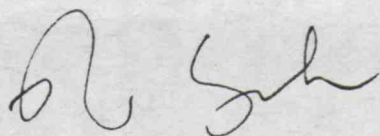


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John Moore Esq MP  
Financial Secretary  
Treasury Chambers  
Parliament Street  
LONDON  
SW1P 3AG

21 February 1985

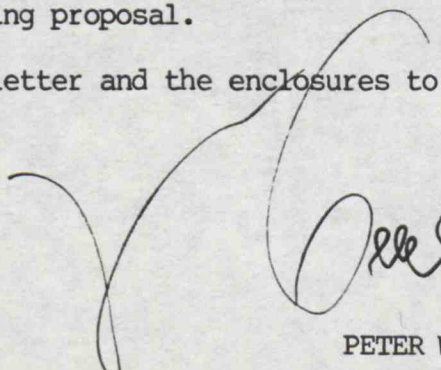


When I saw Nigel Lawson on 12 February, it was agreed that I should have a further meeting with you to consider in greater depth the North Sea fiscal proposals which Treasury and Revenue officials have submitted to Nigel. My office will be in touch with yours to arrange such a meeting at an early date.

As background to our meeting, I enclose a paper setting out my detailed views on the main proposals.

I must again reiterate that I consider the proposal to reduce the corporate tax allowances for exploration and appraisal drilling to be short-sighted and potentially very damaging, not least to the Exchequer in a few years time. It attacks the oil industry at the exploration and appraisal stage, when we want companies to take risks and show the maximum entrepreneurship. While the Exchequer will receive some £3 billion more in 1985/86 from the oil companies than expected a year ago, the proposal Nigel is considering would raise no further revenue in 1985/86 and only £20m in 1986/87. Just as the 1983 Budget had a disproportionate positive impact on confidence amongst UKCS operators, which inter alia contributed to the big upsurge in gas discoveries in 1984 (and thus to the Sleipner decision), curtailment of the relief for E & A drilling risks a much wider adverse impact on the development of the UKCS than the loss of some 15 wells a year. The fact that oil companies' confidence has been weakened by uncertainties about the future level of oil prices means that the damage caused by the proposed measure would be all the greater. And the singling out of exploration and appraisal drilling for withdrawal of relief within the present scientific research allowance would be regarded as incomprehensible, given the importance to the Exchequer and the balance of payments of maintaining North Sea development, and given the line the Chancellor took on incremental development in the 1984 Budget. I believe the only sensible course is to drop this damaging proposal.

I am sending copies of this letter and the enclosures to the Prime Minister and the Chancellor.



PETER WALKER



## BUDGET CONFIDENTIAL

### 1985 BUDGET: IMPACT OF PROPOSALS ON THE NORTH SEA

Paper by the Secretary of State for Energy

#### Introduction

1 This paper sets out my views on the Chancellor's current proposals.

#### EXPLORATION AND APPRAISAL DRILLING

2 The Chancellor's proposals with regard to exploration and appraisal drilling are by far the most important element of the package. In my view they are unacceptable because of the adverse effect they will have on confidence and activity.

3 The key points are:-

- i) The 1983 Budget had the desired effect of increasing confidence and activity.
- ii) Events over the past year have tended to detract from these beneficial effects of the 1983 Budget.
- iii) The combined effect of the 1984 Budget and the new proposals would be to benefit established interests whilst reducing the rewards of enterprise and risk-taking.
- iv) The adverse effect on confidence of the proposed measures will be out of all proportion to the revenues gained.

#### The 1983 Budget

4 This was an important success of fiscal policy. Besides the well documented and publicised effect on development activity, positive consequences have included:

- a) A much needed increase in exploration and appraisal activity, which would otherwise now be declining. I estimate that about one third (55-75) of the 182 wells drilled in 1984 resulted from the 1983 measures. The success rate of this work has remained very high.
- b) The measures have also contributed to finding new UKCS gas reserves, and paved the way for the decision not to proceed with the £30 billion purchase of Sleipner gas.
- c) Improved interest in higher risk, frontier areas, as shown by response to Ninth Round.



These effects have arisen because of the improved climate of company confidence created by the measures, as well as because of their specific economic benefits.

#### Developments since 1983

5 The latest forecast of Government take from the North Sea in 1985/6 is nearly £13 billion - £3 billion higher than forecast last year. Most of the increase arises from the fall in the dollar exchange rate; and has the effect of increasing the average proportion of North Sea revenues taken in tax. The uncertainties created by doubts about the future of the oil price, of the dollar/sterling exchange rate and of interest rates mean that confidence among oil companies is now markedly less than it was in the months immediately following the 1983 tax reliefs.

#### The 1984 Budget and the current proposals.

6 The latest estimates of the net reduction in taxes to the industry from the 1984 Budget changes is £90m a year. (£240m from general corporation tax changes, less £120m from advance corporation tax and £30m related to farm outs). But the total tax paid by the industry has since the 1984 Budget been increased by about £50m a year as a consequence of the Department's new guidelines on farm outs. Overall during 1984/5 the industry's tax burden has been reduced by about £40m a year.

7 The Chancellor's proposal on exploration and appraisal drilling would take an average of £65m a year from the industry over four years from 1986/7, ie they would, in overall cash terms, more than cancel the industry's gain in 1984. But what is more important than the overall effect on the industry is its distribution and impact on development. Whilst the gains from the 1984 Budget measures accrue to owners of existing developments, your proposed measures fall on those risk taking enterprises seeking to establish and develop new fields in the UKCS and thus prolong its life.

#### Impact on company confidence of exploration and appraisal proposals.

8 Over the last year uncertainties on the oil price, higher interest rates, and increased losses on downstream operations have combined to make the climate of confidence less strong. It would be a mistake to run the risk of a further serious impact on confidence by the proposed reduction in exploration and appraisal drilling allowances. This would react on all aspects of offshore activity. In 1983 PRT relief was extended to all exploration and appraisal drilling. The current proposal would be correctly seen as a partial reversal of the 1983 measures specifically targetted on North Sea activity. This would result in doubt about the/  
...



continued willingness of Government to maintain other parts of the 1983 package. There could well be an over-reaction which would be difficult and expensive to remedy.

9 A loss in confidence could be expected to arise quickly after the announcement of this proposal. In particular, some companies could well scale down the drilling obligations which they were prepared to take on Ninth Round blocks; this would become public knowledge and would create the impression the Government does not know what it wants. The financial benefit of the proposal, such as it is, would not arise quickly - it is zero in 1985/86 and £20 million in 1986/7. It is trifling compared to the £3 billion gain already likely.

Direct economic effects of exploration and appraisal proposals

10 Economic analysis by my Department shows that the Chancellor's proposal would remove about one fifth of the incentive to exploration and appraisal provided by the 1983 extension of PRT relief. Other, cruder analyses based on cash flow and post-tax well costs - which are important for companies - suggest bigger reductions, up to one-half. All this suggests that the proposal would reduce drilling rates by over one-fifth of 55-75 wells, say about 15 wells per year. At current success rates this would, on average, result in reserves worth some £2 billion not being discovered each year. The maintenance of production, and revenues, in the 1990s depends on such discoveries.

11 The Chancellor suggests that under this proposal dry wells would still gain 100% immediate relief. Although the details of legislation have not been considered, the Oil Taxation Office however envisage that full relief on such a well would be available only when all drilling in the same geological structure was abandoned. This might be some time later. A dry well which was followed by a successful discovery on the same structure would gain no special relief.

12 The Inland Revenue have argued that exploration and appraisal expenditure is capital and should be treated like other capital expenditure. In fact it is directed at acquiring knowledge, and only very rarely (in 2% of cases, 29 out of 1367, on the UKCS so far) is an exploration or appraisal well used for production purposes, hence becoming part of the capital assets of the field. Accounting treatment of exploration and appraisal expenditure varies around the world and is often dictated by tax laws; but in most other developed countries, companies are given 100% allowances or very rapid write offs.



## BUDGET CONFIDENTIAL

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### Incremental projects

13 Though it is clear that no sound case for a concession has yet been made out, we are all agreed that if one could be, the concession should be given. The industry clearly wants to make another attempt to convince us of the case, and if they are not given another chance, following the Chancellor's forthcoming statement last year, there will be the appearance of a 'brush off' and a bad effect on confidence. The form of words in the Budget statement should have an eye to industry confidence, and companies should be encouraged to come in with new information. I would be grateful if my officials could be consulted about the wording of the proposed letter to UKOOA.

14 With nothing on incrementals in the 1985 Budget, it is even more important that there should be no change on exploration and appraisal allowances. I welcome the fact that the proposal to reduce allowances for certain development drilling expenditure, which would have affected incrementals adversely, has been dropped.

### Minor proposals

15 Data on profitability of onshore activity is very limited but does suggest a potential for tightening the fiscal regime. However, this should be done so as to encourage discovery of new reserves, whilst ensuring that profits on the development of such reserves are properly taxed. No significant tax on profits would be lost if action were deferred to 1986, or even 1987, giving time for a thorough review of likely developments over the next few years, which would also have to take into account the statement made in the Wytch Farm sale document.

16 The effect of both withdrawing PRT relief, and reducing the allowances against corporation tax, for onshore exploration and appraisal expenditure, would be to multiply the post-tax cost of drilling by a factor of over four. This would greatly curtail the level of drilling, which has increased threefold since 1982 and has a high success rate. It would certainly throw a cloud over the forthcoming landward licensing round.

17 The other changes proposed are technical amendments or relate to new situations, and should not give rise to problems within the context of a "no change" Budget.

18 We have received some details of the other Mines and Oilwells allowance changes referred to by the Chancellor and envisaged for introduction in 1986. A benefit of £10-15 million a year will obviously be welcomed by the industry, but if it is to go to farmers-in it will counter the work done over the last two years to minimise tax losses from farm-outs. It will certainly not have any useful impact on the rate of exploration, appraisal, or development.

# INLAND REVENUE NOTES

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Notes on paper by Secretary of State for Energy ('1985 Budget: impact of proposals on the North Sea') enclosed with his letter of 21 February

## para 4: The 1983 Budget

No dispute that 1983 Budget measures were a success. But precise effect on E&A drilling levels uncertain. Energy's estimated figure (one third of 1984 drilling due to 1983 fiscal measures) seems high. Other non-tax factors (eg acreage availability, rig availability, drilling costs) have been encouraging to E&A (which was on rising trend prior to 1983 Budget). And the rest of the tax package (in particular the measures to increase future field profitability) probably more important than the PRT E&A incentive. (Prospects of profitable development are main spur to E&A). Moreover Energy's own calculations indicate that Option B would reduce the PRT E&A incentive only by one fifth.

## Para 5: Developments since 1983

It is suggested that the fall in the £ has the effect of increasing the average proportion of North Sea revenues taken in tax.

We think this analysis is mistaken. Oil taxes are taxes on net revenues (ie gross revenues less expenditure): they are not progressive like, for example, income tax (and the oil allowance is in volume, not value terms, so that its value increases proportionately on a price rise). So as tax accruals rise - because of sterling depreciation or any other oil price change - company take rises in the same proportion. This pattern can be demonstrated by feeding two different sterling price assumptions into the North Sea model, and comparing the results. For example, in 1985, the percentage increase in company take from

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an illustrative price rise of 20% would be almost exactly the same (28%) as the percentage increase in tax accruals.

Paras 6 and 7: the 1984 Budget

There is no dispute that North Sea industry gains substantially from corporate tax reforms in 1984 Finance Act - on average £240m a year (84/5-88/89). This was a widely spread benefit to North Sea industry generally. The offsets referred to (the ACT measure, FA 1984 farmout measures, new Energy licensing guidelines affecting farmouts) are not comparable. They have a very specialised distributional effect; they do not affect development; and they were fully justified in their own right. They could well have been introduced in a year without any offsetting benefit (the fiscal farmout measures in particular were primarily directed at tax avoidance).

Paras 8 and 9: impact on company confidence of E&A proposals

The likely effects on confidence and Ninth Round seem exaggerated. As pointed out, the financial impact is small in overall North Sea context. It will of course be important to present the change properly.

Paras 10-12: direct economic effects of E&A proposals

para 10. We accept that Option B would partially offset the benefit of the 1983 E&A relief by at least one-fifth (Dept of Energy's figure), or perhaps upto one third (our own estimate for 86/7 to 90/91). But we do not accept the alternative Energy figure of upto one half (which may be derived from selectively looking at first 3 years only of full impact). And we do not accept estimated reduction of 15 wells per year: we think the effect would be significantly smaller. It

follows that we think Energy's estimate of upto £2b a year reserves not being discovered is exaggerated: the effect of any E&A reduction would in any case be likely to be deferral, rather than loss, of the reserves in question.

para 11. The approach envisaged for legislation (on which costings are based) is that immediate write off as 'abortive' would not be allowed if E&A activity continued in the same area (looking for the same 'source'). It is understood that possibly some 7% of dry wells are followed by further E&A activity in same area which results in a successful discovery; and another 7% or so dry wells are followed by further unsuccessful E&A activity. (These are only rough estimates). In the first case, the costs of the dry well would only get 25% because the search does not prove eventually abortive; in the second case, the cost of the dry well would be allowed in full once the search for the source has been dropped (or after 5 years if sooner). It is therefore true that on this approach a small minority of 'dry wells' will not get immediate relief: but the great majority will.

Para 12 Accounting and tax treatment of E&A varies. A number of countries give 100%, or rapid write off. But other countries (eg Netherlands, Canada, US) treat parts at least of E&A as capital for tax purposes, and recent US tax reform proposals go further in that direction. International comparisons are an uncertain guide. We need to do what is right and consistent in UK context.

#### Paras 13 and 14: Incremental projects

The position on incrementals, and development drilling, is as set out in the Chancellor's letter of 14 February.

#### Paras 15-18 Minor proposals

The only point at issue relates to onshore fields. It



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should be noted that the proposed PRT change would bring in some £20m-£25m extra revenue over the next 3 years, and would not preclude a further revenue-raising change later this decade.

Rlc

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AT

MR FOLGER

FROM: D WALTON  
DATE: 20 FEBRUARY 1985cc PPS/Chancellor  
PS/FST  
Sir Peter Middleton  
Sir Terence Burns  
Mr Cassell  
Mr Monck  
Mr Battishill  
Mr Burgner  
Mr Evans  
Mr Allen  
Mr Davies  
Mr Culpin  
Mr Griffiths  
Mr Mowl  
Mr Robson  
Mr Hacche  
Ms Leahy  
Mr Page  
Mr Pickering o a  
Mr Pratt  
Mr Vernon  
Mr Webb  
Miss Deyes  
Mr T Jones - CSO  
Mr N Coote - CSO  
HE/17  
Mr Turnbull

Thanks, I agree. Now that Ministers are using a GDP denominator - and EAZ did not query its use when consulted over your earlier minute - let us stick with it for this round at least. But if EAZ or PE1 wanted to switch to GNP for eg the Budget briefing that would be fine by me.

MHH

20.2.85

## NORTH SEA OIL AND GAS AS A PROPORTION OF GDP

There have been a number of queries concerning my minute of 15 February on this subject. Basically it boils down to whether we should quote North Sea oil and gas as a proportion of GDP or GNP.

2. Mr Hacche referred me to the attached article from the April 1984 EPR. This explains why comparisons such as these are possibly best made using GNP. On this basis Mr Hacche estimates that in 1983 oil and gas accounted for 5¼ per cent of GNP.

3. There are two problems with this figure as I see it. The first is that the latest published figure for oil and gas as a proportion of GNP is tucked away in last year's D/En

'Brown Book' and is for 1982. This contrasts with a 1983 figure for oil and gas as a proportion of GDP readily available in Table 3.7 of the 1984 Blue Book.

4. Secondly, whatever the merits of using GNP rather than GDP in individual cases, it is GDP which is the more familiar concept and is now in use in this context. To produce a lower, "more favourable", figure using an unfamiliar concept (even though technically this might be the better comparison) that is less up to date than a comparable, readily available, published figure might just leave us open to a "sleight-of-hand" charge.

5. I think that for general non-specific briefing purposes, therefore, we should continue to use the all-purpose formulation outlined in my earlier minute, namely

"oil and gas account for about 6 per cent of GDP".

*David Walton*

DAVID WALTON

## North Sea oil and gas: contribution to GNP

Estimates of the contribution of North Sea oil and gas to gross national product (GNP) at current factor cost are set out in the table below. The contribution is defined as the total sales value of oil and gas production and services rendered, less the goods and services bought by the North Sea sector, and interest, profits and dividends (IPD) due abroad. It is the sector's contribution to GNP, rather than to gross domestic product (GDP) (which is the more common calculation in the case of other sectors in the economy), which is thought to be more relevant in the case of oil and gas, because of the significance of overseas remittances in the North Sea sector.

The contribution of North Sea oil and gas is now estimated to have been about 5¼ per cent in 1983, compared with 4¾ per cent in 1982.

### Estimates to 1988

*£ billion, current prices*

	1980	1981	1982	1983	1984	1988
Value of oil and gas sales	9.6	13.3	15.5	18.3	19.7	19.5
less goods and services purchased†	1.0	1.4	1.9	2.2	2.5	2.9
less IPD due abroad	2.2	2.4	2.6	3.0	3.2	2.7
GNP arising within sector	6.4	9.5	11.0	13.1	14.1	13.9
As % of total GNP* in that year	3¼	4½	4¾	5¼	5	4

†Defined as operating plus exploration costs less employment incomes

\*The projection of the denominator — total GDP at factor cost — is based on GDP in money terms growing at the rates assumed in the MTFS.

The sector's contribution to GNP is projected to show a slight fall in 1984, partly because of the forecast rise in total GNP this year and partly because real sterling oil prices are assumed to fall compared with their level in 1983. With oil production projected to peak over the next 2-3 years, the contribution of the sector to GNP is assumed to fall to about 4 per cent by the end of the MTFS period.

The estimates of the contribution to GNP in 1983 and 1984 are about ½ percentage point higher in each year than those made at this time in 1983. This is for the same reasons, described in the article, as government revenues have been and are expected to be higher than was assumed in last year's FSBR.

This definition of the contribution does not measure the net extent to which GNP is higher as a direct result of oil and gas production. The size of the net addition to GNP will depend on the difference between the rates of return earned by the capital and labour employed in the North Sea (and owned by UK nationals) and what they might have earned in alternative uses elsewhere.

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