Prime Minister (1)

Agree, subject to colleagues views', to publication of this reply?

MCS 26/7

01 211 6402

The Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
LONDON
SW1P 3AG

Yes

26 July 1982

Dear Chancellor,

OIL DEPLETION POLICY - RESPONSE TO REPORT FROM SELECT COMMITTEE ON ENERGY

I attach a draft response to the above Report. will request is required

As we have agreed, this deals with both the depletion aspects and the Committee's criticisms of the North Sea fiscal regime. It will therefore go out in both our names.

As regards depletion policy per se, there is much in the Report with which, I am sure, we can both agree. Effectively, it argues that we should let market forces work and that any general Government intervention should be restricted to a possible future situation where the national interest is clearly and substantially at risk. While the Committee's rather cavalier treatment of the fiscal regime clearly cannot be allowed to go unchallenged, I think we should welcome the general thrust of the Report in emphasising the need to encourage exploration and development. A response on these lines would also help to improve the oil industry's confidence and attitudes.

Events have moved on since David Howell made his depletion policy statement in 1980. We have already announced that there will be no production cuts before 1985 at the earliest. A number of development proposals have been deferred by the companies and those that we expect to come forward are unlikely to result in substantial new quantities of oil starting to flow until we are over the mid-1980s "hump". In these circumstances I agree with the Committee's conclusion that there should be no direct and general intervention to restrict North Sea production, subject only to the safeguard of "reserve powers". A clear statement on these lines would be welcome news to the oil industry as well as our EC partners.

I believe it is most important that we get the reply to the Committee before the House rises for Recess. (We have already overshot the two month deadline for responding to Select Committee Reports). The substance of the draft has been agreed between our officials. I also understand that the part dealing with the fiscal regime reflects some comments made by John Wakeham. I hope therefore that you will be able to let me have a reply by close of play on Tuesday 27 July.

I am copying this letter and the draft reply to the Prime Minister, Francis Pym, Patrick Jenkin, George Younger, Sir Robert Armstrong and John Sparrow.

Yours sincerely,

pp. NIGEL LAWSON

(Approved by the Secretary of State
and signed in his absence)

Energy Pol Pt 7

cc JV

MBPM

MS 30/7

CABINET OFFICE

Central Policy Review Staff

70 Whitehall, London SW1A 2AS Telephone 01-233 7765

From: John Sparrow

Qa 06003

CONFIDENTIAL

30 July 1982

The Rt Hon Nigel Lawson MP
Secretary of State for Energy
Thames House South
S W 1

Dear Nigel,

Oil Depletion Policy - Response to the Report from the Select Committee on Energy

I have seen your letter of 26 July to the Chancellor of the Exchequer enclosing a proposed Government reply to the Select Committee on Energy's Report on Oil Depletion Policy.

I support the proposed statement and welcome your decision on the use of reserve powers as part of the general policy of allowing market forces to set depletion rates.

I am sending a copy of this letter to the recipients of yours.

Yours sincerely,

John.

John Sparrow

CONFIDENTIAL

Energy

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

28 July 1982

The Rt Hon Nigel Lawson, MP
Secretary of State for Energy

Dear Nigel

OIL DEPLETION POLICY - RESPONSE TO REPORT FROM SELECT COMMITTEE ON ENERGY

26 July - attached

Thank you for sending me the draft response to this Report. As you say, it reflects comments made by John Wakeham; and I am happy for it to go out in both our names.

I am copying this letter to the recipients of yours.

GEOFFREY HOWE

28 JUL 1982

Prime Minister ①

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MCS 26/7

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Chancellor of the Exchequer
HM Treasury
Parliament Street
LONDON
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Yours sincerely,

pp. NIGEL LAWSON

(Approved by the Secretary of State
and signed in his absence)

SELECT COMMITTEE ON ENERGY

NORTH SEA OIL DEPLETION POLICY

MEMORANDUM BY THE SECRETARY OF STATE FOR ENERGY
and THE CHANCELLOR OF THE EXCHEQUER.

Introduction

The Government welcomes the Committee's Report (published on 18 May 1982) as a thoughtful and constructive contribution to the consideration of the important question of the depletion of the nation's offshore oil reserves.

2. The Government cannot accept some of the Committee's arguments and conclusions, particularly the criticisms of the North Sea Fiscal Regime. But it agrees with the Committee's general conclusion that the emphasis at the present time should be to encourage exploration and development. The Government's objective is to maximise economic oil production over time. It has already announced that it does not intend to impose production cutbacks before 1985 at the earliest. It also considers that it would not be appropriate in the foreseeable future to delay development. There are, however, as the Committee recognise, many uncertainties on the oil scene and the Government welcomes the Committee's recommendation of the need for the Government to retain reserve powers which could be implemented should circumstances change. Meanwhile the need for good oil-field practice and the tight control of gas flaring will continue to be given higher priority.

Government's Approach

3. Oil depletion policy must be consistent with the main thrust of the Government's wider economic policy objectives. As the Committee recognise, the Government has to consider very carefully both the macro and the micro economic effects of depletion decisions. These include the contributions current revenues make to the nation's prospects of general economic recovery; the possibility that, with rising oil prices, the revenues might ultimately be higher if production were delayed; and the effects that depletion controls might have on the thorough exploration and exploitation of the UK Continental Shelf.

4. Decisions on the rate of production would be much simpler if the future could be predicted with any certainty. As the Committee recognise, this is not possible. Uncertainties exist over world oil supply prospects, the ultimate size of the UK's recoverable reserves, the exact pattern of UK demand and supply over time, production costs, the future path of oil prices, the possible returns from alternative investments, and the particular relationships that may exist between the rate of oil production and other macro-economic factors. In particular, the future path of oil prices, which is crucial to any decision to intervene directly and sensibly to control UK oil production, is highly uncertain. The Government agrees with the Committee that clear economic advantages need to be demonstrated before a restrictive depletion policy can be justified. Such a clear economic advantage cannot be demonstrated, and in the Government's view the uncertainties are too great to justify Government action in the foreseeable future to delay UK oil production.

5. The Government attaches great importance to retaining the confidence of the UK oil industry. Depletion is one of the factors which determine the attractiveness of the UK as an operating environment for the oil companies. Other factors include licensing arrangements, the fiscal regime and political stability. The Government hopes that its recent announcement that there will not be production cuts before 1985 at the earliest, and this response to the Committee's Report, will be further encouragement to the oil industry to continue to invest in the North Sea.

6. The statement on oil depletion policy made by the then Secretary of State for Energy (The Rt Hon David Howell MP) on 23 July 1980 emphasised the major uncertainties about future levels of North Sea production and UK consumption which pointed to a flexible, case by case, approach to depletion decisions. The statement also stressed the need to ensure good oil-field practice at existing and new fields and stated the Government's intention to tighten control of gas flaring. Good oil-field practice and control of gas flaring remain essential to achieve optimum oil and gas recovery in the national interest.

7. The Report suggests (paragraph 19) that "If the income over time from oil exploitation is maximised by the uninhibited actions of the oil companies it should also follow that Government revenues would also be maximised if the tax system is designed to avoid distortions". It goes on to recognise (paragraph 21)

that the Government may have a different perception of the optimal depletion rate from the North Sea. This difference in perceptions may also arise at the field level. As the Committee note, the oil companies tend to use higher discount rates than the Government in valuing the streams of expenditure and income likely to arise from a new field and in assessing the attendant risks. The result is that companies will tend to put greater emphasis on high levels of production in the earlier years of field life, the Government relatively more emphasis on maximising the total amount of oil recovered over the lifetime of a field. All oil-field experience shows that too rapid a rate of depletion in the earlier years of a field's life can prejudice the total amount of oil ultimately recovered from a field. In these circumstances, it is not necessarily true that what is good for the oil companies is good for the nation. The Department of Energy therefore needs to pay particular attention to improving recovery ratios by ensuring that field development proposals are adequate to drain the likely oil accumulation(s) effectively (through the arrangement of production facilities, drilling programmes and well producing rates), and that pressure maintenance techniques are employed wherever possible at an early stage in field life.

8. The Government policy of reducing gas flaring where technically and economically feasible has succeeded in bringing it down from the peak rate of 21.5 million cubic metres a day (mcmd) in June 1979 to 12 mcmd in May 1982, while oil production has increased by 30% to its present level of around 2 million barrels a day. The purpose of reducing flaring for later recover of the gas is to conserve a valuable resource in its own right, rather than as the Report implies (paragraph 76) to delay oil production (although that may in certain circumstances be an indirect consequence of flaring restrictions).

9. The Government agrees with the Committee that development delay is preferable to other available depletion controls. In economic terms, development delays are to be preferred to production cutbacks because costs, as well as production (and hence revenues) are delayed. Where a new field has discounted costs amounting to half its present value revenues, delay in developing the field begins to become economically attractive if oil prices rise in real terms at only half the discount rate; whereas production cuts, as the Committee recognise, only do so when the rate of increase in oil prices exceeds the discount rate.

10. Any development proposal now coming forward is unlikely to result in oil starting to flow until after the peak years of 1985-86 envisaged in the Department of Energy's central projections. In view of all the uncertainties and taking account also of the need to avoid any fluctuations in orders for new developments, in the interests of the offshore supplies industry (Report, paragraph 83), the Government agrees that there is no case in the foreseeable future for deferring new field developments. The Committee may be assured that there have not been, and will not be, any avoidable delays in consideration by the Department of Energy of new field development proposals.

11. The Government considers that what is required in the present circumstances is a pragmatic and flexible approach concentrating on:-

- the monitoring role favoured by the Committee;
- conserving gas for later recovery where technically and economically feasible by continuing a tight flaring policy;
- encouraging further exploration (see paragraphs 15 - 20 below).

There is thus a wide measure of agreement between the Committee and the Government on the approach to oil depletion policy.

12. It is, however, the Government's intention to retain reserve powers of intervention, as the Committee recommend, against the possibility of some clear shift in the oil market or elsewhere which threatened to open up an important divergence between the national interest and the established pattern of depletion on the UKCS.

13. These powers will not be used lightly. The circumstances of their use would indeed relate (Report, paragraph 92) to "specific and overriding requirements in the national interest or to a radical change in circumstances pertaining to the UKCS and its development". The Committee gives an illustration of two such situations (Report, paragraph 46). To seek to move from illustration to specification of the conditions in which such controls would be activated (paragraph 92) is, however, unrealistic. The Government cannot responsibly constrain its ultimate freedom of manoeuvre. What is has done, and will continue to do, is to illustrate by its actions that there will be no wanton interventions to disrupt company expectations of their prospects on the UKCS. If circumstances should change such that it became necessary to consider seriously the use of reserve powers, the Government would certainly consider what assurances might be given in parallel.

14. For the reasons given above (paragraph 9), if reserve powers have to be used, development delay is to be preferred to other available options, as the Committee recognise. Royalty banking involves certain costs and potential risks for the Government, associated with the lack of incentive for companies to recover the banked oil when fields are in decline. It is not, therefore, an acceptable option.

The Longer Term - Licensing and Exploration Policy

15. The Government attaches importance, as does the Committee, to encouraging more exploration.

16. Much has already been achieved. 47 exploration wells were started in 1981 - the highest number since 1977. Including appraisal drilling, 73 wells were started, a total higher than that of any of the three preceding years. Latest figures for the current year suggest that the level of exploration in 1982 will be higher still.

17. The Government has also increased the pace and scale of licensing through more regular and larger licensing rounds: the Seventh Round was as big as the two previous rounds together and attracted a high level of interest. The application rate for blocks in deep waters (up to 3000 feet), was high - 22 out of 34 on offer - even though no special incentives (as proposed in paragraph 86(ii) of the Report) were offered. Altogether, 90 blocks were licensed - the highest number so far in any round since the Fourth - including 42 in areas commanding a £5 million premium. Some drilling under Seventh Round licences has already been undertaken, with encouraging results.

18. The Government proposes to license about 85 blocks in the Eighth Round. There will be a wide choice of blocks, in line with a suggestion made to the Committee by some of the companies. Areas in which there has as yet been no exploratory drilling will be opened up and further opportunities provided for exploration in the established gas province of the Southern Basin of the North Sea. The Round will for the greater part be based on the discretionary system but some blocks will be put up for auction. The terms of future licensing rounds will be kept under review.

19. The Government does not discount, as the Committee appears to do (Report, paragraph 86 (iii)), the importance of exploring territory licensed in the early rounds. These rounds involved large acreages. Until this territory has been drilled its prospectivity cannot be assessed. Some companies have tended to concentrate exploration activity in the particularly attractive territory offered in later rounds. The Government looks to the companies to increase their efforts in neglected territory.

20. The success of the Government's licensing and exploration policy will be kept under careful review as will the possible need for incentives to encourage exploration in frontier areas, such as the allocation of larger areas for individual licensing or longer periods for exploration (Report, paragraph 86(ii).

Fiscal Regime and Depletion Policy

21. While tax must clearly be a factor to be taken into account in considering the implications of any depletion policy, the Government agrees with the Committee's view (paragraph 93 of the Report) that the fiscal regime is not (for reasons identified by the Committee) a suitable instrument for implementing such a policy, and the Government has not attempted to use it in this way. The Government's own analysis of the effects of the fiscal regime on North Sea development does however differ significantly from that made by the Committee.

The Level of Tax and Development

22. At paragraph 87 the Committee concludes from the evidence put to them that there is a substantial risk that development is being discouraged directly and indirectly by the form of the fiscal regime. The Government does not accept this conclusion. Before making its recent Budget proposals for oil taxation, the Government consulted very fully with the oil industry and considered carefully such evidence as oil companies provided on the effects of the tax regime either generally or on particular projects. In evaluating this evidence it is of course necessary to look critically at generalised assertions and so far as possible to seek more detailed evidence on the profitability of investments. The Government made its own thorough analysis of profitability both in relation to existing fields and also, on the best information available, in relation to likely future developments. The methodology used and some of the conclusions as at December 1981 were explained in the Treasury's Supplementary Memorandum (Q.2a, 2b and 3).

23. There is close and continuing consultation on this work between the Treasury, the Inland Revenue and the Department of Energy. The position is regularly updated in the light of revised forecasts of oil prices, costs and production profiles. Full use is made of the information supplied to the Department of Energy on individual projects. Returns are examined against a variety of different assumptions. (For example, although the North Sea oil price fell by $4 just before the 1982 Budget, this was well within the price sensitivities tested.) A number of different indicators of profitability are examined, including internal post-tax real rates of return, net present values, and cash flows. Some guidance on the ranges of profitability which are likely to be regarded as acceptable by the industry can be found in evidence on existing projects, and in particular in evidence of forecast returns on these projects at the time it was decided to undertake them. On the basis of detailed analysis on these lines, and a critical appraisal of the industry's own representations, the Government believes that a wide range of potential developments in the UK Sector of the North Sea remains attractive. It considers that the fiscal regime is fully compatible with a satisfactory flow of new developments.

24. The Government has carefully examined the factors affecting the deferments mentioned by the Committee in paragraph 73 of the Report and other alleged decisions to postpone developments. It is not convinced that the level of tax has been the determining factor except in one of two cases where it appeared that the pre-1981 system was giving greatly excessive tax reliefs to incremental projects not justified in pre-tax terms. Apart from these, in cases where individual factors have been identified, other factors - in particular price uncertainties and specific technical problems - have been more significant than tax.

25. Obviously this is an area where difficult questions of judgment are involved, and the Government will bear the Committee's concern in mind. However this year's changes - apart from their important structural features (discussed below) - will reduce the burden on the companies by around £90 million in 1983-84 (allowing for the interest cost of accelerated payment). Important further modifications of the original Budget proposals were made at Committee Stage of the Finance Bill. These were designed to meet specific concerns of the industry in relation to less profitable fields. Continued discussions are being held with UKOOA on specific issues, in particular marginal fields and incremental investments in existing fields; the intention is that these should be based, so far as possible, on

more detailed information than the industry has provided hitherto about post tax profitability and cash flow.

The Structure of the Tax Regime

26. As well as expressing concern about the level of tax, the Report also criticises its structure and calls for a thorough overhaul of the regime. (Some detailed comments on these criticisms are given in the Annex.) A number of important structural changes were introduced in the 1982 Budget and Finance Bill, which have now been further modified (subsequent to the Committee's Report) in a number of important respects by the changes announced by the Chancellor on 9 June. All these changes move in the direction sought by the Committee. From the beginning of 1983, the Supplementary Petroleum Duty which is based on gross revenues will lapse, and the arrangements for advance payment of PRT (APRT) will commence. While it is true that APRT will itself be calculated on the basis of gross revenues like SPD, it differs critically from SPD (which is a separate tax imposing its own permanent additional burden) in being an advance payment of PRT which is itself based on profits. It will normally be fully set off against normal PRT liabilities once these arise. And, following the modifications announced on 9 June. liability to APRT will run for a maximum of five years for any single field and any APRT not set off within 5 years will be fully repaid then (rather than at the end of field life under the original proposals). The impact of APRT on less profitable fields has been modified to an important extent by these changes. Moreover liability to APRT (like SPD) arises only after an oil allowance of 1 million tonnes a year per field, which provides very substantial relief for smaller fields (whether these are more or less profitable).

27. It is true that APRT will still impose some tax liabilities before costs have been fully recovered. Indeed it is a main objective of APRT, like SPD before it, to ensure, following the increase in the real price of oil in the late 1970s, that the Exchequer should get some benefit from larger fields in their early years of production. Nevertheless, given that no PRT (apart from APRT) and no corporation tax are due until after costs have been fully recovered, the UK tax system still gives much more "front end loaded" tax relief than most other tax systems. (For example, under the Norwegian system mentioned in the Appendix to the Committee's Report, relief for capital expenditure is spread over 10 years for both corporate tax and the Norwegian special tax.)

28. The Report refers (paragraph 74) to the continuing comparative complication of the North Sea fiscal regime, and also (paragraph 75) to the view of the Comptroller and Auditor General (in his Report on the Appropriation Accounts for 1980-81) that the effects of the present regime are difficult to calculate and are not readily predictable. The Government accepts that the regime remains a relatively complex one, although it believes that abolition of SPD as a separate fourth tier tax and the introduction of APRT (which has been built into the existing PRT structure and will now cease to have any relevance for any particular field within five years of first payment) achieves a modest degree of simplification. It is however inevitable in the Government's view that a regime which is designed to meet multiple objectives and to reflect the widely differing circumstances of oil development in the North Sea should be relatively complex. This is generally the case with oil tax regimes in other countries where the combination of some form of special tax with the normal corporate tax and royalties (which are a normal contractual obligation accepted by oil companies the world over) is commonly found. This complexity does, however, need to be seen in context. The taxpayers concerned are few in number, highly sophisticated and well supported by computer skills. There is no difficulty for them - or the Revenue - in calculating the effects of the regime, or the interactions of its different elements, on the basis of any given set of assumptions. There are of course major problems in predicting profitability of particular projects but this is not due to the complexity of the regime but to large uncertainties about the future of oil prices, production costs and production profiles. However the system might be simplified, these uncertainties would remain (as the Report recognised in paragraph 91).

29. The Report refers (paragraph 73) to the frequent changes in the system. It is true that it has not been possible to provide the degree of stability which had been originally hoped. But the economics of oil production changed so radically as a result of the increase in real oil prices in 1979/80 that it would have been unrealistic to expect that the level of tax or the form of its associated main reliefs could remain unchanged. The main changes made by the present Government reflect this. There has also been a good deal of more technical legislation which has been necessary, often to meet problems put to Government by the industry. The latest changes have, of course, been made specifically in response to representations by the industry on the case for further structural changes.

A New Tax System?

30. The Report calls for a radical change in the tax system. It lists some desiderata for such a system in paragraphs 74 and 87: simplicity, stability, neutrality in its effect on incremental investments, progressivity to take account of large differences in unit costs and profitability, and a level of tax to ensure that high cost fields viable on a pre-tax basis remain so on a post-tax basis. The Government accepts these are in general terms all desirable features. There are however other objectives not referred to by the Committee - in particular the need to secure for the nation a fair proportion of the revenue from a national resource, and the need, where changes are made, to minimise disruptive transitonal problems. And in the real world objectives will be found to conflict to some extent (eg some of the original reliefs designed to take account of differences in unit costs and profitability between fields were found to distort incentives for incremental investment, and a system which provides for rapid recovery of initial costs, and thus for a higher effective rate of tax later in field life, cannot be wholly neutral in its effect on the timing of incremental investments). What has to be achieved is a system which reconciles the various objectives to the maximum extent possible in practical terms. This can only be tested against precise proposals.

31. The structure proposed by the Government following this year's Finance Bill does in the Government's view represent a carefully considered attempt to meet so far as possible the various desiderata and objectives involved in a practical way. Apart from contractual royalties, it will be a system which, once any APRT liability has been set off or repaid, will be fully based on profits. It recognises differences in unit costs and profitability through the important PRT reliefs of oil allowance and safeguard. Detailed analysis has shown that after-tax rates of return on incremental investments after payback has been reached will, following the abolition of SPD, be very close to pre-tax rates of return. Small fields will pay little or nor APRT or PRT (mainly due to the oil allowance) and post-tax returns are therefore not much more reduced compared with pre-tax returns than the returns of any other investment in the economy.

32. The Committee do not themselves spell out the form which they consider the tax structure would have to take to achieve the objectives more satisfactorily than the proposed system. Nor have they attempted to quantify the implications of their ideas in terms of cost (although they express the belief

that the loss of revenue in the short term would be comparatively small). It is difficult for the Government to give a fully considered reaction to the Committee's ideas without knowing what sort of tax system they have in mind. The Government has devoted considerable effort and resources over the past few years to analysing a wide range of alternative tax systems, including for example schemes where tax is explicitly linked to profitability (on the lines recently proposed by the Institute of Fiscal Studies). It does not believe that these alternatives would meet the various objectives involved more satisfactorily than the structure it now proposes. And it has noted that the industry itself is opposed to changes that would involve an unnecessary degree of structural upheaval, together with major uncertainties and significant transitional problems. The Committee themselves have stressed the objective of a greater degree of stability and the undesirability of frequest substantial changes. The Government is therefore opposed to the Committee's recommendation of another fundamental review.

33. The Government believes that the proposed oil tax system provides a reasonable compromise between conflicting objectives and a sound basis for the future. It will, of course, continue to discuss with the oil industry particular problem areas and has certainly not closed its mind to the possibility of detailed improvements if a case can be made out for these. But, as the Chancellor said in his Budget Speech, the Government hopes that the structure of the fiscal regime following this year's Finance Bill will provide a more secure and stable regime for the future, permitting development to go ahead uninhibited by major fiscal uncertainties.

The Fiscal Regime - Some Detailed Comments

Paragraph 71

The marginal rate of tax relief on an investment made after the safeguard has expired is 89.5% where the expenditure qualifies for royalty relief as conveying and treating costs under First to Fourth Round licences - the same as the marginal rate of tax on the resulting income. This results in the post-tax rate of return being very close to the pre-tax rate of return. Where royalty relief is not available and the marginal rate of relief is 85.6%, the difference is still not great. For expenditure at an earlier stage in field life the rate of relief is higher and can exceed 100% but the company normally has to wait for relief to be effective. This can result in post-tax returns being either somewhat higher or lower than pre-tax reliefs, depending on timing, but perfect neutrality is by and large not compatible with a system of front-end loaded reliefs, with tax low in the early years of a field life and high later on.

Paragraph 73

Companies paying PRT do not pay tax at a marginal rate of over 100% on North Sea profits. Because PRT is a tax on oil production profits and there is a ring fence around such profits for corporation tax, losses on activities outside the North Sea cannot be used to reduce North Sea taxes. If losses are being made at the margin outside the North Sea then the marginal rate of tax on a company's activities overall could in principle amount to over 100%. But the ring fence was introduced in 1975 precisely to stop losses outside the North Sea eroding North Sea tax take (see the Report of the PAC 1972/73) and we assume the Committee does not propose the ending of this principle which could put Government's share of North Sea revenues seriously at risk.

The paragraph suggests that when a field is paying tax at the full marginal rate of 90.28 per cent the sahre of total liability taken by taxes on gross revenues is 36 per cent. However even under the present system with SPD, it would be more accurate to say that the percentage is 22 per cent; under the proposed regime it will be between 0 and 14 per cent. All existing fields, and many future ones, come under the first to fourth licensing rounds where conveying and treating costs are allowed against royalties. So to the extent that these costs are allowed royalties are not based on gross revenues; SPD is (although there is a substantial oil allowance not directly related to costs) but APRT is not in that once a field is paying at the full marginal rate APRT is immediately set off against normal PRT based on profits. Under the existing regime, therefore, SPD at 20 per cent is in practice the only tax on gross revenues, equivalent to 22 per cent of the marginal rate. Under the proposed regime no charge on gross revenues will be imposed on fields under the first to fourth rounds, and, where royalties at $12\frac{1}{2}$ per cent are charged under the fifth and subsequent rounds (for which conveying and treating costs are not allowed), the charge on gross revenues will be equivalent to 14 per cent only of the marginal rate. The Committee regard it as anomalous that tax take can increase late in field life; however, this is a corollary of the principle which they stress of giving the maximum front-end loading of relief to allow the cost of investment to be recovered quickly.

<u>Paragraph 102</u>

The opening sentence (on the flexibility of the Norwegian regime) seems difficult to reconcile with the statement in subparagraph (ii). The Government's own analysis of the UK and Norwegian tax regimes indicates that the UK system is much more flexible in giving relief to small fields (possibly including complete exemption from PRT) than the Norwegian system. The UK average tax rate over the whole of field life ranges from 60 - 65% for small fields to percentages in the upper 80s for the very largest. This compares with 80-85% for nearly all fields under the Norwegian system. (The problems and objectives in development in the two countries do of course differ in significant ways, as the Committee recognise).

July 1982

CONFIDENTIAL

Energy

Prime Minister ②

MES 25/2

BI

MAP

SECRETARY OF STATE FOR ENERGY
THAMES HOUSE SOUTH
MILLBANK LONDON SW1P 4QJ
01 211 6402

Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
Treasury Chambers
Parliament Street
London
SW1

24 February 1982

Dear Geoffrey

OIL DEPLETION POLICY: PRODUCTION CUTS

will represent at reg.

I am grateful for the agreement in your letter of 17 February to my announcing the decision on production cuts in the week before the Budget. I am arranging to make the announcement by a Written Parliamentary Answer on 2 March. The text will be as in the draft with my letter of 15 February.

Patrick Jenkin argued in his letter of 11 February against a commitment not to impose production cuts before the end of 1984. I hope he will not press this point. All my contacts with the oil companies convince me that the commitment I propose is important to maintain their confidence in the North Sea. And the effect of production cuts on the exchange rate is so uncertain - paragraphs 26-27 of the Working Group report show that officials do not even know in which direction they would work - that we gain nothing by retaining this highly theoretical option.

I am sending copies of this letter to the Prime Minister, Peter Carrington, George Younger, Patrick Jenkin, Michael Havers and Sir Robert Armstrong.

Yours ever
Nigel

NIGEL LAWSON

25 FEB 1982

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Energy

(2)

Prime Minister

MWS 15/2

SECRETARY OF STATE FOR ENERGY
THAMES HOUSE SOUTH
MILLBANK LONDON SW1P 4QJ

01 211 6402

CONFIDENTIAL

Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
Treasury Chambers
Parliament Street
LONDON SW1

MS

15 February 1982

Dear Chancellor,

OIL DEPLETION POLICY: PRODUCTION CUTS

In your minute to the Prime Minister of 27 January agreeing with my conclusion that we should not impose cuts, you said there might be advantage in making this announcement and that on North Sea tax together, ie at the time of the Budget.

Now that the Prime Minister has agreed that an announcement be made, let us by all means discuss the question of timing as you proposed. But I must tell you that I do not think handling this matter in the way you suggest would be either politic or timely.

An earlier announcement on cuts - and the sooner it comes, the better - would gain us maximum credit with the companies and cause them to take a less hostile view of a later announcement on the limited tax concessions which we have in view. By contrast an announcement on cuts in the Budget package itself would be overshadowed by the rest of the Budget and would lose impact with the companies. But there is a more fundamental objection to the course you propose. Production cuts are neither a taxation nor an expenditure decision, and are thus in no sense a budgetary matter. The inevitable result of linking the two issues would be to strengthen the views of those who believe we are using the tax regime as a back door depletion instrument.

I enclose a copy of the Written Answer I have in mind.

I am sending copies of this letter to the Prime Minister, Peter Carrington, Francis Pym, George Younger, Patrick Jenkin, Michael Havers and Sir Robert Armstrong.

Yours sincerely,

Janet h. Chadwick

NIGEL LAWSON

(Approved by the Secretary of State and signed in his absence)

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OIL PRODUCTION CUTS - DRAFT WRITTEN ANSWER

On 23 July 1980, my predecessor announced to the House the Government's general approach to oil depletion policy.

In that statement, however, he left open the question of oil production cutbacks which, under the assurances given to the oil companies by the Rt Hon Member for Chesterfield on 6 December 1974 and honoured by the present Government, started to become available from the beginning of this year. After very careful consideration of all the relevant factors, I have decided not to impose such cutbacks, at least until the end of 1984.

This will allow the oil industry a firmer basis for their further exploration of and investment in the UK Continental Shelf which will help to increase oil supplies in the 1990s and beyond.

But I shall continue to consider the implementation on a case-by-case basis of the other measures announced by my Rt Hon Friend. In particular, I shall continue the policy of ensuring that development of new and existing fields proceeds on the basis of good oilfield practice consistent with optimum oil and gas recovery and that wasteful gas flaring is minimised.

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VB

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Energy

10 DOWNING STREET

From the Private Secretary

9 February 1982

Oil Depletion Policy: Production Cuts

Thank you for your letter of 8 February.

The Prime Minister is content to proceed as your Secretary of State proposes.

I am sending copies of this letter to Brian Fall (FCO), John Kerr (HM Treasury), Jonathan Spencer (Department of Industry), Muir Russell (Scottish Office), Jim Nursaw (Law Officers' Department), David Wright (Cabinet Office) and Gerry Spence (CPRS).

MCS

Dr. David Lumley,
Department of Energy.

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AW
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(1)

SECRETARY OF STATE FOR ENERGY
THAMES HOUSE SOUTH
MILLBANK LONDON SW1P 4QJ
01 211 6402

Prime Minister

Content?

MCS 8/2

Yes mt

Michael Scholar Esq
Private Secretary to
the Prime Minister
10 Downing Street
London
SW1

8 February 1982

Dear Michael

OIL DEPLETION POLICY : OIL PRODUCTION CUTS

Thank you for your letter of 4 February. ? 1/2

My Secretary of State is satisfied that an announcement in inescapable. The oil companies have to be told where they stand and to do this without informing Parliament would provoke a major row. Oil depletion policy is seen as important by Members on both sides of the House. We have said in several Parliamentary replies that a decision on production cuts will be announced as soon as possible. The Select Committee on Energy will shortly be reporting on depletion policy. They, too, have been told that an announcement on production cuts will be made as soon as possible. Mr Lawson would however intend to make the announcement in a Written Answer and to play it generally in a low key.

Mr Lawson is however content to avoid linking the decision to the lifetime of this Parliament and to state instead that it will hold until the end of 1984.

If the Prime Minister is content Mr Lawson will discuss the timing of an announcement with the Chancellor. He believes that it should be made as soon as possible, but will of course circulate a draft to the Prime Minister and other colleagues concerned.

I am copying this letter to the recipients of yours.

Yours ever

David Lumley

DAVID LUMLEY
Private Secretary

Energy Policy PX

file VB.

be Walters Duguid.

10 DOWNING STREET

From the Private Secretary

1 February 1982

OIL DEPLETION POLICY: PRODUCTION CUTS

The Prime Minister was grateful for your Secretary of State's minute of 20 January, proposing an announcement that the Government has decided against imposing production cuts from UKCS oil fields. She has also seen minutes dated 27 January by the Chancellor, Foreign Secretary and Robin Ibbs on the same subject.

The Prime Minister agrees with the conclusion against the imposition of production cuts but she doubts whether an announcement should be linked to the lifetime of this Parliament, as proposed in paragraph 8 of your Secretary of State's minute. She has asked whether it would be possible to announce the decision as being one for the next two or three years; she has also asked whether it is inescapable that an announcement has to be made.

I am sending copies of this letter to Brian Fall (FCO), John Kerr (HM Treasury), Jonathan Spencer (Department of Industry), Muir Russell (Scottish Office), Jim Nursaw (Law Officers' Department), David Wright (Cabinet Office) and Gerry Spence (CPRS).

MCS

J.D. West, Esq.,
Department of Energy.

VB

Yes but I don't like it. Linked to the lifetime of this Parliament - can we say for 2 or 3 years? Do we have to make an announcement? not

Prime Minister

Please see minutes from the Chancellor, Lord Carrington, Alan Walters; and Nigel Lawson.

Do you agree that we should decide against imposing production cuts?

And to an announcement on the lines of para 8 of Nigel Lawson's minute?

MCS 29/1

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CONFIDENTIAL

Qa 05797

To: MR SCHOLAR

From: J R IBBS

27 January 1982

Oil Depletion Policy: Production Cuts

1. I have seen the Secretary of State for Energy's minute of 20 January and his conclusions that production cuts should not be imposed for the lifetime of this Parliament.

2. The CPRS has consistently been concerned that the short term value to the Treasury of the maximum output of oil has tended to outweigh longer term arguments for the conservation of a valuable resource. It may well be that the balance of argument on this occasion is as the Secretary of State has concluded, but I am uneasy about the weight he attaches to the point covered in paragraph 6(iii) of his minute, namely that production cuts could discourage adequate further investment by the oil industry in the North Sea. I appreciate that the oil industry is likely to argue that depletion controls would be discouraging; it is already very concerned about the North Sea fiscal regime. In practice, however, the only effect of depletion control would be to remove (by deferment) a slice of the immediate excess above UK requirements; I do not believe that the industry (whatever it might say) would really regard such modest depletion policy decisions as reducing the long term attractiveness of North Sea investment.

3. There seems to me therefore to be a danger that this argument has been overstated, and that the balance of overall argument may be finer than the Secretary of State's minute suggests.

4. I am sending a copy of this minute to the Private Secretaries to the Foreign Secretary, the Chancellor of the Exchequer, the Secretaries of State for Energy, Industry and Scotland, the Attorney General, and to Sir Robert Armstrong.

JRI

CONFIDENTIAL

COPY
J.V., A.D., ~~A.W.~~

FCS/82/18

SECRETARY OF STATE FOR ENERGY

Oil Depletion Policy: Production Cuts

1. I welcome the proposal in your minute of 20 January to the Prime Minister that we should not impose oil production cuts in the UK sector of the North Sea for at least the lifetime of this Parliament. Given the interest that there is likely to be in the decision, I assume you would agree that our officials should arrange that Embassies in Community countries be briefed in advance to inform the other Governments as soon as any announcement is made in Parliament.

2. I am sending copies of this minute to the Prime Minister and to the other recipients of yours.

C

(CARRINGTON)

Foreign and Commonwealth Office, SW1
27 January 1982

CONFIDENTIAL

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

PRIME MINISTER

OIL DEPLETION POLICY : PRODUCTION CUTS

Nigel Lawson sent me a copy of his minute of 20 January to you in which he reports his conclusion against the imposition of oil production cuts.

2. I fully support his conclusion. The imposition of cuts in 1982 and 1983, with the substantial increases in the PSBR described in Nigel's minute, would certainly endanger our wider economic objectives, as paragraphs 26-31 of the officials' report rightly emphasise. I too am not much impressed by arguments about increases in the real sterling value of oil if it is left in the ground. It certainly is no part of this Government's philosophy to engage in what would amount to commodity speculation on a massive scale, particularly when the uncertainties involved are so great.

3. I would like to discuss with Nigel the precise timing of the announcement. As he says, production cuts are linked in the oil companies' minds with our decisions on North Sea tax, and there might be advantage in making the announcements together. But this is something that he and I can consider together.

4. I am copying this minute to the Foreign Secretary, the Secretaries of State for Energy, Industry and Scotland, the Attorney General and to Sir Robert Armstrong.

G.H.

27 January 1982

CONFIDENTIAL

cc Mr. Hoskyns
Mr. Duguid
Mr. Vereker

MR. SCHOLAR

OIL DEPLETION POLICY: PRODUCTION CUTS

1. The Secretary of State for Energy's memorandum of 20 January considers the case for production reductions in our oil resources. The objective would be to defer production until the 1990s.

2. During the summer I chaired a seminar where Professor Maurie Adelman, one of the world's leading authorities on the economics of the oil industry, gave a paper on this topic. I believe he produced convincing arguments that we should not defer production at all. The best production rate will be determined by the existing market incentives.

3. I am therefore happy to endorse the proposal of the Secretary of State for Energy.

26 January 1982

ALAN WALTERS