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CABINET

MINISTERIAL COMMITTEE ON ECONOMIC STRATEGY

A GAS TAX OR LEVY

NOTE BY THE CHANCELLOR OF EXCHEQUER
AND THE SECRETARY OF STATE FOR ENERGY

At E(79)14th we were asked to examine further the possibility of reducing the British Gas Corporation's (BGC) excessive profits either by applying Petroleum Revenue Tax (PRT) to exempt North Sea gasfields or by a charge on the British Gas Corporation themselves.

FORM OF LEVY

2. The attached paper by officials suggests that any tax should be related to PRT-exempt gas only and has examined four options: removal of the PRT exemption; a tax on gas production; a levy on BGC's gas purchases; or a lump sum deducted from their profits. Quite rightly it recommends against a profits levy since this will have few presentational advantages and is no great improvement on the present system of charging Corporation Tax with BGC depositing any surpluses with the NLF. (The political point to be tackled is that although BGC profits are forecast to rise from £400m for 1979/80 to £654m for 1980/81, which we might explain, they will rise to £1b in 1981/82 and £1½b in 1982/83. Such high profits will make it difficult to justify further gas price rises and could encourage high wage claims. We therefore need to devise a defensible means of reducing such high profits.)

3. The paper also recommends against the first option, removal of PRT exemption, on the grounds that it will involve massive losses to the PSBR because the oil producers, many of whom are foreign companies, are bound to benefit: and against the second, a tax on gas production, because it will be a new tax on offshore production; will require complex primary legislation; and will inevitably be difficult to administer.

4. The third option, a levy on gas purchased by BGC, is the most attractive course. It meets our wish to reduce BGC's profits by increasing their costs and, at the same time, it can be shown to be part of a policy of removing the economic rent arising from the PRT-exempt gas available to BGC. It also leaves BGC with an incentive to efficiency in the short term, and to keen purchasing and well-justified investment in the longer term. We shall, however, have to continue to rely on the financial target as the main discipline on BGC's financial performance. Their target will therefore need to be adjusted if we agree to impose a levy on their purchases, and it is important that they should know its amount at least for the target period.

AMOUNT OF LEVY

5. The upper limit for the levy will be the amount of economic rent (roughly BGC's extra profits as a result of its privileged purchasing position) accruing to BGC. BGC will argue to be allowed to retain a sufficient profit to reflect what they would regard as the present efficiency of their operations, but our aim should be to pitch the levy so as to secure as much of the economic rent as possible while taking account of the practical realities.

6. The effect on the PSBR of such a levy will be neutral. It will, however, increase the figure for public expenditure (by well over £1b in the PES period depending on the rate of the levy) due to a switch from reverse-NLF paid by BGC (which reduces public expenditure) to a levy which will count as tax receipts. This will need careful presentation in view of our commitment to reduce public expenditure as a proportion of GDP.

TIMING AND PRESENTATION

7. If the Committee agree that there should be a levy, the choice is between legislation this Session or next. The Chancellor is reluctant to include the clauses in the Finance Bill. He argues that it would inevitably give the levy the guise of a tax - there would need to be a ways and means resolution - and the public would perceive it as an increase in the indirect tax burden. There is also some risk, which officials are now exploring, that inclusion of the necessary provisions in the

Finance Bill might make the Bill hybrid. We clearly cannot risk that. The alternative is for there to be special legislation either this Session or very early next. The introduction of legislation next Session could be foreshadowed by an early announcement directly there have been consultations with BGC. In the view of Secretary of State for Energy this should be done during the Budget debate.

8. Presentation would need to emphasize that the levy would obtain for every citizen, rather than gas consumers only, the benefits of BGC's surplus profits which they earn as a result of both their privileged position, and the increases in energy prices generally. (The parallel here is with PRT.) The presentation would also need to deal with the charge that the price increases derived from the financial target were themselves a concealed tax increase. This can be done by emphasizing once again that higher gas prices are justified by the costs of replacing a finite resource and by reference to other energy prices.

RECOMMENDATIONS

9. We recommend therefore that:

(a) BGC's excessive profits from 1980/81 onwards should be reduced by a levy on their purchases of PRT-exempt gas;

(b) we should announce our intentions soon with a view to taking the necessary powers as soon as practicable;

(c) the levy should be set at a level which will secure as much as possible of the economic rent going to BGC;

(d) BGC's financial target should be adjusted accordingly; and

(e) Treasury and Department of Energy officials should consider together an appropriate levy, after consultation with BGC, and should report back to Ministers accordingly.

G. H.
D.A.R.H.

Department of Energy
22 February 1980

CONFIDENTIAL

A GAS TAX

Note by officials

At E(79)18th the Chancellor and Secretary of State were invited to examine the case for eliminating British Gas' surplus profits either by removing the PRT exemption from PRT-exempt gas fields or by some form of charge on BGC themselves. This paper considers these options and recommends a levy on PRT-exempt gas purchased by BGC.

OBJECTIVE

2. The basic objective of any gas tax must be to reduce BGC's excess profits without undermining their efficiency.

3. These excess profits arise mainly because BGC have access to supplies of gas exempt from Petroleum Revenue Tax (PRT) at well below its market value. They do not collect all of this economic rent (calculated at about £2bn) because a substantial amount goes to their customers and this will continue, albeit at a reducing rate, until the underpricing of gas to the consumer is finally corrected. The tax should therefore be determined by the proportion of the economic rent the Government wished to collect. However since the pricing decisions for the next three years have been taken and BGC's financial target set, the form and amount of the tax have to be set against the background of BGC's profits (£654m in 1980/81 rising to £1,511m in 1982/83) and the extent to which Ministers wish to reduce them. It is therefore important that any tax should be compatible with the financial target (adjusted as necessary) and for at least the same period since otherwise the discipline of the target will be undermined.

4. Another important consideration is that the form of the tax should not act as a disincentive to keen purchasing of new supplies by BGC nor to further exploration and development of North Sea gas. For both these reasons the tax should clearly be related only to PRT-exempt gas which also is where the current economic rent arises. (PRT is designed to collect the economic rent from those fields which are not exempt.)

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FORM OF TAX

a) Removal of PRT Exemption

5. At present virtually all UKCS gas purchased by BGC comes from fields exempt from PRT because the contracts had been settled in advance of the legislation. It would not be practicable to impose PRT on these fields without renegotiation of the contracts between BGC and the oil companies up to something like the Frigg market price for North Sea gas (expected to be about 17p a therm in 1980/81 escalating thereafter). PRT could then be imposed on the resultant profits made by producers. This would however mean difficult negotiations for all of the parties concerned (including government involvement); complex legislation on allowable costs offset against taxation liability; and an increase in the PSBR since the tax system could not appropriate all the increase in licensee's revenues. The initial loss to the PSBR would be about £1bn, a substantial proportion of which would go to non-British companies. Furthermore because the renegotiated prices would be much higher than BGC's prices could support, it would inevitably mean substantial losses for BGC. This course has few attractions. Present arrangements between BGC and the Southern Basin producers are working well enough; the producers are making a reasonable return on their investments; and BGC have made the right signals on prices for new contracts. We do not therefore recommend it.

b) Tax on gas production

6. Some of the problems associated with removing the PRT exemption could be avoided by imposing a tax on gas production. The feasibility of this course depends critically on the terms of each contract which would need to be discussed with the producers. If, as seems likely, this tax could be passed straight on to BGC it would be an effective way of reducing BGC profits. The tax could be expressed in terms of pence per therm of PRT-exempt gas produced. It need not be set at a level which would leave BGC with a loss or disturb the pricing decisions already taken although it would, of course, require the financial target to be amended.

7. This approach has the advantage that the tax would appear as a cost in BGC's accounts and would reduce their profits (a good point in terms of public presentation). However, given the number of oil companies concerned it would be complex to administer, and would probably require complex primary legislation. As a new tax it would appear to be adding to the tax burden; and it would need to be administered by the Chancellor's Departments. It would be seen by the offshore producers as another destabilising factor in the offshore taxation regime and would probably be resisted by them. It would require amendment of BGC's financial target. We do not therefore recommend this course.

c) A Levy on Gas Purchased

8. A levy (pence per therm supplied) on BGC's purchases of PRT-exempt gas would, on the other hand, have most of the attractions of a tax on gas production with fewer of its disadvantages. Presentationally it would also appear as a cost and reduce BGC's profits. It would be bound eventually to lessen both the public's and employees' awareness of BGC's profits. It would however still require the financial target to be amended. Although it could be effected by an amendment to Energy legislation which would give the Secretary of State the power to determine the amount of the levy by order, this would inevitably have to be subject to affirmative resolution. These difficulties are not however of the same order as with the other methods and a levy on BGC's gas purchases has the advantage of affecting only BGC and not the rest of the industry. We therefore see considerable benefit in this approach to increasing BGC's costs through a government levy thereby reducing their profits.

d) A Lump Sum Levy Deducted from BGC's Pre-tax Profits

9. As an alternative to the three methods of increasing BGC's gas costs it would be possible to deduct a lump sum levy (calculated by reference to the economic rent arising from PRT-exempt gas) from BGC's profits. This would be similar to the existing system whereby BGC's profits will be subject to an increasing amount of Corporation Tax (47% in 1982/3) but could be levied in advance and at a higher rate thus reducing their excess profits. Although it would be administratively more simple, it would have few of the presentational attractions of the other methods; could have a disincentive effect on BGC's future purchasing and investment decisions; and would not be a great improvement on the status quo. We do not therefore recommend it.

THE AMOUNT OF THE LEVY

10. As mentioned earlier the overriding consideration affecting any levy or tax should be the amount of the economic rent Ministers wished to collect and will be presented as such. The £2bn p.a. economic rent which we calculate should be available from PRT-exempt gas would represent a levy of about 10-12p per therm of gas supplied. Ultimately we would expect to collect the full amount of this economic rent, leaving BGC to make a commercial return on their operations. However, with BGC's profits forecast to rise from £654m to £1,511m over the target period Ministers could not impose a levy as high as 10-12p a therm without causing BGC to make substantial losses or necessitating far higher domestic price rises than those already planned.

11. Clearly the amount of the levy cannot be decided finally before BGC have been consulted, but our aim should be to pitch the levy at a rate which would remove from BGC as much as possible of the economic rent while leaving their profits at a level which could be justified commercially and which would avoid a major and public disagreement with the Corporation which might upset the pricing decisions already taken. The table in paragraph 12 sets out some purely indicative figures of a levy of say 1p per therm for 1980-81, 2.5p per therm for 1981-82 and 5p per therm for 1982-83. This would leave BGC with an average return of about 5 per cent per annum on CCA assets (compared with 9 per cent) over the target period. It would collect about half the economic rent by about 1982-83 and would give BGC much the same as the return they should make this year. But if the levy was to be properly defensible in economic terms, it ought to be pitched at a level which secured as much as possible of the economic rent going to BGC apart from the amount which would still be going to gas consumers.

12. BGC would need to calculate the detailed effect on their forecast profits/cash flow of a levy set at the levels mentioned above. Therefore any estimate which has of course been drawn from forecasts which are themselves liable to substantial variation, must at this stage be highly tentative. We calculate the effects at outturn prices would broadly be as follows:

	1979/80	1980/81	1981/82	1982/83
		£m		
Profit pre-tax interest and levy	400	700	1000	1500
(% return on CCA Assets	(5.0)	(6.5)	(9.0)	(11.5)
Levy (1p 80/81 2.5 81/2 5p 82/3)	-	200	500	1000
Profit post levy pre interest + tax	400	500	500	500
(% return on CCA Assets)	(5.0)	(5.0)	(5.0)	(4.5)
Corporation Tax-Charge	-	100	200	200
- Payment	-	-	100	200

13. The effect on their cash flow should cause them to start reducing their NLF deposits from 1981/82 so that by the end of the target period they will stand at £200m which is the current level. If in later years the levy were raised further BGC could become a substantial new borrower again.

14. EFFECT ON PSBR AND PUBLIC EXPENDITURE

The effect of the levy on the PSBR would be neutral since it would be replacing NLF deposits and Corporation Tax payments by BGC. The effect on public expenditure is more difficult to calculate since BGC's NLF deposits reduce public expenditure whereas Corporation Tax and the levy are receipts. The effect therefore in general will be to increase public expenditure by the amount BGC's NLF deposits are reduced. This is an inconvenient effect of converting a large part of BGC's post-tax surpluses from NLF deposits, which reduce the nationalised industries total net new borrowing, into a tax receipt, which increases Government revenues. The increase above planned public expenditure levels would be very large, e.g. over £1bn over the 3 years to 1982-83 on the assumptions set out in paragraphs 11 and 12. This has little significance for the economy - the effect on the PSBR is neutral - but it would require the most careful presentation.

TIMING AND PRESENTATION

15. Whichever of the routes is adopted Ministers may see advantage in announcing their intentions soon. It could be presented as a natural sequel to the energy policy considerations which underlay the pricing decisions already announced. Clearly BGC need to be consulted before any announcement is made (and the amount of the levy and consequent adjustment to the financial target would have to be discussed with them) but this need not delay the announcement of the Government's intentions.

RECOMMENDATIONS

16. We therefore recommend that:

(a) the tax to remove BGC's excess profits should be by way of a p.therm levy directly on BGC's purchases of PRT-exempt gas;

(b) it should be announced soon, and cover at least three years so as to be compatible with and run concurrently with a revised financial target for BGC; and

(c) it should be set at a level which would secure as much as possible of the economic rent going to BGC.