Death knell or crying wolf?

The impact of the Fair Fuel Stabiliser on North Sea oil production

A briefing by PLATFORM and Greenpeace

In April the Chancellor, George Osborne, launched his 'Fair Fuel Stabiliser'. This linked the rate of tax paid by oil companies to global oil prices. When the price of oil was above $75 a barrel, the rate of tax on North Sea oil profits would rise, with the additional revenue used to lower the price of petrol and diesel. The measure is expected to raise £2 billion pounds over the course of the Parliament, although this is cancelled out by a £2 billion reduction in income from fuel duty.

The Chancellor claimed that the stabiliser would raise enough money to avoid a planned increase in fuel duty, and also pay for a 1p per litre cut. This, he argued, would save the average driver £3 when filling up their car. The announcement followed a period of exceptional profits for the oil and gas industry, buoyed by oil prices reaching record highs.

The oil industry reacted furiously. Malcolm Webb, chief executive of industry lobby group, Oil and Gas UK claimed that, "this change in the tax regime will decrease investment, increase imports and drive UK jobs to other areas of the world."[i] Treasury Minister Justine Greening was reportedly "grilled alive" in a meeting with oil industry executives.[ii] A number of major oil companies announced plans to put investments on hold whilst they considered the impact of the new tax changes.

This two-part briefing examines the changes to North Sea tax and the impact on the oil and gas industry, before considering ways in which the Chancellor may respond to the industry's campaign against the changes.

Part one: how has the oil and gas industry been affected?

The oil and gas industry has framed the changes as a 'windfall tax', giving the impression that it was sudden and opportunistic. Wikipedia described windfall taxes as "a higher tax rate on profits that ensue from a sudden windfall gain to a particular company or industry."[iii]

But this description is inaccurate. For starters, the Fair Fuel Stabiliser is revenue neutral: i.e. it does not result in an increase in total revenue to the Treasury. Instead, the stabiliser transfers the burden of taxation from the customer (motorists) to the producer (oil companies). When oil price is high, upstream tax (on offshore extraction) goes up and downstream tax (on petrol, diesel etc) comes down, and vice versa.

Whilst it is true that the industry does not appear to have been consulted in advance, plans for a fuel duty stabiliser were first suggested by George Osborne in 2008, reiterated in advance of the Emergency Budget last summer, and trailed heavily in the run up to the 2011/12 Budget.[iv] [v]

The UK's North Sea tax regime remains competitive

The industry has argued that the rate of tax makes investment in the UK uncompetitive, especially when compared to other European countries. But the UK's tax rate compares very favourably to other countries. The rate of tax on wells drilled since 1993 is 62%. Norway, which has the same geology as the UK, has a 78% tax rate on oil production profits. In a 2009 oil industry survey, the UK was voted the companies' favourite country to invest in, out of 152 countries (outside North America).[vi]

UK oil taxation has been historically amongst the lowest in the world. The rate of tax was increased modestly in 2002 and 2005, at a time when the oil price (and post-tax profits) was considerably lower. In 1997/8, when Gordon Brown considered a tax on North Sea production, the oil industry ran a successful campaign against it, arguing that since the oil price was low, they couldn't afford to pay more taxes.[vii] But the price of North Sea oil rose 31% in the first quarter of 2011.[viii]

On 29 March, energy giant Statoil halted work on a North Sea development, claiming that its decision was informed by the increase in taxation on the industry. It said that it needed time to "pause and reflect" on the future of its Mariner and Bressay fields to the south east of Shetland.

However, three days later Statoil announced the discovery of a new field in Norwegian waters that would potentially produce 500 million barrels. It declared that it would be concentrating its efforts there as a result, despite Norway having a 16% higher rate of tax on oil extraction.

Investor confidence in North Sea oil companies remains strong

Independent financial analysts Edison Investment Research have just published a post-Budget report examining the viability of North Sea oil companies as investments. They found that last year, the average increase in share value for oil companies operating in the North Sea was 192%. Many of the companies operating in UK territorial waters were, in their words, "best value" for further share profitability.

"Despite the negative sentiment around the UK government increasing the marginal tax rate from 50% to 62% in last week's budget," the report concluded, "the North Sea independents continue to offer the potential for spectacular returns."

The North Sea independents just released their annual reports. In each case, they reported record profits, heavily influenced by high oil prices. For example, Valiant Petroleum's CEO, Peter Buchanan, admitted that the company's cash reserves and cash flow had been "boosted by the recent higher oil prices."[ix]

Investor's Chronicle noted that North Sea independent EnQuest's bottom line was "helped by a 25 per cent rise in the realised price for each barrel of oil sold". In mid-April, the Telegraph advised its readers to buy EnQuest shares.[x]

Tax breaks mean many companies won't be affected by the new tax increase

Simon Lockett, chief executive of Premier Oil said: "Premier is currently sitting on $1.1bn (£677m) of tax credits. What that means is that we're sheltered from [the tax rise] for a good few years to come."[xi]

Xcite Energy has stated that "Recent Budget changes in North Sea tax will not affect the Company's plans to move forward with its First Stage Development. The increased benefit of the heavy oil tax allowances will have a material offsetting effect on the increased supplemental corporation tax charge."[xii]

In December Valiant announced its intention to apply for a license from the UK government to exploit a new 'drill ready' deep water oil field to the west of Shetland. On the 31st March, one week after the Budget, Valiant submitted their application for a license to drill, seemingly unperturbed by the new tax regime.

Perhaps the final word on the impact of the changes should be left to the Financial Times. On Friday May 13, its lead editorial, entitled *Big oil protests too much on tax*, gave a damning review of the oil and gas industry's campaign.

High taxes on North Sea oil and gas were justified because the industry enjoyed "profits in excess of the level needed to attract capital into these sectors. This excess is due to the natural scarcity of the product… These "superprofits"… ought to be captured in their entirety for the benefit of the public."[xiii]

"The UK and the US have long undertaxed the sector," the paper concluded. "The change of heart is being handled clumsily… Even so, it is long overdue."

Part two: how is the Chancellor likely to act?

Despite a sustained campaign from the oil and gas industry, the Chancellor seems unlikely to rescind his flagship policy. Summoned before the Energy and Climate Change committee, the Energy Secretary, Chris Huhne, told MPs that the tax would have minimal impact and was therefore here to stay.

"If people are going to follow their own self-interest – which is a fair assumption for this industry as it is for people in the rest of the economy – there is not going to be a significant impact on investment from these changes at these oil prices," said Mr Huhne.

Are more tax breaks on the way?

Instead, it appears that the Government is considering offering more tax breaks to the industry. Worryingly, they appear to be considering giving tax breaks to encourage the riskiest sort of drilling – operations in deep water.

The oil and gas industry met with the Chancellor to discuss the changes to North Sea oil taxation. Following that meeting, Oil and Gas UK, the trade lobby group, put out a press release, which suggested that, "The Treasury has requested further discussion on how to improve the operation of the trigger price mechanism and new and further field allowances."

Field allowances are major tax breaks to new oil and gas exploration in specific areas. At present, they give oil companies tax credits of up to £800 million per oil field.[xiv] A leaked letter from the oil industry to Treasury Minister Justine Greening shows that the industry is demanding that any new or extended 'new field allowances' would need to be large enough to "lift subject fields out of the proposed Supplementary Charge completely."

Could tax breaks be extended to deep water drilling?

The Chancellor told the Treasury Select Committee that they were looking at ways to encourage drilling in deepwater off the coast of Shetland. "In the [Budget] there is an explicit commitment given to look at new-field analysis. I think, and this is true of the previous Government as well, the truth is that we have not cracked West of Shetland yet. It is an extremely difficult environment in which to extract oil."[xv]

He explained that "new-field allowances, which were only introduced in 2009… are a relatively new feature of the regime, [which] we are actively looking at. I certainly want to encourage new exploration in West of Shetland."

Drilling off the west of Shetland is especially hazardous. The Energy and Climate Change committee (ECC) said that "There are serious doubts about the ability of oil spill response equipment to function in the harsh environment of the open Atlantic in the West of Shetland". Chris Huhne told the ECC committee that an oil spill off the coast of Shetland would be "an absolutely enormous environmental disaster".

Conclusions

The historically-low rates of taxation on North Sea oil production that oil companies have enjoyed are effectively a public subsidy. Even taking the Fair Fuel Stabiliser into account, the UK taxation regime compares favourably with many other parts of the world - competition between upstream oil production companies for new resources is such that they can't easily withdraw from such a regionally important oil and gas production area.

The 'pain' being expressed by the oil industry appears to be a strategic means of exerting pressure on the government to gain more substantive tax breaks, that could in turn be used as a financial incentive to exploration and extraction in new areas like the West of Shetland.

Oil company profits continue to increase in spite of increases in production costs and taxation in the UK. Rather than continued fiddling with the UK tax regime for offshore oil exploration in a vain attempt to court UK offshore operators, the UK government needs to acknowledge that it is no longer possible to address the challenge of oil supply by continuing to drill in marginal fields like those west of Shetland. Reducing our oil dependency will come – in the short to medium term - from dramatically increased fuel efficiency for passenger and goods vehicles, better spatial planning in order to reduce the need to travel, as well as accelerating the development of renewable electricity supply, in order that the emerging electric vehicle fleet will be genuinely zero carbon.

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