

Copy to Mr. Walters.

Prime Minister.



Are you content with the package which has been called for to become more diverse?

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

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PRIME MINISTER

In view of the present state of the oil market - the "take" should be as high as possible

NORTH SEA FISCAL REGIME

You will be interested to know where things now stand on my Budget proposals affecting the North Sea fiscal regime.

2. Last year we decided that there was scope for additional taxation on North Sea operations (mainly because of the major hike in oil prices in the late 1970s), and that the structure had to be made more responsive to oil price changes in future. In my Budget I therefore introduced the Supplementary Petroleum Duty (SPD) at 20 per cent of gross revenues (less an oil allowance of 1 million tonnes a year), and limited two of the main reliefs for Petroleum Revenue Tax (PRT) - "uplift" and "safeguard" - to the earlier years of an oil field's life. These changes were estimated to produce an additional £1,020 million for 1981-82 - mostly from the SPD.

3. The oil industry had made clear their strong opposition to the SPD when it was first announced not only because of the 'take' but also because the tax was levied on gross revenues not profit. In view of their representations, we decided that the SPD should be introduced for 18 months only (to end June this year), to give time for the industry and us to consider alternatives.

4. Since then, I have received representations from the main industry representative bodies (the UK Offshore Operators Association - UKODA, and the Association of British Independent Oil Exploration Companies - BRINDEX), some individual companies and some independents (including the Institute of Fiscal Studies). The main common element in the industry's representations has been the plea for a substantial reduction in Exchequer take and



the abolition of SPD (with arrangements on at least a temporary basis for accelerating PRT take instead). These proposals and the existing regime have been reviewed by the Treasury, Inland Revenue, and the Department of Energy. Following that review Nigel Lawson and I have agreed on a package of measures which will be announced in the Budget.

5. We are not convinced by the case for a substantial reduction in yield. Despite the current weak state of the oil market, analysis suggests that the existing North Sea fields currently in production or under development remain reasonably profitable on a wide range of assumptions about the future movement in the oil price, and that potential future fields are also likely to remain attractive. But neither do we think there is scope for any increase in the overall yield. The industry has shown considerable concern, some of it genuine, about the level of taxation, and may need something of a psychological boost. With the present state of the oil market, I think this points to a modest reduction in take, though going less far than the oil industry would wish.

6. We have decided to make the following changes to the structure of the fiscal regime, which do, I think, improve the structure without sacrificing our objectives on yield. These are:-

(a) to abolish the SPD with effect from end 1982 (i.e. extending it to run for a further 6 months only);

(b) to introduce from 1 January 1983 an "advance PRT", computed as SPD is as present, but differing from SPD (which as a separate tax in its own right is only deducted in computing PRT liabilities) by being set off in full against PRT liabilities as soon as these arise, or - failing set off - by being eventually repaid;



(c) to increase the rate of PRT from 1 January 1983 to 75 per cent instead of 70 per cent;

(d) to introduce "smoothing" arrangements for paying most of PRT liabilities by monthly instalments from 1 July 1983 (instead of in two large lump sum payments in a year).

7. We believe that the advantages these structural changes offer are:

(a) they - in particular the abolition of SPD - are a significant move towards the industry's own proposals, but the advance PRT will continue to ensure a substantial Exchequer yield from fields in their early years of production before they become liable to ordinary PRT.

(b) Post-tax rates of return on additional investment in existing fields will be much closer to pre-tax returns, so reducing the risk that incremental investment at the margin to recover oil that otherwise might be lost might be made uneconomic solely because of the tax system.

(c) The marginal rate comes down from 90.3 per cent to 89.6 per cent.

(d) The position on creditability against foreign tax, a matter of particular concern to the US companies, should be somewhat improved (though this does of course ultimately depend on the attitude of the US authorities).

(e) "Smoothing", which secures a more even public sector cash flow will be a considerable benefit to monetary management.



8. The estimated cost of the package is:-

	<u>£m (gross)</u>	<u>Interest gain from "smoothing"</u>	<u>Overall Effect</u>
1982-83	0	0	0
1983-84	-100	+20	- 80
1984-85	-160	+40	-120
1985-86	-140	+50	- 90
1986-87	<u>-280</u>	<u>+70</u>	<u>-210</u>
	<u>-680</u>	<u>+180</u>	<u>-500</u>

That is consistent with our conclusion on the taxable capacity of the oil companies. From 1982-83 to 1984-85, the reduction represents less than 1 per cent of North Sea yield as compared with the reduction of 5 per cent which industry wanted.

9. Apart from the main structural proposals, I propose to legislate for a few minor changes to improve the regime - in part in response to the industry's representations. There are also a number of particular problems affecting PRT expenditure reliefs in certain circumstances and the taxation of pipeline tariffs and other non-oil receipts. We need to deal with these but I have agreed with Nigel Lawson that we should defer legislation until 1983 and issue a consultative paper with our proposals shortly after the Budget.

10. I believe that this package - in combination with the decision not to impose production cuts for the time being which Nigel Lawson will be announcing shortly before the Budget - should go a long way towards reassuring the industry that North Sea development can now go ahead on the basis of a more stable structure which has taken account of some of their main objections to the existing regime. The industry will inevitably still claim that overall tax is too high. But I do not think we could ever expect to agree with them on that! While we shall obviously need to keep matters under review in the event of changes in the economics of the



oil industry, I believe that our judgement of taxable capacity is broadly right in existing circumstances and should prove reasonably robust against quite a wide range of the more likely possible future developments. It is vital to strike the right balance between the need on the one hand to give adequate incentives to the industry to ensure the further development we need and the need to ensure the maximum Exchequer yield. I believe this package does that.

11. I am copying this minute to Nigel Lawson.

A handwritten signature in black ink, appearing to be 'G.H.'.

(G.H.)

26 February 1982