuild the oil industry's confidence. The Department of Energy were therefore particularly concerned about the Chancellor's proposals on appraisal and exploration drilling, notwithstanding his concession on the immediate write-off of abortive expenditure. The Secretary of State stressed that this was highly marginal development where any adverse change in the tax regime could have a damaging effect.

14. The Chancellor doubted whether the changes he had in mind would have an effect on the behaviour of the companies concerned. He pointed out that these factors were much less important than others which the industry would be bound to take into account. The oil companies had enormous cashflows



at present. Their earlier experience of diversification had been an unhappy one, so they were likely to wish to continue to invest in oil and the UK tax regime was a particularly favourable one for them.

15. The Minister of State expressed his genuine concern about the effect of the proposed changes on the Ninth Round. The signs were that the industry was prepared to take a bigger risk on this occasion and that more small and medium-sized companies were involved. He therefore foresaw a real danger that a number would withdraw. The Chancellor emphasised that the major risk for such companies was that of drilling a dry well. In such cases, he was permitting immediate write-off.

16. The Secretary of State said that he would welcome a breakdown of the revised CT forecast. Once he had this, he would discuss with the Financial Secretary his response to the Chancellor's proposals. The Minister of State said that he would also like to look at the technical problems associated with writing-off expenditure immediately in the case of dry wells. He feared that in practice there could be some delay before the relief could be claimed.

17. The meeting closed at 4.55 pm.

Distribution

Those present
 Chief Secretary
 Minister of State
 Economic Secretary
 Sir P Middleton
 Sir T Burns
 Mr Littler
 Mr Bailey
 Mr Monck
 Mr Battishill
 Mr Burgner
 Mr Monger
 Mr Robson
 Mr Cropper
 PS/IR

MOM
 MISS M O'MARA