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10 DOWNING STREET

THE PRIME MINISTER

30 January 1985

Dear Patrick,

I am sorry that my answer to your Question yesterday afternoon, on limiting North Sea production, was not entirely correct. As you quite rightly said, the Government retains reserve powers to limit North Sea production. Under the terms of the licences, production must have the consent of the Secretary of State for Energy, and the levels of production for which consents have presently been granted could over time be varied.

But as I sought to say, the central issue is not what powers may technically be available, but the Government's overall policy towards the oil industry, which is of very great importance to us. Successive governments have aimed to create a climate of confidence to assure the very major investment decisions required for successful exploitations of th offshore petroleum resources, and to ensure the maximum benefit to the nation. Specific assurances have been given on the use of these particular powers. And you will probably recall that, in reply to the Select Committee on Energy's 3rd Report 1981-82, the Government agreed that such reserve powers should be retained, but would not be used lightly. The Government agreed with the Committee that the circumstances in which they might be used would relate to specific and overriding circumstances in the national interest or to a radical change in circumstances pertaining to the UKCS and its development.

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Britain, with some 5 per cent of world oil production, is not in a position to exert any substantial measure of control or leverage over world oil prices. A move to cut UK production would impose very clear and tangible losses on the nation, while there is great uncertainty about any potential benefits. The use of these powers in present market circumstances is therefore not justified. As I remarked, the policy of the United States is really very similar. With four times our production their potential influence is much greater than ours if they saw a balance of advantage in seeking to hold back production.

Yours ever

Margaret

Patrick McNair-Wilson, Esq., M.P.

AT Briefing from Energy on oil production.

PRODUCTION CONTROLS

Background Note

1. Under the terms of model clauses incorporated in every licence, oil can be produced only with the consent of the Secretary of State for Energy. A production profile is negotiated as part of the development plan. The Department insists on a stringent interpretation of the requirements of "good oilfield practice" ie minimising risks of damage to the reservoir or of reducing ultimate economic recovery. Operators often seek production increases as development work improves knowledge of the reservoir characteristics, but this is not always agreed; sometimes the consent level is reduced. Consent levels are averages for the period, and there are no controls on daily or monthly production as such. But production has on occasion had to be reduced or shut in in order to remain within the consent.

2. About half of UK production comes from fields covered by short term consents, usually of 6 months' validity. These cannot be varied during their term without the licensees' agreement. Other fields have longer term approvals or consents. In most cases these can be varied after an initial period of immunity, but 6 months notice must be given, cuts are limited to 20% at most and the SOS must consider any representation made by the licensees on relevant technical or financial matters. A few SMALL fields have long term consents which cannot be varied.

3. In addition to legal constraints, Ministerial assurances have been given on the possible incidence of production cuts. These limit cuts to 20% at most, even where that is not legal requirement. In some fields, even 20% might damage long term recovery and would not be attainable in practice. Also, all fields are assured of an initial immunity period, typically 4-5 years.

4. Overall it would be possible to impose cuts, at a minimum of 6 months notice, to the extent of something less than 350,000 b/d (13% of current production). This might be increased by something less than 50,000 b/d in stages over the following 12 months. The constraints are essentially legal, and are only marginally increased by the assurances.

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Prime Minister

HOUSE OF COMMONS

LONDON SWIA OAA

31st January 1985.

Dear Prime Minister,

Thank you very much for your letter of 30th January 1985.,about my question to you,relating to the control of oil production in the North Sea.

I am most grateful to you for making the position so clear.

My only concern is that at this somewhat difficult time for sterling,which I believe will pass by mid year,we should use all the weapons available to us to protect the international value of our currency.

Whilst, I of course accept your view about the impact any production cut by us might have upon the world price of oil, I do nevertheless believe that provided we can demonstrate to Saudi Arabia,and the other big producers that we do not intend to throw caution to the wind,and engage in what they might regard as unfriendly acts, the more likely we are to see a return to stability in the oil market. This must be in our best interest.

Thank you again for so kindly writing.

Yours ever,

Patrick McNair-Wilson

Patrick McNair-Wilson.

The Rt.Hon.Margaret Thatcher M.P.

irresponsible and irrational". If that is what he thought then, I hope that that is what he thinks now, and that he thinks that the action that has been taken to stop this is right and well judged in the circumstances.

Mr. Kinnock: I do think it irresponsible and irrational, but it is the right hon. Lady who believes in the market system and not us. Her response again today will impress nobody, either at home or abroad. It is the right hon. Lady who has surrendered policy-making entirely to the whims of the market. The result is chaos, a crisis of confidence and a huge rise in interest rate burdens on both business borrowers and home buyers. Is the right hon. Lady going to change her policies in the light of that experience or will she go on with the same mixture of panic and paralysis that has brought us to this mess?

The Prime Minister: I am not quite sure whether the right hon. Gentleman is objecting to what we have done or saying that we should have done nothing. In fact, the action that my right hon. Friend took was to maintain the financial strategy that has brought inflation lower for a longer period than any other Government have done previously and which, in spite of the effects of a coal strike —*[Interruption.]*—for 10 to 11 months last year has kept the current account in surplus.

Mr. Kinnock: The right hon. Lady's strategy is coming apart at the seams, and she knows very well that it is coming apart at the seams. What we want is a real strategy to give proper growth and recovery to our economy, and all we are getting from the Government, especially now, is dithering and, again this afternoon, dodging. That will only mean more on the dole and more in debt. We have not a crisis of confidence in the country but an absence of confidence in the Government. Are the Government willing to change their policies and will the Prime Minister really help by chucking out the Chancellor?

The Prime Minister: The action taken has been such as to impose financial discipline on all sections of the economy, including the Government. I remind the right hon. Gentleman that gross domestic product is at its highest ever level. I hope that he is pleased about that. Fixed investment across the economy is at its highest ever real level. Retail sales are at their highest ever real level; they have increased by 4 per cent. in volume. Profits increased by 20 per cent.—*[Interruption.]*—in the first three quarters of 1984. The Government's record on inflation is second to none. If the right hon. Gentleman listens to what is being said about unemployment he will understand that the most important thing in tackling unemployment is to keep down inflation.

Several Hon. Members *rose*——

Mr. Speaker: Order. I repeat what I said last week during Prime Minister's Questions. The Leader of the Opposition gets a fair hearing and it is only right that the Prime Minister should get an equally fair hearing.

Mr. Hordern: As interest rates have been increased to a level that must put at rest any fears that there may have been about inflation and as the markets are now offering the best opportunity ever seen for our exporters and businessmen to do business abroad, what reason have we to complain?

The Prime Minister: As my hon. Friend will be aware, markets are opening up because of the strength of the dollar and the weakness of sterling compared with the dollar. He will be aware also that it is vital to stay competitive on wage costs. The people who can benefit most from that are those who are best able to take advantage of the present exchange rate. My hon. Friend will know that our wage costs are rising and that the Opposition support every wage claim. At the same time, the wage costs of our competitors are either remaining stable of decreasing. If the Opposition want to improve the prospect of employment they must help to keep down unit wage costs.

Mr. Patrick McNair-Wilson: As, in part, sterling's problems stem from uncertainty over oil prices, and as overproduction at a time of depressed demand leads to a disorderly market, will my right hon. Friend confirm that the Government have reserve powers to limit production and depletion in the North sea? Will she consider using these to underpin the light crude oil price and so help to bring back stability to the oil market?

The Prime Minister: The policy that we pursue is really the same as that of the United States. We do not have powers to restrict production in the North sea but, we have powers to purchase 51 per cent. of that production at whatever is the market price. I think that we must stick to that.

Mr. Steel: When will the Prime Minister recognise that the rest of the world does not share her rosy view about her handling of the economy and that it is possible that the rest of the world is right and that she is wrong? Since she spoke on "Woman's Hour" and said that the pound was undervalued she has had to increase interest rates to their highest level for 150 years. Will she explain to the House why it is that the pound does not do what she tells it to do?

The Prime Minister: I note what the right hon. Gentleman says about interest rates. He will note that interest rates in real terms are not as high as they have been in the United States, and I am often urged to follow the course of the United States.

Q2. **Mr. Willie W. Hamilton** asked the Prime Minister if she will list her official engagements for 29 January.

The Prime Minister: I refer the hon. Gentleman to the reply that I gave some moments ago.

Mr. Hamilton: In view of the shambles in which the Prime Minister finds herself, does she not think that it is now appropriate for her to dispose of the Chancellor of the Exchequer, in the national interest? As she cannot find a satisfactory alternative, will she say whether the promised tax concessions will be implemented in the Budget? If they are, will that result in more new real jobs, in her terms?

The Prime Minister: I think that the hon. Gentleman must await the Budget. I remind him that the Government have raised the thresholds of personal taxation by 16 per cent. That means that income that is tax-free has been increased by 16 per cent. The previous Labour Government lowered thresholds.

Mr. Grylls: Does my right hon. Friend accept that, although the high interest rates that have had to be introduced are a worry and a difficulty for industry, business in Britain will, nevertheless, support the Government while they continue to keep inflation down? Indeed, business would probably send the Government a

Mr. Kirkwood: Will the Secretary of State confirm that it will be no part of the review that he announced earlier that he will allow the Americans to stockpile chemical weapons in British bases?

Mr. Heseltine: I have no proposals of that sort before me.

Ethiopia (RAF Aircraft)

12. **Mr. Wallace** asked the Secretary of State for Defence if he will extend the Ethiopian tour of duty of Royal Air Force transport planes for a further three months.

Mr. Stanley: Our offer to extend the airlift to the end of March and to review the position again nearer that time, has been accepted by the Ethiopian Government. I am glad to tell the House that the British RAF and Army detachment in Ethiopia has now airlifted some 6,000 tonnes of relief supplies, and has taken part in recent trials in the air dropping of supplies to more inaccessible parts of the famine area.

Mr. Wallace: I think that hon. Members on both sides of the House will pay tribute to the work done by the RAF. The public, having responded so well to the appeals that have been made, think that it is important, both for distribution purposes and psychologically, that the Government continue their commitment. Will the Minister give the House more reassurance about the future extent to which food can be taken to the Tigré and Eritrea regions of Ethiopia by the RAF?

Mr. Stanley: I am grateful to the hon. Gentleman for what he said about the contributions made by the armed services. Undoubtedly, they have been strikingly effective in the utilisation of the two Hercules that we have out there. We shall continue the dropping operation by conventional landing techniques, but, as I have said, we have just started exploring the possibility of air dropping. Whether we shall be able to do that will depend on whether we can put together arrangements for the landing of ground parties, which is obviously crucial when dropping by free fall.

Sir Hector Monro: Will my right hon. Friend go further and warmly congratulate the Hercules squadron —both the aircrew on their exceptional airmanship and the ground crew on their exceptional servicing record— thus keeping the squadron going on short runways and in difficult conditions, and thereby playing an important part in the relief of this difficult part of east Africa?

Mr. Stanley: I am most grateful to my hon. Friend. I can certainly bear witness, from my experience out there just before Christmas, of the difficult landing and take-off conditions that the RAF has successfully dealt with, not least in coping with the considerable problems represented by the bird strikes, which took out about 9ft of the leading edge of one of the wings of the Hercules just before Christmas. All concerned have done outstandingly well.

Mr. O'Neill: I congratulate the Government on their work, but will the Minister confirm that the cost of the work is being borne by the Ministry of Defence and will not be coming out of the overseas development budget?

Mr. Stanley: No, that is not quite correct. For the first three months of our contribution the costs were borne exclusively by the Ministry of Defence, on the defence budget. With the extension of the operation from the beginning of February we have agreed to share the costs equally between the Overseas Development Administration and the Ministry of Defence.

Royal Observer Corps

13. **Mr. John M. Taylor** asked the Secretary of State for Defence when he last reviewed the role and resources of the Royal Observer Corps; and if he will make a statement.

Mr. Lee: The role and resources of the Royal Observer Corps are kept under regular consideration in conjunction with the Home Office. The corps continues to provide an excellent service and there are no present plans for a review.

Mr. Taylor: While I thank my hon. Friend for his reply, may I ask him to say whether he is committed to sustaining the resources and morale of those who serve the Royal Observer Corps and will he from time to time say how the great majority of the British people appreciate its vigilance?

Mr. Lee: I am delighted to have this opportunity of paying tribute to the Royal Observer Corps. Its morale is excellent. It does a first-class job for us. There are 11,000 serving members at present and the corps costs less than £5 million a year. It is a first-class unit.

PRIME MINISTER

Engagements

Q1. **Mr. Dykes** asked the Prime Minister if she will list her official engagements for Tuesday 29 January.

The Prime Minister (Mrs. Margaret Thatcher): This morning I had meetings with ministerial colleagues and others. In addition to my duties in the House I shall be having further meetings later today.

Mr. Dykes: As there still is very great public anxiety on the subject, will my right hon. Friend undertake this afternoon to look at the subject again and reassure the House and the nation that the Government will look twice at the dangers of imposing any additional forms of taxation on pension funds or lump sum payments?

The Prime Minister: I recognise the concern about this subject. I refer my hon. Friend to the statement that was made in the House, in response to questions, by my right hon. Friend the Chancellor of the Exchequer. As my hon. Friend will be the first to appreciate, I cannot say anything more at the present time, but I do urge him to look at that statement by my right hon. Friend.

Mr. Kinnock: Three weeks ago the Government were against the idea of increasing interest rates to defend sterling, but they did increase them and it did not work. Two weeks ago the Government scorned the idea of intervening to defend sterling, but they did intervene and it did not work. Can the Prime Minister tell us what she is going to do now?

The Prime Minister: I recall the right hon. Gentleman saying on 15 January that he was absolutely against speculation against the pound and that he thought it was

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HOUSE OF COMMONS

FIRST REPORT FROM THE

ENERGY COMMITTEE

TOGETHER WITH AN APPENDIX
AND MINUTES OF PROCEEDINGS

Session 1982—83

NORTH SEA OIL DEPLETION POLICY: THE GOVERNMENT'S OBSERVATIONS ON THE COMMITTEE'S THIRD REPORT OF SESSION 1981–82

Ordered by The House of Commons *to be printed*
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MINUTES OF PROCEEDINGS RELATING TO THE CONSIDERATION OF THE REPORT

MONDAY 20TH DECEMBER 1982

Members present:

Mr Ian Lloyd, in the Chair

Mr Michael Ancram
Mr Ednyfed Hudson Davies
Mr Ted Leadbitter
Mr Robert McCrindle
Mr Michael Morris
Mr Arthur Palmer
Mr Tony Speller
Mr Edwin Wainwright

Draft Report, proposed by the Chairman (North Sea Oil Depletion Policy, The Government's Observations on the Committee's Third Report of Session 1981–82), brought up and read.

Ordered, That the proposed Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 13 read and agreed to.

A Paper was ordered to be appended to the Report.

Ordered, That this be the First Report of the Committee to the House.

Ordered, That the Chairman do make the Report to the House.

Ordered, That the provisions of Standing Order No. 85 (Select Committees (Reports)) be applied to the Report.

APPENDIX

NORTH SEA OIL DEPLETION POLICY

Memorandum by the Secretary of State for Energy and the Chancellor of the Exchequer

Introduction

The Government welcomes the Committee's Report (published on 18 May 1982) as a thoughtful and constructive contribution to the consideration of the important question of the depletion of the nation's offshore oil reserves.

2. The Government cannot accept some of the Committee's arguments and conclusions, particularly the criticisms of the North Sea Fiscal Regime. But it agrees with the Committee's general conclusion that the emphasis at the present time should be to encourage exploration and development. The Government's objective is to maximise economic oil production over time. It has already announced that it does not intend to impose production cutbacks before 1985 at the earliest. It also considers that it would not be appropriate in the foreseeable future to delay development. There are, however, as the Committee recognise, many uncertainties on the oil scene and the Government welcomes the Commit-

tee's recommendation of the need for the Government to retain reserve powers which could be implemented should circumstances change. Meanwhile the need for good oil-field practice and the tight control of gas flaring will continue to be given high priority.

Government's Approach

3. Oil depletion policy must be consistent with the main thrust of the Government's wider economic policy objectives. As the Committee recognise, the Government has to consider very carefully both the macro- and the micro-economic effects of depletion decisions. These include the contributions current revenues make to the nation's prospects of general economic recovery; the possibility that, with rising oil prices, the revenues might ultimately be higher if production were delayed; and the effects that depletion controls might have on the thorough exploration and exploitation of the UK Continental Shelf.

4. Decisions on the rate of production would be much simpler if the future could be predicted with any certainty. As the Committee recognise, this is not possible. Uncertainties exist over world oil supply prospects, the ultimate size of the UK's recoverable reserves, the exact pattern of UK demand and supply over time, production costs, the future path of oil prices, the possible returns from alternative investments, and the particular relationships that may exist between the rate of oil production and other macro-economic factors. In particular, the future path of oil prices, which is crucial to any decision to intervene directly and sensibly to control UK oil production, is highly uncertain. The Government agrees with the Committee that clear economic advantages need to be demonstrated before a restrictive depletion policy can be justified. Such a clear economic advantage cannot be demonstrated, and in the Government's view the uncertainties are too great to justify Government action in the foreseeable future to delay UK oil production.

5. The Government attaches great importance to retaining the confidence of the UK oil industry. Depletion is one of the factors which determine the attractiveness of the UK as an operating environment for the oil companies. Other factors include licensing arrangements, the fiscal regime and political stability. The Government hopes that its recent announcement that there will not be production cuts before 1985 at the earliest, and this response to the Committee's Report, will be further encouragement to the oil industry to continue to invest in the North Sea.

6. The statement on oil depletion policy made by the then Secretary of State for Energy (The Rt Hon David Howell MP) on 23 July 1980 emphasised the major uncertainties about future levels of North Sea production and UK consumption which pointed to a flexible, case by case, approach to depletion decisions. The statement also stressed the need to ensure good oil-field practice at existing and new fields and stated the Government's intention to tighten control of gas flaring. Good oil-field practice and control of gas flaring remain essential to achieve optimum oil and gas recovery in the national interest.

7. The Report suggests (paragraph 19) that 'If the income over time from oil exploitation is maximised by the uninhibited actions of the oil companies it should also follow that Government revenues would also be maximised if the

tax system is designed to avoid distortions'. It goes on to recognise (paragraph 21) that the Government may have a different perception of the optimal depletion rate from the North Sea. This difference in perceptions may also arise at the field level. As the Committee note, the oil companies tend to use higher discount rates than the Government in valuing the streams of expenditure and income likely to arise from a new field and in assessing the attendant risks. The result is that companies will tend to put greater emphasis on high levels of production in the earlier years of field life, the Government relatively more emphasis on maximising the total amount of oil recovered over the lifetime of a field. All oil-field experience shows that too rapid a rate of depletion in the earlier years of a field's life can prejudice the total amount of oil ultimately recovered from a field. In these circumstances, it is not necessarily true that what is good for the oil companies is good for the nation. The Department of Energy therefore needs to pay particular attention to improving recovery ratios by ensuring that field development proposals are adequate to drain the likely oil accumulation(s) effectively (through the arrangement of production facilities, drilling programmes and well producing rates), and that pressure maintenance techniques are employed wherever possible at an early stage in field life.

8. The Government policy of reducing gas flaring where technically and economically feasible has succeeded in bringing it down from the peak rate of 21.5 million cubic metres a day (mcmd) in June 1979 to 12 mcmd in May 1982, while oil production has increased by 30% to its present level of around 2 million barrels a day. The purpose of reducing flaring for later recovery of the gas is to conserve a valuable resource in its own right, rather than as the Report implies (paragraph 76) to delay oil production (although that may in certain circumstances be an indirect consequence of flaring restrictions).

9. The Government agrees with the Committee that development delay is preferable to other available depletion controls. In economic terms, development delays are to be preferred to production cutbacks because costs, as well as production (and hence revenues) are delayed. Where a new field has discounted costs amounting to half its present value revenues, delay in developing the field begins to become economically attractive if oil prices rise in real terms at only half the discount rate; whereas production cuts, as the Committee recognise, only do so when the rate of increase in oil prices exceeds the discount rate.

10. Any development proposal now coming forward is unlikely to result in oil starting to flow until after the peak years of 1985–86 envisaged in the Department of Energy's central projections. In view of all the uncertainties and taking account also of the need to avoid any fluctuations in orders for new developments, in the interests of the offshore supplies industry (Report, paragraph 83), the Government agrees that there is no case in the foreseeable future for deferring new field developments. The Committee may be assured that there have not been, and will not be, any avoidable delays in consideration by the Department of Energy of new field development proposals.

11. The Government considers that what is required in the present circumstances is a pragmatic and flexible approach concentrating on:—

—the monitoring role favoured by the Committee;
—conserving gas for later recovery where technically and economically

feasible by continuing a tight flaring policy;

—encouraging further exploration (see paragraphs 15–20 below).

There is thus a wide measure of agreement between the Committee and the Government on the approach to oil depletion policy.

12. It is, however, the Government's intention to retain reserve powers of intervention, as the Committee recommend, against the possibility of some clear shift in the oil market or elsewhere which threatened to open up an important divergence between the national interest and the established pattern of depletion on the UKCS.

13. These powers will not be used lightly. The circumstances of their use would indeed relate (Report, paragraph 92) to 'specific and overriding requirements in the national interest or to a radical change in circumstances pertaining to the UKCS and its development'. The Committee gives an illustration of two such situations (Report, paragraph 46). To seek to move from illustration to specification of the conditions in which such controls would be activated (paragraph 92) is, however, unrealistic. The Government cannot responsibly constrain its ultimate freedom of manoeuvre. What it has done, and will continue to do, is to illustrate by its actions that there will be no wanton interventions to disrupt company expectations of their prospects on the UKCS. If circumstances should change such that it became necessary to consider seriously the use of reserve powers, the Government would certainly consider what assurances might be given in parallel.

14. For the reasons given above (paragraph 9), if reserve powers have to be used, development delay is to be preferred to other available options, as the Committee recognise. Royalty banking involves certain costs and potential risks for the Government, associated with the lack of incentive for companies to recover the banked oil when fields are in decline. It is not, therefore, an acceptable option.

The Longer Term—Licensing and Exploration Policy

15. The Government attaches importance, as does the Committee, to encouraging more exploration.

16. Much has already been achieved. 47 exploration wells were started in 1981—the highest number since 1977. Including appraisal drilling, 73 wells were started, a total higher than that of any of the three preceding years. Latest figures for the current year suggest that the level of exploration in 1982 will be higher still.

17. The Government has also increased the pace and scale of licensing through more regular and larger licensing rounds: the Seventh Round was as big as the two previous rounds together and attracted a high level of interest. The application rate for blocks in deep waters (up to 3000 feet), was high—22 out of 34 on offer—even though no special incentives (as proposed in paragraph 86(ii) of the Report) were offered. Altogether, 90 blocks were licensed—the highest number so far in any round since the Fourth—including 42 in areas commanding a £5 million premium. Some drilling under Seventh Round licences has already been undertaken, with encouraging results.

18. The Government proposes to license about 85 blocks in the Eighth Round. There will be a wide choice of blocks, in line with a suggestion made to the Committee by some of the companies. Areas in which there has as yet been no exploratory drilling will be opened up and further opportunities provided for exploration in the established gas province of the Southern Basin of the North Sea. The Round will for the greater part be based on the discretionary system but some blocks will be put up for auction. The terms of future licensing rounds will be kept under review.

19. The Government does not discount, as the Committee appears to do (Report, paragraph 86 (iii)), the importance of exploring territory licensed in the early rounds. These rounds involved large acreages. Until this territory has been drilled its prospectivity cannot be assessed. Some companies have tended to concentrate exploration activity in the particularly attractive territory offered in later rounds. The Government looks to the companies to increase their efforts in neglected territory.

20. The success of the Government's licensing and exploration policy will be kept under careful review as will the possible need for incentives to encourage exploration in frontier areas, such as the allocation of larger areas for individual licensing or longer periods for exploration (Report, paragraph 86(ii)).

Fiscal Regime and Depletion Policy

21. While tax must clearly be a factor to be taken into account in considering the implications of any depletion policy, the Government agrees with the Committee's view (paragraph 93 of the Report) that the fiscal regime is not (for reasons identified by the Committee) a suitable instrument for implementing such a policy, and the Government has not attempted to use it in this way. The Government's own analysis of the effects of the fiscal regime on North Sea development does however differ significantly from that made by the Committee.

The Level of Tax and Development

22. At paragraph 87 the Committee concludes from the evidence put to them that there is a substantial risk that development is being discouraged directly and indirectly by the form of the fiscal regime. The Government does not accept this conclusion. Before making its recent Budget proposals for oil taxation, the Government consulted very fully with the oil industry and considered carefully such evidence as oil companies provided on the effects of the tax regime either generally or on particular projects. In evaluating this evidence it is of course necessary to look critically at generalised assertions and so far as possible to seek more detailed evidence on the profitability of investments. The Government made its own thorough analysis of profitability both in relation to existing fields and also, on the best information available, in relation to likely future developments. The methodology used and some of the conclusions as at December 1981 were explained in the Treasury's Supplementary Memorandum (Q.2a, 2b and 3).

23. There is close and continuing consultation on this work between the Treasury, the Inland Revenue and the Department of Energy. The position is regularly updated in the light of revised forecasts of oil prices, costs and production profiles. Full use is made of the information supplied to the Department of

Energy on individual projects. Returns are examined against a variety of different assumptions. (For example, although the North Sea oil price fell by $4 just before the 1982 Budget, this was well within the price sensitivities tested.) A number of different indicators of profitability are examined, including internal post-tax real rates of return, net present values, and cash flows. Some guidance on the ranges of profitability which are likely to be regarded as acceptable by the industry can be found in evidence on existing projects, and in particular in evidence of forecast returns on these projects at the time it was decided to undertake them. On the basis of detailed analysis on these lines, and a critical appraisal of the industry's own representations, the Government believes that a wide range of potential developments in the UK Sector of the North Sea remains attractive. It considers that the fiscal regime is fully compatible with a satisfactory flow of new developments.

24. The Government has carefully examined the factors affecting the deferments mentioned by the Committee in paragraph 73 of the Report and other alleged decisions to postpone developments. It is not convinced that the level of tax has been the determining factor except in one or two cases where it appeared that the pre-1981 system was giving greatly excessive tax reliefs to incremental projects not justified in pre-tax terms. Apart from these, in cases where individual factors have been identified, other factors—in particular price uncertainties and specific technical problems—have been more significant than tax.

25. Obviously this is an area where difficult questions of judgment are involved, and the Government will bear the Committee's concern in mind. However this year's changes—apart from their important structural features (discussed below)—will reduce the burden on the companies by around £90 million in 1983–84 (allowing for the interest cost of accelerated payment). Important further modifications of the original Budget proposals were made at Committee Stage of the Finance Bill. These were designed to meet specific concerns of the industry in relation to less profitable fields. Continued discussions are being held with UKOOA on specific issues, in particular marginal fields and incremental investments in existing fields; the intention is that these should be based, so far as possible, on more detailed information than the industry has provided hitherto about post tax profitability and cash flow.

The Structure of the Tax Regime

26. As well as expressing concern about the level of tax, the Report also criticises its structure and calls for a thorough overhaul of the regime. (Some detailed comments on these criticisms are given in the Annex.) A number of important structural changes were introduced in the 1982 Budget and Finance Bill, which have now been further modified (subsequent to the Committee's Report) in a number of important respects by the changes announced by the Chancellor on 9 June. All these changes move in the direction sought by the Committee. From the beginning of 1983, the Supplementary Petroleum Duty which is based on gross revenues will lapse, and the arrangements for advance payment of PRT (APRT) will commence. While it is true that APRT will itself be calculated on the basis of gross revenues like SPD, it differs critically from SPD (which is a separate tax imposing its own permanent additional burden) in being an advance payment of PRT which is itself based on profits. It will normally

be fully set off against normal PRT liabilities once these arise. And, following the modifications announced on 9 June, liability to APRT will run for a maximum of five years for any single field and any APRT not set off within 5 years will be fully repaid then (rather than at the end of field life under the original proposals). The impact of APRT on less profitable fields has been modified to an important extent by these changes. Moreover liability to APRT (like SPD) arises only after an oil allowance of 1 million tonnes a year per field, which provides very substantial relief for smaller fields (whether these are more or less profitable).

27. It is true that APRT will still impose some tax liabilities before costs have been fully recovered. Indeed it is a main objective of APRT, like SPD before it, to ensure, following the increase in the real price of oil in the late 1970s, that the Exchequer should get some benefit from larger fields in their early years of production. Nevertheless, given that no PRT (apart from APRT) and no corporation tax are due until after costs have been fully recovered, the UK tax system still gives much more 'front end loaded' tax relief than most other tax systems. (For example, under the Norwegian system mentioned in the Appendix to the Committee's Report, relief for capital expenditure is spread over 10 years for both corporate tax and the Norwegian special tax.)

28. The Report refers (paragraph 74) to the continuing comparative complication of the North Sea fiscal regime, and also (paragraph 75) to the view of the Comptroller and Auditor General (in his Report on the Appropriation Accounts for 1980–81) that the effects of the present regime are difficult to calculate and are not readily predictable. The Government accepts that the regime remains a relatively complex one, although it believes that abolition of SPD as a separate fourth tier tax and the introduction of APRT (which has been built into the existing PRT structure and will now cease to have any relevance for any particular field within five years of first payment) achieves a modest degree of simplification. It is however inevitable in the Government's view that a regime which is designed to meet multiple objectives and to reflect the widely differing circumstances of oil development in the North Sea should be relatively complex. This is generally the case with oil tax regimes in other countries where the combination of some form of special tax with the normal corporate tax and royalties (which are a normal contractual obligation accepted by oil companies the world over) is commonly found. This complexity does, however, need to be seen in context. The taxpayers concerned are few in number, highly sophisticated and well supported by computer skills. There is no difficulty for them—or the Revenue—in calculating the effects of the regime, or the interactions of its different elements, on the basis of any given set of assumptions. There are of course major problems in predicting profitability of particular projects but this is not due to the complexity of the regime but to large uncertainties about the future of oil prices, production costs and production profiles. However the system might be simplified, these uncertainties would remain (as the Report recognised in paragraph 91).

29. The Report refers (paragraph 73) to the frequent changes in the system. It is true that it has not been possible to provide the degree of stability which had been originally hoped. But the economics of oil production changed so radically as a result of the increase in real oil prices in 1979/80 that it would have been unrealistic to expect that the level of tax or the form of its associated

main reliefs could remain unchanged. The main changes made by the present Government reflect this. There has also been a good deal of more technical legislation which has been necessary, often to meet problems put to Government by the industry. The latest changes have, of course, been made specifically in response to representations by the industry on the case for further structural changes.

A New Tax System?

30. The Report calls for a radical change in the tax system. It lists some desiderata for such a system in paragraphs 74 and 87: simplicity, stability, neutrality in its effect on incremental investments, progressivity to take account of large differences in unit costs and profitability, and a level of tax to ensure that high cost fields viable on a pre-tax basis remain so on a post-tax basis. The Government accepts these are in general terms all desirable features. There are however other objectives not referred to by the Committee—in particular the need to secure for the nation a fair proportion of the revenue from a national resource, and the need, where changes are made, to minimise disruptive transitional problems. And in the real world objectives will be found to conflict to some extent (e.g. some of the original reliefs designed to take account of differences in unit costs and profitability between fields were found to distort incentives for incremental investment, and a system which provides for rapid recovery of initial costs, and thus for a higher effective rate of tax later in field life, cannot be wholly neutral in its effect on the timing of incremental investments). What has to be achieved is a system which reconciles the various objectives to the maximum extent possible in practical terms. This can only be tested against precise proposals.

31. The structure proposed by the Government following this year's Finance Bill does in the Government's view represent a carefully considered attempt to meet so far as possible the various desiderata and objectives involved in a practical way. Apart from contractual royalties, it will be a system which, once any APRT liability has been set off or repaid, will be fully based on profits. It recognises differences in unit costs and profitability through the important PRT reliefs of oil allowance and safeguard. Detailed analysis has shown that after-tax rates of return on incremental investments after payback has been reached will, following the abolition of SPD, be very close to pretax rates of return. Small fields will pay little or no APRT or PRT (mainly due to the oil allowance) and post-tax returns are therefore not much more reduced compared with pre-tax returns than the returns of any other investment in the economy.

32. The Committee do not themselves spell out the form which they consider the tax structure would have to take to achieve the objectives more satisfactorily than the proposed system. Nor have they attempted to quantify the implications of their ideas in terms of cost (although they express the belief that the loss of revenue in the short term would be comparatively small). It is difficult for the Government to give a fully considered reaction to the Committee's ideas without knowing what sort of tax system they have in mind. The Government has devoted considerable effort and resources over the past few years to analysing a wide range of alternative tax systems, including for example schemes where tax is explicitly linked to profitability (on the lines recently proposed by the Institute of Fiscal Studies). It does not believe that these alternatives would meet the

various objectives involved more satisfactorily than the structure it now proposes. And it has noted that the industry itself is opposed to changes that would involve an unnecessary degree of structural upheaval, together with major uncertainties and significant transitional problems. The Committee themselves have stressed the objective of a greater degree of stability and the undesirability of frequent substantial changes. The Government is therefore opposed to the Committee's recommendation of another fundamental review.

33. The Government believes that the proposed oil tax system provides a reasonable compromise between conflicting objectives and a sound basis for the future. It will, of course, continue to discuss with the oil industry particular problem areas and has certainly not closed its mind to the possibility of detailed improvements if a case can be made out for these. But, as the Chancellor said in his Budget Speech, the Government hopes that the structure of the fiscal regime following this year's Finance Bill will provide a more secure and stable regime for the future, permitting development to go ahead uninhibited by major fiscal uncertainties.

The Fiscal Regime—Some Detailed Comments

Paragraph 71

The marginal rate of tax relief on an investment made after the safeguard has expired is 89.5% where the expenditure qualifies for royalty relief as conveying and treating costs under First to Fourth Round licences—the same as the marginal rate of tax on the resulting income. This results in the post-tax rate of return being very close to the pre-tax rate of return. Where royalty relief is not available and the marginal rate of relief is 85.6%, the difference is still not great. For expenditure at an earlier stage in field life the rate of relief is higher and can exceed 100% but the company normally has to wait for relief to be effective. This can result in post-tax returns being either somewhat higher or lower than pre-tax reliefs, depending on timing, but perfect neutrality is by and large not compatible with a system of front-end loaded reliefs, with tax low in the early years of a field life and high later on.

Paragraph 73

Companies paying PRT do not pay tax at a marginal rate of over 100% on North Sea profits. Because PRT is a tax on oil production profits and there is a ring fence around such profits for corporation tax, losses on activities outside the North Sea cannot be used to reduce North Sea taxes. If losses are being made at the margin outside the North Sea then the marginal rate of tax on a company's activities overall could in principle amount to over 100%. But the ring fence was introduced in 1975 precisely to stop losses outside the North Sea eroding North Sea tax take (see the Report of the PAC 1972/73) and we assume the Committee does not propose the ending of this principle which could put Government's share of North Sea revenues seriously at risk.

The paragraph suggests that when a field is paying tax at the full marginal rate of 90.28% the share of total liability taken by taxes on gross revenues is 36%. However even under the present system with SPD, it would be more accurate to say that the percentage is 22%; under the proposed regime it will be between 0 and 14%. All existing fields, and many future ones, come under the first to fourth licensing rounds where conveying and treating costs are allowed against royalties. So to the extent that these costs are allowed royalties are not based on gross revenues; SPD is (although there is a substantial oil allowance not directly related to costs) but APRT is not in that once a field is paying at the full marginal rate APRT is immediately set off against normal PRT based on profits. Under the existing regime, therefore, SPD at 20% is in practice the only tax on gross revenues, equivalent to 22% of the marginal rate. Under the proposed regime no charge on gross revenues will be imposed on fields under the first to fourth rounds, and, where royalties at $12\frac{1}{2}$% are charged under the fifth and subsequent rounds (for which conveying and treating costs are not allowed), the charge on gross revenues will be equivalent to 14% only of the marginal rate. The Committee regard it as anomalous that tax take can increase late in field life; however, this is a corollary of the principle which they stress of giving the maximum front-end loading of relief to allow the cost of investment to be recovered quickly.

Paragraph 102

The opening sentence (on the flexibility of the Norwegian regime) seems difficult to reconcile with the statement in subparagraph (ii). The Government's own analysis of the UK and Norwegian tax regimes indicates that the UK system is much more flexible in giving relief to small fields (possible including complete exemption from PRT) than the Norwegian system. The UK average tax rate over the whole of field life ranges from 60–65% for small fields to percentages in the upper 80s for the very largest. This compares with 80–85% for nearly all fields under the Norwegian system. (The problems and objectives in development in the two countries do of course differ in significant ways, as the Committee recognise.)

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