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~~BUDGET~~ CONFIDENTIAL

Treasury Chambers, Parliament Street, SWIP 3AG
01-233 3000

8 March 1985

The Rt Hon Peter Walker MBE MP
Secretary of State for Energy
Department of Energy
Thames House South
Millbank
LONDON SW1

Dear Secretary of State,

John Moore has reported to me following his further discussion with you of our North Sea fiscal proposals, and I have, of course, seen your letter to him of 21 February, with its enclosed paper, as well as your letter of 4 March to me.

In the light of all this, I have now reached the following decisions on the various Budget issues affecting oil:

(a) We are agreed that no action should be taken this year on incremental investment. I will of course be prepared to look at any new evidence which the industry may provide, but I think the onus should be firmly on them to mount a case for change. The commitment to backdate any proposals for change to 1984 will in any case lapse, as I explained to you, and I am happy for your officials to be consulted on the terms of the letter which John Moore will send to UKOOA on Budget Day.

(b) In the light of my decision to retain 100 per cent capital allowances for scientific research, I have now decided that oil and gas exploration and appraisal activity should also continue to get 100 per cent relief on the present basis, subject only to a general exclusion of land from SRA. This is unlikely to have much, if any, relevance to E&A expenditure.

(c) I propose, as I have already indicated, to leave the present position on development drilling unchanged this year. But I may need to consider this further in the light of developments on the mines and oil wells allowances - see (f) below.

(d) Given the retention of 100 per cent E&A capital allowances, I propose to remove immediate PRT E&A relief for onshore fields. Onshore fields are very profitable, and there is in my view no justification for continuing to give PRT relief here, primarily at the expense of offshore yield.

(e) I propose to take action on the three other minor items we have discussed (two removing anomalies affecting extended production tests, and the third correcting a minor technical anomaly in the Oil Taxation Act 1983).

(f) Finally, on mines and oil wells allowances, my aim, as you know, is to publish proposals in a consultative document in the early summer for legislation next year.

I am sure you will particularly welcome the retention of 100 per cent allowances for exploration and appraisal expenditure.

I am copying this letter to the Prime Minister.

Yours sincerely

Margaret O'Mara

NIGEL LAWSON

(approved by the Chancellor and signed in his absence)

01 211 6402

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
Treasury Chambers
Parliament Street
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4 March 1985

Dear Nigel -

NORTH SEA FISCAL REGIME: 1985 BUDGET

As we agreed on 12 February, I have discussed further with John Moore your Budget proposals affecting the North Sea, as set out in your letter of 14 February. I attach a record of our discussion, and also some comments prepared by my officials on the notes John left.

Your main proposal is to reduce the corporation tax allowances for exploration and appraisal drilling, to raise £20 million in 1986/7 and an average of £65 million a year over the four years from then. My views on this proposal have not changed since I wrote to you on 30 January. The latest forecast of Government take from the North sea in 1985/6 is nearly £13 billion - £3 billion higher than was forecast last year (and with the dollar exchange rate at the level which applied on the day I met John, the figure could be £1 billion higher still). It would be absurd to place at risk the improved climate of confidence in the North Sea, created by the 1983 fiscal changes for which you worked so hard, and which underpins the maximisation of future revenues, for the sake of so small a short-term Exchequer gain. For several reasons, as explained in my paper and to John, the climate of confidence has become more fragile. A reduction in allowances now, specific to front end, high risk activity in the North Sea and having the effect of partially reversing one of the 1983 changes, could have a psychological impact out of all proportion to its size.

It was kind of John to suggest that officials could look further at the possible rules for allowing immediate write-off of abortive expenditure under your proposal, so as to continue such relief for dry holes. But it does seem that any set of rules could create complex problems of definition and scope for disputes with companies, and in any case such amendments would presumably reduce the Exchequer gain from the proposal still further and make it even less worth the risk.

I realise that the Inland Revenue are concerned that an apparently special treatment for North Sea oil and gas could lead to pressure for similar special treatment from other industries. But I am confident that the special nature of North Sea activity, and the special tax regime to which it is subjected, would allow such pressures to be resisted without difficulty. In any event, if the scientific research allowance continues as now there is nothing specially conspicuous about continuing also its application to exploration and appraisal drilling.

Perhaps I should explain why I regarded the net effect on the North Sea industry of the 1984 Budget as a £90 million a year benefit, not £240 million. The latter figure is, as you pointed out in your letter of 14 February, the benefit to the industry of the general corporation tax measures announced then: but we concluded in 1984 that this benefit, concentrated as it was on existing producing interests rather than new activity, should be at least partially offset, resulting in the package of measures finally agreed. Details are set out in my officials' comments on your officials' notes. In any case, it is quite wrong to consider together the 1984 benefits to the industry, which were concentrated on established producing interests, and the current proposal which would hit new, high risk activity.

On incremental projects, John said that he hoped that we could work out together a suitable form of words for the Budget speech. I am sure that this is right, and that our Departments can also agree on the wording of follow-up letters for John to send to UKOOA and for officials here to send to the individual companies involved in the study.

I am pleased that you have already said that you do not intend to pursue, at least in 1985, the proposal to reduce corporation tax allowances for certain development drilling, in view of the adverse effect a change would have on incrementals.

Finally, I remain of the view that we should not make any change this year in the allowances against PRT for onshore exploration and appraisal, but should ask for a thorough review of the onshore fiscal regime with a view to action in 1986 or 1987.

I hope that in the light of these points and the discussion I had with John, you will not pursue these proposals further. This would make for a "no change" 1985 Budget in the North Sea - the first since that of 1978.

I am copying this to the Prime Minister.

Yours
Peter

PETER WALKER

DEPARTMENT OF ENERGY COMMENTS ON INLAND REVENUE NOTES OF 26 FEBRUARY

Para. 4: the 1983 Budget

Exploration and appraisal drilling rates did rise between 1981 and 1983. But much of this rise represented a lagged response to the 1979 oil price increase. This increase led to a desire to drill many more wells in 1980 and 1981, but the drilling rigs were not available to do this. Once they did become available, and rig charter costs fell, there was a rapid rise in the drilling rate as the pent up demand was met; but without the 1983 Budget the drilling rate would have been likely to have peaked, and now to be falling.

This view of the Department of Energy, expressed earlier in Steering Group discussions, is the same as that of independent work by Petroleum Information Limited. They expressed surprise at the increased level of activity in UK waters in 1982. They argued that the only reasons for this were higher BGC offer prices (whose effect would be confined to the Southern Basin, excluded from our work) and the arrival of new, sophisticated drilling rigs, following earlier rig shortage, which had led to over supply of rigs, lower charter costs, and stacked rigs.

Para. 5: developments since 1983

The purpose of this paragraph was to put the revenue raising potential of the exploration and appraisal proposal in the context of the total revenue potential of the North Sea. We accept that the proportion of net revenues taken in tax will not have increased as a result of the fall in sterling against the dollar.

Paras. 6 and 7: the 1984 Budget

The ACT clawback proposal was brought into the 1984 Budget discussions at a late stage (on 21 February, 1984) as a means of reducing the uncovenanted benefit to existing fields arising from the general corporation tax measures. The "1984 package" eventually agreed by the Secretary of State and the Chancellor is summed up in the Chancellor's minute of 2 March 1984 to the Prime Minister, which contained the passage:

> "...I have also examined the implications for North Sea development of my wider proposals on corporation tax. North Sea companies will gain substantially from these, particularly the existing fields. As I see no reason to relax the present fiscal regime in the North Sea, this implies that these gains should be at least partially offset. I do not want to raise the rate of

Para. 11 The figures quoted for the incidence of 'dry wells' followed by other activity are very approximate, and a detailed historical analysis, which we have not had time to do, would be required to obtain more accurate figures for the UKCS. In fact, it is not clear to us how any unambiguous definition of a 'dry well' can be made. The application of such a definition would need to involve both tehnical and economic factors, ie it would effectively be discretionary. Until more work is done on this, which would be a major task, all the figures quoted here are hardly more than guesses.

Para. 12 We agree that accounting and tax treatment of exploration and appraisal varies (we commented as such on previous assertions that it was normally regarded as capital expenditure). In many other countries, to whom international oil companies could easily transfer their attention, including Norway, the treatment of exploration and appraisal is much more advantageous to companies than the Chancellor's current proposal. We also agree that we need to do what is right and consistent in the UK context. But it is clearly neither right nor consistent to treat exploration and appraisal wells (of which, as noted, only 2% have become part of the capital assets of their fields, and then only after re-working) as capital.

Paras. 13 and 14: Incremental projects

These were touched upon at the meeting and are mentioned in the Secretary of State's covering letter, herewith.

Paras. 15 to 18: Minor proposals

We would emphasise again that data on future profitability of onshore activity are very limited and a detailed study is necessary before decisions are taken. Meanwhile it seems quite wrong to attack the highest risk area of onshore activity for the sake of an average of £7-8 million a year. This course seems even more extraordinary when at the same time Mines and Oilwells allowance changes are being considered which would reduce revenues by £10-15 million a year (£5 million of it onshore) without any benefit to activity.

PRT. Instead I intend to stop the repayment of ACT which is presently allowed when corporation tax liabilities are reduced as a result of PRT deductions. This measure should not affect development. It goes a considerable way to offsetting the gains in the North Sea from the wider corporation tax package, but a net benefit will remain.

Taken together [with the farm-out changes] these proposals will, on our latest forecasts, reduce Exchequer revenue from the North Sea by on average about £55 million a year over the next five years....."

Later estimates revised the £55 million figure to £90 million. Thus the ACT measure was most certainly considered as an integral part of the 1984 Budget corporation tax measures, and the farm-out proposals were also brought into the final package adopted by Ministers. (Measures involving the PRT position of farmers in and out had been announced some months earlier and were also implemented in the 1984 Budget.)

Paras. 8 and 9: impact on company confidence

We do not believe our views on the likely effects on confidence are exaggerated. Our concerns were repeated at the meeting on 26 February and are summarised in the Secretary of State's covering letter, herewith. We accept that the financial impact of the proposals is small, compared to the totality of North Sea take. But it is concentrated on the high-risk activities which must be encouraged if the economic recovery of petroleum is to be maximised.

Paras. 10-12: direct economic effects

Para. 10 Any estimate of the number of wells likely to be affected by the proposed measure is unavoidably judgemental, but we believe our estimate of 15 per year is a reasonable, if not highly cautious, view of the number at risk. We believe this figure to be fully justified by the detailed analysis carried out by officials and it is consistent with the figure of one-fifth. The subtantially higher figures of one-third and one-half represent the results of analyses which companies could well do immediately after any announcement of a change, and which could well affect the reactions of senior company management to it. Use of these indicators together with the general impact on confidence,would all tend to increase the direct economic impact above one-fifth of that of 1983, ie 15 wells is a minimum figure. The reserves these wells are likely to discover are needed to maintain production,and hence revenues, from the 1990s onwards. In cases where economic development of these reserves depends on the use of existing facilities, deferral could amount to loss.

NORTH SEA FISCAL REGIME: SECRETARY OF STATE'S MEETING WITH THE FINANCIAL SECRETARY, TUESDAY 26 FEBRUARY 1985

Present:	Secretary of State for Energy	Financial Secretary to the Treasury
	Minister of State for Energy	
	Sir Kenneth Couzens	
	Mr Guinness	
	Dr Myerscough	
	Mr Reidy	

1. The Financial Secretary opened the discussion by saying that he would leave a note, prepared by his officials, which commented on the paper attached to the Secretary of State's letter of 21 February. He started by making four points:

(a) He regarded the North Sea as now being a mature oil province. Exploration and appraisal there could no longer automatically merit the same tax treatment as ordinary scientific research.

(b) The analogy with scientific research really applied to exploration wells only. The Secretary of State's concern that dry wells would not always be allowed immediate write off had been noted, and further discussions at official level might lead to resolution of this point.

(c) The Secretary of State would be aware of the pressure from other industries for special treatment following the general corporation tax changes announced in the 1984 Budget. It would be awkward if a highly profitable industry, which could afford the minimal additional costs involved, were isolated from the changes affecting other industries. Whilst he accepted that the Exchequer benefit from the changes was minimal, this argument could also be applied the other way round - the cost to the industry was also minimal.

(d) The £65 million a year average cost to the industry of the 'Option B' proposal now being made by the Treasury should be compared to the average £240 million a year benefit to the industry from the 1984 corporation tax changes. He did not understand how the Secretary of State could argue that the costs of a corporation tax clawback and farm-out changes should be deducted from this benefit. These changes would have occurred anyway. In his mind the overall 1984 and 1985 package of corporation tax changes would leave the industry £175 million a year better off.

2. The Secretary of State for Energy pointed out that when the Chancellor and the Financial Secretary had been at the Department of Energy, they had pressed strongly for fiscal changes to improve company confidence and to promote further activity in the North Sea. Their efforts to this end had been very successful. The positive effect of the 1983 Budget had been continued in the 1984 Budget, for example by the statements made on incrementals. The UKCS was currently regarded as a good location for continuing investment by the industry, which had many other investment opportunities overseas. Consequently, the response to the Ninth Licensing Round had been much better than expected. But now industry confidence was threatened by uncertainties about the oil price, and by the possibility of a US levy on imported oil. Over the last two or three months, industry anxiety about the possibility of adverse fiscal changes here had increased considerably. It would be absurd to put at risk the confidence of an industry which would provide Government revenues in 1985/86 of nearly £13 billion (based on £1=$1.12; with £1=$1.05 it could be £14 billion). The risk might be worth taking for hundreds of millions of pounds a year additional revenue, but not for £65 million a year, which was less than the effect on North Sea take of a half cent change in the pound/dollar exchange rate. If the financial impact were reduced by protecting fully the allowances for dry holes, the benefits would be even smaller.

3. The Minister of State said that the psychological impact of a change now would be out of all proportion to its size. The proposal would hit hard at the front end, high risk activity. It would lead to niggling arguments about the treatment of particular expenditure items. In most other countries, drilling expenditure received fiscal treatments as a revenue cost. This included Norway, where other relaxations in the fiscal regime were being considered. If we tightened our regime, activity could well be deflected there.

4. Mr Guinness explained that his assessment was that whilst the lack of any definite concession on incrementals in the 1985 Budget would lead to expressions of disappointment, these would be controllable. But a reduction of drilling

allowances would be taken very badly indeed. It would not be subjected to rational economic analysis, but would be seen as a fundamental change in direction by the Government. The same people who put together the 1983 fiscal package would be accused of pulling it apart. This must be a very short sighted policy. The Secretary of State added that it only needed one or two companies to pull out of the Ninth Round for the whole climate of confidence in the North Sea to be soured.

5. Sir Kenneth Couzens said that the clear policy towards the UKCS signalled by the Government in the 1983 Budget had been a marvellous success. The statement on incrementals in the 1984 Budget had been in the same direction. The Sleipner decision had helped to create a good climate for continuing UKCS activity. Our oil and gas province was high cost, but at the moment all was going well. In his view, the Chancellor should not now give the wrong signal for the sake of fiscal tidiness. He could not believe that Treasury Ministers would be under significant pressure from other industries if the existing structure of exploration and appraisal allowances was left alone.

6. The Secretary of State, summing up, said that the North Sea industry was unique, because effectively the Government had a very large equity shareholding. He added that the applications for Ninth Round tender blocks had brought in considerably more than the proposed changes would gain in a year. He hoped that it was abundantly clear to the Financial Secretary that all Ministers and key officials concerned with North Sea oil and gas were genuinely very worried at the proposed change in exploration and appraisal allowances. Mr Guinness added that the oil companies simply did not believe that the Government would contemplate such a change.

7. The Financial Secretary said that he took all the points that had been made very seriously, and would report them back to the Chancellor. He felt that a satisfactory form of words could be found for the Budget statement on incrementals, and he had already made the point that the allowances for dry holes could be looked at further. He drew attention to the fundamental nature of the changes in the corporation tax system made by the 1984 Budget and to the fact that the oil industry had benefited substantially from them. He did not see how the highly profitable North Sea industry could be isolated from the

further consequences of these changes. The intention to review the exploration and appraisal allowances had been announced at the time of the 1984 Budget. The Secretary of State and Sir Kenneth Couzens however pointed out that North Sea activities were subject to a different tax regime from the rest of industry, which gave the Exchequer an equity interest of well over 80%. If exploration and appraisal allowances were singled out from other scientific research allowances for worse treatment, that would discriminate against the oil industry.

8. It was agreed that the Secretary of State would consider the Treasury's comments on his paper and then write back to the Chancellor.

C J Myerscough

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