



31 August 2018

Global Witness submission to the Treasury consultation on Draft Legislation for “Transferable Tax History”

Overview

On 6 July 2018 Her Majesty’s Government proposed to allow North Sea oil producers to transfer tax histories along with interests in oil and gas assets (“transferable tax histories” or “TTH”). The aim is to incentivise investment in late-life oil fields by new companies. TTH will allow companies buying assets to use the seller’s tax histories to offset decommissioning losses when they fall due.

Global Witness believes TTH is fiscally dangerous and inadequately justified. As a result, it should be immediately and indefinitely postponed, pending a full assessment of the true potential cost of the policy. TTH is a significant extension of the system of tax cuts, tax reliefs and contractual guarantees available to North Sea oil producers, which has already undermined the UK’s share of oil profits and put the Exchequer on the hook for exorbitant decommissioning liabilities as North Sea oil fields cease production. ***An economic analysis commissioned by Global Witness¹ forecasts that TTH could add more than £3bn to the UK’s decommissioning bill over the first ten years, with further potential costs beyond this time horizon, or should more TTH deals be struck than our modelling assumes.²***

Our analysis shows that TTH is fundamentally a gamble on the future oil price. TTH inflates the tax reliefs available to new companies, amplifying UK’s liability for decommissioning-related tax rebates should oil fields be abandoned following a downturn in the oil market cycle. The policy appears to rest on the assumption that additional decommissioning exposure will be compensated by higher revenues, driven by new investment. We see an alarming lack of evidence supporting this assumption, with detailed modelling of the long-term impact on decommissioning costs, revenue

¹ The analysis was conducted by an industry expert with 40 years’ experience of oil and gas financial management. See appendix 2 for a full biography.

² For all figures, see the analysis in full in appendix 2.

and investment incentives in different oil price scenarios conspicuously absent from the policy documents justifying TTH.

The sums at stake are formidable, with HMRC projecting decommissioning of oil infrastructure to cost £64bn over the next four decades. HMRC believes the UK Exchequer is already liable for £24bn of this colossal sum. This cost is already beginning to crystallize through expensive tax rebates to oil companies, with which UK oil revenues have not always kept pace: In two of the last five financial years, UK's rebates to companies have exceeded North Sea oil revenue. In 2015-2016 and 2016-2017 UK was paying industry to take its oil.³

TTH extends the tax reliefs which created this perverse outcome, yet we found no analysis of the impact on public decommissioning liabilities in the policy justifications for TTH. In fact, Treasury's revenue projections do the opposite, employing a five-year reference period which *includes* the years in which we would expect the UK to benefit from increased production, but *stopping before* the years where deferred decommissioning costs would logically materialise. Nor do the projections take account of the potential for TTH to change the investment incentives facing companies, in that past behaviour may be a poor indicator of future decisions once TTH is in play.

Our fear is that TTH – the latest in a series of “competitiveness” incentives loosening the fiscal regime – may buy a few years of increased production at the cost of large, unfunded liabilities around future decommissioning costs. This submission explains these risks systematically and in detail:

- Part 1 sets out the backdrop to the TTH policy, and how tax reductions and tax rebates have propped up declining production levels.
- Part 2 explains the cost of these policies to the Exchequer in terms of future tax rebates, particularly around decommissioning costs.
- Part 3 summarises our economic analysis, setting out how TTH extends the decommissioning reliefs regime and carries substantial potential costs to the Exchequer in a depressed future oil market.

³ See the “Statistics of Government Revenues from UK Oil and Gas Production” (June 2018) p7: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/721314/Statistics_of_government_revenues_from_UK_oil_and_gas_production_June_2018_.pdf

- Part 4 criticises the serious flaws in the Government’s cost-benefit analysis justifying TTH and the lack of evidence supporting the implicit assumption that TTH will generate more for the Exchequer in revenues than it racks up in additional costs.
- Appendix 1 examines TTH in the wider context of UK’s Maximising Economic Recovery (MER) policy, explaining how the shortcomings of TTH also reflect the shortcomings of MER as a resource stewardship policy, which focuses on immediate fiscal return at the expense of long-term value and climate commitments.

Global Witness therefore recommends that the Government:

- Immediately and indefinitely postpones implementation of TTH, until adequate modelling is done to understand the full, long-term impacts
- Prepares and publishes a detailed model of the impact of TTH on public liability for decommissioning liabilities in different oil market scenarios.
- Prepares and publishes a cost benefit analysis – showing the impact of TTH on liabilities and revenues – on a timescale consistent with the 44-year decommissioning projections compiled by HMRC.
- Accompanies any future TTH policy with a detailed plan as to set aside sufficient current revenue to cover the decommissioning liabilities.
- Review the “Maximising Economic Recovery” policy to reconcile it with both a long-term plan to fund decommissioning costs, and the Paris climate agreement.

Part 1: Tax reduction and refunds in the North Sea

Oil and gas from the UK continental shelf has generated an estimated £330bn for the UK Exchequer since the late 1970s.⁴ Having peaked in 1999, however, UK production has been in decline for over 20 years. Having produced nearly 42.8 billion barrels of oil equivalent (boe) to date⁵, the UK has an estimated 7.4 billion boe in discovered undeveloped resources in its territorial waters. In addition, the Oil and Gas Authority believes there may be around 1.9 to 9.2 billion boe waiting to be found.⁶

In an attempt to encourage investment and in line with UK's successive UK Governments have made the oil and gas tax regime steadily more favourable to industry, lowering the tax rates and extending the tax reliefs on oil and gas. Since 2014 this policy trend has been formalised in the UK legislation through the obligation for the Government to pursue a "Maximising Economic Recovery" strategy ("MER"). Measures implemented since 2010 include:⁷

- Reductions of the Supplementary Charge from 32% to 10%
- Reduction of Petroleum Revenue Tax from 50% to 0%
- Introduction of "Investment and Cluster Area Allowances"
- Extension of the Ring Fence Expenditure Supplement from six to 10 accounting periods
- Extension of carry back of ring fence losses to 2002
- Introducing "Decommissioning Relief Deeds"

Yet any fresh investment brought to the UK North Sea has come at a fiscal cost. The first impact of these changes has been to **reduce** the Exchequer's share of profits from oil and gas produced from the UK. This is the impact which tends to generate the most coverage in UK press. As reported recently in the Financial Times:

*"The UK Treasury is set to miss out on billions in tax revenues from higher oil prices this fiscal year, as a result of tax changes that are coming under scrutiny following a recovery in production in the North Sea... UK tax revenues from the North Sea will not reach even a quarter of the amount raised in 2010 — when prices were last near this level for a prolonged period — when adjusted for lower expected production volumes."*⁸

⁴ HM Treasury, March 2017, "[Discussion paper: Tax issues for late life oil and gas assets](#)", p.5

⁵ Natural Resource Governance Institute, 5 October 2015, "[Did the UK miss out on £400bn worth of oil revenue?](#)"

⁶ OGA, 2016, "[UK Oil and Gas Reserves and Resources](#)", p.3

⁷ HM Treasury, March 2017, "[Discussion paper: Tax issues for late life oil and gas assets](#)", p.7

⁸ Financial Times, 20 August 2018, "[North Sea production recovery fuels fears of tax blow in budget](#)"

The second impact, however, relates to extended carry-back rules, which allow oil and gas companies to offset losses against past tax payments going back several years, far further than their counterparts in other industries. These tax reliefs result in generous tax **rebates** to oil and gas producers.

This is the key point: while reductions to oil taxes **reduce** the UK's share of profits from each barrel of oil, the carry-back rules require the UK to **refund** oil and gas companies taxes they have paid. The former may have resulted in lower sub-optimal historic revenues, but it is the latter which has major fiscal implications for tomorrow's governments. Any extra revenue generated today for the UK comes at the cost of a major refund bill in the future.

The **refund** process has already begun. According to Government oil revenue data, between 2015 and 2018 the Exchequer made tax refunds of almost £3 billion relating to oil and gas activities:⁹

Tax Period	Corporation Tax	PRT	Total
2015/2016	400	562	962
2016/2017	558	654	1,212
2017/2018	179	569	748
Total	1,137	1,785	2,922

Some years the UK can afford to pay the refunds from its oil and gas income, other years it cannot. In the 2011-12 financial year, the UK took in over £10 billion from oil and gas production. By 2015-16, however, the UK's return on oil and gas was net negative, with revenues having slumped to **minus £2m**. The following year the **UK paid out £316m more in tax refunds than it received in oil revenues**. Tax receipts then recovered to £1.2bn in 2017-2018.¹⁰

The **refund** dynamic is vital to any analysis of TTH. As explained in Part 3 below, TTH extends the tax reliefs generating these expensive tax refunds. Any new production incentivised by TTH is being bought at the cost of tax rebate liabilities in future years, which remain due whether or not the UK receives enough oil and gas revenue that year to pay for them.

⁹ Appendix 2, p.10, based on data in HMRC, June 2018, [Statistics of Government Revenues from UK Oil and Gas Production](#), p.7

¹⁰ See HMRC, June 2018, [Statistics of Government Revenues from UK Oil and Gas Production](#), p.7

Part 2: The most expensive tax refunds are due to decommissioning costs

The financial pressure on the Exchequer from tax refunds will be particularly acute when fields reach the end of their lives and the production infrastructure must be taken down. In “decommissioning” years, companies may post significant pre-tax losses on their balance sheets. These decommissioning-related losses can then be offset against past profits and a major tax refund may become due.

Decommissioning – the plugging of abandoned oil wells and removal of infrastructure – is the biggest liability facing UK’s oil and gas industry over the next 30 years. The UK Government expects decommissioning to cost £64 billion between 2018 to 2063.¹¹ In line with the “polluter pays” principle and UK law, decommissioning is the responsibility of the companies producing oil. Through extensions of the companies’ tax reliefs, however, UK has become liable for a significant part of the cost.

Under general corporate taxation rules, a company which makes a loss in one year is permitted to set the loss off against the profits of the previous year. Since 2010, oil and gas companies have been able carry back decommissioning losses against profits as far back as 2002.¹² The UK Government describes the resulting regime as *“one of the most competitive oil and gas fiscal regimes in the world”*¹³ and, as noted by Treasury, *“...the flexibility to relieve losses available at the end of a field’s life is far more generous than is available in other industries, as the losses can be carried back considerably further.”*¹⁴

The extended carry-back of losses means that large tax rebates will become due to oil and gas companies in decommissioning years. The UK will have to subsidise decommissioning costs by handing the taxes the companies have paid back to them. The UK Government anticipates decommissioning refunds will cost the Exchequer **£24 billion** over the next three to four decades.¹⁵ This is equivalent to well over half the annual budget of Scotland.¹⁶

¹¹ See HMRC, June 2018, [Statistics of Government Revenues from UK Oil and Gas Production](#), p.21

¹² Corporation Tax Act 2010, s.42

¹³ HM Treasury, March 2017, [“Discussion paper: Tax issues for late life oil and gas assets”](#), p.3

¹⁴ HM Treasury, March 2017, [“Discussion paper: Tax issues for late life oil and gas assets”](#), p.12

¹⁵ See HMRC, June 2018, [Statistics of Government Revenues from UK Oil and Gas Production](#), p.21

¹⁶ Based on the [reported budget](#) for Scotland for 2018-2019 of £40.6bn

The 2015-2016 financial year shows the impact such refunds can have. In 2016, pursuant to new transparency legislation,¹⁷ Royal Dutch Shell disclosed it received tax rebate worth over \$142m.¹⁸ According to press reports, \$116m of this was believed to relate to the cost of removing the Brent platform in the North Sea.¹⁹ As described in Part 1 above, between 2016 and 2017 the UK paid out £318m more in tax refunds than it received in tax for its oil and gas.

Crucially, this refund to Shell was **not** a consequence of low oil prices. The bearish oil market in 2016 may have impacted UK oil revenue and the Exchequer's ability to pay the refund from oil tax receipts, but the refund itself was a direct result of UK tax reliefs in the oil and gas sector, and the extensive carry-back rules enjoyed by oil and gas companies. As set out in Part 3, ***this is precisely the mechanic of the UK's oil and gas fiscal regime which is being extended via TTH.***

¹⁷ Under the EU Accounting and Transparency Directives, Shell was required to disclose payments to governments for all their projects worldwide.

¹⁸ See Royal Dutch Shell, [Report on Payments to Governments for the Year 2016](#), p.12

¹⁹ Glasgow Herald, 14 June 2017, "[Shell gets \\$142m tax refund in UK as decommissioning bills mount](#)"

Part 3: TTH will increase decommissioning-related tax refunds

As set out in Parts 1 and 2, tax reductions and tax reliefs introduced under the “driving investment principles”²⁰ for the UK North Sea have seriously reduced the UK Exchequer’s share of per barrel profits from oil and gas production. In a 2015 study, resource governance experts the Natural Resource Governance Institute identified lower tax take as one of the key factors contributing to the UK missing out on £400 billion over 40 years, compared to Norway’s earnings per barrel for its oil. As noted by NRGI:²¹

“For other countries seeking to extract more from their resources this case study suggests a valuable lesson: given political stability and competent institutions, a state can have both a relatively high tax burden on its industry and direct ownership of assets, and deliver more revenue for its citizens and still attract investment.”

Looking forwards, however, these tax incentives have also made the UK Exchequer liable for significant future tax rebates when companies’ decommissioning costs fall due. TTH is an extension of current strategy and may magnify the public liabilities involved. As described in a 2017 Treasury discussion paper:

“TTH will allow the seller of a UK or UKCS [UK Continental Shelf] oil or gas field to transfer to the buyer of the field some of its historic profit chargeable to Ring Fence Corporation Tax (RFCT) and Supplementary Charge (SC) (referred to as tax history).”²²

The hope is that new companies specialising in late-life oil assets will buy UK field interests from existing owners and continue production for a few years longer than their predecessors. If the new company’s profits do not meet its decommissioning costs, it will be able to set off the decommissioning-related loss against the historic profits and tax payments of its predecessor. In other words, the incoming company will be allowed to claim rebates of taxes it did not pay.

TTH is thus designed to maximise claims under the decommissioning refund regime: if a company exiting the North Sea does not claim a refund, its successor can inherit the right to do so. It is

²⁰ See for example Oil and Gas Authority, “[OGA Overview 2016](#)”, p.16

²¹ Natural Resource Governance Institute, 5 October 2015, “[Did the UK miss out on £400bn worth of oil revenue?](#)”

²² HM Treasury, November 2017, “[An outline of transferable tax history](#)”, p.7

designed to ensure that all the unused tax rebates claimed by one company or another, in the hope this money will be invested in increasing production from the UK North Sea.

As explored further in Appendix 1, this rationale behind the policy is questionable on several levels, including the lack of a Treasury strategy to ringfence money for these refunds to be paid, and a lack of consistency with UK's climate commitments. In purely fiscal terms, however, the question is whether TTH is a good deal for the UK – what are the additional costs and will TTH generate enough extra revenue to cover them?

In Global Witness' view the evidence presented by Treasury justifying TTH falls well short of answering that question. As described in Appendix 1 below, this contains no comprehensive analysis of extra decommissioning liabilities, no long-term projections of the impact of TTH on future revenue, no consideration of the potential for TTH to impact company behaviour (with a knock-on impact on the usefulness of precedent as a predictor of future investor behaviour) and nothing indicating the impact on the future oil price of this cost-benefit analysis.

Global Witness therefore commissioned its own analysis testing the fiscal outcomes of TTH on UK public oil revenue under different assumptions of future oil prices, decommissioning costs, oil production levels and operating costs.²³ This is attached as Appendix 2 with the key findings summarised below.

Key finding 1: The profitability of TTH to the Exchequer is highly contingent on the oil price.

Our economic analysis shows that the overall impact of TTH will depend on future oil prices:

“In general, the lower are crude oil prices, the greater the impact that TTH will have on company cash flows and on Treasury taxes collected. In effect, during periods of lower prices TTH will exacerbate Treasury exposure and partially insulate buyers of assets.”²⁴

This correlation is also explicitly built into the draft TTH legislation. While companies can negotiate how large a tax history to transfer,²⁵ a TTH transfer will only “activate” where a company's profits

²³ For full details of the methodology and assumptions underpinning the economic analysis see Appendix 2, p3.

²⁴ Appendix 2, p.10

²⁵ See s.3.1(b) of Part 2, [Schedule 1 of the draft TTH legislation](#), “Total TTH amount”

from a transferred field are exceeded by its decommissioning costs.²⁶ The amount of TTH is limited to the difference between the two.²⁷

The cost of TTH to the Exchequer is therefore directly dependent on the profitability of the oil and gas fields transferred. Field profitability is determined by the global oil prices and the level of operating costs, with the oil price likely to be the most volatile variable.

Neither the oil price, however, nor industry operating costs, are in the control of the UK Government. TTH is therefore a long-term bet on the global oil price and other factors beyond public control.

Key finding 2: In adverse market conditions, TTH could cost the UK Exchequer over £3bn

Our economic analysis clearly shows Treasury exposure will be greatest when the oil price is low²⁸:

“Overall impact on the Exchequer could range from virtually zero to roughly £3+ billion reduction in tax receipts over the next ten years depending on oil prices and a number of asset sales and decommissioning.”²⁹

Should oil prices remain high, profits from new production may exceed decommissioning costs and TTH for few fields will not be “activated”. Should oil prices fall, however, The UK Exchequer will be left with expensive rebate liabilities without have benefitted from any increased production revenue to pay for them. This could result in over **£3 billion or more in extra costs to the Exchequer over the first 10 years**, stemming from refunds claimed over and above what would have been claimed without TTH in place. This would increase the £24 billion public liability for decommissioning-related tax refunds anticipated by HMRC by over 12.5%.³⁰

It should also be noted that this economic analysis was conducted over a 10-year time horizon. Should decommissioning costs rise or TTH incentivise more transactions than anticipated in the model, this could increase the cost to the public accordingly, as will any additional decommissioning liabilities which become due beyond that 10-year window.

²⁶ See s.27.1(b) of Part 5, [Schedule 1 of the draft TTH legislation](#), “TTH activation”

²⁷ See s.35(b) of Part 5, [Schedule 1 of the draft TTH legislation](#), “Total activated TTH amount”

²⁸ Based on an oil price of \$40 per barrel and 100 field interests sold using TTH. For a full methodology see Appendix 2, p3.

²⁹ Appendix 2, p.10

³⁰ Based on HMRC’s estimate of £24bn, HMRC, June 2018, [Statistics of Government Revenues from UK Oil and Gas Production](#), p.21

Key finding 3: TTH may change the incentives for oil producers

As described in the economic analysis, the availability of TTH may radically alter the economics of oil fields acquired by new entrants to the North Sea. Under current tax rules, the economic analysis notes that new entrants will generally have an interest in fully developing the production potential of their acquired fields, to maximise the profitability of their new asset:

“in virtually all circumstances without TTH, a buyer of a field equity interest currently has a built-in incentive to invest in developing additional production as the production associated with that investment would serve to add sufficient new taxable income to enable fuller deductibility and carry-back of decommissioning losses.”³¹

In other words, new entrants are currently incentivised to make new investments in their acquisitions to attain fuller tax recovery for decommissioning costs. This incentive falls away where TTH has allowed the seller to inherit a substantial history of taxed profits:

“In other words, one of the reasons for making new investments under the current system is the potential to attain fuller tax recovery for decommissioning costs. This “incentive” for new investment will no longer be in place under a TTH system.”

and

“TTH will generally reduce existing incentives for making new investments in acquired oil fields, especially in lower price environments.”³²

Perversely, TTH may therefore actually reduce the cost to new entrants of early withdrawal from their fields.

Key finding 4: The immediate beneficiaries of TTH will be the sellers exiting the oil fields

As explained in our economic analysis, sales of interests in oil and gas fields are typically agreed based on the net present value of the asset: if the buyer’s calculation of value meets that of the sellers, the offer is likely to be accepted.³³ One significant variable is the tax situation of the buyer and seller:

³¹ Appendix 2, p.7

³² Appendix 2, p.10

³³ Appendix 2, p.3

“These results typically vary due to different views on oil prices, ability to reduce costs, and upside potential for adding new production. But they can vary due to different tax situations of the buyer and seller such as the buyer’s lack of a history of taxable income creating an inability to fully recover the tax refund associated with deducting and carrying back the loss associated with the cost of future decommissioning.”

By allowing the buyer to price in an element of the seller’s tax history, TTH will bring these estimates closer together, in theory allowing more oil field transactions to take place. Crucially, the immediate beneficiary is the **Seller** of the oil fields, in that TTH creates a larger market for interests in ageing fields and allowing them to command a higher sales price:

“In the case of TTH the additional tax reduction value to the buyer certainly will be incorporated into the seller’s analysis and part of that value may be “extracted” by the seller in the form of a higher sales price.”³⁴

This in turn could reduce new investment obtained through TTH:

“Depending on how much of the additional value attributable to TTH will be extracted by the seller of the field interest, TTH may actually end up limiting or having no effect on the number of asset acquisitions.”³⁵

In effect, TTH may subsidise existing producers’ exit from the UK North Sea, allowing them to get expensive decommissioning liabilities off their books, rather than boost the capital available to the buyers to invest in increased production. This comes at potentially significant cost to the Exchequer, in terms of additional rebate liabilities and may not produce the investment TTH was intended to incentivise.

Additional note: The decommissioning costs are estimates and could rise

We note further that the economic analysis is based on certain key assumptions, including the cost of decommissioning in the UK North Sea:

³⁴ Appendix 2, p.3

³⁵ Appendix 2, p.10

“The Oil and Gas Authority and the UK Oil and Gas Industry Association survey estimate annual decommissioning costs in the UK to be in the range of £1.7 to 2.0 billion per year over the next ten years... The base case assumption used in the economic analysis was that the full decommissioning costs per field would average £125 million.”³⁶

As described above, HMRC anticipates decommissioning costs of £64bn by 2063.³⁷ While it is possible, as suggested in the economic analysis, that technology advances will drive decommissioning costs down, it is equally possible that unforeseen contingencies could push decommissioning costs up.

Indeed, a rise in costs is anticipated in section 5 of the draft TTH legislation, which provides for TTH transfer of an “uplifted decommissioning costs estimate” worth up to double the estimated decommissioning costs.³⁸ While TTH tax rebates will always be capped at actual decommissioning costs, the fact that policy makers have provided for this contingency suggests that industry and regulators anticipate decommissioning costs could over shoot current estimates by up to 100%.

Overall assessment

The overall picture is therefore one of uncertainty: the “profitability” for the UK of TTH is dependent on market forces beyond our control; the revenue projections based on precedent of past industry behaviour must be treated with caution, because of changed incentives; and the final cost of decommissioning is a major variable. Depending on oil price movements, TTH could cost the UK over £3 billion or more in additional tax refund liabilities over 10 years, and with skewed incentives and a volatile oil price, there is no clear picture on how much additional revenue TTH will bring in. The immediate beneficiaries appear to be companies exiting the UK North Sea, who are looking for new buyers on whom to offload their decommissioning liabilities, rather than the new companies on whose investment TTH relies.

³⁶ Appendix 2, p.5

³⁷ See HMRC, June 2018, [Statistics of Government Revenues from UK Oil and Gas Production](#), p.21

³⁸ See s.5(d) of Part 2, [Schedule 1 of the draft TTH legislation](#), “The “uplifted decommissioning costs estimate””

Part 4: Government has failed to quantify the impact of TTH on decommissioning-related tax refunds

Under these circumstances, we would expect the policy justifications for TTH to include detailed modelling of the financial impact of TTH over the newly extended field lifetimes, showing the financial impact of TTH on production revenue and decommissioning rebates, along with explanations of the underlying assumptions around the operating costs, decommissioning costs and the oil price. In other words, there should be a published analysis showing the possible profits and costs to the Exchequer in different market conditions. In Global Witness' view, the published information justifying TTH falls well short of this standard.

The Government has published the following on the subject:

- HM Treasury: [An outline of transferable tax history](#), November 2017
- HM Treasury: [Discussion paper: Tax issues for late life oil and gas assets](#), March 2017
- [Draft legislation and guidance on transferable tax histories](#)
- Description of TTH in the [Policy Costings Document accompanying the 2017 Autumn budget](#) (p.15)
- [Minutes from the Expert Panel on tax issues for late-life oil and gas assets](#), April 2017

We have identified a variety of apparent shortcomings in the public justification for TTH, in which the Government's cost-benefit analysis is either unclear or evidently deficient.

Shortcoming 1: No data quantifying impact of TTH on overall decommissioning rebates

Parts 1, 2 and 3 of this submission set out how the Exchequer is liable for expensive decommissioning-related tax rebates and how TTH will magnify that exposure, potentially costing the UK an extra £3 billion or more. Alarming, none of the above documents even acknowledge the potential for TTH to increase UK public liability for decommissioning costs, let alone try to quantify this increase in different market scenarios.

HMT's November 2017 discussion paper reproduces a table of "Exchequer impact", copied from the Autumn budget, which forecasts additional profits of £70m by 2023. This projection does not explain any of the assumptions as to oil price or operating costs on which these numbers are based, nor does it specify whether they are gross or net of decommissioning liabilities. The discussion paper notes that the figures have been certified by the OBR, yet the OBR forecast evaluation report for 2017 suggests that considerable uncertainty remains about HMT's fiscal modelling of oil and gas revenues:

“While developing the new model, HMRC identified an issue in the way that company-level losses were being carried forward to be set against future profits. This was corrected in our March forecast, reducing receipts by around £1 billion a year.”³⁹

This uncertainty as to the basis of the government’s revenue projections for TTH is pointed out in the Economic Analysis, which states:

“Presumably [emphasis added], the HMRC has incorporated the critical belief that the tax losses to the Exchequer due to permitting TTH will be more than offset by additional taxable income that could be generated from oil and gas activity presumably incentivised by TTH.”⁴⁰

The Government’s figures do not clearly state whether potential additional costs have or have not been considered. They do not quantify additional decommissioning liabilities, or any of the assumptions underpinning the presumed belief that extra revenues will be sufficient to cover them.

Ironically, this issue is noted in the minutes of the expert panel convened on TTH, in which the group agreed that *“any change would have to ensure that there would be no additional net cost to the Exchequer.”⁴¹* Yet we could locate no confirmation in the subsequent policy documents for TTH that this condition was assured.

Shortcoming 2: Inappropriate time horizons which appear to exclude decommissioning costs

The “Exchequer impact” data referred to above makes revenue predictions from the 2017-2018 financial year through to the 2022-2023 financial year. It projects that TTH will generate an extra £70m over that period.

As set out above, there appear to be considerable uncertainties around that figure. In addition, we view this as an entirely inadequate time-horizon over which to assess the TTH policy. As explained in Part 2 above, HMRC anticipates that decommissioning costs will continue to become due until 2063, forty years after the end of Treasury’s reference period. As our economic analysis shows, even

³⁹ Office for Budget Responsibility, October 2017, [“Forecast Evaluation Report”](#). P.74

⁴⁰ Appendix 2, p.2

⁴¹ [Minutes from the Expert Panel on tax issues for late-life oil and gas assets](#), April 2017 p.3

extending the time horizon to ten years, the short-term £70m benefit is a drop in the ocean compared to the possible £3 billion plus in additional costs.

Worse, the six-year time horizon employed by Treasury is potentially profoundly misleading. The stated aim of the TTH policy is to extend the life of UK oil fields and delay the onset of decommissioning.⁴² If we assume TTH will meet this objective, the reference period selected by Treasury includes the years in which UK may benefit from extra revenues, but stops short of the years in which delayed decommissioning costs crystallize. This is an arbitrary and misleading reference period which disguises the long-term impacts of TTH as a whole.

Shortcoming 3: Failure to recognise the potential for TTH to produce perverse incentives, under which future production trends may diverge from past behaviour.

Without details of the assumptions underlying the Exchequer Impact, it is difficult to assess the validity of the projections of £70m extra revenue by 2023. As described in Part 3 above, however, the changes to incentives for decision makers in oil and gas producing companies in the UK resulting from TTH mean that any projections of future revenue based on patterns of past behaviour should be treated with caution.

Once again, there is no indication that Treasury has considered the potential for TTH to change producers' behaviour, such that the assumptions underpinning the extra revenue projection may not hold true. This is explained succinctly in the Economic Analysis:

*"The positive impacts to the Exchequer that were envisioned presumably were based on greater investment and higher production levels expected to be incentivised via TTH. It is difficult to reconcile this expectation with the actual loss of economic incentives that the current system would have provided."*⁴³

Overall assessment of the Government's analysis

In our estimation, the published policy justifications for TTH fall well short of an empirical standard whereby government could rationally and confidently adopt the TTH policy in the interests of the UK. The publications to date do not adequately assess the cost, nor the benefit, of the policy over an appropriate time period.

⁴² HM Treasury: [An outline of transferable tax history](#), November 2017, p.4, para 1.5

⁴³ Appendix 2 p.10

Global Witness therefore recommends that the Government:

- Immediately and indefinitely postpones implementation of TTH, until adequate modelling is done to understand the full, long-term impacts
- Prepares and publishes a detailed model of the impact of TTH on public liability for decommissioning liabilities in different oil market scenarios.
- Prepares and publishes a cost benefit analysis – showing the impact of TTH on liabilities and revenues – on a timescale consistent with the 44-year decommissioning projections compiled by HMRC.
- Accompanies any future TTH policy with a detailed plan as to set aside sufficient current revenue to cover the decommissioning liabilities.
- Review the “Maximising Economic Recovery” policy to reconcile it with both a long-term plan to fund decommissioning costs, and the Paris climate agreement.

Appendix 1: TTH, MER and wider resource stewardship

As set out in Parts 1,2, 3 and 4 above, we are deeply concerned by the potential impacts of TTH, which represent a significant extension of a decommissioning relief policy, in turn creating huge future liabilities for UK tax payers and, in unfavourable market conditions, we believe could add £3 billion or more to overall costs to the UK. We consider the Government's analysis of these risks to be inadequate and we recommend the policy is immediately removed from the legislative agenda, pending full financial modelling of the impact of this change.

In addition, however, we consider TTH to be one symptom of a wider policy failure around UK oil and gas production, whose MER framework prioritises short-term fiscal benefit at the expense of wider resource governance priorities.

MER incentives are producing liabilities which are unfunded by Treasury

To our knowledge, no money is being set aside from current oil and gas revenue to pay for rebates arising on decommissioning costs. Current UK oil and gas revenue is funding the UK's budgetary expenditure. HMT is spending money it may one day have to pay back.

This suggests an alarming disconnect between MER and UK budgetary policy: MER is incentivising new production through promises of future rebates, but HMT is spending any money generated from it rather than accumulating a reserve to pay for them. Decommissioning costs crystallize when fields are abandoned and production ceases, creating an obvious danger that the rebate demands will spike just as oil and gas revenues are drying up and that money must come from other sources of income. As occurred in 2016, the UK may face a large decommissioning-related rebate bill just when it does not have the cash flow to pay for it.

TTH may magnify whatever financial impact ultimately hits. Yet the absence of a clear analysis of the impact of TTH on decommissioning costs suggests MER is generating tax incentives without sufficient fiscal planning. Any policy based on the assumption that TTH will generate fresh current revenue must be accompanied by a strategy to repay the future liabilities which are quid pro quo.

MER liabilities are being locked in by secret contracts

Since 2013 The Government has been signing "decommissioning relief deeds" (DRDs) with oil and gas companies.⁴⁴ These agreements "lock-in" the current levels of decommissioning reliefs available

⁴⁴Decommissioning relief deeds were introduced in the Finance Act 2013, based on a [2012 consultation](#) responded to by industry and their legal and tax advisors.

to companies, committing The Government to compensate companies should the reliefs be reduced by future governments. Although a model “DRD” is available online, the actual contracts signed with companies are not typically made public.

DRDs tie the hands of future governments, which is worrying given the scale of decommissioning liabilities and the size of the tax rebates we have already seen claimed. As described above, the UK’s decommissioning relief policy may be storing up expensive rebates, which will have to be paid by future governments just as oil and gas revenues are drying up. Should the oil market dip or decommissioning costs rise creating higher decommissioning related rebates than anticipated, the compensation mechanic will leave future governments with no means of cushioning UK from the fiscal blow.

MER is incompatible with the Paris agreement

In 2015, nearly 200 countries agreed to limit global temperature rises to well below 2°C, with the aim of limiting temperature rises to 1.5°C, delivered through national action plans to reduce emissions accordingly.⁴⁵ There is overwhelming evidence that the carbon in even existing fossil fuel production will take the world well beyond these limits; therefore meeting these commitments will require not only a moratorium on new exploration, but the winding down of a substantial portion of current projects.⁴⁶

As the UK is a signatory to the Paris agreement, the MER strategy is incompatible with this commitment. The central obligation of MER is to *“take the steps necessary to secure that the maximum value of economically recoverable petroleum is recovered from the strata beneath UK waters”*.⁴⁷ Tax incentives such as TTH are conceived as tools for maximising production towards that aim. The Paris goals, on the other hand, require UK to recover a far lower proportion of its remaining oil and gas than the theoretical economic maximum. This in turn requires an entirely different policy toolkit, aimed at establishing Paris-compatible maximum production targets and a strategy to determine which combination of oil fields can most safely, efficiently and profitably exhaust UK’s “quota”.

⁴⁵ See European Commission, https://ec.europa.eu/clima/policies/international/negotiations/paris_en

⁴⁶ See for example Oil Change International, October 2016, [“The Sky’s Limit: Why the Paris climate goals require a managed decline of fossil fuel production”](#)

⁴⁷ UK OGA website, accessed 27 August 2018, <https://www.ogauthority.co.uk/regulatory-framework/mer-uk-strategy/>

Prior to any new oil and gas tax incentives, therefore, the Government should reconcile its oil and gas policy with its climate commitments, establishing how much of UK's reserves it can justly and equitably extract. This will inform decisions as to whether costly new investment incentives such as TTH are necessary, or whether UK will "max" its quota by running down existing production. Investment in depleted fields targeted by TTH – which require costly and energy-inefficient enhanced oil recovery techniques with higher carbon emissions – may not offer the best value for the UK.⁴⁸

Appendix 2: Economic Analysis.

Please see separate document.

⁴⁸ See for example Adam R. Brant, 2011, [Oil Depletion and the Energy Efficiency of Oil Production: the Case of California](#)