



House of Commons
Scottish Affairs Committee

Effects of tax increases on the oil industry

First Report of Session 2007–08

*Report, together with formal minutes, oral and
written evidence*

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The Scottish Affairs Committee

The Scottish Affairs Committee is appointed by the House of Commons to examine the expenditure, administration, and policy of the Scotland Office (including (i) relations with the Scottish Parliament and (ii) administration and expenditure of the office of the Advocate General for Scotland (but excluding individual cases and advice given within government by the Advocate General)).

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The following were also members of the Committee during the inquiry:

Gordon Banks MP, (*Labour, Ochil & South Perthshire*)
Mr Jim McGovern MP, (*Labour, Dundee West*)

Powers

The committee is one of the departmental select committees, the powers of which are set out in House of Commons Standing Orders, principally in SO No 152. These are available on the Internet via www.parliament.uk.

Publications

The Reports and evidence of the Committee are published by The Stationery Office by Order of the House. All publications of the Committee (including press notices) are on the Internet at www.parliament.uk/parliamentary_committees/scottish_affairs_committee.cfm. A list of Reports of the Committee in the present Parliament is at the back of this volume.

Committee staff

The current staff of the Committee are Dr Sue Griffiths (Clerk), Duma Langton (Committee Assistant) and Annabel Goddard (Secretary).

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1 Introduction

1. North Sea oil and gas is one of Scotland's most valuable natural resources; one that gives rise to a significant number of jobs and opportunities in the oil and gas sector and its associated support services and supply chain. The oil and gas industry in the UK has helped to foster a "centre of global engineering excellence" and now employs over 100,000 people in Scotland, generating export earnings of £4 billion per annum.¹ Continued investment and exploration are important in order to safeguard these jobs.

2. Since 2002 there have been three major changes in the North Sea fiscal regime (see paragraph 7). In May last year we announced an inquiry into the effects of tax increases on the oil industry. We are grateful to all those who responded to our call for evidence and particularly to those who gave evidence at the three public hearings we held on this issue. Details of all those who gave evidence are included at the end of this Report (see page 14). Our inquiry has sought to examine the effect of tax increases and whether, as a consequence of the changes to the fiscal regime, some potential investments have become uneconomic.

2 Background

UK Continental Shelf

3. Exploitation of the natural resources of the UK Continental Shelf (UKCS) is maturing;² oil and gas production peaked in 1999 and continues to decline steadily. By 2006 some 36 billion barrels of oil equivalent (boe) had been produced and the UKCS is estimated to have about 15 to 25 billion boe still to be recovered.³ The UK is now a net importer of oil and gas, although our reserves will continue to play a vital role in our economy for many years to come.⁴ Most of the remaining reserves are likely to be found in relatively small oil and gas fields, increasingly remote from existing infrastructure, such as pipelines,⁵ and many of the remaining smaller accumulations are likely to be found in more technologically challenging areas.⁶ Depending on the interplay between the international price of oil, the cost of exploitation and the on-costs of tax and other expenses, smaller fields may not attract the investment in infrastructure needed to make them viable.⁷ Mr Blackwood, Director BP North Sea, said that the North Sea was now a difficult place to find significant quantities of oil and gas. He said it was "hardly an optimistic location for new discoveries".⁸ Production has fallen despite continued investment and cost inflation is high

1 Q2

2 Ev 48 and 54

3 H M Treasury, *The North Sea Fiscal Regime: a discussion Paper*, March 2007, para 1.2

4 *Ibid.*

5 Ev 40

6 Ev 49

7 Qq 7 and 91, Ev 40, 48-49, 54 and 62

8 Q91

because of global competition for supply chain resources.⁹ The industry faces rising costs¹⁰ and a declining rate of post tax return.¹¹

The need for sustained investment

4. For exploitation of these resources to be maximised, sustained investment is crucial.¹² While the UKCS has some attractive features from an investment point of view,¹³ the United Kingdom Offshore Oil and Gas Industry Association (UKOOA),¹⁴ told us it was increasingly difficult to attract investment.¹⁵ There are a number of initiatives aimed at increasing investment such as the PILOT programme, fallow processes, ‘Promote’ licences, initiatives on brown fields and the 100% first year capital allowance.¹⁶ Witnesses from the industry told us that anything to support investment in marginal projects and small pools was welcome.¹⁷ The PILOT initiative, which aims to maximise recovery from the UKCS, is regarded as a tremendous success.¹⁸

3 The fiscal regime

The current regime

5. The Government has a crucial role to play in ensuring that the regulatory and fiscal regimes are fit for the future.¹⁹ The Treasury told us that the Government was committed to a “strong and vibrant” UK oil and gas industry. This commitment is reflected in its twin policy objectives of promoting investment in the UKCS and ensuring the UK receives a fair share of the revenues from a national resource. The overall aim is to maximise economic recovery of the UK’s oil and gas reserves. The interests of the producers and taxpayers have to be carefully balanced;²⁰ oil and gas companies need to receive a fair post-tax return on their investment, which recognises the risks they face, and the UK taxpayer needs to get a fair share of the revenue derived from the exploitation of its natural resources.²¹

9 Ev 49

10 Q91, Ev 2, 40, 54 and 62

11 Q29

12 Ev 2

13 Ev 41

14 UKOOA is now known as Oil and Gas UK.

15 Ev 3

16 Q9, Ev 3 and 47

17 Q120

18 Q9

19 H M Treasury, *The North Sea Fiscal Regime: a discussion Paper*, March 2007

20 Qq102 and 167

21 Qq167 and 180

6. The current fiscal regime is complex. Profits arising from extraction potentially fall within three regimes:

- Petroleum Revenue Tax—a field based tax, which does not apply to fields given development consent on or after 16 March 1993 (non-taxable fields);
- Ring-Fenced Corporation Tax—Corporation tax in the North Sea is subject to special rules so that profits from oil extraction activities cannot be reduced by losses from other trading activities; and
- The Supplementary Charge—introduced by the Finance Act 2002, the Supplementary Charge is an additional 10% charge on adjusted ring-fenced profits. The Supplementary Charge was increased to 20% from 1 January 2006.²²

7. Mr Blackwood told us the UK had had a reputation for fiscal stability but alleged that this had been quickly destroyed over the last three to four years.²³ The major tax increases since 2002 are:

- 2002—introduction of the Supplementary Charge at 10%;
- 2004—advanced phasing of corporation tax payments for the oil and gas industry; and
- 2005—doubling of Supplementary Charge to 20%.²⁴

8. Mr Blackwood gave his view that the latest tax increase was “ill-judged and in defiance of the realities”.²⁵ UKOOA argued that the increase in Supplementary Charge was the third significant tax increase in three years and claimed the UK oil and gas sector was the most highly taxed sector in the UK.²⁶ However, the Treasury have told us that the increase in the rate of Supplementary Charge restored “the balance between producers and consumers in light of the significant increase in oil price since 2001”.²⁷

9. The Treasury told us that the UK fiscal regime was broadly comparable to the fiscal regime in countries that were our main competitors for investment, such as the Gulf of Mexico and the Netherlands, and was more favourable than the fiscal regimes in Sweden, Denmark and Italy.²⁸ Before the 2005 increase in Supplementary Charge the UK had the fifth lowest tax take of 65 different oil regions around the world. The increase in Supplementary Charge moved the UK down to about the eighth or ninth lowest tax take. The Treasury argued that the UK’s favourable position is a result not only of the modest tax take but also of the other incentives and allowances, such as the 100% first year capital allowances for North Sea investments.²⁹

22 H M Treasury, *The North Sea Fiscal Regime: a discussion Paper*, March 2007

23 Q127

24 Ev 53

25 Q91

26 Ev 1

27 Ev 63

28 Q184

29 Ev 38

The effects of tax increases

10. Tax increases have the potential to damage future investment³⁰ and shorten the life of the industry.³¹ They also have the potential to affect development of fields, reduce exploration, and increase investment uncertainty. Professor Alexander Kemp of the University of Aberdeen, noted that undeveloped gas discoveries that were marginal as investments became even more so after the tax increase in December 2005.³² He concluded that the tax increase would have a marginal effect on investment and changes would be needed in the tax regime if oil prices fell. He recommended linking the Supplementary Charge to oil prices.³³ The Treasury felt that index linking the rate of Supplementary Charge in this way would introduce too much volatility, unpredictability and complexity into the fiscal regime.³⁴ Mr Blackwood said that there was little appetite for it from industry.³⁵

11. UKOOA said there might have been an expectation that the tax burden on the industry would fall as production declined in order to extend the productive life of the UKCS.³⁶ They believed that the latest tax increase would have a detrimental long-term impact on recovery from the UKCS and that the fiscal and regulatory regime was unsuitable for the remaining life of the North Sea. Malcolm Webb, Chief Executive of UKOOA, claimed that projects that might have gone forward before the tax increase might now not happen,³⁷ and that the tax increases had made the UKCS less attractive to investors.³⁸ No evidence was presented to the Committee of projects that had not been realised. Shell argued that the UKCS was a maturing province, where industry faced increasing difficulty of access, high costs, rising supply chain costs and increased competition for global investment funds.³⁹ They said fiscal stability was key to attracting investment and called for a review of the increase in Supplementary Corporation Tax.

12. One of the effects of the tax increase had been to reduce the net present value of investments, that is, the revenue generated from exploitation of the reserves held in the ground extrapolated into the future and discounted back to present values.⁴⁰ Maersk Oil described how, in their calculation, the tax increase had eroded the value of its investment in the UK by about 15%. They concluded that the tax increase and the threat of further tax increases affected how their company viewed the UK in terms of future investment.⁴¹

30 Qq104 and 115

31 Ev 62

32 Ev 41

33 Ev 40

34 H M Treasury, *The North Sea Fiscal Regime: a discussion Paper*, March 2007

35 Q139

36 Ev 1

37 Q40

38 Q109

39 Ev 48

40 Ev 41

41 Ev 43

13. Mr Blackwood, Director BP North Sea, said,

The unfortunate truth, therefore, is that on almost every possible measure the UKCS is becoming a much more difficult place in which to operate. Common sense would dictate that this is possibly one of the last provinces of the world to have warranted a tax increase, and possibly the only redeeming factor is the current high oil price which, although disturbing for many other reasons and irrelevant in terms of UKCS competitiveness, it does help to disguise some of the things I have been talking about.⁴²

He described the additional fiscal burden as compounding the difficulties of attracting investment to the UKCS.⁴³ Some witnesses stated that there had been adverse impact on investor confidence.⁴⁴

14. Scottish Enterprise expressed the view that reduced investment would pose a serious threat to the supply chain (the human and technical resources deployed by the oil industry).⁴⁵

15. OGIA, the Oil and Gas Independents' Association, said that the supply chain was an important factor and any damage to it could make it more difficult to attract investment.⁴⁶ There is some evidence of resources, such as rigs and other equipment, leaving the North Sea, which might be hard to win back.⁴⁷ Mr Blackwood stated that the tax increases also had an impact on exploration; new drilling in the UKCS has tended to be adjacent to existing infrastructure rather than in undeveloped oil and gas fields.⁴⁸

16. Other witnesses offered a different view of the scale of any impact the tax increases might have had. Amicus did not believe there was any detrimental impact due to the increase in Supplementary Charge as the current high oil price made it affordable. However, they were concerned that a drop in oil prices might lead to a loss of jobs. They called for a simpler tax regime for the oil and gas sector that would be more responsive to fluctuations in oil prices.⁴⁹ Professor Kemp has reported that he envisages only a modest impact on investment.⁵⁰ The Treasury told us that the twenty-fourth licensing round had shown continued strong interest in UKCS.⁵¹ The Treasury's analysis was that the latest tax

42 Q91

43 Q91

44 Ev 43, 48 and 62

45 Ev 62

46 Ev 53

47 Ev 54

48 Q113

49 Ev 46

50 Professor Alexander G Kemp and Linda Stephen, University of Aberdeen, *North Sea Study Occasional Paper No. 10 Prospects for Activities in the UKCS to 2035 after the 2006 Budget*

51 Q167

increase would only have a small impact,⁵² with only two of sixty-eight projects becoming marginal.⁵³

17. Several of our witnesses argued that it was difficult to see the effects of the latest tax increases immediately because of the long lead times in the industry.⁵⁴ The full impact may not be visible for three to four years.⁵⁵ **We conclude that it is impossible to isolate with certainty the impact of tax increases from that of other factors such as price or initiatives designed to stimulate investment or increase recovery, including the PILOT programme or the brown field initiatives.**⁵⁶ In our view, the fiscal regime is unlikely to be the most important factor driving investment decisions in major fields. Although tax is clearly significant, the nature of the oil and gas fields, the underlying geology and future oil and gas prices are more likely to be the dominant drivers,⁵⁷ but the fiscal regime may be a factor affecting investment in older, more marginal fields.

18. **There is a need to balance the return on investment and the return to the UK taxpayer for the use of its natural resource.** In this context, it is important to consider the effects of the current high oil price. Malcolm Webb described how high oil prices in the North Sea masked the effects of the latest tax increase;⁵⁸ a view shared by Mr Blackwood.⁵⁹ When the prices of oil and gas rise, companies' profits from their investments increase considerably.⁶⁰ The latest tax increase will have a greater impact on investment decisions if the price of oil falls. Industry would like an undertaking from the Government that the tax will be reassessed if prices soften.⁶¹ Given the long lead time on investment decisions, the greatest risk to jobs would come from a rapid fall in price and slow action on taxes.⁶² Several witnesses spoke of the need for the Treasury to take prompt action on tax if the price of oil falls.⁶³

19. We spent a good deal of time talking to our witnesses about the price level below which there would be serious consequences; much of this discussion focused on what would happen if prices fell below \$30-40 per barrel.⁶⁴ There does not seem to be much prospect of a fall in the price of oil to those levels. The price of oil recently pushed past \$95 per barrel.⁶⁵

52 Q168

53 Q170 (See also Qq 209-10)

54 Q110 and Ev 50.

55 Qq104 and 115

56 Ev 50

57 H M Treasury, *The North Sea Fiscal Regime: a discussion Paper*, March 2007, para 1.3

58 Q2

59 Q91

60 Q167

61 Q142

62 Ev 46

63 Qq4, 34, 43 and 102 and Ev 40.

64 For example, Q140

65 BBC News, *Oil retreats after breaching \$96*, Thursday, 1 November 2007 – <http://news.bbc.co.uk/1/hi/business/7072476.stm>

Prices have more than quadrupled since 2002 and are currently 40% higher than at the start of 2007.⁶⁶

20. The Treasury told us that all taxes were kept under review.⁶⁷ A dramatic change in the price of oil would have implications for most of the UK economy and it is difficult to imagine that a dramatic shift in price would not lead to some change. In its consultation paper on the North sea Fiscal Regime, the Treasury said “all taxes are reviewed on a Budget-by-Budget basis and changes in oil prices are factored into such reviews”.⁶⁸

The need for fiscal stability

21. The industry made clear its view that fiscal stability was key in attracting investment.⁶⁹ UKOOA argued that instability damaged the UK’s competitiveness.⁷⁰ They believed that the effect of several changes within a short space of time had earned the UK a reputation within the industry for fiscal instability. It was also clear from the evidence provided to us that these were wider concerns than just the latest change to the Supplementary Charge.⁷¹

22. Mr Blackwood told us that any tax increase made it harder for him to attract capital and people to the UKCS.⁷² However, while fiscal stability is important, witnesses from the Treasury suggested that the UK’s fiscal regime was “broadly comparable with our main competitor regimes” despite the recent changes.⁷³ While there was some disagreement about what stability meant, with industry wanting taxes to fall as the price of oil falls but not to rise when it rises, OGIA suggested that what was most important was predictability.⁷⁴ **We conclude that a simple fiscal regime that is consistent and predictable would be of most benefit to the industry and the UK in the long term.**⁷⁵

23. The Government has made a commitment that there would be no further changes to the fiscal regime for oil and gas companies in the remainder of this Parliament.⁷⁶ The industry seeks even greater stability and predictability than this commitment offers. Professor Kemp argued that the assurance from the Treasury that Supplementary Charge will not be increased for the rest of the Parliament was of limited benefit where investments had to be considered over a much longer time frame.⁷⁷ However much such guarantees might be desirable, and despite industry’s claims that there was greater fiscal stability in the past, no government has ever been able to make a commitment that binds its successor.

66 BBC News, *What is driving oil prices so high?*, Thursday 1 November 2007 – <http://news.bbc.co.uk/1/hi/business/7048600.stm>

67 Q189

68 H M Treasury, *The North Sea Fiscal Regime: a discussion Paper*, March 2007

69 For example see Q12, Ev 1 and Ev 48-49.

70 Ev 3

71 Q13

72 Q91

73 Q184

74 Ev 53

75 Q120

76 Q193

77 Ev 41

4 Improving communication

24. The 2007 Pre-Budget Report said “The latest round of discussions on the North Sea fiscal regime with the oil and gas industry ended in September 2007. The Government is considering the conclusions from these discussions and will publish a consultation document examining the options for further action in due course”.⁷⁸ Some commentators see the publication of the North Sea discussion paper as a positive step and view the formal consultation as building on a period of relatively informal consultation, where the policy areas and options that the Government would consider were not always clear.⁷⁹

25. **We are heartened by the positive moves by the Treasury to consult on the North Sea fiscal regime⁸⁰ and by the engagement of industry with that consultation.** Both sides appear to see the ongoing process of consultation as constructive.⁸¹ Previous discussions between the Treasury and the industry have identified a number of desirable features of any fiscal regime: simplicity, predictability, and recognition of the long-term nature of the industry and investment lead times.⁸² We hope that these features will be taken into account as part of the ongoing consultation on the North Sea fiscal regime. However, in addition to these desirable features, other simple changes in approach could make a big difference. For example, the industry is keen to see a more joined-up approach from Government in the form of joint meetings with Energy ministers and Treasury ministers.⁸³ From an industry perspective it makes sense to join up policies across the whole industry, taking a holistic approach, and we do not see why Government should not approach it in the same way. We believe that the breadth of the current consultation is important as it cannot be sensible to look at only one or two elements; the whole fiscal regime needs to be examined and it is important to identify what the Treasury and the industry want from the fiscal regime. Only then can we start the tricky business of getting from here to there, while maximising recovery of the UK’s natural resources.

78 H M Treasury, *2007 Pre-Budget Report and Comprehensive spend Review*, paragraph 5.86

79 http://www.ukbudget.co.uk/UKBudget2007/NorthSeaOilTax/budget07_oilandgasringfenceactivities.cfm

80 Ev 63

81 Qq12 and 176

82 H M Treasury, *The North Sea Fiscal Regime: a discussion Paper*, March 2007

83 Q10

5 Conclusions

26. The fiscal regime must promote investment and ensure that financially viable recovery from the UK Continental Shelf is maximised. But it must also ensure that the UK taxpayer gets a fair return. Despite the ongoing consultations on the shape of the fiscal regime, UKOOA remains of the view that the latest tax increase has damaged the competitive position of the UKCS.⁸⁴

27. It is clear from the evidence before us that the government and industry share a common goal of maximising recovery from the UKCS. They differ on whether the recent tax changes hinder the achievement of this shared objective. If prices fall it seems clear that there would be a negative impact,⁸⁵ but while prices remain high the true impact of the tax increases may remain much harder to see.

28. Within the industry, there is clearly a perception of instability and if there are to be further changes to the fiscal regime they should seek to improve stability and predictability, without harming the UK's already competitive position or depriving the UK Government of a fair share in the economic rent from the exploitation of its natural resources. Changes to the fiscal regime should aim to make the system simpler to administer both for companies and HM Revenue and Customs.

29. We urge the Government and the industry to engage constructively in the current dialogue and to build on that dialogue going forward once the current consultation comes to an end.

84 Ev 63

85 Q102

Conclusions and recommendations

1. We conclude that it is impossible to isolate with certainty the impact of tax increases from that of other factors such as price or initiatives designed to stimulate investment or increase recovery, including the PILOT programme or the brown field initiatives. (Paragraph 17)
2. In our view, the fiscal regime is unlikely to be the most important factor driving investment decisions in major fields. Although tax is clearly significant, the nature of the oil and gas fields, the underlying geology and future oil and gas prices are more likely to be the dominant drivers, but the fiscal regime may be a factor affecting investment in older, more marginal fields. (Paragraph 17)
3. There is a need to balance the return on investment and the return to the UK taxpayer for the use of its natural resource. (Paragraph 18)
4. We conclude that a simple fiscal regime that is consistent and predictable would be of most benefit to the industry and the UK in the long term. (Paragraph 22)
5. We are heartened by the positive moves by the Treasury to consult on the North Sea fiscal regime and by the engagement of industry with that consultation. (Paragraph 25)
6. Within the industry, there is clearly a perception of instability and if there are to be further changes to the fiscal regime they should seek to improve stability and predictability, without harming the UK's already competitive position or depriving the UK Government of a fair share in the economic rent from the exploitation of its natural resources. Changes to the fiscal regime should aim to make the system simpler to administer both for companies and HM Revenue and Customs (Paragraph 28)
7. We urge the Government and the industry to engage constructively in the current dialogue and to build on that dialogue going forward once the current consultation comes to an end (Paragraph 29)

Formal Minutes

Tuesday 20 November 2007

Members present:

Mr Mohammad Sarwar, in the Chair

Ms Katy Clark

David Mundell

Mr Ian Davidson

Ben Wallace

Mr Jim Devine

Effects of tax increases on the oil industry

The Committee considered this matter.

Draft Report (*Effects of tax increases on the oil industry*), proposed by the Chairman, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 29 read and agreed to.

Resolved, That the Report be the First Report of the Committee to the House.

Ordered, That the Chairman make the Report to the House.

Ordered, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

Written evidence was ordered to be reported to the House for printing with the Report, together with written evidence reported and ordered to be published on 10 July and 16 October.

[Adjourned till Monday 26 November at 12.55pm]

Witnesses

Tuesday 20 June 2006

Mr Malcolm Webb, Chief Executive, **Mr Mike Tholen**, Economics and Commercial Director, United Kingdom Offshore Operators Association (UKOOA) Ev 4

Tuesday 18 July 2006

Mr Dave Blackwood, Director, BP North Sea, **Dr Rebecca Brown**, Finance Manager, Apache North Sea Ltd. Ev 20

Tuesday 31 October 2006

Ms Judith Knott, Head of Corporate Taxation Team, HM Treasury, **Ms Jo Wakerman**, Head of North Seas Branch, Corporate Taxation Team, HM Treasury, **Mr Edward Zamboni**, Assistant Director and Head of Large Business and International Analysis, HM Revenue & Customs Ev 31

List of written evidence

UKOOA	Ev 1, 19, 30
HM Treasury	Ev 38
Professor Alex Kemp	Ev 40
Letter to the Chairman from Maersk Oil North Sea UK Limited	Ev 42
Amicus	Ev 45
Shell UK Limited	Ev 48
Letter to Energy Review Team, Department of Trade and Industry from Shell International	Ev 51
Oil and Gas Independents Association Limited (OGIA)	Ev 52
Scottish Enterprise	Ev 62
Oil & Gas UK	Ev 63
Letter to the Chairman from Angela Eagle MP, Exchequer Secretary, HM Treasury	Ev 63

Publications from the Scottish Affairs Committee since 2005

The following publications have been produced by the Scottish Affairs Committee since the beginning of the 2005 Parliament:

Session 2006-07

Reports

First Report	Work of the Committee in 2006	HC 308
Oral and written evidence	Scotland Office Annual Report 2007. Minutes of Evidence Tuesday 17 July 2007	HC 943-i
Memorandum	Spring Supplementary Estimate 2007: Explanatory Memorandum by the Scotland Office	HC 906

Session 2005-06

Reports

First Report	Work of the Committee in 2005	HC 836
Second Report	Meeting Scotland's Future Energy Needs: the Westfield Development Centre	HC 1010
Third Report	<i>Putting Citizens First</i> : the Report from the Commission on Boundary Differences and Voting Systems	HC 924
Fourth Report	The Sewel Convention: the Westminster perspective	HC 983
First Special Report	Meeting Scotland's Future Energy Needs: Government Response to the Committee's Second Report of Session 2005-06	HC 579
Second Special Report	The Sewel Convention: the Westminster perspective: Government Response to the Committee's Fourth Report of Session 2005-06	HC 1634
Minutes of Evidence	Scotland Office Annual Report 2005. Minutes of Evidence Wednesday 19 October 2005	HC 580-i
Minutes of Evidence	Scotland Office Annual Report 2006. Minutes of Evidence Tuesday 4 July 2006	HC 1440-i
Oral and written evidence	The potential benefits for Scotland of the 2012 Olympics	HC 658 i-vi
Memorandum	Spring Supplementary Estimate 2006: Explanatory Memorandum by the Scotland Office	HC 1106

Oral evidence

Taken before the Scottish Affairs Committee on Tuesday 20 June 2006

The Committee met in the Council Chamber, Aberdeen

Members present:

Mr Mohammad Sarwar, in the Chair

Danny Alexander
Mr Ian Davidson
Mr Jim McGovern

Mr Angus MacNeil
David Mundell

Memorandum submitted by UKOOA

(i) *Introduction*

UKOOA was extremely disappointed with the tax increase imposed in December 2005. This was the third significant tax increase in three years (2002 Budget, 2005 Budget and 2005 PBR) and together these repeated increases have resulted in the UK oil and gas industry being by far the highest taxed sector of the UK economy.

The UK Offshore Oil and Gas industry (the Industry) makes a vital contribution to both the Scottish Economy and the wider UK Economy, providing energy, investment and employment. After a decade of fiscal stability, the UK has acquired an international reputation of fiscal instability within the industry and UKOOA is concerned about the consequences of the tax increase which we outline below. With production beginning to decline, it might be expected that the tax burden should be reduced, rather than increased, to encourage investment and help extend the productive life of the basin.

- **The latest tax increase will have a detrimental long term impact on the recovery of oil and gas reserves from the UK Continental Shelf;**
- **The Fiscal and Regulatory regime as now constituted is unsuitable for the second half of the life of the North Sea;**
- **Industry makes a substantial contribution to the UK economy both directly and through investment in a world class supply chain, providing highly skilled employment and substantial total tax revenues to the Exchequer.**

(ii) **After four decades the UK still remains a significant oil and gas producer**

- Whilst production peaked in 1999 (oil) and 2000 (gas), in 2004 the UK remains the fourth largest gas producer and thirteenth largest oil producer in the world;
- In 2005, the UK produced 1.2 billion boe (barrels of oil equivalent¹) from the continental shelf, adding to the total of 35 billion boe produced since 1970;
- The Industry provided a reliable, dependable supply of gas to the UK market throughout the winter and it has the potential to do so for many years to come if investment and activity can be appropriately sustained.

(iii) **Development of the UK's oil and gas reserves has come as a result of massive investment and expenditure to the benefit of the whole economy**

- Since 1970, the Industry has (in 2005 money)
 - Invested £222 billion in exploration and capital development,
 - Spent £120 billion on operating these oil and gas fields and assets;
- The UK Continental Shelf (UKCS) will need to attract £100s of billions of new investment if the full potential of the basin is to be realised.

¹ "barrel of oil equivalent" (boe) equates gas volumes with oil, so that a single measure can be made of the two in combination.

(iv) The UK will become more dependent on oil and gas over the next decade

- Oil and gas, predominantly from the UKCS, provided 75% of the nation's primary energy needs in 2005;
- DTI figures show that, even with rapid growth of the renewables sector, UK reliance on oil and gas could increase to 83% of primary energy demand by 2020;
- To the extent that we do not produce oil and gas from the UKCS, we will have to import it, to the detriment of the balance of payments, economy and Exchequer.

(v) Sustained investment is essential to deliver the second half of the UKCS

- The UK has produced 35 billion boe from the UKCS since gas production first commenced in 1967. Substantial opportunities remain and existing reserves and new exploration may deliver another 16–27 billion boe over time. However the drive to explore and develop these reserves will depend on the competitiveness of the UK as an oil and gas producing province and requires an appropriate fiscal and regulatory environment suited to the second half of the life of the basin;
- This is still a high risk industry, where three in four exploration wells are unsuccessful, failing to discover economic reserves. New discoveries in the UKCS are now typically 10 to a hundred times smaller than in the past. Recent discoveries have averaged at 20–30 million boe and were less than 20 million boe in 2005. Rising costs and an increasing tax burden are eroding the attractiveness of many of these opportunities.

(vi) The UK Exchequer has been a major beneficiary of the UKCS

- The UKCS has provided £215 billion in direct tax revenues to the UK Exchequer since 1970. The total tax contribution is much larger through the economic activity generated by the supply chain and individuals employed by the Industry;
- Direct fiscal revenues have increased rapidly over the last three years, even before the latest tax increase, rising from £4.3 billion in fiscal year 2003–04 to £9.6 billion in 2005–06;
- Maximising recovery from the UKCS has the potential to double fiscal revenues over the remaining life of the basin and sustain the large number of companies working in the supply chain plus the jobs which they provide.

(vii) Activity increased in 2005 on the back of higher oil prices, however rapidly rising costs are now a threat to long term competitiveness

In 2005:

- The UK produced 3.2 million boe per day, (645 million barrels of oil and 85 billion cubic metres of gas);
- Total investment rose 30% to £4.8 billion, the largest of any industrial sector in the UK;
- The number of wells drilled increased 30% on 2004;
- The Industry spent £5.2 billion to operate the offshore fields, pipelines and onshore terminals, an 11% increase on 2004;
- Unit costs (per boe) increased 20%, underlining the competitive pressures.

In 2006:

- The UK will produce around 3.0 million boe per day;
- Total expenditure, covering investment and operations, will rise to around £11 billion, halving the rate of production decline;
- If prices average \$57, the Industry will pay £10.3 billion in 2006 and will be proportionately higher if oil prices remain above this figure.

(viii) This industry provides employment for a highly skilled workforce which is sustained by the continued investment in the UKCS

- The industry will provide employment for 380,000 in 2006, an increase of 20,000 over the last two years:
 - comprising 290,000 directly employed by oil and gas companies and the supply chain, with another 90,000 jobs supported by their economic activity;
- Employment is spread across the UK, with over a 100,000 skilled people in Scotland directly employed by the industry.

(ix) The supply chain which developed on the UKCS has an increasing global presence

- The supply chain has grown rapidly over the last two decades and now serves both the UKCS and many other oil and gas provinces. Its presence in the UK still relies on there being a robust offshore industry in the UKCS;
- Scottish export earnings alone have grown from £2 billion since 1998 to £4 billion in 2004, the contribution to the UK economy is conservatively estimated at double this;
- The UKCS supply chain is now diversifying to work in the renewables sector and other parts of the energy industry.

(x) Continued Fiscal instability will damage UK competitiveness

- SCT, the Supplementary charge to Corporation Tax, was doubled to 20% from Jan 2006; new developments are now taxed at 50%, older fields which pay PRT are taxed at 75%.
- The tax increase may have limited impact in the short term because most investments were already committed before this latest blow. It is almost inevitable though that there will be a long term impact on recovery:
 - Oil and gas activity in the UK is now 16% less attractive,
 - Investors now add a risk premium to UK investments because of fiscal instability,
 - The post-tax rate of return from the UKCS has declined over the last five years despite increases in the oil price, reflecting increasing costs and rising taxation;
- The UK fiscal regime has failed to provide long term stability to encourage investment. There is increasing evidence that high risk exploration is less attractive and marginal developments are not being pursued. Despite recent oil and gas price increases, the minimum field size now being developed appears to be rising as a result of higher costs, the tax increase and a perception of increased regulatory and fiscal risks;
- The UKCS is now increasingly exposed to lower oil and gas prices. Without very prompt activity by Government, activity would decline sharply if oil and gas prices revert towards previous norms.

(xi) There are lessons to learn from the 2002 increase in taxation

- Whilst it is not easy to provide a simple econometric measure to demonstrate the impact of the 2002 tax changes on the UKCS, it had a demonstrable detrimental impact on activity and investment.
- It was already becoming difficult to attract new investment into the UKCS even before 2002. The number of new development wells drilled per year had been reducing sharply and exploration and appraisal drilling had also exhibited a similar trend. These trends were accelerated by the imposition of SCT. By the end of 2003, the number of stacked rigs and the lack of activity across the supply chain in the UK demonstrated the size of the challenge the industry was facing;
- DTI and Industry both separately and through PILOT have done a lot to rebuild confidence and improve the investment climate since 2002. This has also been aided by the recent surge in oil prices. Measures such as the Fallow process and Promote licences plus the 100% First Year Capital Allowance and the Infrastructure Codes of Practice have led to a significant improvement in Commercial and Exploration activity and encouraged investment in new projects. The focus on Brownfields now appears to be having a similar positive impact. The number of new entrants to the UKCS over the last couple of years is also testament to this work and the future opportunities which remain in the basin.

(xii) Rising costs and increased taxation may determine the outlook for 2006 and beyond

- Costs continue to rise rapidly on the back of higher oil prices;
- Rates for semi-submersible rigs have risen six-fold since the start of 2004, with jack-up rig rates rising three-to-four fold over the same period;
- The UKCS must compete both regionally and globally for rigs, resources and skilled personnel;
- Government can not presume that the UK will remain a preferred location for investment;
- Production has the potential to decline at less than 5% pa over the remainder of the decade provided current rates of investment can be sustained;
- The latest survey forecasts production of around 2.7 million boe per day in 2010. However, 20% of this forecast production has yet to receive final investment decision and it will be critical to sustain this rate of production.

(xiii) **Energy Policy needs to be better aligned and represented within Government**

- There are too many different and unnecessarily burdensome regulatory influences from the UK and EU which fail to recognise the objective of maximising economic recovery of UK oil and gas reserves;
- The unsatisfactory rules regarding decommissioning provide an example of conflicting policies which hinder the trading of assets and may well result in the premature removal of existing pipelines to the detriment of future production;
- A single focused approach on energy is essential to develop a diverse supply mix which maximises the opportunities presented from indigenous resources;
- Currently, energy policy is being determined by a number of separate teams, including DTI, Treasury, DEFRA, Foreign Office and the Prime Minister's office;
- UKOOA believes that this is not sustainable and that a more efficient and coherent approach is required, preferably managed by a dedicated department and headed by a Secretary of State for Energy.

14 June 2006

Witnesses: Mr Malcolm Webb, Chief Executive, and *Mr Mike Tholen*, Economics and Commercial Director, UK Offshore Operators Association, gave evidence.

Q1 Chairman: Good morning. We are delighted to be in Aberdeen, the capital of the UK's oil industry. This is our first meeting on our inquiry into the effects of tax increases on the oil industry, and could I thank the staff here in the Town House for helping with today's arrangements. Mr Webb, we know that you were supposed to meet the Minister for Energy today.

Mr Webb: I do not think so. I think I am relieved of that today.

Q2 Chairman: We thank you and Mr Tholen for coming here this morning. Before we ask our detailed questions do you have any opening remarks you would like to make?

Mr Webb: Yes, Chairman, I just have a few and I will not keep you for long, I hope. Today the UK relies on oil and gas for three-quarters of its energy supply. The latest DTI projections show that that will grow to 80% by 2020, even allowing for strong growth in the renewables sector. The UK offshore oil and gas industry has provided this country with a secure supply of oil and gas since the mid 1960s and with full self-sufficiency for the last 10 years or so. Today we still supply the country with all its requirements of oil and over 90% of its requirements for gas. The UK, however, is now a mature, high cost oil and gas province in which production and discovery size is falling, technical risk is increasing and cost inflation a significant concern. Given the right moves by industry and Government this industry could still be providing more than 50% of the UK's total requirement for oil and gas in the year 2020. If, however, we make the wrong moves the game could be more or less over by then. UKOOA was and remains very disappointed by the latest tax increase on UK oil and gas announced in the Chancellor's Pre Budget Report. This, the third significant tax hit on our industry in three years, not only clearly demonstrated the fiscal instability of the UK to potential investors but also imposed a tax burden on an industry which at this point of its cycle should be given fiscal encouragement rather than yet more tax increases which at the very best can be described as

not encouraging. The current very high oil price is masking the effects of this latest tax increase and the UK offshore oil and gas industry is now dangerously exposed to a downwards price correction. To fail to maximise the potential of the UK offshore would not only be injurious to UK security of energy supply; it would also result in the permanent loss of economic benefit to the nation and foreshorten and possibly kill off parts of the UK oil and gas supply chain. This centre of global engineering excellence, which has grown up on UK oil and gas, now employs well over 100,000 people in Scotland and is one of this country's most remarkable industrial success stories, providing not only high grade employment and technical expertise for this country but also export earnings for Scotland alone of £4 billion per annum and rising. In short, the PBR hike was disappointing because it was inconsistent with the PILOT vision. It seemed to demonstrate that the Treasury was more interested in maximising short term tax receipts than the ultimate recovery of the UK's oil and gas reserve which drives the PILOT vision and we believed was the shared objective of industry and Government and should in our view be a central plank of UK energy policy.

Q3 Chairman: Thank you very much. Mr Tholen, would you like to say anything?

Mr Tholen: No, that is fine, thanks.

Q4 Chairman: As you mentioned in your initial remarks, we are seeking to discover whether tangible damage has been done to the industry by the tax increases recently announced by the Chancellor, and if the more marginal fields have become uneconomic. What effect do you think the tax increases will have on the oil industry specifically and on the Scottish economy generally?

Mr Webb: I think the immediate impact of the tax increases is not likely to be particularly significant. The industry was already heavily contracted for this year, plans were set in place and we are enjoying a particularly high oil price at the moment. We are aware that some marginal projects (that were

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marginal before the tax increase) have become even more marginal afterwards and possibly will not proceed but those tend to be in the smaller range of projects and the immediate impact of this latest tax increase is not likely to be seen right now. As I said in my opening remarks, I think the danger is in the medium to longer term. A very poor signal has been sent to investors about fiscal stability in the UK and, furthermore, this basin at the moment is facing a number of challenges in terms of both technical risk and costs. This tax increase has not helped on that and if we were to see a downward price correction then very fast moves would need to be taken in my view by the Treasury in order to avoid very substantial damage not being done immediately to the industry.

Q5 Chairman: I have here a copy of the report from Professor Alexander G Kemp at the University of Aberdeen Business School, and he says in this report that the oil tax change will have only a modest effect if oil prices stay at \$40-plus by 2030.¹ What is your view on this?

Mr Webb: I think I would disagree with Professor Kemp on that. Forty dollars is a number at which I think this basin could be struggling. Why do I say that? When I came into my current job three years ago I saw the basin, frankly, not performing particularly well when the price was hovering at round about \$30. We have had a significant amount of price inflation since then and we also have this latest tax increase, so therefore I would not be so comfortable about \$40. I think \$40 could be a slightly difficult price for this basin. I do not know if Mike would like to add anything to that.

Mr Tholen: No, I think it shows it pretty well. I know the paper you are referring to and it is a good runner on what to perceive for the future but what he has problems trying to capture is the big change in costs we have seen in the last two years. Much of his data predates the rapid changes both in prices and costs and the effects we have seen then on the basin.

Q6 Mr MacNeil: Would you say 50?

Mr Webb: It is difficult to say what that number would be, frankly. I should avoid predictions on price as well, really, but my view is that at \$30–40 this basin is certainly going to be struggling, but that is a personal view.

Q7 Chairman: Professor Kemp also mentions in his report that by 2035 another 24–25 billion barrels of oil equivalent can be recovered but the great majority of these fields will be small and this poses a challenge for the industry. Do you have a view on this?

Mr Webb: On that I think we would almost entirely agree with Professor Kemp's views. We see the range of potential recoverable reserves from the North Sea as somewhere in the range of 16–27 billion barrels yet to be got and we believe that we can be optimistic

and think about the higher end of that range if all goes well. However, what is also very clear is that these reserves that we are finding now are in much smaller accumulations than they were previously. The early fields in the North Sea were elephantine fields with recoverable reserves in the billions of barrels. Today the typical field size is somewhere in the 25–30 million barrels recoverable, so there are many more small fields that will need to be brought on stream in order to achieve the ultimate goal of maximising recovery at something like 25 billion barrels or thereabouts.

Q8 Chairman: So there is the possibility that huge oil reserves can be recovered which is very precious to our economy and job opportunities, but what steps do you think the Government should be taking to ensure that potential investors make sure that we will explore those oil fields?

Mr Webb: I have said a number of negative things. Maybe I could say a few positive things.

Q9 Chairman: I would like to hear those as well.

Mr Webb: I think the Government has done an awful lot that is extremely good. I do think that the PILOT initiative and the things that have flowed from that in a co-operative sense of joint venture between Government and all parts of the industry have been tremendously successful. We have had a very encouraging response to the 24th licensing round. In part that has been born out of the strong co-operative work that is going on between industry and the Government and the PILOT initiative, so I think there is an awful lot going on that is good at the moment, a great deal going on that is good, in co-operation between all sides of industry—the supply chain, the operators and Government. My concern is, and I think we expressed this also in our submission to the Energy Policy Review, that we are not entirely convinced that all of Government is joined up on some of these policy initiatives. That is why we have been critical about what the Treasury did and, as I said in my opening remarks, it seemed to me that what the Treasury did was somewhat inconsistent with the PILOT vision, and the PILOT vision is quite clear: it is to maximise recovery from this basin in the national interest for all the reasons that you have listed. We just think that there is a need for a bit more joined-up Government on a number of these issues. However, I would not want to be taken as saying that everything this Government is doing on oil and gas is wrong. It is doing an awful lot of right things, particularly around the PILOT initiatives.

Q10 Danny Alexander: You have talked about, and you have talked about this in your written submission as well, the co-operative spirit that there is with DTI in particular. In advance of the tax change that took place was there consultation from the Treasury? Would you say that the Treasury fits into that wider positive consultative spirit that you were describing or is it more removed from the interests and understanding of the oil and gas industry here?

¹ University of Aberdeen, *North Sea Study Occasional Paper No 10. Prospects for Activities in the UKCS to 2035 after the 2006 Budget*, Professor Alexander G Kemp and Linda Stephen, University of Aberdeen.

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Mr Webb: I think it is more removed. We have a regular meeting with the Treasury. Every six months the industry leadership team has had a meeting at senior ministerial level, which has been with the Paymaster General to date; I understand it is going to be John Healey in the future, who has taken over the remit in this area, and we have had a regular dialogue with the Treasury. I am bound to say that to some degree we wonder—and I should be careful here—whether all of our messages have got through. The other point I would make is that we find it rather regrettable that we have to have a series of separate discussions on these issues. We would like to have one discussion with all the parties in the room. We would like to see the Energy Minister and the Treasury Ministers there so that we can discuss these matters together instead of having a series of separate discussions. That is not very efficient and, frankly, I do not think it is very conducive to bringing all the parties together to have these separate discussions. We would rather see that brought together.

Q11 Mr MacNeil: It seems you are making a plea for joined-up Government there, which has been a well used phrase over the last seven or eight years.

Mr Webb: It is, is it not?

Q12 Mr MacNeil: I wanted to return to the maxim in your opening statement about fiscal incentives when you said that the North Sea was perhaps dangerously exposed and you talked about the Treasury moving to maximise the short term tax take as opposed to maximising long term revenue that could be got for the nations in total. What incentives do you think the Treasury should be employing in the North Sea to ensure that there are better fiscal incentives?

Mr Webb: I do not think the industry is looking for tax handouts; it is not looking for incentives of that nature. The way to incentivise this industry is to give it fiscal stability and some security in that regard. There are also a number of tax issues in the wings that need to be resolved, and again I would not want to be taken as saying that we are not engaged with the Government on these issues. The Treasury, after the Pre Budget Report, first announced what seemed to us to be a limited consultation on what they call structural issues. Further discussions at one of those meetings at the Treasury has resulted in that consultation being widened quite considerably. As we understand it, we are now about to engage in a consultation with the Treasury on all matters related to the fiscal scene in the UK bar the latest PBR tax increase. I do not think that is up for consultation; that is a done deal. It is important that we have that discussion because there are a number of significant fiscal issues lying out there in the wings which are causing problems for the industry at the moment.

Q13 Mr MacNeil: Such as?

Mr Webb: One is the future of petroleum revenue tax: what is going to be the position on that? Petroleum revenue tax is a rather cumbersome tax to administer and it will not be too long before it goes

negative, frankly, and therefore the industry believes, and the Treasury also probably shares this view, that something needs to be done about petroleum revenue tax. Our concern is that something is done about petroleum revenue tax and ends up loading more cost and expense on the industry rather than resolving the problem. There are also a number of fiscal issues around the decommissioning area. They are linked to some degree to PRT, but not exclusively, and to the whole fiscal relationship on the retirement of the assets in the North Sea. Frankly, that is a process that we do not want to see happen too soon. There is an important point here. If that ring main of offshore infrastructure is taken away too early a number of these small fields will never be produced. That is why I said in my opening remarks that if we get this right we have got a good future; if we get it wrong there will be irrecoverable economic loss because a number of these small fields will never be produced.

Q14 Mr MacNeil: You talk about a ring main being taken away. I am not sure what you mean by that.

Mr Webb: I am sorry. It is my shorthand for the offshore infrastructure that is out there at the moment, the pipelines and the connecting platforms.

Q15 Mr MacNeil: Why will that be taken away?

Mr Webb: If those platforms and pipeline systems do not have sufficient volume of production going through them to justify their continued maintenance then they will be required to be taken away. That is the way the system works. If they become redundant they will be taken away.

Q16 Danny Alexander: What changes to that system could help?

Mr Webb: There are a number of things around the decommissioning issues that could help. There are problems at the moment with carry-back of decommissioning allowances for tax. There are also problems around securitising those abandonment obligations. I do not know if you know it, but the way our tax system works for oil and gas in this country, you cannot make fiscally efficient retirement provision for those assets.

Q17 Mr MacNeil: What effect does the £2 billion increase in tax from the Chancellor, the 10–20%, have on what you have mentioned in the pipeline? What effect will that have on the continued maintenance of that infrastructure?

Mr Webb: It does not help because, of course, this is not just £2 billion one year; it is potentially £2 billion and more for a number of years that will be taken away and cannot be invested in the North Sea. I should make one thing clear though. This year we are not expecting it to be £2 billion. The latest Treasury estimate is that the incremental tax attributable to the PBR increase is £0.9 billion this year. Why is that? It is in part because the industry is investing so much in the offshore at the moment and therefore that has reduced the effective tax take.

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Q18 Mr Davidson: Can I follow up one point you made? In your written submission there is a sentence, “There is increasing evidence that high risk exploration is less attractive and marginal developments are not being pursued”, yet in the *Evening Express* that we picked up yesterday it says the offshore oil and gas industry is booming again, according to the figures of yesterday, and applications for new UK oil and gas exploration and production licences are at their highest level for 30 years. It is in the newspaper so it must be true, and it does seem to contradict the point that was made in your written submission which perhaps, in the light of experience, looks as if it was scaremongering. Can you comment on that?

Mr Webb: Yes. It was not scaremongering and it was not intended to be scaremongering. It was meant as an honest comment on the fears that we have in our association for the medium to longer term future of the UK offshore oil and gas industry. To take the point about what is happening in the short term, as I have mentioned before, at the moment we have very high oil prices. These are historically high oil prices. That is encouraging an awful lot of short term activity within the oil fields at the moment. I was looking at the UKOOA projections for wells to be drilled this year. The good news is that those look like they are going to be substantially up on last year, and where that increase is most marked is in development wells. There is a big increase in the number of development wells being drilled, so infill and wells designed to capture production now on existing or near existing fields. The exploration number, however, that we are now projecting, and we have to be slightly careful on this because it is based on the first quarter of this year’s activity, is a significant decline on last year’s number of exploration wells. That is not a good sign. If we are going to recover the maximum from this province we have to keep up our exploration activity and we are currently projecting something around the fifties for the number of exploration and appraisal wells to be drilled this year. That is somewhat low, so not everything is without concern here. As far as the licensing round is concerned, that, as I have said before, is testament to some excellent work that has been done in the Department for Trade and Industry on modernising the licensing system and making it more attractive to a whole range of players, including a lot of small companies, the so-called promote licensees, who come in and can pick up acreage and try and build up a prospect of it for two years and then see if they can get the wherewithal to drill later on. What I did not see (and it would interest me to see) announced in the DTI result was the number of firm exploration wells that were committed in this round of licensing. I do not know what that number is. That would be an interesting signal to see whether also there is an increase in exploration appetite there.

Q19 Danny Alexander: Could you explain how the tax changes have led to what has been described as the UK attracting a reputation for fiscal instability within the industry? Some would argue that having

a tax rise on a particular industry was an indication of its success and indeed the profits made by it, and therefore it could be seen as a sign of health rather than of insecurity.

Mr Webb: I am not sure other industries in the UK would agree with you that they should be rewarded for success with yet more tax. The example I would give for the instability is those three significant tax hikes that I have talked about. We had the introduction of supplementary corporation tax, which moved the corporation tax level payable in the oil and gas industry from 30% to 40% in the 2002 Budget. In the 2005 Budget we had an acceleration of payments of oil taxation, which took another billion out of the industry that year, and then in the 2005 Pre Budget Report—and that was part of my surprise, that such a significant tax increase was announced in the Pre Budget Report; I do not think we have had its like before—we had a doubling of supplementary corporation tax so that we are now paying corporation tax at a rate of 50%, and on top of that we have petroleum revenue tax at 50% on the older fields, giving us a highest marginal rate of 75%. Frankly, I do not think that encourages success. I think it slightly penalises it.

Q20 Danny Alexander: What impact does that sense of instability have, because what you are saying is that it is not just the level of taxes but also the fact that there is uncertainty about what is going to happen to tax next.

Mr Webb: Quite.

Q21 Danny Alexander: What impact has that had on future investment decisions, given the importance that you have outlined for investment decisions that are being taken now?

Mr Webb: I think the answer is that investors are more cautious. We know that some companies now are testing projects against tax hurdles in the UK that are higher than the current rate of tax here in the UK, so they are judging the projects, not against today’s tax rate but, cautiously and prudently, I would say, in view of the recent track record, against higher tax rates than that, so it induces people to put in a sort of risk premium on tax when considering their investment in the North Sea.

Q22 Danny Alexander: Could you estimate the scale of that risk premium?

Mr Webb: I do not know whether Mike has a feel for what risk premium they are loading at the moment.

Mr Tholen: I imagine some companies are taking the previous increase and saying that might happen again simply because they base their experience on what they have seen in the recent past.

Q23 Danny Alexander: So they might be assuming a further rise of 10% as a basis for judging whether or not it is a viable project?

Mr Tholen: They will certainly test against a range of things, against costs and tax uncertainty. That will certainly be priced in, not least on much of what we are looking at in exploration in the future.

Q24 Danny Alexander: In your submission you talk about the fact that oil and gas activity in the UK is now 16% less attractive as a result of the last increase, so that would be an assumption of, as it were, 32% less attractive overall?

Mr Tholen: That could be the assumption, yes.

Q25 Mr Davidson: Can I follow up that point? Are you saying to us that industry is pricing in a further 10% increase in its estimates for future investment, from which I take it that we could levy a further 10% tax increase and not scupper any of the projects?

Mr Webb: No, because I think that that increase will be scuppering some of the projects. There is a limit to how much this can go on. I heard that, for the company that was applying this extra hurdle, as a result of that the minimum size of development it would look at had also increased quite significantly.

Q26 Mr Davidson: Given that the oil price has shot upwards, clearly that has been financially beneficial to a substantial amount of the industry and it is essentially windfall gains. Do you not think it is reasonable for the Government to seek to have an element of that windfall gain come to Government rather than simply remain with the companies, and that therefore some form of tax increase, perhaps not this form but some form, was entirely appropriate and indeed was popular?

Mr Webb: In our view what the Government had done previously in the Budget of 2002 was having that effect. We could perhaps show you some workings on this that we have done. Post all taxes, we see the rate of return in the North Sea, and this is before the last tax increase, falling, not rising. In other words, the Government was getting an increased share of the benefits from the North Sea before this latest tax increase came in.

Q27 Mr Davidson: When you say the Government's share was rising, not falling, are you saying that the industry's share was falling?

Mr Webb: Post tax.

Q28 Mr Davidson: As a result of the oil price increase the industry was worse off than it was before? I find that difficult to believe.

Mr Webb: We have got very significant cost inflation going on in this industry at the moment. The cost of rigs, for example, has at least quadrupled over the last two or three years. Some rigs have gone up six-fold over that period. There is very significant cost inflation, some of this borne out of the problems with Katrina, of course, in the Gulf of Mexico which decides the global position on oil supply, so not everything has been moving positively along with oil prices here for the industry, and the tax take has gone up. Would it be helpful if we showed you a graph we have?

Q29 Mr Davidson: While that is being distributed can I clarify one point? You talk about inflation in terms of rig rates and so on. Rigs are part of the industry and presumably the fact that rigs are attracting higher costs or higher prices is a bonus for

that part of the industry. This is rent that they are receiving which is at a much higher level than it was before, so presumably those prices are being driven up by scarcity, but they are not in turn being driven up by the costs of the rigs themselves. It is just that the rigs themselves are able to extract a much higher price than they were before, so that is additional money going into the industry. Therefore, if you are looking at the industry as a whole, the fact that one section is charging more than another section is not an indication that the money is going out of the industry overall.

Mr Webb: One could say that, but if you look at it in a UK sense that can be happening, because what is happening is that we are in international competition for these scarce resources, so some of those resources are moving outside the UK, and the costs with them, it is true, but they are then not available to us in the UK to use, which increases the scarcity here which pushes the price up and certainly reduces the oil companies' margins. Would it help if Mike explained this graph to you?²

Mr Tholen: What you see here is work that refers to the ONS statistics on rate of return and it is stuff that the Chancellor has quoted and is well known within Treasury; we have discussed this with them. The blue line at the top shows the pre-tax rate of return which, as you see, ranges from about 15% in 1995 through to 35% in 2005. The data is straight off the ONS website. What you see in the red line is the post-tax rate of return because the numbers at the top exclude PRT, corporation tax and the supplementary charge. Clearly, pre-tax rates of return have pretty much followed the oil price, albeit they have not risen as fast, because costs have gone up a lot in the last few years. Post-tax, when you look at the impact of both costs and tax, we see that, particularly since 2002, the rate of return within the industry has declined. These numbers we have discussed with Treasury, they are aware of them. We discussed them first with the Paymaster General in November and have presented them again to Treasury several times since. It shows that underneath the industry is undoubtedly a healthy one but one that is having to fight to remain as attractive as it was even three or four years ago despite the current high increases in oil and gas prices.

Mr Webb: I am bound to say as well that another element of disappointment with the Pre Budget Report was when the Chancellor referred to 40% rates of return in the industry but we are still not sure where the 40% number comes from. The ONS number is somewhat lower than that, but also, very significantly, return on capital employed is a calculation that is done before tax, and this industry is unlike any other industry in that it pays significant amounts of special tax. As I say, our marginal rate on the older fields is 75%. There is no other part of British industry that is paying tax at that level. Therefore, to compare pre-tax rates of return of this industry against any other is a meaningless exercise.

Q30 David Mundell: In the context of stability, what I have picked up is that, whilst we may have a

² See graph Ev 19. Blue line is shown as a black unbroken line and red line as a paler unbroken line.

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superficial view that other parts of the world are politically more unstable, is it not the case that in recent times they have had a more stable tax regime than here in the UK in terms of the predictions that are made in the context of investment?

Mr Webb: That is a recurrent comment I have heard from my members, yes, that if you go into other parts of the world the risk inherent in retrospective change to the deal that has been done is very low indeed, much lower than it would seem to be in this country now. I was speaking to somebody the other day who was talking about, for example, Egypt, and they were mentioning that their production chain contract in Egypt has not been changed on terms of Government and industry take since it was signed and they have great confidence that it will not be. I have heard that in various other comments on other parts of the world, so it would be a mistake to believe that the industry does not take rather seriously fiscal instability that we do now seem to have vested on us here. The Chancellor, in all fairness, did say in his Pre Budget Report that he would not change the tax rates on this industry again for the life of this Parliament, but that again demonstrated a slight lack of awareness of this industry. This is an industry where projects take normally two to three years to bring on stream, so that comment, as one of my members said wryly to me, just means, "I am not going to be taxed whilst I am doing all the investment but all bets are off once I start production". That much security, however, I suppose was welcome. What we would like to see is that extended somewhat beyond a period of just a few years.

Q31 Mr MacNeil: Mr Tholen, you mentioned testing against a higher tax rate by companies and, listening to Mr Webb's earlier comments about maximising the long term revenue, between you both what effect do you think this is going to have on maximising the long term revenue, the amount of money we can get out of the North Sea, given that there seems to be a finite time due to the infrastructure difficulties of rusting pipelines and whatever? The reason I ask this is that any responsible finance minister has to look for the maximising of the revenue as opposed to short term gain and filling a real black hole in his economic sums?

Mr Tholen: The best example I can give you is, again, going back, you perhaps heard people mention last night the "Tale of Two Futures" and the vision of how industry can look if we keep investing at appropriate rates, basically maxing out, compared with what happens if we just look at what the current plans will deliver, or if we look at what happens if investment dries up. There are three scenarios: fast depletion, the current plans and what we can deliver based on the potential in the basin. When you look at that, and again this is work we have presented to Government, you see a tax capacity that is close to three times as big as if you look at what happens if you keep investing at the current rates compared with what happens if we see investment drying up. That gives a good example of the future opportunities, both for Government and for industry, if we see the right level of activity delivering that right result.

Mr Webb: I do not think that is something that the Government disagrees with because they put that very graph in their Energy Policy Review document. If you look at the document that launched the Energy Policy Review that Tale of Two Futures graph was in there.

Q32 Mr MacNeil: Do you think the tax increase helps maximise the revenue for the country or are we jeopardising gains to future generations as a result of that?

Mr Webb: I believe that maximising short term tax revenues risks damaging long term returns, and not just financial returns. I do actually think that this precious gift that we have of the UK offshore is of huge benefit to us in terms of security of energy supply. Yes, we are not self-sufficient in gas now but we are still a significant producer. Remember, the UK is a larger oil and gas producer than Kuwait; it is a larger oil and gas producer than Indonesia and Nigeria. It is still a significant player on the world scene and can continue to be so for years to come. We will still be self-sufficient in oil until about 2010. After that, yes, again, we will be importing some of our requirements but we can still be a significant producer and that is very important in my mind in terms of energy security of supply. To have that in the mix is very important, and that is not to say anything about the jobs that this industry supports, both in our companies but also in the supply chain.

Q33 Mr MacNeil: If you have a fear of it drying up in any way because of what the Chancellor has done, how much will we not extract as a result? Is that possible to quantify?

Mr Webb: It is. Maybe we could come back to you with a quantification of that but I can give you a feel for it in the terms of that Tale of Two Futures. What we showed there was that if we could maintain investment at the current level going forward then in 2020 we could be producing round about two million barrels of oil and gas equivalent a day. If, however, we went on the scenario that the investment dries up, then we could be down to producing something like half a million or so barrels a day at that point. Then the basin gets into very difficult territory because at those levels of production we will see a lot of that infrastructure going away, never to be put back again, and that will leave the smaller puddles of gas and oil, if you like, that are around probably never to be recovered because they are too small to justify the investment in the delivery infrastructure.³

Q34 Mr McGovern: Can I ask a question on this graph here? The post-tax rate of return in my opinion, and I am not an economist, still looks pretty healthy to me. It is not as high as it has been but it is certainly not as low as it has been. Could you comment on that? I know that these figures are probably as recent

³ *Note by Witness:* UKOOA reflected that the "Tale of Two Futures" provided some indication of the volumes of oil and gas which were at risk if investment were not be sustained. This shows, by 2002, that 3 billion boe (barrels of oil and gas equivalent) could be lost if investment were not sustained at recent rates.

as you can provide but could you say how you feel the most recent increase would affect that? Also, in answer to one of Angus's questions, you said that you felt that it was a short term gain and there would be possible damage to long term returns. Do you mean long term returns for people investing in that industry?

Mr Webb: I mean long term returns into the country as a result of that, what we could produce from the whole basin. That is the potential damage. Who is to say a significant price increase will not happen—and, by the way, we are not predicting it and we will give no predictions on oil and gas prices? I do not know if you saw it yesterday but I was struck by, in the *Financial Times*, a comment about refining capacity but it linked into oil and gas supply and I will just give you two quotes: “Merrill Lynch expects global oil production to rise by 2.6 million barrels a day next year, which would lead to further increases in the global stockpiles”, and then at the end, “Oil inventories in countries of the OECD are even higher than the very high levels seen in 1998 which triggered an oil price collapse to \$10 and demand started to slow”. Please, I am not suggesting that we are going to have any oil price collapse. What I am saying though is that the oil market is a market and prices can go down and we know that. It is a very volatile market. If there is a price reduction now then very sharp action is going to have to be taken by the Government to make sure that the offshore does not go into meltdown. I do not think that answers all of your questions. Can you remind me what they were?

Q35 Mr McGovern: It was on the graph.

Mr Webb: I will hand over to Mike to explain the technicals of that but maybe I will just say that yes, let us not pretend this is not a profitable industry and, frankly, a very successful industry. This is an oil and gas industry that has invested £215 billion in the offshore so far; that is capital investment, and has spent another over £100 billion on operations in the offshore. To attract those sums of money you need to be a successful and profitable going concern and we have certainly got those, I am pleased to say, in the North Sea and they are still coming here. Yes, it is a profitable industry but I do not think it is a wildly profitable industry at those sorts of return.

Mr Tholen: I do not know if I can add much to that. The post-tax rate of return is on a par with certain other sectors—pharmaceuticals, banking, which also seem to be profitable industries and, as we all know, deliver very good benefits to both society and to the economy in terms of employment, tax paid and wealth creation for the nation. That is what the industry seeks to do.

Q36 Mr McGovern: We have heard a lot about fiscal stability. Could you clarify for me more precisely just how a stable fiscal regime would help to promote maximising production from the UK Continental Shelf?

Mr Webb: There are many risks involved in this industry and most of those are not controllable by Government. They are the significant technical risks

that there are in these hostile waters offshore the UK and bringing back these more complex reservoirs. There is a significant price risk. One only has to look back at the record of prices in oil and gas in the world to see how volatile those markets are. These are the risks that the industry has to accommodate and take on board, let alone the engineering risk in some of these projects, which is also quite significant. Those are risks that the industry has to take on board and it can deal with those, but it is made much worse if there is another wild card in the pack, which is the fiscal rate changing with some rapidity over time and giving rise to concerns of real fear of that happening again. That is a risk that Government can control and if they control that for us correctly it helps us greatly get on and manage the other very significant risks that our companies have to manage. That is the core of it.

Q37 Danny Alexander: Mr Webb, can I follow up what you meant in response to Mr McGovern's previous question, which was in relation to—and I am not asking you to make predictions—the impact of a fall in the oil price? As a result of the tax change that has been made and also the instability of us building in an extra premium in those investment decisions, roughly to what level would the oil price have to fall before you started seeing a marked impact on investment decisions on the UK Continental Shelf and how does that differ from what the situation would have been last year or three or four years ago?

Mr Webb: That is a prediction though, is it not, that you are asking me to make? I think I have to be very careful. I think I have said it before, actually. I think that the area of risk lies somewhere between \$30 and \$40.

Q38 Mr Davidson: Can I come on to the question of opportunities for growth? If you had not had to find this £0.9 billion oil tax what would it have been spent on? Would it have just gone to lining the pockets of shareholders or were there any particular projects that you can identify as having been missed?

Mr Webb: As you rightly say, this year it is £0.9 billion. If the industry had had that £0.9 billion what would it have done with it? I think it would have invested a very significant amount of it. Part of the reason that it is not £2 billion but £0.9 billion is that the industry is investing so hard in the North Sea at the moment, so I think some of it would have gone there and some of it would have gone to pay returns to shareholders, no doubt.

Q39 Mr Davidson: What would the balance have been? Given that the industry, from what you are indicating, would appear not to have been deterred from investing by this tax increase, are there any projects that you can identify that were foregone as a result of the increase?

Mr Webb: No.

Q40 Mr Davidson: So there is no evidence that investment has been affected by the tax increase, just assertion?

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Mr Webb: Yes, I cannot point you to a list of projects that have been cancelled as a result of that, but I do know from my conversations with my members that projects are not going forward that might otherwise have gone forward.

Q41 Mr Davidson: But it is undoubtedly the case that had the tax increase not gone ahead there would have been much more money going into shareholders' pockets? That is clear.

Mr Webb: There would have been much more money available to companies to spend as they saw fit, yes. Some of that, I think, would have gone into investment as well and the growth of these companies.

Q42 Mr Davidson: Yes, but growth where? Would this just have been in growth abroad?

Mr Webb: No, I think it would have been growth here as well.

Q43 David Mundell: There have been reports that some parts of the industry have indicated to workers already in the industry that there would be no further exploration as a result of these tax changes. Are those reports accurate, that the impression has been given within the industry that this will end production?

Mr Webb: Not that I am aware of, no. I hope UKOOA, for example, has been consistent in its message here. We never believed that this latest tax increase was going to have a short term impact. Most of the activity, as I said before, was already contracted before this happened and we are in an area of very high oil price at the moment and scarcity of resource, so we did not see anything happening in the short term. Long term commitments have been taken on contracts before the tax rise happened. The central danger here is what happens if we have a downward price correction from these high oil prices? If that happens I think we are in a very uncomfortable position at that point. If that were to happen you could see a tailing off of all sorts of activities, both exploration and development, rather rapidly. At the moment we are not predicting that anything like that is happening. It is that risk that we think we have been exposed to.

Q44 David Mundell: Perhaps you would say a bit more about this issue around the oil price recovery, which is currently, as I understand it, at round about \$70 a barrel, how the differential price affects investment decisions and at what point, regardless of the tax regime, the exploration becomes unattractive.

Mr Webb: We are enjoying high oil prices at the moment. That is helping in a basin such as the UK and it is another thing I do not think we should lose sight of. In cost terms this is a somewhat uncompetitive basin, even against some of our near competitors. If you take Norway, for example, finding costs in the UK are five times as high as they are in Norway. The reasoning for that is that when you find it in Norway you still tend to find it big. Here you find it quite small, so there is cost pressure on this basin and this basin is helped by higher oil prices. This

basin was last in very serious crisis at the end of the 1990s when the price fell shortly to \$10 and languished at round about \$12 or \$13 for some time. At that level of price this industry frankly was in crisis. It was out of that actually that the very good arrangements where industry/Government co-operation and PILOT were born. I think that the danger point, as I have said before, is much higher than \$12 or \$13, and I can only say I think it is somewhere in the region of \$30 to \$40, when we would begin to see the basin struggle and there would be a need for corrective action. The most obvious corrective action, because there is not much we can do about the physical issues here, would be an adjustment in the tax take.

Q45 David Mundell: So you would favour some form of almost index-linking of the tax take?

Mr Webb: No, I am not sure that I do favour index-linking. What I favour is a fair and stable tax regime going forward that we can all plan on. What indexation misses, and it is quite an important point, is that all the risk in the type of regime under which we work in the UK is with the company. There is no Government money at risk, there is no taxpayers' money at risk. The entire risk is taken by the companies. Having taken that risk, if, every time the oil price bubbles up, the Government comes along and peak-shaves something off the top that in my view is unbalancing the game. That should not happen. What we should do is agree what a fair fiscal regime is and employ that, recognising that we have peaks and troughs in this industry. Yes, today we are at \$70 dollars. In 1998, 1999 we were at \$10, and that is the sort of planning cycle that we live with in this industry. The fields can take two or three years in the planning. They can then have a life of 10, 15 years. It is across that cycle that the industry plans and it is across that cycle that it seeks to get its return on its investment. If the Government keeps on coming in at every peak and gobbling up the goodies, if I can put it that way, and does nothing in the troughs when the price falls, then we are in a serious problem.

Q46 Mr MacNeil: Just to follow up the point that Ian was making earlier, you corrected me when I said it was £2 billion and it seems the Chancellor has put another £1.1 billion in a black hole, so it is actually £0.9 billion.

Mr Webb: Yes, it has not a black hole because the Chancellor—and this would happen in any event and maybe it is a sad reflection upon what has happened—is enjoying increased tax revenues from the increased price, so he is going to get about £12.5 billion, we think, this year from the offshore oil account.

Q47 Mr MacNeil: With regard to the question of the £0.9 billion being otherwise used for shareholders or for exploration in the North Sea, what percentage roughly of that £0.9 billion that is now in the Treasury would you have expected would have gone to shareholders or on exploration in the North Sea? Secondly, Ian asked about evidence and he said there was no evidence at all. Do you collect evidence of

non-activity? How do you know things are not happening? It is easier to say when things are happening than when they are not happening.

Mr Webb: It is a very good point. No, we do not collect evidence of non-activity. It is very difficult to obtain. Also, companies are somewhat loath to advertise that they are not doing something. They are happy to advertise what they are doing but they are not particularly keen on wasting their time talking about what is not going to happen. We do not collect data on lack of activity in that way. What I am aware of is various conversations with people in the industry who are telling me that the hurdle on size of prospect to look for has gone up, that they are testing things at different tax rates now and that they are being generally more cautious in their approach to that. Having said that, the oil price at the moment is approaching \$70 a barrel and that is stimulating quite a lot of in-field development work, as we can see. As I was saying before, we have got this big increase in the development wells but not an increase in the exploration activity, so you can see where the activity is going. It is going into those shorter term plays at the moment.

Q48 Mr MacNeil: Do you know what percentage that is?

Mr Webb: No, I am not sure I can give you that.⁴ Can we reflect on that and maybe come back to you? I cannot give you a division as to how that £0.9 billion is falling between returns to shareholders and investment. I am not sure I am ever going to be able to give you an answer but I promise you that we will reflect on it. The other point I would make is that it is not just tax that is the issue here. It is not just the tax cost that has gone up but the other costs in the industry are also causing pressures at the moment, and that, of course, is showing its way into more expenditure because the same is costing more these days owing to the significant price inflation that we have in the industry.

Q49 Mr Davidson: It is this point about the same costing more. That is, though, increased rent, as it were, accruing to other players in the industry, not necessarily the major developers but other parts of the industry are benefiting quite considerably from the increased rent that they can draw from the majors as a result of oil scarcity, and therefore overall that means that some sections of the industry will undoubtedly be financially much better off than other ones. That correction in a sense is a redistribution of resources within the industry rather than any loss.

Mr Webb: Yes, I think you have a fair point to a significant degree there but not all of these extra costs are within the industry. You will be aware, for example, that most commodity prices have increased significantly, including the price of steel. That is a cost increase that is not, if you like, being kept within the family, so there definitely is leakage to other parts of industry, if I can put it that way.

Q50 Chairman: If any information is available can you please write to the Clerk? That would be very helpful.

Mr Webb: We will be pleased to do that.⁵

Q51 Chairman: It is obvious that the drop in the price is a bigger threat to the industry than this tax increase of £0.9 billion. I cannot understand: if a company is selling their goods at \$30 a barrel and the price goes up to \$70 a barrel, then why should the Government not take a share of the huge profits that the company will be making?

Mr Webb: First, can I come back? I think there is one thing I would like to underline. This tax take is not £0.9 billion. It was an increase in corporation tax rate, a doubling of the supplementary corporation tax rate, which this year might result in an extra £0.9 billion but, depending on your price assumption, is going to take tax next year and the year after and the year after, so it is a very significant tax hike. If you put it in money terms it is greater than £0.9 billion. On the second point, why not tax when the price is high, I can only go back to what I said before: the price is not always this high. It is high at the moment but this is a very volatile market. I will not make a prediction on oil and gas prices but I will tell you one thing: I am sure that they will not be where they are today next year. Whether that is down or up I do not know.

Q52 Chairman: But it depends what the costs are. Professor Alexander G Kemp says here that if the price falls below \$30 there will be a need to review the tax rate. There is a huge gap between \$70 a barrel and \$30 a barrel.⁶ Would you agree with that?

Mr Webb: As I said, I think I would take a more conservative approach to that. I am worried about a range of higher than \$30. I would be concerned more towards a level of \$40.

Q53 Chairman: At what level would you be concerned?

Mr Webb: As I have said, between \$30 and \$40, and I think I would be starting to get concerned at about \$40.

Q54 Danny Alexander: I suppose some people would say that if some of the major oil companies are put off by the instability of the fiscal regime, there are plenty of smaller companies which are keen to come in, and so if a major pulled out there would be plenty of minnows to come in behind them, or is it the case that if the majors pulled out you would no longer get the investment in the infrastructure which the smaller companies rely on to carry out their work?

Mr Webb: I think the answer is that we need all the clubs in the bag. Going forward from here, we need the continued dedication of the majors; we certainly need the contribution from the new players. Thirty-five per cent of the capital investment last year was made by companies that had come into the North Sea since 1999, so these new players are having a very

⁴ *Note by Witness:* UKOOA has reflected further on this question and would advise that it has no further evidence it can offer beyond that already provided to the committee.

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⁶ See Ev

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significant impact and it is very good. I go back to what the DTI has done in very good measure in making this an interesting and attractive place for smaller companies to come and get involved in, and we can also see that in the latest 24th licensing round with the very large number of people there. That is all good, but if we are going to make a success of the North Sea in its second half, and we are into its second half now, we are going to need all of the players to play their part. You are quite right: the major companies have a significant part to play. They are owners of a significant proportion of the infrastructure. It is important that that is maintained and kept in place and that it is there and available for these new players and these smaller fields as they go forward. I think there is a role for everybody and I think all parts of the industry are playing their part and doing a good job at the moment.

Q55 Mr McGovern: If I can go back to Angus's question about how, if the money had remained with the companies, it might have been divided. I thought you said in response to his original question that the money would have been spent as the companies saw fit, and so, given that you have got over 30 members in UKOOA, it would be wild speculation to try and say how would they have divided it into 30 different companies, so I do not know if that helps to answer his earlier question. Do you think that the changes to the tax regime will mean that there will be less money available for training?

Mr Webb: No. I think the industry is putting in a significant effort on training and will continue to put in a significant effort on training and I do not see that there will be a deficit on that. In fact, I think there are some very encouraging things going on at the moment, again, some of them linked into that PILOT process as well, on training. The industry is doing good work there. I do not see any signs of slackening back on the training side. In fact, I see an increase in the training spend because the industry is somewhat resource constrained. The most important resource we have definitely is our human resource and we are doing what we can to improve supply into the industry and there have been some very encouraging initiatives launched here in Aberdeen recently by OPITO, the industry's training body, which has sought to bring more people into the industry and make the industry more available to people in this country.

Q56 Mr McGovern: Thanks, Mr Webb, I am delighted to hear that. There had been a fear in some quarters, and perhaps it has been a bit too simplistic, that because of the changes there would be an impact on training and that impact would lead to one of two scenarios: one, that the same amount of people would be trained but to a lesser skill level, with all the implications that would have for employment levels, and the second scenario would be that fewer people would be trained and there would also be implications for health and safety. Has that view been too simplistic and can you confirm that that is not the case?

Mr Webb: Yes, I can, unequivocally. I think the industry is doing more and it is committed to do yet more on the training front. The industry leadership team under PILOT launched a project last year called the "pinch-points" project because there was a lot of apocryphal news out there that the industry was being constrained by a labour shortage, so a study was done and some particular pinch points were indeed discovered and projects have been put in place to cope with that. Some of these pinch points were very interesting. For example, riggers and scaffolders were seen as particular pinch points. Now I am pleased to say that projects are going ahead to train more people in those skills and bring them into the industry and also projects to bring more mature technicians from other industries into our industry. We also run one of the most successful modern apprenticeship schemes in the country. The Young Technician Training Programme is delivering 100 highly qualified young technicians into the industry every year, so the industry has got a good track record there but it is not resting on its laurels and is continuing to invest on that side and I have seen no evidence of cutback on training.

Q57 Mr McGovern: Thanks again, and again I am delighted to hear that, in particular about the apprenticeship schemes. I had been told that there is a massive skills gap in the industry currently, so it is great to see people being trained up and there is possibly a bigger training budget than there has been previously. Given all of these things would that not support the contention in the local press that business is booming?

Mr Webb: I would not wish to deny that right now this town is booming and I am very pleased to see it booming and the industry is going full pelt at the job ahead of it. There is no doubt about that. That is going on right now. I come back to the point that the concern I have is do we have a fiscal and regulatory regime that is fit for purpose for the second half of the North Sea and can take the knocks that I think will come when we get price adjustments?

Q58 Mr Davidson: I want to follow up one point from Jim's comments. You said there would be no adverse impact on training. Do I take it there is no possibility of adverse impact on health and safety?

Mr Webb: Oh no.

Mr Davidson: Thank you. I just wanted to have that on the record.

Q59 Mr MacNeil: In your memorandum you say the Government cannot presume that the UK will remain the preferred location for investment but do you think there could be other preferred locations for investment?

Mr Webb: I suppose we could look at that around the North Sea and then globally around the North Sea. There is Norway, of course; that is right on our doorstep, Holland to a lesser degree. They are in the same period of maturity as we are but the tax take in Holland now is nowhere near what it is in the UK. The tax take in Norway at the top end is roughly the same as it is in the UK but, as I said, they are still

finding elephants and we are finding much smaller game here now, so you have got competition there. Then you look elsewhere. The UK is now uncompetitive, I would say, in terms of tax and probably cost compared to the Gulf of Mexico, both shallow and deep, so those areas are also strong competitors. Then you have got the whole of the west coast of Africa, those African developments, as well. There is lots of stuff around the globe that people can invest in as opposed to coming here.

Q60 Mr MacNeil: And yet when you look to Norway, in particular, do you ever envy Norway's wisdom in setting up an oil fund as was advocated initially by Tony Benn and certainly by my party, the SNP, and that Norway are now getting more money for the nation each year from the oil fund than they are getting from the oil? Does UKOOA have a view on that or do you just work from day to day?

Mr Webb: UKOOA does not have a particular view on that. That is one that we will leave to you politicians and the electorate to work out. I do not think that is something upon which oil companies should presume to dictate.

Q61 Danny Alexander: Following up alternative locations for investment, can you think of another area that might attract investment which has a more unstable tax regime than the way the UK is at the moment?

Mr Webb: Off the top of my head, no. Mike, can you think of any?

Mr Tholen: I cannot say I can.

Mr Webb: I cannot think of anywhere else that has put through three major tax increases in three years, no. Again, let me reflect upon that and I will tell you if we can find somewhere else. I will come back to you, Chairman, on that point.⁷

Q62 Chairman: In other countries I believe some governments take a share of the profits as well which the UK does not.

Mr Webb: That is right.

Q63 Chairman: How would you explain that?

Mr Webb: You can say that the special taxation that we have in this country is the way that the Government takes its share of profits. I think we have to be careful in comparing different regimes. As I said, this is an equity based regime here where the equity investor takes all of the risk and the Government is exposed to none of the risk. If you go into other areas where the government is taking profit share the government shares in some of the risk as well; it certainly shares in, for example, the price risk, and that is not the case in this country. The entire risk is borne by the investor.

Q64 Mr Davidson: Can I just follow up this question of alternative locations for investment, and particularly you mentioned the west coast of Africa, and recently off Nigeria there were kidnappings, were

there not? Can I ask how you balance political instability as distinct from fiscal instability? I would have thought that by and large Nigeria is not necessarily the safest place to invest and a whole number of west African states are potentially failed states. How does the industry do that sort of trade-off?

Mr Webb: I am bound to say it is largely all in the same pot when you are looking at political risk. Forgive me: my focus is really very much on the UK so I am not current with those sorts of decisions that are being taken in companies at the moment, but the industry is very well versed in looking at political risk of all sorts and is used to operating around the world under various types of regime. It is just that the risk comes down in the end to the economics of the situation and extreme fiscal risk can be just as bad as other sorts of political risk.

Q65 Mr Davidson: Would you characterise this as extreme fiscal risk?

Mr Webb: No, that was probably an overstatement on my part. We have got high risk here. High risk has been demonstrated. Instability has been demonstrated over the last three years.

Q66 Mr Davidson: The sort of Bennism that was being lauded a moment ago is perhaps extreme political risk and was even at the time when that was fashionable but maybe we should move on from that.

Mr Webb: I should maybe point out that at one stage I worked for the British National Oil Corporation, so I have some experience of that as well.

Q67 Mr Davidson: It does not make you a bad person.

Mr Webb: No. It was a very interesting period in my life, I must say.

Q68 David Mundell: Can I ask you a question about the wider energy policy in the context of the memorandum that you have provided? The Committee has already in its past life done a major report on energy issues within Scotland and, of course, the Energy Review which you referred to is ongoing. You have asserted in your document that by 2020 energy generated from oil and gas could account for 83% of the UK's requirements. Given the indication that the Government appears to be poised to announce a new generation of nuclear stations do you think that is still a credible statement?

Mr Webb: Yes. The 83% comes out of the DTI scenario which is favourable to gas. They run another one which is favourable to coal and which I think comes out at 78%, and that is why in my remarks I was talking about 80%. We are talking about 2020 and the real point here is, when is this nuclear build going to come in? There is another point before that, if I may say so. People often confuse—and I am not suggesting that the Committee is doing this—electricity generation and primary energy supply. Electricity generation accounts for about a third of primary energy used in this country. About 21% of that third is attributable to nuclear at the moment. The impact of nuclear on the primary energy supply is somewhat muted. By the time you have taken it

⁷ UKOOA confirms it is not aware of a country which has seen greater tax changes on oil and gas production over the last three years than the UK.

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through that it is today about 7 or 8% of primary energy supply. Furthermore, even if—and who knows what is going to happen with this Energy Policy Review?—the firing gun is started now and the building of new reactors is facilitated, it is unlikely that those are going to come on stream much before 2020. Over that period I do not see the nuclear equation having a dramatic impact on that forecast that is contained in the DTI document. I still think in the medium to near term this country is going to be very significantly reliant upon oil and gas for its primary energy supply and that is why we need to do all that we can to maximise our own indigenous production. Can I say that there is something else here as well? I think I may have slightly overlooked this. There is another reason for maximising indigenous production. It does not just relate to the oil and gas and security of supply and the fiscal contribution that that can make, but also to what has grown up around this industry of ours, this magnificent supply chain that we have, which is largely a Scottish story. This is a world-beating engineering success story we have got here. The global sub-sea fleet is controlled from Aberdeen. The UK is without doubt, and Scotland is really at the core of this, the global leader in sub-sea engineering and is certainly a world leader in offshore engineering. This is an entirely remarkable success story. It is another reason why we need to go on and maintain the health of this domestic industry we have got because that supply chain relies to some degree upon that home base. It is now growing into international markets and this number of £4 billion of export earnings for Scottish-based firms that the SCDI have discovered—and that is the 2004 number, by the way, which is the latest one that is available and we know it is growing—is very significant. Therefore, that half of the story should not be overlooked. Where it puts Scotland frankly is in leading edge technology and industry and its potential for export earnings after we have finished the second half of the North Sea. When we do ultimately take the last barrels out of the North Sea one would hope that still working in the world will be this tremendous supply chain capability that has been built up along with the indigenous production.

Q69 David Mundell: I think that is a very important point. How will that sustainability of the supply chain, controlled and based here in Scotland, be maintained? What factors are going to influence that? In our informal discussions last night somebody indicated to me that one or two companies had re-headquartered, or whatever the phrase is, again because fiscal arrangements might have been more favourable elsewhere.

Mr Webb: Yes. The supply chain, thank goodness, is not treated in a different fiscal way from the rest of British industry, so they are not enjoying these special taxes that we enjoy, which I think is a plus and I hope that always remains, no matter how successful they become. I think the best way they can be helped in the short term is to maintain the strong base here that they have got and from which they can develop and grow. Going back to the Tale of Two Futures picture,

if, over the next five or 10 years we saw a sudden decline in the domestic base then that would not bode very well for the long term sustainability of the supply chain industry that has grown up taking on the world from Scotland, but if we can keep this industry going for another few decades yet I think that is the best thing we can do to help them assure that long term future.

Q70 David Mundell: It is a credible proposition that, even if the focus in 30 or 40 years' time was on west Africa or other even unconsidered parts of the world at the moment this North Sea basin was completed, it is a realistic proposition to say that there could still be a vibrant supply chain industry based here in Aberdeen.

Mr Webb: Oh, yes, based on the strong technical expertise in this industry, which is superb. This is really leading edge stuff. This is one of Britain's great engineering success stories. To some degree, unfortunately, it is one of Britain's best kept secrets as well. I think it is entirely credible and the market out there is huge. The market is not just the private oil companies; it is also state oil companies around the world. They contract.

Q71 Danny Alexander: Can I follow up one of the points that David was asking about in relation to broader energy issues? I wonder to what extent you think the possibility of carbon capture and storage and the use of disused oil fields for that purpose can help, particularly to sustain the infrastructure within the UK.

Mr Webb: It is a difficult issue. I am not sure that it really helps on the infrastructure point because, remember, you would be taking the flow a different way. The infrastructure is used to take production from the fields to shore. If you are going to engage in using offshore fields for carbon capture and sequestration then you are going to be moving the CO₂ in the opposite direction. The second thing is that much of the infrastructure offshore needs very significant re-engineering because of the particular requirements of CO₂; it is a very corrosive gas, so there is that as well. Having said that, CO₂ capture and sequestration must present us with a very interesting opportunity. There are hurdles that need to be overcome, some of them illegal. At the moment I think, under EU statutes, it is illegal to dump CO₂ in depleted reservoirs offshore, but there must be some potential there. It is a very interesting project which society could use in order to overcome some of the environmental issues around the burning of fossil fuels, be they hydrocarbons or coal. It is very interesting and you are right; sorry, I was being negative when I talked about the infrastructure. There is a potential use here for depleted oil and gas reservoirs, certainly. I am bound to say the economics of it at the moment are not proven but it certainly does present some very interesting opportunities.

Q72 Mr Davidson: I want to follow up David's point by saying that I think that you are absolutely right on the question of the future of the export expertise and so on and the strength of the supply chain and many

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of us who have travelled to other oil producing countries recognise the role that Scotland can and ought to play in developing all that. Unfortunately, our remit today is dealing with the taxation issue and therefore we have not delved into those issues to the same extent, but in one of the paragraphs in your submission you mention that maximising the economic recovery of oil and gas reserves has been hindered by too much red tape from the EU and from Britain. Would you expand a little bit on that and clarify which regulations you have in mind, bearing in mind the perspective that in a sense if it was not for regulations some employers in my constituency would have small boys climbing chimneys? Your burdensome regulation is health and safety protection for some of my constituents and it is a question of striking that balance. I am not quite sure which regulations you would refer to as being unduly burdensome.

Mr Webb: Can I give you an example? I will give you a concrete example because it shows two things: the good work that PILOT can do and the sort of regulation that I am talking about. The stewardship initiative is one of a series of really significant initiatives that the PILOT has launched, and they run from Fallow acreage, Fallow discoveries, to the industry code of practice on access to infrastructure. There is a lot we could talk about there, but one of them is the stewardship initiative, which some people have dubbed “the Fallow fields initiative”, which was designed to look at the stewardship of the fields in the North Sea and to make sure that all that could be done was being done to maximise the opportunities around those fields. As part of that exercise what was unearthed was that the industry was doing something called a field production report every year. Every field that was in production did this big, statistically weighted review upon what would happen, sent it off to the Department of Trade and Industry, where, frankly, it gathered dust. Nothing happened to it. It was quite expensive for the industry to produce and it was more or less no use at the other end but it was still being produced under this regulatory arrangement. As a result of the stewardship initiative it was agreed that that should be dispensed with and in its place should be put a much more focused inquiry on issues which relate not just to the productive capacity of the installations but to safety as well, which go to the heart of stewardship, and the annual field report was done away with. That is the sort of better regulation move that we want to see. We want to see the time-honoured old regulations questioned and where they are no use to get rid of them and put something else stronger and better and better for purpose in their place. No, we are not saying deregulate the North Sea.

Q73 Mr Davidson: What your story in a sense indicates to me is that there are existing mechanisms in place which are working, which are removing unnecessary, burdensome regulations at the moment. I am not clear from putting together what you have said now and in your submission that these unnecessarily burdensome regulations are not already being tackled.

Mr Webb: In our view they are not being tackled speedily enough and we want to see more action on that. That is the substance of that point. We have had discussions with the Better Regulation Task Force on this as well. We are seeking to stimulate those discussions in PILOT. There is a range of things that we think could be done more efficiently and more effectively and, yes, you can be assured that we are engaged with Government on that and we will continue to press on those issues.

Q74 Mr Davidson: Do you accept that it is reasonable for us to have some anxieties about the point you made, that it failed to recognise the objective of maximising the economic recovery of UK oil and gas reserves? I think that there will be some balances to be struck between potential environmental damage and maximum recovery and there are some elements within your industry that I do not think it would be entirely reasonable for us to be expected to trust completely to protect the environment when there are clearly enormous financial incentives to cut corners.

Mr Webb: I do not think that there are financial incentives to cut corners if environmental safety is put at risk, frankly. I do not think that pays ultimately, and I do not think the industry sees it that way. However, I agree with you, and I am not saying that we want a regulation-free offshore oil and gas industry. What we want to see is a regulatory regime that is fit for purpose for the second half of the North Sea. I cannot overstate the fact that the second half is different from the first half and it needs a lighter, different touch on a number of these regulatory issues but we are not saying take away environmental protection, take away this, take away that and just let us rip at that. That is not what we are saying, but let us get it more fit for purpose than it is today.

Q75 Mr Davidson: Can I just clarify that when people say “lighter touch” they generally mean “less of”?

Mr Webb: Yes.

Q76 Mr Davidson: Which generally means laxer. I hope you understand my meaning.

Mr Webb: And I understand your concern as well, but if you go back to the example I gave, I think that is the way of doing these things, lighter, much more effective, and there is a gain on both sides there. I think the Government is much better informed through this new stewardship process than it ever was under the other process.

Q77 Mr Davidson: So things are getting better? Things can only get better?

Mr Webb: I do not just believe that things only get better. I would not want you to believe that there is not a lot of good that is going on within the industry and between Government and industry at the moment. There is a lot of good work going on. Specifically on your inquiry today, I have to say that the PBR was not one of those good things. We do not regard it as the right move right now, but that is not to deny that there is a lot of other good stuff going on. I could give you a list of these regulations; there are a number of them. Some of them we are making

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progress on. Others I think we need to do a bit more pushing on before we get there. I hope through the PILOT and other mechanisms we can achieve that but we are talking on these issues.

Q78 Mr MacNeil: You were talking earlier about the burdens of identification. The example you brought forward was the paper exercise. I used to be a teacher and I know, speaking to teachers, that teaching is almost a by-product of what they do now because of the regulations and the growth of bureaucracy. Have you identified the particular burdens and categories and if there are any costings on producing that again and a loss of taxation revenues?

Mr Webb: I am not sure I have them all costed. I can give you some other examples. We are concerned about both the fiscal and the regulatory regime around decommissioning at the moment, which is putting quite a significant burden particularly upon new entrants into the North Sea.

Q79 Mr MacNeil: Have these been systematically categorised?

Mr Webb: They are well understood within the industry and they are the subject of debate at the moment between the industry and Government.

Q80 Mr MacNeil: The reason I ask if there is systematic categorisation is that it helps those outwith the industry maybe understand the issues with industry that you are talking about because otherwise we are just getting a series of anecdotes rather than anything else.

Mr Webb: This is a slightly difficult concept. One of the issues around decommissioning is the fact that the Government has adopted what it sees as a particularly risk-averse approach on decommissioning and has put very significant burdens in terms of continuing liability on ex-licensees. As a result of that, when licence transfers occur both the Government and to some degree industry look for the incoming companies to give guarantees or assurances with regard to the decommissioning liabilities. Those guarantees are tending to take the form of bankers' letters of credit, which are both expensive and also burden the balance sheets of smaller companies. I would not deny this is not a very difficult and complex area but it is an area where we have got to move from where we are if we are going to have the right regime for the second half of the North Sea. There is discussion going on at the moment within the industry leadership team and PILOT on the whole decommissioning issue and that issue includes the securitisation of these obligations and how we can best go about that in a way that does not overburden new entrants coming in. That is another example of what we are doing.

Q81 Mr MacNeil: Last June in their report on fuel prices, colleagues on the Trade and Industry Committee were critical of UKOOA for your perceived reluctance to continue the easing of fuel poverty.⁸ Given your members' charitable support for

organisations in Aberdeen such as Aberdeen Foyer, do you consider the criticism of UKOOA to be unwarranted?

Mr Webb: No, I do not. I think fuel poverty is a serious issue. Poverty is a serious issue. I think they are, however, matters that need to be dealt with by governments, not individual industries. I would say as an aside that one of the things that has probably taken more people in this country out of fuel poverty than any other thing in the last 40 years has been the availability of piped natural gas to communities throughout the length and breadth of this country. That has been very significant as the easing of fuel poverty. Indeed, I have had discussions with the fuel poverty lobby and I was struck by the number of ideas that they had to extend the reach of the natural gas main to more people in this country as a significant way of easing fuel poverty. I do not think that the industry's record as a whole in this regard is at all bad, but I do think that the issue of poverty, be it fuel poverty or any other form of poverty within society, is essentially an issue for you, the politicians, to decide and act upon as opposed to individual industries.

Q82 Mr MacNeil: You said in the earlier part of your evidence that the Chancellor shows a lack of awareness of the industry. What sort of questions do you think a committee such as ours should be asking the Chancellor in the light of his increasing taxation?

Mr Webb: It is probably not for me to tutor you as a committee on that but one of the things I would be interested in, and I think we are interested in, is that we still do not quite understand where the 40% rate of return that the Chancellor spoke about came from. I suppose one would be interested to know his views upon the medium to long term position on the UK oil and gas reserves and how the Treasury could act with other parts of Government to ensure that we maximise the ultimate recovery and how that can be best achieved.

Q83 Mr Davidson: Mr Webb, how do you think a single Department for Energy would be able to do a better job within the current disparate arrangement where several Government departments have separate areas of responsibility?

Mr Webb: It might not. It depends upon how that department is staffed, run and focused, I suppose is the answer to that. What we are saying here, and it has been said already, is that we are looking for more joined-up government on energy policy. We do think that energy policy at the moment is in danger of being created in various parts of Government by creating a new Department for Energy under a Secretary of State. We think that there would then be a sharp focus within Government and hopefully that individual would be able to drive a consistent energy policy right across Government. That is really what we are looking for here.

Q84 Mr McGovern: In your opening remarks and your answer you admit that that might not be the solution, that it would depend how it was staffed and how it was run, but you think that it would be a step in the right direction?

⁸ Trade and Industry Committee Report, *Fuel Prices*, HC279, Session 2004-05.

Mr Webb: Yes. I personally think, and it is in our submission, that that would be the right step forward, but just an organisational move of itself is not enough. We need to create, and I hope it is going to come out of this later stage of the Energy Policy Review, a very clear energy policy which covers all aspects of energy in this country. It would be good if we could have one consistent dialogue with Government on those issues instead of, as I have said before, these several dialogues that we are having.

Q85 Mr MacNeil: Do you think there is a feeling within the industry that the Chancellor looks at you as a cash cow, whereas we see other countries in Europe that have no oil and they are running more successful economies?

Mr Webb: All I can say is that at this point the industry is somewhat concerned and driven by the fact that we have had three significant tax increases in three years, and that is not a positive thing for the industry and the industry is concerned about that, both for the effects that it has had and also for the effects that it could have in the future.

Q86 Mr MacNeil: Would it help if these three tax increases had been one?

Mr Webb: Maybe not.

Q87 Chairman: Mr Webb, you were not very sure how much of the taxation of £0.9 billion would have gone to the shareholders and how much would have gone into investment in exploration. Would you have any idea what percentage would have gone probably to tackle fuel poverty or any charitable causes?

Mr Webb: No, because I do not keep any tag upon the charitable activities of my membership. That is a private matter for them. It is not something that a trade association would ever concern itself with.

Q88 Chairman: The Trade and Industry Committee tried very hard with the high oil prices to get the industry to give an undertaking to contribute money to fuel poverty, which they refused, and the Committee in turn said, "If you don't hand over at least some money voluntarily, we will quite understand if the Chancellor takes it by force". How do you comment on that?

Mr Webb: I disagree with the comment. If we look back to fuel poverty and the responsibilities of industry and the Government, I think the responsibilities of my members are to provide this country with the best oil and gas industry in the world, and I think we are almost there, also one of the safest oil and gas industries in the world. We know we are not there yet and we are determined to

get there and we have strong plans in respect of that, and it is also to work with the Government to maximise recovery from the profits and to pay our taxes, and we are paying taxes. We are paying significant taxes, £12.5 billion or thereabouts this year. If you take the product that we produce and take it downstream, you will find that the £12.5 billion that we pay is a pale reflection almost of the £30 billion that then comes at the petrol pump from oil and gas, so from the oil and gas stream one can see that the Government is enjoying a revenue of somewhere round about £40–45 billion each year. That is about 10% of Government revenue and that is a fair pot, I would have said, to tackle fuel poverty.

Q89 Chairman: I can understand, Mr Webb, that it is the Government's responsibility to deal with fuel poverty and social issues and so on, but of course, when we are living in the world we have huge corporate companies whose budgets probably are more than some of the countries have available to them, and so do you not think those companies should be encouraged to participate in charitable causes where they can help people who are in need and that they have some obligations to society?

Mr Webb: I think companies do, through their corporate social responsibility programmes in this country and abroad, undertake various charitable works. I do not have an aggregation of that because we do not check those statistics, but I still do think that our primary obligation is to run a first-class industry for the benefit of this nation, to make sure that our employees are properly trained, that they are safe at their work and that we are doing all that we can to maximise recovery from the North Sea oil and gas reserves. What I do not think we should be involved in, and I think it is a very dangerous route for industry or Government to go down, is subsidising fuel to the end consumer. I think that is a very dangerous route to go down.

Q90 Chairman: Thank you, Mr Webb and Mr Tholen. That concludes our questions. Before I declare the meeting closed do you wish to say anything on any areas which we have not covered in our questions?

Mr Webb: No. I think you have raised a very comprehensive set of questions and I thank you and the members of the Committee for giving us the opportunity to put the case for UK oil and gas to you today. Thank you very much indeed.

Chairman: Thank you once again, Mr Webb and Mr Tholen. Your evidence, I am sure, will be very helpful to this Committee when we finally report and we will make sure that your concerns are expressed in our report.

Further memorandum submitted by UKOOA

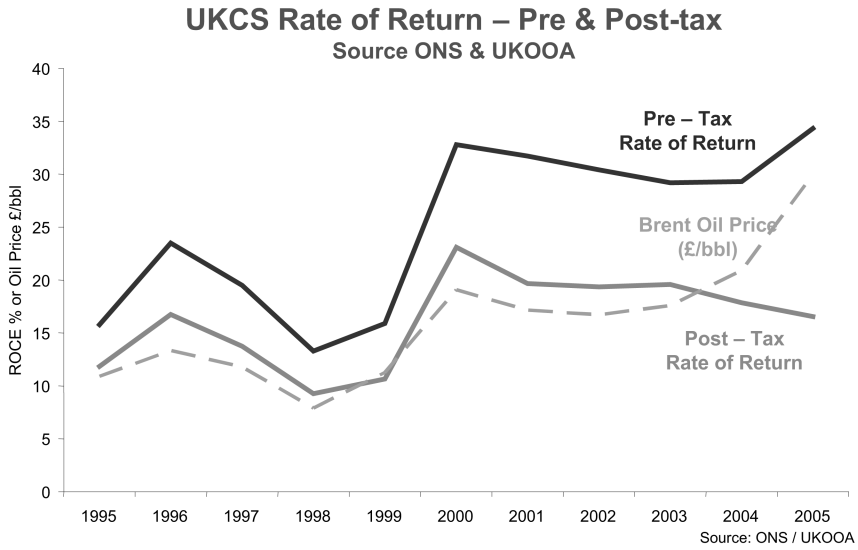
UKCS Rates of Return (Post-Tax) Flat, Despite Rising Oil Prices

Increased Rates of Return have been cited as the motivation for the recent tax increase on the UK Oil and Gas industry. Whilst pre-tax rates of return have increased on the back of higher oil prices, UKOOA’s own analysis shows that **rates of return post tax have declined since 2002**.

The Office of National Statistics (ONS) regularly publishes details of the Rates of Return² for the oil and gas sector. ONS follows the convention in reporting Rates of Return on a pre-tax basis. However, in doing so it fails to highlight that the UKCS is taxed at a much higher rate than other industries, with marginal tax rates which now range from 50%–75% from 1 January, 2006.

UKOOA has made comparison of ONS Rate of Return on both a pre-tax and post-tax basis for the UKCS over the last decade which has been shared with HM Treasury. Despite the increase in oil price since 2003, the post tax rate of return has declined over the last five years. In large part, this reflects the tax increase imposed on the UKCS in 2002; it demonstrates that even before the latest tax increase in 2005, the fiscal regime was already very effective in transferring economic rent to HM Treasury. The continued decline of the post-tax Rate of Return also raises concerns about the long term competitiveness of the basin, all the more so when oil and gas prices have been rising.

It should also be noted that UKOOA has fundamental reservations on the use of Rate of Return as a measure of profitability. Economic measures are used to drive investment rather than accountancy measures such as Rate of Return. UKOOA consider that ONS figures understate the massive capital investment in the UKCS, leading to an over estimation of the Rate of Return. In recognition of this, ONS, on their website, express concern about the use of this measure for the UKCS.



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² This profitability measure is more usually referred to as “Return on Capital Employed” (ROCE). It is an accountancy measure calculated as the ratio of EBIT (Earnings before Tax and Interest) to capital employed.

Tuesday 18 July 2006

Members present:

Mr Mohammad Sarwar, in the Chair

Danny Alexander
Ms Katy Clark
Mr Ian Davidson
Mr Jim Devine

Mr John MacDougall
Mr Jim McGovern
David Mundell
Mr Charles Walker

Witnesses: **Mr Dave Blackwood**, Director, BP North Sea and **Dr Rebecca Brown**, Finance Manager, Apache North Sea Ltd, gave evidence.

Q91 Chairman: Good afternoon and welcome, Mr Blackwood and Dr Brown, to today's evidence session on the Scottish Affairs Committee inquiry into the effects of tax increases on the oil industry. Before we start on the detailed questions, would you like to make any opening remarks?

Mr Blackwood: Yes, Chairman, thank you for this opportunity; I would like to summarise very quickly BP's attitude to what is in fact the third UKCS tax increase in as many years. Observers of the North Sea might easily assume it is a straightforward exercise to assess the effects of any movement in tax and give precise measurements of how that behaviour is thereby affected, but it is not quite as simple as that in that past decisions cannot be turned on or off instantly and it is too soon to assess the full implications of the last budget. What I can say with certainty as the head of BP's activities in the North Sea is that any tax increase in the North Sea makes my task of attracting capital and manpower into the UKCS more difficult, and the reason for this is because of some unavoidable facts and realities about the North Sea itself, and I would just like to highlight some of these. The first is in the area of exploration: the North Sea has become a very difficult place to find significant quantities of oil and gas. The average size of fields is getting smaller and at a commercial exploration success rate of the last few years of somewhere between 10 and 20% at best, the North Sea is hardly an optimistic location for new discoveries. Secondly, production, which has fallen from a peak of 4.6 million barrels of oil equivalent per day—oil and gas—in 1999 to 3.3 million in 2005, a fall of nearly 30%, despite the industry investing over £40 billion in the UKCS over the last five years, so inescapably the North Sea is subject to the laws of physics. The third is cost: current cost inflation is running at somewhere between 15 and 20% per annum because of the global competition for supply chain resources, both human and technical. That actually means we have to spend more just to stand still. The unfortunate truth, therefore, is that on almost every possible measure the UKCS is becoming a much more difficult place in which to operate. Common sense would dictate that this is possibly one of the last provinces of the world to have warranted a tax increase, and possibly the only redeeming factor is the current high oil price which, although disturbing for many other reasons and irrelevant in terms of UKCS competitiveness, it does help to disguise some

of the things I have been talking about. One last point: all of these factors are challenging, they are not insurmountable, and UKCS could still have an exciting future. According to the latest data there is still up to 26 billion barrels of oil equivalent to be found and developed in the UK. BP plans to spend in excess of £1 billion per annum within the UKCS over the medium term. The question is whether it is sensible to have compounded the difficulties I have expressed with an additional fiscal burden. Most of our challenges are dictated by nature; all government can do is to help provide an appropriate fiscal and regulatory regime, appropriate that is for maturity of the province, rather than the short term economic pressures of the day. That is why we believe that the recent tax increases have been ill-judged and in defiance of the realities. It has dealt a blow to investors' confidence in the North Sea and it is a bad advertisement to other governments across the world. If the oil price were to weaken significantly, it could have even worse consequences, which is why we as a corporation have argued that if taxes are introduced when prices are high, they should be removed if and when they fall and investors should be given certainty that this will be the case. BP remains committed to the UKCS, we are not afraid of the challenges we face, it is our job to overcome them, but the tax increase can hardly be described as sensible or helpful.

Q92 Chairman: Dr Brown, do you want to say anything?

Dr Brown: First of all I would like to say that Apache welcome this opportunity to be here today, and I trust that by the end of this session you will have gained a better understanding of what a company such as ourselves brings to the UK and how the fiscal environment can impact what we do. There are a couple of remarks that I would like to make that are intended to act as some sort of further context to your possible questions. Apache has been in the North Sea for just over three years, making their entrance with the purchase of the Forties Field. During the time we have been here, we have invested \$1.1 billion in wells and facilities in the region and taken Forties production from around 40 MBD to over 70 MBD. We have also required a further 36 blocks through the 22nd and 23rd licensing round and have bid for more in the ongoing 24th round. To date we have drilled over 30 Forties production wells and over 10 exploration and appraisal wells outside

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of the Forties area. We have a rig contracted for a further exploration appraisal programme due to start later this year. I could go on, but I am sure that you have got the message that we are a high activity company and the North Sea is a key piece of business for us. Our intent when we came to the North Sea was to make this a key region for us and to grow our business here. We can grow our business through acquisition of existing fields and/or development of new fields, or in some cases redevelopment of old fields; in many cases the development of a new field or the redevelopment of an old field would be a marginal project, and the current environment of high costs and the latest tax increase will have an impact on these projects. In our opinion the UK Government needs to encourage investment in such projects as part of the objective to maximise recoverable hydrocarbon reserves.

Q93 Chairman: Can you please tell the members of the Committee very briefly the extent of your respective companies' operations in the North Sea?

Mr Blackwood: The extent of the operations. We have been in the North Sea as BP for somewhere in the order of 40 years, starting in the southern basin, 30 years in the oil provinces further north and we are today still producing around half a million barrels of oil equivalent a day. We are the largest investor and the largest net producer of oil and gas in the UKCS.

Dr Brown: As I said in my opening comments, we have been here for three years. The Forties at the moment is the only field we operate, producing around 70 MBD and we are undertaking exploration programmes as well.

Q94 Mr Davidson: I wonder if I could just follow up the points that Mr Blackwood made. You said it was too soon to tell whether or not there had been any adverse consequences as a result of the tax increase. Over how long a period must we wait before it is clear?

Mr Blackwood: If I can tell you a bit more as to what was behind that; the nature of the activity in the industry just now is pretty tight for resources globally, which leads everyone to try to plan further ahead to get their activity sets clearly laid out and contracts in place for both the human and the hardware components of the business available to them, to get rigs, to get vessels et cetera. Most companies have 2006 and 2007 pretty tightly laid out in front of them, and in truth that activity will continue pretty much as it was planned. The issue then becomes as we look further into the future; the marginal projects, as they are examined with a slightly higher tax regime, are the guys which are going to suffer and people will not make those longer term decisions. The other piece we need to bear in mind that has a time component to it is pretty much the inflationary element I referred to; the cost base of the industry pretty much tracks the oil price with a lag of something like 18 to 24 months, so we are actually still in the course of 2006 and possibly into 2007 yet to see that cost base come up completely to match where today's prices are. People will then be evaluating stuff with higher oil prices, admittedly—

but with a higher cost base than the last couple of years and a higher tax regime, so to me it is going to be three or four years before we actually see decisions being made differently.

Q95 Mr Davidson: Can I follow up that point about the cost base? You did indicate that cost inflation was 50%.

Mr Blackwood: No, 15 to 20%. If I could amplify that, it is a span from some areas which are next to nothing because there are long term contracts in place, through to the most acute example which is drilling rigs; where the day rate for drilling rigs has increased by anything from a factor of three to a factor of six—not percentages, multiples.

Q96 Mr Davidson: A factor of 300 to 600% of an increase is certainly a great deal less than the increase in tax and in many ways it could be argued that the fact that the tax has increased as a percentage much less than the increase in your costs, so maybe we ought to make sure that these things rise in parallel.

Mr Blackwood: I make this point only: the presumption in many quarters is that as the oil price has increased, all of this rent is actually available to the operators but I would say quite a lot of it is dissipated down through the entire chain of the industry.

Q97 Mr Walker: If oil remains, say, above \$50 for a considerable amount of time, will that not mean that previously uneconomic reserves come into play and it is more viable to abstract them from the ground?

Mr Blackwood: If investor confidence arrives in a place where there is a belief that those sorts of levels of prices will sustain, yes, I would agree with you, sir.

Q98 Mr Walker: That means wells that were previously deemed to be exhausted although perhaps 50 or 60% of the reserves were left could be revisited.

Mr Blackwood: Potentially.

Q99 Danny Alexander: You mentioned in response to Ian's question that plans for 2006–07 are pretty much set in stone and that they will go forward whatever happens and it is the future decisions going on that could be affected by the tax change. Is it simply the tax change in itself that affects those decisions or is there also a factoring in of perceptions about future tax changes that may or may not happen that influences those decisions too?

Mr Blackwood: I think it is more the reality of the change we have, but we will always look at sensitivities. In the economic evaluation of a long term capital investment you look at the sensitivities on every parameter—the costs, the reserves—and you look at the sensitivities on the fiscal regime as well. Fundamentally it is factoring in the change we have already seen.

Q100 Mr Devine: Apache has been in the North Sea for three years.

Dr Brown: Yes.

Q101 Mr Devine: How much profit have you made each year in those three years and how much profit has BP made from the North Sea in the last three years?

Dr Brown: I do not have those figures with me today but I could certainly provide them.¹

Mr Blackwood: I can get them for you as well.²

Q102 Mr Walker: In your opening statement you mentioned the impact that taxation may have on future exploration; do you think the Chancellor's tax of £2 billion, although it may fill a short term gap, will discourage future exploration of perhaps marginal sites and fields?

Mr Blackwood: That is the question of the day. Hopefully as Government and the industry share a common view of maximising recovery from the North Sea, the question is has this fiscal change helped or hindered achieving that objective? Our premise is that certainly if we see a world in which many, our company included, believe we will see these prices soften again—if we arrive at a situation of having softer prices and this fiscal regime—we will damage that ultimate objective of maximising recovery. That is why as a corporation we have been pretty consistent that what we really believe and we would like some assurance on is that in the event of oil prices coming back down, we would like to see this tax revisited.

Q103 Mr McGovern: Can I just clarify that, and I would appreciate it if Mr Blackwood and Dr Brown could answer. As the price of oil stands at the moment you do not have a problem with the tax level, it is only if the price per barrel falls that you regard it as a problem.

Mr Blackwood: I would not use those words.

Q104 Mr McGovern: That is the impression I am getting.

Mr Blackwood: If I gave you that impression I gave you the wrong one. In absolute terms this tax already has the potential to damage that future recovery and in three or four years time we will find out what the scale of that may or may not be, but as an absolute backstop we, the North Sea, are actually heading for a bad place if indeed the price softens and this fiscal regime is still in the same place.

Q105 Chairman: We would like to know whether tangible damage has been done to the industry by the tax increases recently announced by the Chancellor, and if the more marginal fields have

become uneconomic. What effect do you think the tax increases will have on the oil industry and on the Scottish economy?

Dr Brown: I think the tax increase will impact marginal fields and there are projects at the moment where that could be the difference between it maybe going ahead or not. Obviously, if these projects do not go ahead that will be less money into the Scottish economy so it will impact it.

Q106 Chairman: Mr Blackwood, do you want to say anything on this?

Mr Blackwood: I believe, Chairman, we tend to think of this as big, discrete projects. The days of multi-billion pound developments of several hundred million barrels in the North Sea are unlikely to be seen again, so today we are talking more of a continuum of smaller projects, much smaller projects—orders of magnitude smaller which may involve three or four wells, which themselves will cost tens of millions of pounds. It then becomes very much more of a continuum where those at the margin, not the average projects but the expensive ones—and the expensive ones today are west of the Shetlands with small accumulations of single figure millions, five million barrels—could be facing development costs north of \$20 per barrel. By the time you factor in that, the cost of operating it, the cost of finding it, it becomes a pretty expensive business. It is those marginal ones, therefore, which over the next three or four years are the ones that are going to suffer.

Q107 Mr Walker: Why would you bother with those anyway? You are a global, international company, you are not going to waste your time anyway with five million barrel reserves; why would you do that as a business, even if it was marginally economically viable? Why would you waste your manpower and resource on chasing small deposits like that when you have got the rest of the world to focus your attention on?

Mr Blackwood: You would do that and you would only do that because they are additions to infrastructure which already exists. You would not go chasing small projects like that in splendid isolation.

Q108 Danny Alexander: Before we move on I just want to follow up a point that Dr Brown made; I wonder if you could give us any specific examples of developments you are engaged in or maybe will be looking to do in the future which might be affected in the way that you describe?

Dr Brown: I cannot really say that due to commerciality, but we do have a particular project that we are looking at and I would say fiscal is one of the key areas that could make or break the project.

Q109 Mr Davidson: One of the difficulties I am having in getting to grips with this is that there is nothing that anybody seems to be able to put their finger on as an adverse effect of the tax increase, and I remember when we were discussing the introduction of the national minimum wage—which

¹ Pre and post tax profit data for Apache North Sea Limited for 2003 and 2004. 2005 data is not yet finalised.

	2004	2003
Profit/(loss) before tax	\$9,030,000	(\$11,852,000)
Profit/(loss) before tax	\$1,721,000	(\$11,111,000)

² BP's profit in the last three years (\$ million mod)

	2003	2004	2005
UK upstream post tax profit	1,951	2,106	1,672

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would not apply to yourselves—we were told that civilisation would come to an end if we introduced a national minimum wage and there was literally no adverse consequence at all. How can you demonstrate to us that this is not just simply scaremongering, that there is some connection that there is going to be between the tax increase and adverse consequences? I presume that neither of you particularly like paying tax; I am not particularly fond of it myself either, but it has got to be done and we are trying to minimise the damage. So far as we have not heard anything, I think, that convinces us that there have been adverse consequences flowing directly from this rise.

Mr Blackwood: Let me try to be honest and realistic in two cases as it were. As I say, we are not talking of a world today of some big, discrete, chunky projects, so how it will play out in the future is—decisions such as how far ahead do we commit ourselves? How far ahead do we actually book rigs to drill wells for us at these prices today, with this fiscal regime and an ever-decreasing parcel size of oil that we are going to find? The physics are all going against us, it is getting more difficult and more costly and it will stop us making commitments further ahead in time unless we have some sort of comfort that this is going to be a cost base and a fiscal base that is actually going to react to the oil price. It would be a foolish company that actually today walks in with this cost base for five or 10 years into the future. People will be hesitant to do that. The other way in which it shows up—and this is more at an industrial level in the basin, as it were—in absolute terms, like it or lump it, in gross maths, we have made UKCS in relative terms less attractive than it was—that is a simple statement of fact. What that is giving rise to is resources—both human and very skilled resources and the capital resources in the form of diving support vessels and rigs et cetera—which are starting to slowly leave the basin for other places where they can get longer term certainty. If we lose that resource we actually will not be able to execute the work programmes we would like to. That is a real risk: you have changed that relative attractiveness in an industry where it is currently globally tight, if you change any one place the resources move.

Q110 Mr Davidson: Pretty much the same sort of thing was said at the time when they introduced the Plimsoll Line and stopped small boys climbing chimneys, but there is nothing that I can grasp here that is flowing directly as an adverse consequence in the way that some of my colleagues were suggesting. Doctor, is that a reasonable assumption?

Dr Brown: I would just make the comment that it is too early to see that impact but I do agree with Mr Blackwood's comment that there is this long lead time and people will not be locking into long term contracts at this type of price for a development five years down the road.

Q111 Mr Walker: You will invest your shareholders' money where you can get the best return and potentially this tax may just price you out of some

Scottish oilfields and you will put that investment into oilfields somewhere in Kazakhstan, for example?

Mr Blackwood: I compete for BP's global capital on a variety of parameters including the economic attractiveness, the political stability et cetera where the resources are and the ability for us to deploy technology to develop them. That competition for capital is how it will work.

Q112 Mr Walker: The North Sea has no automatic right to expect BP capital and future investment if the environment is uncompetitive in that marketplace.

Mr Blackwood: Yes, and just going back to the previous question, we have altered that balance.

Q113 Mr McGovern: The Scottish Affairs Select Committee recently travelled to Aberdeen to take evidence from UKOOA and ironically, I think coincidentally, on the day the local Aberdeen press carried a story of record application for licences to explore, they were at an all-time high, which seems to me to be totally at odds with your contention that this change to the tax regime has had a detrimental effect on new exploration.

Mr Blackwood: We need to look through the entire process of applying for a licence, working up the drillable prospects, drilling wells and turning them into development. What we are seeing today with a lot of the good work that has gone on between the industry and the DTI—the inside the PILOT forum, of which we are a part—we have put processes in place which have really engendered activity in this front end, and there has indeed been a high level of interest in new licence rounds. The big question is whether that is translating forward into wells being drilled by way of exploration wells into development and then turning them into production. The data on that one is not quite so optimistic. The data thus far from 2005 to 2006 shows we are seeing an increase in development wells, which are typically drilling oil next to adjacent oil infrastructure that has already been found, but we are actually still seeing a decrease in exploration. Whilst there is a lot of activity at the front end, that is not yet manifesting itself and actually turning into new exploration wells being drilled.

Q114 Mr McGovern: Can I just ask Dr Brown do you concur with that assessment?

Dr Brown: When you apply for an exploration licence—I think exactly as Mr Blackwood said—it is around the exploration, you are not committing yourselves to a development, it is around that first stage in the process.

Q115 Ms Clark: You have obviously heard from one of my colleagues one indication as to whether there has been an impact from this particular tax base; we also know that historically huge profits have been made by the oil companies out of the oilfields in the North Sea. Do you accept that you have not really

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been able to bring any tangible evidence to this Committee that there has been any detrimental effect so far from the taxes that have been levied?

Mr Blackwood: I would put to you that we have been very honest that during 2006 and 2007 you are very unlikely to see much of an impact; I do believe we will start to see the beginning of an impact after that period and if prices soften we will see a very significant impact.

Q116 Ms Clark: With the current levels of pricing do you think it is quite reasonable that the British taxpayer also should share in the profits that are being made by the oil industry?

Mr Blackwood: Absolutely; the British taxpayer is sharing in those profits via the tax regime as it exists: as we make more profits through increased prices we pay more taxes.

Q117 Mr Devine: You made an interesting comment that when you bid for BP's development money there are certain criteria, one of which is political stability. Can I take from that that if Scotland went independent, creating instability, that would have big implications for you as a company?

Mr Blackwood: I would leave it to others to judge whether that would create a higher or a lower level of stability. We work with scores of governments around the globe and I am sure we could manage to work with a Scottish government as well if one existed.

Q118 Ms Clark: On the issue of political stability, particularly in the oil markets, political stability must be one of the major factors that you take into consideration. Surely Britain must be one of the more politically stable areas where oil companies can invest and for that reason must be a very attractive option for oil companies.

Mr Blackwood: Yes, it is a cocktail of all those parameters. Unquestionably it is one of the more politically stable, and the obvious comparator is the other side of the Atlantic which many would regard as being in the same arena in terms of political stability—albeit a tax regime where the average tax is around the 45% mark as opposed to our taxes here which vary between 50 and 75%. We also need to factor into that cocktail fiscal stability; we have not yet mentioned a lot of the big decisions. We have just developed the first phase of the Clare Oilfield and we are looking very hard at trying to develop the second phase of it; this could be a billion pound decision eventually when we have finished the appraisal work and it has a payback period that looks over a couple of decades, it is a 20 year decision. When you look at that over that period of time, one of the things you are looking for is stability when you make that investment and we are as the UKCS not anywhere near the top of the league these days in terms of stability with the number of changes we have had in the last three or four years. Very few countries have changed more than UKCS has in the last three or four years.

Q119 Danny Alexander: Given what you have said about the importance of fiscal stability, I ask you the same question I asked UKOOA when we saw them, which is could you think of any fiscal regime in the world that is less stable than the UK's from your experience of the last two years; following on from that, in the energy review that the Government published last week they made clear that the Treasury's review of the fiscal framework will be "vital" to the UK's oil and gas resources. In your discussions with the Treasury will you be seeking an opportunity to try and get a decision on this tax increase reversed?

Dr Brown: We are taking part in the consultation with the Treasury and we have presented what we see would help a company like ourselves around the marginal projects, but we have not asked for a reversal—we have not been prescriptive as to what form that might take.

Q120 Danny Alexander: Can I press you on that, what changes do you think would help a company like yourself on marginal projects in relation to the fiscal regime?

Dr Brown: I do not have specific proposals if you like for tax changes, but we would welcome anything that would support investment in marginal projects and small reserve pools.

Mr Blackwood: If I can go back to the question on countries which have changed more, the countries that come to mind are Russia, Venezuela. I would like to think of us not in that peer set in terms of fiscal stability. They additionally have huge resource prizes to chase, they are much less mature provinces with much bigger resources and a degree of instability, while there is still a huge prize to chase, will be tolerated by investors from around the globe; they are therefore in a very different situation from ourselves. On the second part about consultation on the fiscal regime going forward, we welcome the consultation—we welcomed it before this increase—but I think there is an issue there of we do need to be measured and thoughtful about this. We would like to see a regime which is maybe simpler and, in truth, a steady, consistent, preferably low tax rate as we see ourselves into the next couple of decades. The question is getting from here to there, we have a pretty complex structure and getting from here to that place is something that we need to do in dialogue in a very considered manner.

Q121 Mr MacDougall: This is a question I was going to ask later on, but this seems a very appropriate time to ask it. There have been press reports recently that BP, along with four other companies, have taken a 49% share in the Russian company Rosneft. That would seem to me to give an indication of companies now beginning to look elsewhere for a variety of reasons. Do you think that is the case, do you think that companies are going to start moving into these areas much more quickly than we imagined and is this the beginning of that process?

Mr Blackwood: As a multinational oil company you are always going to keep a balance in this global portfolio. The North Sea has, hopefully, a very

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healthy future in front of it, but we cannot escape the physics—the individual pool sizes are getting smaller, the costs are increasing. Hopefully it has a healthy life in front of it for two or three decades but it is finite, so corporately we will be looking to keep investing overseas to keep the size of the corporation.

Q122 Mr MacDougall: Obviously, development costs money and money requires oil in order to pay for the development. At the end of the day a certain amount of resources could be steered in one direction and you would think by that particular move that that is the beginning of a move towards creating shares, spending that money in other countries where it is much more profitable and that at the end of the day a lesser commitment then falls to the North Sea by that process. Even if it is only one minute particle of commitment that is lessened to that process, it can only then multiply as more development opportunities unfold themselves within countries such as Russia. Would that not be the scenario?

Mr Blackwood: It is very fair to say that any of the multinationals will keep a balanced portfolio. The North Sea is unquestionably, as I keep coming back to, a matter of physics; we would love to see it grow but we cannot, so that share, that investment, will to some degree decline with the physics and the ability to find new accumulations, so to a degree some of this is inevitable.

Q123 Mr Devine: It is estimated that oil companies in Britain paid just under £10 billion in taxes last year and that in this financial year it is going to be over £10 billion. That is not really a hard hit for the oil companies, is it?

Mr Blackwood: I cannot speak for the rest of them. I keep going back to the premise that the fundamental question, if I can paraphrase it, is can we afford it? I do not think the question is can we afford it? The question should be, is this tax regime actually going to maximise recovery from the basin, which is what we all want? My hypothesis is in the long term no, and that is really to me the fundamental question.

Q124 Mr Davidson: Presumably the way to maximise extraction from the North Sea is to have no taxes at all; that would make it much more attractive, would it not? It is a question of where do you strike the balance.

Mr Blackwood: Absolutely, striking the balance is the key issue there. As the basin matures, as the parcel sizes get smaller, as exploration becomes more difficult, as development costs are increasing by the day, it is striking that balance against that physical and economic backdrop.

Q125 David Mundell: Can I just ask you a question about the PILOT, because I see that you have both been involved with that and one of the issues which came up when we were in Aberdeen was the fact that the changes in the tax regime had not come through that channel and that that had not really been an

environment that dealt with that issue and was not perceived by those who gave us evidence there as terribly helpful.

Mr Blackwood: The PILOT relationship I actually believe has been very productive for both sides. It keeps a very important line of dialogue open fundamentally between the DTI and the industry and it has led us to work a lot of things productively. The brown fields initiative—I do not know whether you have heard of it—that gave rise to the fallow and stewardship initiatives that have gone on I think have been good examples of the Government and the industry working together actually with this common aim of maximising recovery. It has done a lot of good stuff on that front. The conversations that then need to go beyond the DTI have been a bit more erratic and less detailed, less intense. As PILOT and as UKOOA we find our way in to see the Paymaster-General maybe a couple of times a year and the intensity of dialogue in there is nothing like as detailed as it is with the DTI within the PILOT. Something that would build on the consultation process that is underway just now to start to deepen that relationship can only be a good thing.

Q126 David Mundell: It is finding a context because I sense that my colleagues remain sceptical of the view that the industry is not in fact over-egging it in relation to the damage that the tax changes will or could do. Surely it must be about finding a forum of trust by which there can be at least some consensus on what the effect of any particular measure is.

Mr Blackwood: Part of the desire for a bit more dialogue is that within PILOT with the DTI we have hopefully demonstrated as an industry that we can take quite thorny issues and work on them together and actually come up with some very good initiatives, fundamentally on self-regulation. We have been able to demonstrate to the DTI that we are an industry that is capable of policing itself in some areas; if we could take that depth of dialogue to fiscal issues I believe we would get a better result sometimes. Some of the disappointment has been that despite this richness of dialogue with the DTI in 2002 and in the recent exercise also there has been no prior consultation.

Q127 Mr McGovern: You have heard that a couple of weeks ago we took evidence from UKOOA in Aberdeen. Can I ask you both how you would view UKOOA's assertion that the tax increase has led to the UK acquiring "an international reputation of fiscal instability within the industry"?

Dr Brown: I would agree with that statement. One of the factors that attracted Apache to the North Sea was the fiscal stability, and that was I guess when we were looking at the region four years ago, and I do not think we could make the same statement today that it is stable.

Mr Blackwood: If I can go back to prior comparators, as I said I had a trawl around our company to see where we have changed in the last five years, where we have changed more than the UKCS. The list produced Russia and Venezuela so we are up there compared to other oil-producing

regimes, we have changed as much as anyone. We used to have an enviable reputation for stability, but we have destroyed that pretty quickly in the last three or four years.

Q128 Mr McGovern: I have a feeling members of the Committee would maybe beg to differ with that. You have maybe touched on this in prior questions as well but exactly how would a stable fiscal regime help promote maximising production from the UK Continental shelf?

Mr Blackwood: We are making significant investment decisions for large new fields which get into tens or hundreds of million pounds. Part of that is looking at the 20 years and trying to evaluate the economics and if you cannot plan on any certainty in the fiscal regime in the 20 years the confidence to make those investments will decrease. People will factor in higher risk profile or will not make the investments; that is the damage that instability does, it is destroying that confidence for a 10, 15, 20 year investment.

Q129 Mr McGovern: Just as a supplementary to that can I just ask you to clarify what suggests stability in 10 years, 15 years or 20 years?

Mr Blackwood: At the moment all we have to go on is to the end of this Parliament.

Q130 Mr McGovern: But is that new, has that not always been the case?

Mr Blackwood: The history has been much better than that until the last four or five years. In the days of the large developments in the North Sea we had much more stability than we have seen in the last four or five years.

Q131 Mr McGovern: If I can just press you on that a little, please, what in the past would define for you that stability would go beyond the life of a Parliament?

Mr Blackwood: Quite simply just the history that it did not and the reality of it. The reality of the last four years is three changes in four years.

Q132 Mr McGovern: With all due respect that is easy to say with hindsight, but back then how did you know that things would not change beyond the life of a Parliament?

Mr Blackwood: The simple answer is that I was not around then to know but I am assuming that the people who were making in those days the developments of the Forties and the Brents, multibillion pound investments, had some degree of comfort that they were actually going to see a regime that was not going to change year on year.

Mr McGovern: I am not entirely confident that you have answered it, but I will accept that.

Q133 Mr Davidson: Given that you are multinational companies, how can we be assured that as it were you do not have just one big bucket of money from which if we were not drawing it in tax you would have just spent it somewhere else—I mean, BP has just spent a huge amount in Russia.

How do we know that if we had not levied this additional tax you would actually just have spent more buying shares in the Russian company; how do we know that it would actually have gone back into the UK and been invested in the North Sea?

Mr Blackwood: The simple truthful answer is we do not know, we do not know the proportions of what would have been reinvested in the North Sea, what would have been returned to shareholders. The one I would put to you is that it is money that is not reinvested in BP somewhere, and in our case it is not into stuff that it is going to find its way back into the London listed company where it is paying all of its corporate taxes. One way or another it was coming back into the UK.

Q134 Mr Davidson: Up to a point. Can I just clarify whether or not there is any tax increase ever anywhere that you have actually welcomed?

Mr Blackwood: Not to my knowledge.

Q135 Mr Davidson: I thought that. In terms of stability, if the price of oil falls and we heeded your point about decreasing tax in those circumstances, would you regard a tax increase then as being a cause of instability.

Mr Blackwood: A tax increase in the event of a price fall.

Q136 Mr Davidson: Sorry, a decrease then.

Mr Blackwood: I get your point, we like stability when it is going up and we do not like it when it—

Q137 Mr Davidson: Yes, is that correct?

Mr Blackwood: Yes.

Q138 Mr Davidson: You can cope with the instability if it is in your direction but you cannot cope with instability if it is in our direction.

Mr Blackwood: The stability I am seeking is the reassurance from the Government now that if and when that price comes back down, this tax increase will be revisited. Call it stability, call it certainty, that is what we want.

Q139 Mr Davidson: I have more sympathy for that position, I understand that much more clearly and it seems to me that the corollary of that again is that if the price continues to rise then we could continue to increase the taxation.

Mr Blackwood: Can we separate two issues here? One is this notion of index-linking as it were; the whole idea of index-linking—I am glad to see it appears that the Government does also agree with where we are, that this is not a good idea for anyone: you have volatility in your tax receipts, we have volatility in what we try to plan for by way of investments, I just do not see that as a model that works for anyone. There is one concept of where should the tax take be at different prices? The index-linking just creates too much volatility for everyone and the issue, if I can paraphrase, that instability is okay when tax rates are going down, it is not a variable either, it is an absolute. If we stay with this cost base that we are working our way up to at the

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moment, and this tax regime, and in three or four years out there we see the price softening down again—it is not a relative thing, it is an absolute, investment will drop.

Mr Davidson: I do understand that but we have also got to take that in the context of drilling prices going up 300% or 600% and so on; given that, you face all those other pressures as well and it is highly unlikely that you would ever be able to identify the impact that this tax increase had because you cannot take it in isolation.

Q140 Chairman: Prices are high just now and companies are making profits and the Government is making profits, but the ultimate price is being paid by consumers and the motorists; they are not getting any benefit out of this. Can you tell me at what level, if the price falls, you will be really concerned and you would like to see a decrease in taxation? Is it at 40, 35, 30, 25?

Mr Blackwood: It is a very extreme statement, Chairman, and I think I would put it in a range. I know there is stuff out there just now which would be and is today unattractive economically, it just does not return its costs in the low 30s, so if things were coming down the other way you are going to start to see that pain threshold become an issue at something more like \$40.

Q141 Chairman: Then you would be really concerned. Of course then the Committee members and the Government would be sympathetic, when you were not making that—

Mr Blackwood: It is hard to make a precise judgment on that figure.

Q142 Chairman: I can also understand the industry's concerns that there must be some type of certainty; you do not want to be in a situation where next year or in two years there is another tax increase. Would you be looking for some kind of guarantee from the Government that there will be no tax increases within the next five years or 10 years?

Mr Blackwood: If I was only allowed one wish, my wish would be actually to have some undertaking that in the event that this price softens in the medium term future, this recent tax increase would be revisited.

Chairman: Thank you. John.

Q143 Mr MacDougall: This Committee has a deep interest in how Scotland will meet its future energy needs and we were very interested in UKOOA's view that, by 2020, energy generated from oil and gas could account for 83% of the UK's requirements. Given that the Government has just announced an energy review that involves commitment to a new range of nuclear power stations in Britain, and also recognition of the need to address this issue of renewables for Scotland, do you think UKOOA's view is a credible one, is an accurate one?

Mr Blackwood: It is slightly gas-biased if I am honest, with respect, but I do think we need to have clarity between the recent energy review which, if I may say, has focused almost too hard on electricity

generation and the UKOOA view which has focused more on the totality of what are our fuel needs which include transportation, mobile needs as well. It may be slightly on the high side but I think that whether the number is that or whether the number is slightly less than that, the fundamental message is that in 2020 we are still going to be critically dependent on oil and gas from the UKCS. The real point that UKOOA is trying to make behind that is that it increases the pressure on all of us, on Government and on industry, to try and maximise that recovery. Whether the number is 70% or 80% is almost immaterial.

Q144 Mr MacDougall: We heard today from the Prime Minister a report-back from the G8 saying that all the members of the G8 have agreed now to recognise that there is a global warming situation that has to be addressed, and part of that you may think is to cut back and try and encourage—obviously in a sustainable way—a move away from that type of energy source and a move into the more environmentally friendly ones. All the indicators, therefore, appear to be that we are heading in a different direction from the kind of direction that would actually make you feel more comfortable with oil and gas. Is that something that you believe has been taken into account in an accurate way? You have mentioned UKOOA's view, but in general do you think that that has been taken seriously enough by the oil companies?

Mr Blackwood: Yes, I believe it has and I think we have to temper it with obviously everybody can actually sign up to that aspiration; the reality is how are we going to achieve that and fill the gap if we take oil and gas away? That then brings in the hard realities—the aspiration is great, it is actually how do we achieve it.

Q145 Chairman: Mr Blackwood, we are talking about slightly over 80% or less. If we have a situation where this country has to be dependent 83% on gas and oil, do you not think this would be a disaster for our economy in this country, especially the gas when we have to be dependent on imports from abroad. I can see that we have to strike a balance between coal energy, wind energy, tidal, hydro, thermal, solar, but to give the figure of 83%—I do not think it is a difference of five or less, I think the figure has been exaggerated substantially.

Mr Blackwood: Chairman, I honestly do not know enough of the depth of UKOOA's figures to defend or attack them, but the sense is that UKOOA has focused more on our total energy requirements. All of those things you mentioned there of coal, solar, of wind and wave, these are all conversations which we are focusing on at the moment around the generation of electricity.

Q146 Chairman: We are making reasonable progress on renewable energy in Scotland. Committee members visited Orkney and Shetland where the wind average blow is 35 miles per hour, and I think

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we can generate a huge amount of energy from there. These are optimistic figures we are talking about from renewables.

Mr Blackwood: I believe the first distinction we need to make is that between the set of figures which relates to how we generate our electricity and the UKOOA figures which look at our total energy demand. Unless we assume that in 2020 we are all driving electric cars there will still be a large component of our primary energy consumption of fuel for mobile purposes, which then causes the figures to be ones that you see.

Q147 Mr Walker: What percentage of our overall energy use is accounted for through electricity, business and domestic, and what percentage is accounted for by cars and lorries?

Mr Blackwood: Off the top of my head I could not tell you, but I can happily get you that data.

Mr Walker: That would be quite interesting, thank you.³

Q148 Ms Clark: On that point a huge contributor towards our carbon emissions is all forms of transport, in particular cars of course. When we were in Shetland last week when the Committee was there we went to an experimental hydrogen production plant, and indeed we saw a hydrogen-powered car. There is an international acceptance that we can no longer rely on hydrocarbons because of climate change, but also because of the fact that the oil is going to run out, it is a finite resource. How do you think you are going to be affected when vehicles are moving towards hydrogen as a method of road fuel rather than hydrocarbons? The major car companies are investing in this and I would like your comments on that and how you think it would affect your business.

Mr Blackwood: We are as involved as anyone in trying to develop alternative fuels and it is a little-known fact that BP is either the first or second in the globe in terms of the manufacture of affordable fuel cells. We have just announced a £500 million investment in biomass and we are completely in alignment with the statement that says we need to alter our carbon footprint as we look forward 20, 30, 40 years into the future. What we are doing is trying to find a responsible way of getting there, to get there in a responsible and feasible way without taking away anyone's right to heat, light and mobility is the task we all face.

Q149 Ms Clark: Given that it is essential for humanity that we do tackle these issues and that we move towards, for example, hydrogen fuelled cars as soon as possible, what kind of fiscal regime do you think is required to encourage companies like yourselves to be actively investing in such a development for the future?

Mr Blackwood: With respect the conversation here is about the fiscal regime to the extent that it affects our extraction of oil and gas in the North Sea and there is a piece here which actually gives rise to the carbon emissions. The fiscal policies that attempt to look at how we should try to manage carbon actually need to move themselves to the consumption end of the scale and actually see how we take carbon into the equation at that end. It is a step too far to connect those policies to extraction.

Q150 Mr Walker: I think I have asked this, but if you were to have a wish list of removing red tape that would enable you to get at your gas and oil more effectively, what would it be? What is the one single thing that causes you most misery?

Mr Blackwood: On red tape?

Q151 Mr Walker: Yes, the annoyance, everybody talks about red tape.

Mr Blackwood: “Unforecast” regulation coming by and large on the environmental assurance front—not the environmental performance front, but the environmental assurance and the paperwork around it, more and more of it coming from Brussels.

Q152 Mr Walker: Can you give us some examples of painful legislation that perhaps is questionable in its merits?

Mr Blackwood: Our commitment to reduce the amount of oil in produced water which is discharged, which is actually giving rise to re-injecting that water back into the reservoirs underground, which means we will run turbines to produce the power to re-inject that water; those turbines will emit CO₂.

Q153 Mr Walker: Basically it is a false economy because you are spending more energy to re-admit that water than if you disposed of it in a more traditional fashion.

Mr Blackwood: Yes.

Mr Walker: Sorry, I am being a bit dopey here, I was just reflecting—

Mr Devine: Can we record that for the minutes?

Mr Davidson: Ten out of 10 for self-awareness.

Q154 Mr Walker: There used to be a Department of Energy; do you think you would benefit from the re-introduction of a Department of Energy as opposed to these various bodies that all have a finger in your pie—for want of a better description?

Mr Blackwood: I would not be presumptuous enough as to tell Her Majesty's Government how to organise themselves, but I do believe a more focused, more cohesive approach to energy policy—we welcome the energy review but building on that and having a more cohesive approach to energy policy where we actually deal with more of a singular face from Government can only be a good thing.

Q155 Mr Walker: Finally, do you think that the BP public relations campaign that has been run over the last 12 months in reference to what you are doing with renewables, what you are doing for the

³ Percentage of UK overall energy use. BP does not generate independent UK energy use data in the details. We suggest the DTI would be the most accurate and reliable source for this data.

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environment, has been effective in re-positioning your company as being green, a proponent of green policies?

Mr Blackwood: With respect, this public relations campaign has been no more than a statement of fact that we are investing in these different technologies. It is not an attempt to re-brand, it is an attempt to genuinely confront the issues we have spoken about.

Mr Walker: I was not meaning to be argumentative, that is a very good point. The perception that people have of the oil industry—the people who have to take responsibility for that are the oil industry, and it comes from within the oil industry so it is up to you to challenge those perceptions. I would agree that a lot of what you are doing is to be welcomed, and I wish you perhaps had broadcast that at an earlier stage as opposed to being a little bit frightened to engage with the public.

Mr McGovern: Last June, in their report on *Fuel Prices*, the Trade & Industry Committee were fairly critical of UKOOA members for your perceived reluctance to contribute to the easing of fuel poverty. Can I ask you both if you consider such criticism to be justified or unwarranted?

Q156 Mr Walker: Speechless.

Mr Blackwood: Can I ask Dr Brown to answer that question first?

Dr Brown: I do not feel qualified to answer that question.

Q157 Mr McGovern: Okay, thank you.

Mr Blackwood: I will stick my chin out; I believe the criticism to have been unwarranted. It is a very real issue that we are all concerned about, but I think people have heard the wrong way the statement which UKOOA made as a reflection of industry. Fundamentally, this is a very real issue but it is an issue that—whatever the mechanism is there to fund and how this is dealt with—it is something that should be dealt with by governments and not by individual corporations.

Q158 Chairman: I appreciate that it is an issue that you believe is the responsibility of governments and they have to ensure they are dealing with the issues of poverty and fuel poverty, but at the same time do you not think that when the companies are making huge profits this is something they owe to the community as well. There are a number of organisations who have their budgets set for the community involvement and community purposes.

Mr Blackwood: If you look at our personal record and the industry's record, we make significant investments in the community. I signed a paper the other day for another instalment and we are spending £10 million planting trees across Scotland as an abatement of the carbon emissions of our activities; we are engaged with local schools, there is a long list of where are actually involved with the community.

Q159 Mr Walker: Am I right in thinking that some of your larger shareholders are pension funds?

Mr Blackwood: Yes.

Q160 Mr Walker: So a lot of this profit that you earn is paid out in dividends that go to pension funds.

Mr Blackwood: Correct.

Q161 Mr Walker: That allows us to retire with a degree of comfort hopefully.

Mr Blackwood: One calculation says one pound in every six.

Q162 Mr Walker: One pound in every six you have generated.

Mr Blackwood: Yes.

Q163 Mr Walker: Not in profit, just one pound—

Mr Blackwood: In the return that goes back to these pension funds. That is one calculation; I do not think I could tiptoe my way through it.⁴

Q164 Mr Davidson: Indeed it is one calculation, but of course the pension fund distribution in that way is somewhat uneven and I suspect that my constituency does not get as much of a share of that as perhaps Mr Walker's constituency. It is an interesting point that you make about the question of distribution of finance to deal with fuel poverty being a responsibility of government, and I think I accept that, but should we accept then that the corollary of that is that we have to levy taxes sufficient to pay for it and if you are not doing it then we have to pay for it and we have to do it by raising taxes on people like yourselves. To some extent it comes back to this point about there has never been a tax increase you met that you liked, and the difficulty we have with this is the extent to which we believe the industry is crying wolf. You have been quite honest with us in giving us the impression that you are trying to get us to accept that this is a grey area and it is difficult looking forward and so on, but is there anything you can say that would help us overcome this issue as to whether or not you are just simply crying wolf? Some people have been far more strident than yourselves; when we were in Aberdeen, particularly when we were meeting the Chamber of Commerce and some of the people who were there, they were really getting quite excited about all this, they were not dealing with it in the much more responsible and calm manner that yourselves have. Is there any guidance you can give us that helps us weigh this up in the balance?

Mr Blackwood: I would have in my balance the physics on this side, the physical and economical realities. The individual accumulations, which we are now finding in the North Sea, are getting smaller. They are getting more expensive to develop, they are getting more remote and costing more to operate. The fundamental business of the North Sea today is, if everything was left alone and there was no more investment made, the production would decline at something like 20%, exponential physics. The fundamental business of the North Sea is wisely

⁴ *Note by witness:* We estimate that one pound in every six pounds of UK pension funds income, from companies in the FTSE Index, comes from BP's profits.

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laying in capital to slow that down as much as we can and prolong the life of the North Sea. For me, that is sitting on this side of physical data we cannot argue with and if we make it a less attractive investment value on top of that, in the long term it has to hurt. On the other side of the scale at the moment, I think all of this is being masked by today's commodity prices, and can I go back to where I started if that commodity price changes significantly, that scale is going to tip.

Q165 Chairman: If I understood it correctly, in conclusion, Mr Blackwood, you are saying at the present level of prices of oil, the industry is well-equipped to cope with this tax increase, but if the prices soar to the level where you would be concerned about it, you would like the Government to reduce the tax burden on the industry. Secondly,

you are concerned about the uncertainty of the future tax increases and if there was to be some assurance from the Government not to increase the tax in the near future, you would feel comfortable.

Mr Blackwood: I think, Chairman, that is an excellent summary other than maybe to push a little on the starting place, I am not sure the entirety of industry would agree they are well-equipped to deal with it at the moment.

Q166 Chairman: Thank you, Mr Blackwood and Dr Brown. That concludes our questions. Before I declare the meeting closed, if there are any issues which we have not covered during our questioning would you like to shed any light on any issue? We are happy to listen to you.

Mr Blackwood: No, thank you, Chairman.

Chairman: Thank you very much.

Letter to the Committee from Malcolm Webb, Chief Executive, UKOOA

Dear Sir,

OIL AND GAS

I refer to the uncorrected transcript of the oral evidence taken before the Scottish Affairs Committee on Tuesday 18 July in connection with the Committee's inquiry into the effects of tax increases on the oil industry, which evidence has now been published on the Internet. In particular I refer to questions 142 to 145 inclusive. In this series of questions Mr MacDougall and the Chairman are reported as suggesting that the projection that the UK could be reliant on oil and gas for 83% of its primary energy supply in 2020 is a UKOOA generated projection and furthermore that it is a figure which has been "exaggerated substantially".

I believe it important to point out to you and hence to the Committee that, as noted in point (iv) of UKOOA's written submission and as I made clear in my evidence to the Committee on 20 June in reply to questions 2 and 68, this projection comes not from UKOOA but from the Government. I should make it clear however that UKOOA has no reason to doubt the validity of the data or assumptions on which this DTI projection was made. Furthermore we would not agree with the Chairman that the Government's projection is an exaggerated one. In fact we believe it is a proper and prudent assumption for the purposes of planning future energy supply. Currently oil and gas provides approximately 75% of total UK primary energy. This percentage is expected to increase over the next decade, even allowing for a rapid growth of renewable energy, the replacement of nuclear capacity with new build and a strong improvement in energy efficiency.

I would be grateful if you would bring these matters to the attention of the Committee.

1 August 2006

Tuesday 31 October 2006

Members present:

Mr Mohammad Sarwar, in the Chair

Ms Katy Clark
Mr Ian Davidson
Mr Jim McGovern

Mr Angus MacNeil
Mr Charles Walker

Witnesses: **Ms Judith Knott**, Head of Corporate Taxation Team, HM Treasury, **Ms Jo Wakeman**, Head of North Sea Branch, Corporate Taxation Team, HM Treasury, and **Mr Edward Zamboni**, Assistant Director and Head of Large Business and International Analysis, HM Revenue & Customs, gave evidence.

Q167 Chairman: Good afternoon, ladies and gentlemen. Welcome to today's evidence session on the Scottish Affairs Committee's inquiry into the *Effects of tax increases on the oil industry*. Before we ask detailed questions would you like to make any opening remarks?

Ms Knott: Yes, I would, please. Can I also introduce the people here? I am Judith Knott. I am Head of the Corporate Taxation Team in Her Majesty's Treasury. On my right is Jo Wakeman, Head of the North Sea Branch within my Corporate Taxation Team in Treasury, and on my left is Edward Zamboni. He is Head of Large Business and International Analysis in Her Majesty's Revenue & Customs. It is important to emphasise the Government's commitment to a strong and vibrant UK oil and gas industry. This is reflected in the twin policy objectives for the North Sea fiscal regime: to promote investment in UKCS while ensuring the UK receives a fair share of revenues from what is a national resource. These contribute to overall Government objectives to maximise economic recovery of the UK's oil and gas reserves. The Government must therefore strike the right balance between oil producers and consumers by promoting investment and ensuring fairness for taxpayers. Oil companies should receive a fair post-tax return for their risk and investment in the North Sea and the UK needs to get a fair share of the revenues derived from this national resource. There have been significant increases in the oil price since late 2001, particularly marked since spring 2004 with oil prices significantly exceeding market expectations. As a result of these developments market forecasters have increased their expectations of the medium-term outlook for oil prices. Although prices are expected to moderate from current high levels, they are predicted to be sustained at a higher level than the average over the last 20 years. Increased oil prices feed directly into North Sea company profits and, as a result of the recent sustained rises in oil prices, North Sea companies have experienced significant increases in the economic rents they derive from the exploitation of UK oil reserves. With the shift upwards in the outlook for oil prices the increase in economic rents can be expected to continue for a number of years. By last year, therefore, it was clear that the regime put in place in 2002 was no longer appropriate in view of the changes in the global oil market. The increase in the supplementary charge payable by North Sea producers from 10% to 20%,

announced in PBR 2005, restores the balance between oil producers and consumers and reflects the world as it is now. The Government is encouraged by current evidence of continued strong investment and healthy activity in the North Sea. For example, spending by the oil and gas industry is expected to increase to over £10 billion this year with investment within that increasing to over £5 billion, the highest figures in a decade. In addition, the recent 24th licensing round showed continuing strong interest in exploration and investment in the North Sea with a 35-year high in levels of licence applications, including from 28 new entrant companies. The Government is also committed to ensuring that the North Sea fiscal regime is fit for purpose going forward and to this end opened discussions with the industry earlier this year to tackle wider structural issues for the North Sea fiscal regime. This demonstrates the Government's continuing commitment to tackle the strategic issues for the North Sea fiscal regime that are of concern to the oil and gas industry and to Government because of their potential implications for the stability of the regime, for example, decommissioning as the basin matures. At the same time the Government has committed to no further increases in North Sea tax during the lifetime of this Parliament. In summary, the North Sea fiscal regime continues to promote investment while now being fairer to UK taxpayers generally, so meeting the Government's twin objectives.

Q168 Chairman: Thank you. We are seeking to discover whether tangible damage has been done to the oil industry by the tax increases announced by the Chancellor, and whether the more marginal fields have become uneconomic. What analysis have the Treasury and Revenue & Customs done to predict the likely impact the tax increases will have on the oil industry and on the Scottish economy?

Ms Knott: We did a considerable amount of analysis before these changes were made and the conclusion of that analysis was that the impact on the industry, on investment and more widely was likely to be very small indeed. I will ask Jo on my right to give any further details and Edward may also want to add some detail.

Ms Wakeman: As Judith said, we carried out a detailed analysis before introducing the changes. Clearly, the Government wanted to ensure that the regime would continue to deliver the twin policy

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objectives, following the introduction of the increased tax, of continuing to promote investment in the North Sea while ensuring that the UK gets a fair return from what is a national resource. As Judith said, the conclusions from the analysis indicated that there was very little risk of there being any significant damage to investment in the UK Continental Shelf.

Q169 Mr Walker: Can you quantify what “little risk of . . . any significant damage” is? That is little risk of significant damage but is there greater risk of some damage? Those are two slightly contradictory phrases in the same sentence.

Ms Knott: Edward actually did this analysis.

Mr Zamboni: I can give you an indication of the way we approached the analysis. The analysis in fact was a mixture of top-down analysis and bottom-up analysis, but one part of it was to look at the cash flows of 68 prospective new oil field developments individually, so we were able to see on an individual project-by-project basis what the effects of the tax might be, what the effect of typical oil prices might be and so on. What we found from this analysis was that the precise outcome in terms of numbers of projects impacted depended on the economic assumptions and we tried to use a variety of assumptions but under some assumptions there was no impact. Probably the most likely scenario was perhaps one or two projects with some impact but in any event a very small number.

Q170 Mr Walker: So one or two projects out of 68 became perhaps marginal in their viability?

Mr Zamboni: Indeed.

Ms Knott: Under some assumptions.

Q171 Mr Walker: And you are working to the same numbers and figures as the oil companies are working to? There is shared information between the two of you?

Mr Zamboni: Exactly. We use data that they provide as part of surveys conducted by the DTI and the UKOOA trade association.

Q172 Chairman: Obviously, we all feel that the oil and gas industry is very precious to Scottish jobs and the Scottish economy and that is why we are doing this investigation. Does the Scotland Office or the Scottish Executive take part in discussions concerning financial matters, such as changes in taxation rates, which might have particular implications for Scotland? Do you have discussions with the Scottish Executive or the Scotland Office?

Ms Wakeman: We do have conversations with the Scotland Office, yes, and quite clearly the Chancellor will have meetings with the First Minister and with the Secretary of State for the Scotland Office. Clearly, we are not privy to the detail of those discussions but the oil and gas industry is likely to feature among those.

Q173 Mr Walker: But the Chancellor, am I right in thinking, would view these oil reserves as national reserves as opposed to Scotland’s resources so that

might preclude him having a conversation with the First Minister? He is not obliged to have a conversation with the First Minister but he might choose to out of courtesy. Would that be right?

Ms Knott: The general point is that tax matters are for the Chancellor. As a matter of course the Chancellor does have discussions with ministers but we are not privy to the detail of them.

Q174 Chairman: We appreciate that tax matters are Government matters, but what we are asking is, since there are going to be serious implications for the Scottish economy and Scottish jobs does the Government, before it makes big changes in taxation, discuss those with the Scotland Office or the Scottish Executive?

Ms Wakeman: We talk to the Scotland Office during the course of the year as a matter of business at any time. I would reiterate the point that fiscal decisions are for the Chancellor and he does meet on a regular basis with the First Minister and with the Secretary of State and will no doubt discuss these issues with them.

Q175 Mr Walker: But under your model that we were just discussing you do not believe there will be any significant job losses, so again you would not need to have that discussion with the First Minister because in your view it is going to have minimal impact, if any at all, on overall employment levels in the oil industry?

Ms Knott: Absolutely. We believe that the overall impact on investment, and hence down the supply chain on to jobs, et cetera, would be minimal.

Q176 Mr Walker: In July the Government published its energy review. In the section dealing with the UK’s oil and gas resources it is stated that the Treasury’s review of the fiscal framework will be “vital”. Could you tell the Committee how that review is going?

Ms Knott: I assume you mean the fact that we have been having discussions with the oil industry over the last few months about fiscal structure going forward. They have been successful and Jo can give you more detail on those.

Ms Wakeman: I have been leading the discussions from the Treasury point of view. We launched these at Pre-Budget Report in 2005 and then finally closed these at the end of September 2006. These have been successful. We have been extremely encouraged by the response from industry and other stakeholders in the North Sea oil and gas industry, including the supply chain. We have had more than 30 meetings with a range of companies, representative bodies and academics, consultants and also other lobby groups. We have covered a range of issues which are of concern to industry and, of course, Government, as Judith mentioned in her opening statement, to establish what they see as being particular issues of wider concern in terms of aspects of the fiscal regime which are likely to have impacts on the ongoing stability of the regime in the future.

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Q177 Mr Walker: Have you seen the evidence given by the oil producers to us in July of this year?

Ms Wakeman: Yes.

Q178 Mr Walker: Would you say that they are happier about life now than they were perhaps three or four months ago?

Ms Wakeman: It is hard for me to comment but I would like to think so.

Q179 Mr Walker: A lot of the concerns that they raised with us you feel have been covered with you and they are perhaps slightly more comfortable with their position now?

Ms Wakeman: We certainly had two or three very constructive conversations with UKOOA during the course of these discussions, and we will have discussions going forward, which I would say made some very helpful and constructive contributions, so I would hope they feel as we do, that it is a positive relationship that is developing between Treasury and the industry.

Q180 Mr Davidson: Can I just follow that? Surely the oil industry and its lobbyists in particular are bound to be a bit like farmers in the sense that they are never happy because it is either too wet or too dry or too hot or too cold, and if they give the impression they are happy you would assume that something was wrong and that they therefore ought to be taxed a bit more, so they are never going to be happy? Has there ever been an occasion when the oil industry and its lobbyists have indicated that they were happy?

Ms Knott: I think the issue is that what we need to do is strike a balance between the needs of the producers and the UK taxpayer, and what these changes strove to do was to strike that balance. One of the issues that has clearly come over as of great concern for the industry going forward is stability, so not necessarily just the actual amount of tax but also the stability of the regime, and the discussions we have been having with them have allowed us to deal with some of those issues.

Q181 Mr Davidson: That was basically no, then? There has never been an occasion when they have actually been happy? There are some times when they have been less unhappy than others?

Ms Knott: I would not want to comment on their state of mind. We continue to have a very constructive dialogue with the oil industry and with the individual companies within it.

Q182 Mr Davidson: In terms of your initial report, when you talk about a fair post-tax return can you clarify for me how you believe the post-tax return for the oil industry compares with, say, the manufacturing industry in the UK? Comparing the oil industry with other industries or other areas of economic activity, how do their post-tax returns compare?

Ms Knott: I cannot give you a specific comparison with manufacturing but what I can say is that one of the issues that we studied in the lead-up to these

changes was the profitability of the oil sector compared to general profitability outside the financial sector, so general non-financial companies, and there we found that the oil companies were showing profitability of about 35% compared to about 13%.

Ms Wakeman: That was pre-tax profitability.

Q183 Mr Davidson: So pre-tax they are roughly three times as profitable as the rest of the economy?

Ms Knott: Almost, excluding the financial sector, and that was one of the reasons why we felt we needed to redress the balance between the producers and taxpayers.

Q184 Mr Davidson: That seems very reasonable to me. Turning to the other point you made about the need for the UK to get a fair share of the revenues, how does the amount of money that the UK gets from oil compare to other jurisdictions, say, Norway, Saudi Arabia, Dubai? What are we to compare the oil industry here with in terms of contributing to the national exchequer?

Ms Knott: Generally we feel that in terms of competitiveness we have a reasonably competitive regime.

Ms Wakeman: We are broadly comparable with our main competitor regimes, such as the Gulf of Mexico and the Netherlands, and in fact significantly more favourable than some of the regimes, such as Norway and Denmark, and indeed Italy.

Q185 Mr Davidson: Could you let us have a note of the regimes that you believe are less favourable to the oil industry than the UK, because again maybe it is a farmer syndrome but listening to them when we met them in Aberdeen you would have thought that they were being uniquely harshly treated by Britain and everywhere else was far better and more generous to them. It would certainly contradict that if we had some evidence from yourselves that there were other jurisdictions where they were paying more.

Ms Knott: We are happy to do that.¹

Mr Davidson: That would be very helpful.

Q186 Mr Walker: Are either the Treasury or Revenue & Customs involved in the PILOT project or is that the responsibility of the DTI only? You are aware of the PILOT project?

Ms Knott: We are indeed aware of the PILOT project.

Ms Wakeman: There is a PILOT task force.

Ms Knott: We are involved in it although tax itself is not part of the discussions with that group. Jo in particular is involved in that.

Ms Wakeman: There is a representative from Treasury who will attend PILOT meetings which I believe are held every three or four months and there will occasionally be more attendees from Treasury than that but, as Judith said, the forum is not a

¹ See Ev 38.

forum which covers fiscal issues and therefore representation from the tax side of the house in Treasury is not appropriate.

Q187 Mr Davidson: There was coverage in the press during the last year, I think it was in the *Daily Express* so it must be true, that the oil revenue for the UK was of the order of £10 billion. Would you clarify for us what the rough figure was that we drew from that?

Ms Knott: We do have figures. That sounds roughly right.

Ms Wakeman: In 2005–06 in the end we took some £9.7 billion in revenues and the forecast for 2006–07 is in the order of £10.3 billion.

Ms Knott: Is that corporation tax and—

Ms Wakeman: That is all North Sea revenues, so that would include petroleum revenue tax.

Q188 Mr Davidson: When BP gave evidence to us they stated that they would really be concerned if the price per barrel were to fall to \$40 or below. Is there any indication that you are aware of that that might occur within the foreseeable future?

Ms Knott: Certainly when we made the change last year we were looking at the medium term outlook for prices and the change was made on the basis that there had been a sustained increase in the medium term expectation.

Mr Zamboni: We do not ourselves make long term projections of the oil price but we have certainly not relied on any continuation of the current price in the case for making the change a year ago, so we cannot say a specific price threshold at which the case would not exist but it certainly does not depend on the continuation of the current oil price.

Q189 Mr Davidson: I think you can understand the general position of the companies because after some discussion with ourselves they were forced to concede that the end of the world had not yet arrived. However, they were suggesting that it would arrive if the oil price dropped to \$40. In those circumstances is there a mechanism by which Treasury could revisit the taxation regime to give them some sort of comfort so that in the event that the Apocalypse happened and you did have the price dropping to \$40, which they said they could not possibly cope with, you would be able to revisit that and perhaps give them some relief?

Ms Knott: The Treasury obviously keeps taxes under review from year to year, although, as I mentioned, the Chancellor is committed to no further increase during the life of this Parliament and obviously cannot bind future Parliaments in terms of what would happen then. The issue would be, if the oil price were to fall, whether that was a sustained fall or simply a blip, but I think the Chancellor of the day would have to look at all the factors and all the circumstances.

Q190 Mr Davidson: I think we understood that to be the position, that if the price fell to \$40 and it looked as if that was going to be a long term occurrence and was going to cause serious damage to the industry a

prudent Chancellor would want to look again at the question of whether or not the taxation burden on the industry was fair.

Ms Knott: But one thing I would point out is that when the changes were made in 2002 to introduce the 10% supplementary charge the oil price then was back down to \$20.

Ms Wakeman: Medium term.

Ms Knott: The medium term projection at that stage was \$20 a barrel, so \$40 is still substantially more than that \$20.

Q191 Chairman: What you are saying here is that producers are now making \$60 a barrel, the Government is happy, producers are happy, but that when they gave us the figure that if the price fell below \$40 it would be unbearable for the industry that view of the industry is not correct?

Ms Knott: I would not particularly want to give a specific view on that. As things develop, depending on how the oil price moves, obviously, the Chancellor of the day would want to look at all the factors. I am simply pointing out that \$40 is still a lot more than \$20 a barrel which we saw when the 2002 change was made.

Ms Wakeman: One of the points that was made to you by the industry representatives was that the costs in the North Sea and across the globe generally for oil production and exploration have gone up significantly in recent months and years as the oil price has been sustained at higher prices. Quite clearly that has changed the context within which we would be looking at the oil prices.

Q192 Chairman: How can we have a fair assessment of at what level it will be difficult for the industry to survive, earning less money? You are saying \$20, the industry is saying \$40.

Ms Knott: I was not necessarily saying \$20. I was just comparing what the position was back in 2002 but, as Jo has said, there is a whole range of factors—there is the oil price, there are the producers' costs. It is very difficult to pin down one particular factor and say if something happened to that there would be difficulties.

Q193 Mr Davidson: Can I follow this point up? Am I right in thinking that there is a degree of comfort for the industry in knowing that a British Chancellor would want to look again at the rate should the price collapse, yet the industry have been given a commitment that there is going to be no further increase in North Sea tax during the lifetime of this Parliament, according to your statement, so in fact from the industry's point of view there is no down, as it were, if prices go up but there is a potential up if prices go down, so they have the best of all possible worlds in the circumstances?

Ms Wakeman: You are absolutely right in saying that the Government has made a commitment that there will be no further increases in North Sea taxation during the lifetime of this Parliament, and also the Government has an interest in ensuring that

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the fiscal regime continues to deliver its policy objectives and will continue to agree to ensure that that will be the case.

Q194 Mr Walker: What is your model showing for the pricing of oil over the next three to four years? Demand is increasing from the developing economies so you must have a model that forecasts the price of oil.

Ms Wakeman: We do not actually forecast. We are not in the business of forecasting oil prices in the future. We certainly look at what external forecasters would say.

Q195 Mr Walker: What are external forecasters talking about? You have probably looked at that more closely than I have. The lifetime of the next Parliament is not going to be more than three and a half years, is it? It cannot be, so what are you seeing the oil price being over the next few years?

Mr Zamboni: The external forecasts we have seen, for the medium or even longer term, are all saying over \$40 and some well over.

Q196 Mr Walker: And the medium to long term would be three to five years probably, would it?

Mr Zamboni: And longer.

Q197 Mr McGovern: When we asked UKOOA about the possible effects of the £2 billion tax increase on the industry's infrastructure it was pointed out to us that this year's increase would be probably less than half of that. Do you consider that UKOOA and the oil industry have been crying wolf, as it were, and have over-reacted and the possible effects could not possibly be what they had projected?

Ms Knott: When you say that it would be less than half of that are you referring to the changes in the forecast?

Q198 Mr McGovern: My understanding is that they were forecasting the effect that a £2 billion tax increase would have on the industry's infrastructure and it was then pointed out that in this year the actual increase would be less than half of that. Is it your opinion that they over-reacted?

Ms Knott: There is a specific reason for that reduction in the amount of tax that we are taking this year. The reason for that is purely a timing issue, that a lot of the oil companies chose to pay more tax last year and less in this year. This was because of a facility we gave them. When we brought the change in we allowed them to defer their capital allowances to this year rather than last year and a lot of the companies chose to do that and did so very quickly. They made the election to do so very quickly and paid us more tax last year than this year, so there was a timing issue in the receipts. The projected view from the change is broadly about £2 billion a year.

Q199 Mr McGovern: I realise you have had some really constructive meetings with UKOOA, so possibly their position has shifted in the past few months, but how would you respond to UKOOA's

assertion to us back in the summer that the tax increases have led to the UK acquiring "an international reputation of fiscal instability within the industry"?

Ms Knott: We would not agree with the UKOOA assessment of that. We feel that we still have a stable regime.

Ms Wakeman: Quite clearly the Chancellor has given a measure of stability in the medium term with the commitment to no further increases in North Sea taxation during the lifetime of this Parliament. As Judith said, it is not possible for the current Government to bind the hands of a future administration, so any commitment beyond that period would be meaningless and therefore the Chancellor did not make such a statement. The commitment for the lifetime of this Parliament demonstrates the Government's understanding of the industry's need for fiscal stability.

Ms Knott: The other point I would make is that the discussions we have been having with industry about the longer term structure of the North Sea regime have also in a sense increased that stability in that we know what the issues are. We have been having a very open dialogue with the industry about the long term issues that might arise from decommissioning, and I think that in itself will have increased stability.

Ms Wakeman: Absolutely, because it is not just changes in the tax rates that can cause fiscal instability for industry. There could be aspects of the fiscal regime itself which introduced a measure of fiscal instability over the longer term, and it is these particular concerns that we have been attempting to address and understand during the course of these discussions with industry.

Q200 Mr McGovern: In the meetings and dialogue that you have had with the industry do you have an opinion as to whether or not that remains their view, that the UK has acquired this international reputation for fiscal instability, or have they now moved on as a result of the dialogue?

Ms Wakeman: It is difficult for me to comment on quite what their view would be. Clearly, I have seen the evidence that the UKOOA officials gave to yourselves in which they said that, and any change in the tax rate I would expect would lead them to feel that there was some fiscal instability, but beyond that I would not like to comment.

Q201 Ms Clark: Just following on from that, when we heard from BP they suggested that a more stable fiscal regime might help to promote maximising production from the UK Continental Shelf. It now seems very clear that there has been a commitment that there will be no further tax increases during the lifetime of this Parliament. Presumably it is the case that that counters most of the complaints that the industry made to us.

Ms Wakeman: I have heard comment from industry that, given the length of time for which they make investments, say, a discovery that is made now may not be in production by the end of the life of this Parliament because they typically take some two to five years to get the oil and gas on stream, they may

still consider that the Chancellor has not given them sufficient commitment or a long enough commitment to stability but, as I say, clearly the current Government is unable to make a meaningful commitment beyond the end of this Parliament.

Mr Walker: I do not think any Government would make a commitment beyond the end of a Parliament anyway, would it?

Q202 Mr Davidson: Was it not also the case though that the oil industry wanted stability in the sense of a guarantee of no increase in taxation over the life of the Government or longer, but in fact they were in favour of instability should the price of oil fall in order that the Government would be able to change the taxation burden downwards should the economic situation justify it, so they were in favour of instability when it suited them and stability when it suited them, which is an entirely consistent position?

Ms Knott: I see the point you are making. I think we would not want to comment on that.

Q203 Mr MacNeil: I would like to bring your attention to the evidence UKOOA gave this Committee on 20 June in Aberdeen where they were talking about the PILOT initiative that they were working on with the Department of Trade and Industry, but Malcolm Webb, the Chief Executive of UKOOA, said, “. . . it seemed to me that what the Treasury did was somewhat inconsistent with the PILOT vision, and the PILOT vision is quite clear: it is to maximise recovery from this basin in the national interest . . .”, and UKOOA would say that the infrastructure of the North Sea has got a certain lifespan and that the tax rise that the Chancellor made, for obvious deficit reasons, was endangering that.

Ms Knott: I think we would agree that the Government objective, as the PILOT objective, is to maximise economic recovery from the North Sea. The change that was made last year was made because of the increase in the medium term outlook for prices for oil to rebalance between oil producers and the UK taxpayer, given the fact that the oil companies were making very high economic rents from what is a national resource.

Q204 Mr MacNeil: But do you not see that there is pressure for the Chancellor—he will not be the Chancellor in 20 or 30 years’ time—to take as much money as he can at the moment, which may endanger the overall take over a period of 20 or 30 years?

Ms Knott: Based on the analysis we did we felt that there would not be an impact on investment and we do not see there being an impact on the maximisation of economic recovery from the tax change that was made.

Q205 Mr MacNeil: Do you think what you are saying chimes with what UKOOA has told this Committee?

Ms Knott: UKOOA may have a different view of that, but certainly our view would be that it does not damage investment and hence would not have an

impact on that objective, which we share with PILOT and with the oil industry, of maximising economic recovery.

Q206 Ms Clark: In their evidence to us the UK Offshore Operators Association stated that maximising the economic recovery of UK oil and gas reserves is currently hindered by too much red tape from both Westminster and Brussels. Would you like to comment on that but also could you let us know of any plans there are to reduce or remove any unnecessary bureaucracy in the system?

Ms Knott: Were they specifically talking about tax bureaucracy?

Q207 Ms Clark: I think they were making a general point. Obviously, if you could answer from your perspective in terms of the areas that you had contact with that would be helpful.

Ms Knott: Certainly, generally I would say on red tape that we have been doing a lot of work in Treasury and within HMRC to look at the general issue of red tape on business in the tax system. KPMG did a study recently for HMRC on the administrative burdens of the tax system and the figures that came out of that we thought were pretty favourable. This is overall, not just for the oil industry, but the overall burden on business of the tax system is 0.41% of GDP, and that compares with 0.57% in Denmark and 0.82% in the Netherlands. Those are the two countries which use that method of calculating it. We are having a lot of work at the moment. We have got an Administrative Burden Advisory Board which is working with HMRC and Treasury to look at ways in which we can reduce the burden. In terms of specific issues on the oil industry Jo may have more that she can say on that.

Ms Wakeman: All I would comment is that colleagues in HMRC, in the Large Business Service Oil and Gas office, have worked closely over a number of years with industry representatives to try and find ways to reduce the regulatory burden through the tax system and to identify ways that will meet the Government’s need for compliance and comfort, et cetera, but yet find a way for industry to improve their ways of working with Government through the regulatory process.

Ms Knott: The other point I would make is that currently HMRC are carrying out a review which is called the Varney Review and was announced at the Budget. Sir David Varney is reviewing the administration links between large business and HMRC, hoping to improve their effectiveness, trying to ensure world-class tax administration for large businesses, and the oil and gas companies, the majority of which fall into the large business category, would be very much involved in that as well.

Q208 Ms Clark: What are the timescales? You have mentioned the Advisory Board and the Varney Review.

Ms Knott: The Varney Review, which is really looking at the way that large business interact with HMRC and trying to make that more effective and responsive, is reporting at the Pre-Budget Report

stage which will be later this year. In terms of the Administrative Burden Advisory Board, the targets generally for HMRC are to reduce over the next five years the administrative burdens imposed on business by the tax system, and to reduce the time spent filling in forms and returns by at least 10% and the time spent on audit and inspections by 15%, so they are very clear targets over the next five years.

Q209 Mr MacNeil: Can I just return to the PILOT initiative? Again, UKOOA said that they were working in a situation of joined-up government before this tax rise came from the Treasury. You have said that there would be no detrimental effects of this tax rise on the North Sea. Has that been corroborated by any source other than the Treasury?

Mr Zamboni: I believe there may be a submission to you from Professor Alex Kemp of the University of Aberdeen.² He produced an estimate of some possible effects. I am not suggesting that we would agree with all the aspects of his methodology or necessarily with all of the results, but there are one or two figures which he mentions which may be worth reflecting on for comparison. One is that up to 2030 he suggests that there could be a negative impact on investment of one billion pounds, which is on average £40 million per annum. Now, £40 million is less than 1% of the current annual investment spend, so clearly in the greater scheme of things it is not a very substantial amount.

Q210 Mr Walker: What is the current annual investment spend?

Mr Zamboni: It is expected to be about £5 billion this year. In the greater scheme of things that is not really a very material change to the activity on which future capacity depends. As I say, we have reservations with some parts of his study but at least that is something which gives some objective comparison with our own findings.

Q211 Mr MacNeil: So are you saying that Professor Kemp has given a clean bill of health to the Treasury's tax arrangements?

Mr Zamboni: I think that is going slightly further than what I said but I do not think the findings are really miles away.

Q212 Mr Davidson: Just on this point of red tape, has the industry produced a shopping list of red tape that it wants to see struck down? When we spoke to them they were clearly against red tape in general but they were a bit short on specifics. I am remembering, of course, that certainly in my constituency and I think in a lot of other constituencies if it were not for red tape small boys might still be climbing chimneys because red tape stops them being employed in that way. Has the industry produced specifics?

Ms Knott: I have been involved in quite a lot of the dialogue with the oil industry over recent months and we have focused on a lot of issues but red tape has not really featured in that to a great extent at all. It has been more about the structure of the regime rather than red tape.

Ms Wakeman: Certainly discussions have been focused on fiscal issues and the fiscal regime. I might expect that issues that industry had about regulation, both within the UK and, as you mentioned, with Brussels as well, might more likely be directed to colleagues at the Department of Trade and Industry.

Q213 Chairman: Last June the Trade and Industry Committee in their report on *Fuel Prices*³ were critical of UKOOA members for their perceived reluctance to contribute to the easing of fuel poverty. The Committee in effect said that if UKOOA did not hand over at least some money voluntarily they would quite understand if the Chancellor took it by force. Could the latest tax increases be seen as a way of countering the industry's unhelpful attitude?

Ms Knott: I would say it is not specifically to do that but one of the things that was done at PBR was that certain money was allocated to alleviate fuel poverty and also to go towards pensioners' winter fuel payments.

Q214 Mr Walker: Would it be your experience that companies on the whole do not hand over money voluntarily to the Chancellor?

Ms Wakeman: They have not come with—

Ms Knott: If they did it would not be tax.

Q215 Chairman: Would you say that if the industry is making huge sums of money, especially when the prices are \$60 a barrel, it should be generous to the most vulnerable people who are helped to cover fuel prices?

Ms Knott: I really would not want to comment. Our expertise is on tax which is of its nature not a voluntary imposition.

Q216 Mr MacNeil: Since this tax increase by the Chancellor have the winter fuel payments increased?

Ms Knott: Certainly there were continuing winter fuel payments. I am not an expert on fuel poverty, I am afraid, so it would be going rather outside my area of expertise.

Q217 Chairman: Thank you. That concludes our questions. May I thank you for your evidence today. Before I declare the meeting closed would you like to say anything on any issue which we have not covered in our questions?

Ms Knott: No, I think that is fine. We will liaise with your Clerk on the note that you requested on the timetable.

Chairman: That has been extremely helpful for when we compile our report. Thank you very much.

² See Ev 40.

³ See Q81.

Memorandum submitted by HM Treasury

INTERNATIONAL COMPARISON OF TAX ON OIL PRODUCTION

The attached table is drawn from a study by Wood Mackenzie, a leading international energy consulting and research firm headquartered in Edinburgh. The study in question, “Global Oil and Gas—Risks and Rewards” was produced in early 2005, ie before the announcement of the increase in Supplementary Charge in the UK Pre-Budget Report later that year.

The table shows the percentage of the profits (measured by net present value at a 10% discount rate) taken by government in the form of taxes, royalties, etc, based on a typical 100 million barrel oil field development. This is a convenient way of comparing the effect of the different tax regimes which vary considerably in their structural features and can be very complex.

The comparison covers 65 different oil regions around the world. It may be seen that the UK shelf had the fifth lowest government take among the 65 before the increase in the Supplementary Charge. We estimate that the effect of the 10% increase in the Supplementary Charge was to increase the government take by approximately 10% points. Thus the UK government take on the basis of this study would now be around 51% for the base price scenario and 49% for the high oil price scenario. This would put the UK in 8th and 9th place respectively among the 65 in ascending order of government take.

The UK’s favourable position in the table is a reflection not only of its moderate tax rate, but also its system of 100% first year capital allowances for North Sea investment. The UK also has other targeted reliefs and allowances such as the Ring Fence Expenditure Supplement which safeguards the value of allowances for new investors.

8 November 2006

101 mmbbl Standard Field: Government Take NPV@10%: Existing Investor

<i>Base Price</i>		<i>High Price</i>		<i>Rank</i>
Ireland	25.00%	Ireland	25.00%	1
Papua New Guinea	38.03%	Papua New Guinea	34.56%	2
South Africa	40.42%	South Africa	35.35%	3
USA (GoM deepwater)	40.75%	USA (GoM deepwater)	37.46%	4
UK (shelf)	41.13%	UK (shelf)	39.33%	5
UK (Southern Gas Basin)	41.13%	UK (Southern Gas Basin)	39.33%	6
Mozambique	43.78%	Mozambique	40.46%	7
Pakistan	47.68%	Pakistan	46.29%	8
Netherlands (offshore)	49.64%	New Zealand	48.35%	9
New Zealand	51.47%	Italy	48.81%	10
Philippines	51.63%	Argentina	49.46%	11
Canada (East Coast)	52.34%	Netherlands (offshore)	50.27%	12
Bolivia	52.43%	Morocco	50.44%	13
Italy	52.68%	Chad	51.95%	14
Morocco	53.67%	Canada (East Coast)	53.65%	15
Chad	54.09%	Philippines	53.66%	16
Argentina	56.15%	Bolivia	55.73%	17
East Timor-Australia JPDP	57.49%	Canada (Arctic)	57.30%	18
Netherlands (onshore)	59.82%	Netherlands (onshore)	59.17%	19
Canada (Arctic)	60.14%	Australia (offshore)	59.54%	20
Australia (offshore)	63.03%	USA (Alaska)	59.69%	21
Colombia	63.44%	Mauritania	64.50%	22
Peru	63.85%	China (offshore)	64.53%	23
Denmark	65.69%	Namibia	65.04%	24
Mauritania	66.71%	Denmark	65.12%	25
Namibia	67.33%	Colombia	65.79%	26
USA (Alaska)	67.49%	East Timor-Australia JPDA	67.29%	27
China (offshore)	68.80%	Malaysia-Thailand JDA	69.19%	28
Malaysia-Thailand JDA	72.20%	Peru	69.45%	29
Tunisia	74.12%	Brunei	71.47%	30
Norway	75.72%	Tunisia	71.49%	31
Bangladesh	76.26%	Brazil (deepwater)	73.05%	32
Congo (Brazzaville)	78.24%	Brazil (shelf)	73.20%	33
Syria	78.49%	Venezuela	73.36%	34
Brunei	78.50%	Congo (Brazzaville)	73.51%	35
Angola (deepwater)	78.81%	Syria	73.99%	36

<i>Base Price</i>		<i>High Price</i>		<i>Rank</i>
Equatorial Guinea	80.18%	Norway	75.06%	37
Ecuador	81.80%	Bangladesh	76.16%	38
Venezuela	82.54%	Equatorial Guinea	76.61%	39
Brazil (deepwater)	82.55%	Ecuador	78.38%	40
Brazil (shelf)	82.75%	Cameroon	80.99%	41
Cameroon	83.76%	Sudan	82.58%	42
Sudan	85.41%	Angola (deepwater)	83.96%	43
Cambodia	89.53%	Kazakhstan	86.77%	44
Gabon	89.55%	Gabon	88.35%	45
Kazakhstan	90.08%	Egypt	88.55%	46
Indonesia	91.19%	Oman	88.55%	47
Angola (shelf)	91.33%	Indonesia	88.76%	48
India	91.72%	Cambodia	88.77%	49
Cote d'Ivoire	92.40%	Nigeria (deepwater)	90.23%	50
Oman	92.44%	Thailand	91.02%	51
Egypt	92.44%	Algeria	91.09%	52
Nigeria (deepwater)	92.79%	Cote d'Ivoire	91.27%	53
Algeria	94.00%	India	91.48%	54
Thailand	95.54%	Qatar	93.75%	55
Qatar	97.88%	Angola (shelf)	94.07%	56
Vietnam	98.36%	Vietnam	94.66%	57
Libya	98.94%	Yemen	95.96%	58
Yemen	99.42%	Azerbaijan	97.23%	59
Trinidad & Tobago	99.90%	Trinidad & Tobago	97.34%	60
Turkmenistan	101.78%	Libya	98.76%	61
Myanmar	102.71%	Myanmar	99.71%	62
Azerbaijan	110.68%	Turkmenistan	101.51%	63
Malaysia	111.13%	Malaysia	105.30%	64
Nigeria (shelf)	112.08%	Nigeria (shelf)	111.03%	65

Written evidence

Memorandum submitted by Professor Alex Kemp

EXECUTIVE SUMMARY

The UK Continental Shelf is now a maturing petroleum province. The average size of new field is likely to be less than 20 million barrels of oil equivalent. Unit costs of exploitation are now relatively high, with the average being in the \$15–\$20 per boe range. At oil prices generally employed for long-term investments the taxable capacity of many new fields and projects is quite modest, with many having negative returns at prices of \$30 and less. The recent tax increase could reduce total field investment to 2030 by £1 billion or so, with operating expenditures being reduced by a similar amount. Total production could be reduced by around 200 million boe. If the price fell significantly investment would fall sharply. There is a strong case for reducing the investment uncertainty by designing a schedule whereby the rate of Supplementary Charge changes automatically with oil/gas prices.

There is also a case for reducing the non-level playing field against new players, removing the Supplementary Charges on income from new tariff contracts, and providing an R and D incentive for tertiary recovery.

1. *Context*

The recent changes to taxation of North Sea oil and gas should be seen in the context of the present and prospective phase in the development and depletion of the nation's hydrocarbon resources. Production peaked in 1999 and has been declining steadily since then at a pace which has been faster than anticipated. Oil production declined by 11% in 2005 and gas by over 8%. Given the delays in the completion of new storage capacity and gas import schemes the decline in gas production has come at an unfortunate time, resulting in high wholesale winter prices in particular. Oil and gas together constituted around 74% of the UK's primary energy needs in 2005 and will continue to account for much of the country's requirements for many years ahead. The UK is now a net gas importer and in a few years will become a net oil importer as well. For security of supply reasons and to provide adequate time for the completion of gas import schemes and the development of other energy sources it is clearly a national priority that the exploitation of the remaining indigenous oil and gas should be economically maximised.

2. *Smaller Fields and Higher Unit Costs*

Total depletion of North oil and gas to date has amounted to 35.4 billion barrels of oil equivalent (billion boe). The DTI's central estimate of the remaining potential is 23.1 billion boe with low and high estimates of 13 billion boe and 43.3 billion boe respectively. But most of the remaining reserves are likely to be located in relatively small fields and located in areas with inadequate infrastructure. A key example is West of Shetland where there are currently over 20 undeveloped gas fields. The consequence is that unit costs of development and production are relatively high. Over the last two years there has also been a major cost escalation affecting all inputs, but particularly key ones such as drilling rig rates and steel prices (the latter driven by demand from China and thus not particularly related to the recent oil price increases). For the next generation of fields the consequence is that field development and operating costs average \$15 per boe and for the generation after the average could be \$20 per boe.¹ Exploration and appraisal costs are additional to the above. The prospective taxable capacity from new fields and incremental projects needs to reflect these likely exploitation costs.

3. *Investment Decisions, Oil/Gas Prices and Taxable Capacity*

Prospective taxable capacity also depends on the oil and gas prices used for long-term investment decisions. Oil companies are generally cautious on this matter. A recent survey of licensees by the Royal Bank of Scotland² found that the median values were \$33 per barrel and 23 pence per them. The present author employed prices of (a) \$40, 36 pence, (b) \$30, 28 pence, and \$25, 24 pence in a recent detailed study of the prospects for activity in the UK Continental Shelf. The economic modelling of the fields and incremental projects found that the size of the returns to investors on most of them was quite small. Many are unacceptable, particularly under the \$25, 24 pence price scenario. The returns were calculated in terms of net present values discounted at the cost of capital³ which is the conventional way by which investments in the industry are assessed. Taxable capacity is best measured in terms of the size of the net present value or wealth generated by the fields or projects. The effect of any tax increase is similarly best measured by the extent to which the net present value is reduced and its resulting acceptability to the investor.

¹ For a fuller discussion see AG Kemp and L Stephen, *Prospects for Activity Levels in the UKCS to 2035 after the 2006 Budget*, University of Aberdeen, Department of Economics, North Sea Study Occasional Paper No. 101. April, 2006.

² See Royal Bank of Scotland, *Survey Report*, 5th RBS North Sea Conference, Aberdeen, January 2006.

³ A G Kemp and L Stephen, *ibid.* Sum of the annual profits discounted at the cost of capital minus the initial investment costs. The method used by the ONS to measure profitability is conceptually unsound.

4. *The Recent Tax Increase and their Effects on Field Developments*

In the Pre-Budget Statement it was announced that the Supplementary Charge to corporation tax would be increased from 10% to 20%. The resulting tax rate for fields and projects developed before 16 March 1993 becomes 75% from 1 January 2006, given normal corporation tax at 30% and Petroleum Revenue Tax (PRT) at 50%. For exploration and field developments since 16 March 1993 the rate becomes 50%. In general the tax increase reduces the net present value (or wealth generated) from fields or projects by 16.667%. In a detailed study of these effects on all categories of fields and projects (including new discoveries and fields not currently being examined for development) the present author found that from 2006 to 2030 the numbers of projects/fields offering a net present value greater than £10 million before the tax increase but less than that amount after the tax increase (and thus not sufficient to compensate for the risks involved) were as follows:

NO. OF PROJECTS/FIELDS DETERRED TO 2030		
Prices	Discount rate	
	10%	15%
\$30, 28p	16	24
\$40, 36p	12	24
\$25, 24p	22	16

The value of the total reduction in field investment varied according to the oil price and discount rate but averaged around £1 billion at 2006 prices. The total reduction in field operating expenditures also averaged around £1 billion. The total loss of production from these fields/projects was around 200 million boe. These may be defined as fairly modest reductions in activity.

5. *The Tax Increase Exploration, and Possible Investment Risk Premium*

The increase in the tax can also reduce exploration as the expected full cycle returns are reduced. The effect is complicated as the rate of relief for exploration is also increased by the tax increase. Any net negative effect is in addition to those outlined above. Similarly, the recent increase coming on top of other increases in recent years will increase the investment uncertainty in the UKCS. In turn this could lead investors to put an extra premium on the size of their minimum expected returns to compensate for the perceived higher risk. The assurance that the Supplementary Charge will not be increased for the rest of the present Parliament is only of limited benefit to an investor who has to consider a much longer time period.

6. *Undeveloped West of Shetland Gas Fields very Marginal*

The present author has recently conducted a detailed study on how 23 undeveloped gas discoveries West of Shetland could be developed. The main conclusion was that a cluster development was clearly the most desirable from a national viewpoint, but, given the modest sizes of the fields and the high infrastructure costs, the investments were very marginal.⁴ The tax increases have made them even more marginal.

7. *Disadvantaged Position of New Entrants*

The tax system applied to the UKCS has also some attractive features from the viewpoint of encouraging investment. Capital allowances are available on 100% first year basis for all investments. For existing taxpaying licensees the system is in essence a cash flow tax with the Government sharing all the project risks more or less immediately to the extent of 50% for new exploration and developments (and 75% on "old" fields). This is advantageous to licensees able to utilise the allowances from existing income. New players are being actively encouraged to enter the UKCS to examine prospects not considered of core interest by others. New players do not have tax cover and cannot utilise the front-end allowances available to existing tax payers. This disadvantage is increased with the increase in tax rate (which increases the rate at which relief is given for investments). The Government has acknowledged this problem and provides that unutilised allowances be carried forward at 6% compound interest. This rate is a risk-free one and is well below the cost of capital for exploration and development. It needs to be increased if anything approaching a level playing field is to be produced.⁵

⁴ See A G Kemp and L Stephen, Options for Exploiting Gas from West of Scotland, University of Aberdeen, Department of Economics, North Sea Study Occasional Paper No 100. December, 2005.

⁵ The carrying forward of allowances with interest will not level the playing field for an exploration company as exploration costs will only be relieved if a discovery is made.

8. *Increased Tax on Tariff Income*

Third party use of infrastructure is central to the economically efficient development of the many small but currently undeveloped fields. The revised Code of Practice is designed to promote speedy agreements at competitive tariffs. The recent tax increase applies to tariff income. This will not promote competitive tariffs. Asset owners can attempt to have a clause in the contract which would lead to any tax increase being passed on in higher tariffs. The problem was recognised in 2003 when it was decided that PRT would not apply to income from new tariff contracts. It was expected that the net benefit would be passed on in lower tariffs. Consistent with this there is a strong case for removing the Supplementary Charge on new tariff contracts.

9. *Need to Kick Start Tertiary Recovery*

Currently there is little tertiary recovery taking place in the UKCS. The potential increase in recovery from the use of tertiary recovery techniques is very substantial. Example technologies are (1) chemical flood (such as with surfactants or polymers), (2) air injection, (3) microbial EOR, (4) low salinity water flood, (5) CO₂ injection and (6) miscible gas injection. To give these a kick start a tax relief for R and D relating to such schemes could be given. A practical method would be the application of the R and D credit to the Supplementary Charge. (It should be noted that loan interest is not allowed as a deduction against the Supplementary Charge.)

10. *Reducing the Perceived Investment Risk*

The several tax changes over recent years have increased the perceived investment risk. It is also clear from the author's recent study that if a substantial fall in oil prices took place a reduction in the tax rate would be necessary to sustain investment activity. Under current rules, a tax rate reduction would require a discretionary change by Government. This could certainly not be assumed to happen by a prudent investor. To reduce the investment uncertainty is certainly desirable and accordingly consideration should be given to the introduction of formula whereby the rate of Supplementary Charge is clearly and directly related to oil prices. This is not straight-forward in practice because of (a) the co-existence of gas and oil and (b) the volatility of prices in the short-term. These problems can be dealt with by the use of conversion factors and ranges of oil (and oil equivalent gas prices) over a specified period of time.

Professor Alex Kemp
University of Aberdeen

26 June 2006

Letter to the Chairman from Maersk Oil North Sea UK Limited

EFFECT OF TAX INCREASES IN THE OIL INDUSTRY

I am most grateful to you and your fellow members of the Scottish Affairs Committee for taking the time to meet with representatives of the UK Oil and Gas industry under the auspices of the SCDI dinner. It was a good opportunity for us to meet directly with politicians, in a convivial setting, and explain our issues and concerns for the longer term survival and success of the UK oil and gas industry. As I mentioned to you Maersk Oil has some very specific issues arising from the recent increase in SCT from 10% to 20%, impacting our recent \$3 billion investment in the UK, which has potentially damaging repercussions for the future. I hope the attached document will provide more detailed insight into these issues and provide scope for future dialogue.

Maersk Oil in the UK

Maersk Oilie og Gas ("Maersk Oil") is a fully owned subsidiary of A.P. Moller—Maersk ("APMM"). Maersk Oil undertakes oil and gas exploration and production operations worldwide, directly through subsidiary companies. Maersk Oil and its activities are summarised in the attached note "Maersk Oil" (Attachment 1).

The APMM group of companies have its main activities within oil and gas exploration and production, transportation and shipping. Shipping activities in the UK (containers, bulk and logistics) commenced more than 50 years ago, and today the group ranks first or second among UK ship-owners with 42 UK flagged vessels and more to come. The group today employs a staff more than 10,000 in the UK. The activities are summarised in the attached note "A.P.Moller—Maersk in the UK" (Attachment 2).

Maersk Oil has been active in the UK since 1992 with oil and gas exploration activities, and no production income until 2005. Recently, Maersk Oil embarked on a new strategy for significant expansion in the UK, with focus on picking up where other oil companies, frequently the oil majors, have given up or moved on. For this purpose, Maersk Oil draws on its experience with difficult and marginal oil and gas fields in Denmark and elsewhere, supported by a cost-conscious organisation.

Acquisition of Kerr-McGee's UK Activities

In August 2005, Maersk Oil agreed with US independent Kerr-McGee to acquire the majority of its oil and gas activities in the UK. The purchase price (enterprise value) was USD 2.95 billion (GBP 1.75 billion). The agreement became final in November 2005.

The acquisition comprises 10 producing oil and gas fields, three fields under development, a portfolio of exploration licences and a staff of more than 500 in total, mainly based in Aberdeen and at the offshore production sites. The oil and gas fields acquired are all small or marginal in international context.

Maersk Oil acquired Kerr-McGee's interests and activities with the intention of leveraging the considerable expertise obtained from more than 40 years of oil and gas activity and 30 years of specific offshore production experience in Denmark. With the proximity of operations and scope for direct application of management and expert resources, Maersk Oil is well positioned to optimise field development, including near-field appraisal and exploration, and production operations in the UK, aimed at improving production rates and field life for the benefit of ultimate recovery. At the same time, Maersk Oil has the necessary financial resources.

Maersk Oil's expected future investment in the UK is significant. A total investment of USD 1.2 billion (GBP 0.72 billion) in field developments during the period 2006–11 was planned at the time of completion of the acquisition in November 2005, in addition to operational expenditures.

Consequences of the Announced Taxation Increase

Announced only weeks after the completion of the acquisition by Maersk Oil, the new tax increase will deplete significant value from any recent purchaser's investment in oil and gas in the UK. In Maersk Oil's case, approximately USD 0.42 billion (GBP 0.25 billion) or 15% has been depleted from the value of the USD 2.95 billion (GBP 1.75 billion) investment.

In its assessment of the value of the assets, Maersk Oil has relied upon projected after-tax cash flows, applying existing tax rates. Maersk Oil has not previously had oil and gas production and income in the UK and has thus not enjoyed any benefit from the recent high oil and gas prices in relation to the interests acquired.

It is fair to add that Maersk Oil, with the announced tax increase, may now have to reconsider new investment in field developments and exploration, pending further detailed economic analysis.

The UK Challenge

The further identification and development of oil and gas reserves on the UK Continental Shelf—with value creation for companies and society as the result—require investors with substantial financial, technological and managerial resources. With the maturity of the known UK oil and gas resources, new concepts and solutions will be required to counter the natural production decline in a commercially viable manner.

Maersk Oil is among the companies that are willing and capable of investing in mature fields and the development of small and marginal fields. Such investments are made possible by the application of state-of-the-art drilling and well completion technology, combined with simple surface facilities and high operational efficiency.

It is imperative for the future of mature oil province like the UK Continental Shelf to be able to attract and retain the more specialised operating companies when the oil majors move on. Maersk Oil is such a company.

Jobs

Maersk Oil's recent acquisition involves 500 jobs, mainly in Aberdeen and at offshore production sites. Maersk Oil's intention has all along been to grow the business, in the UK.

For this ambition to be practicable, the fiscal regime is obviously of great importance. The announced tax increase has created a great deal of anxiety also among the staff in Aberdeen where Maersk Oil continues to be asked about the effect on future activities and employment.

CONCLUSION

The recent tax increase is inequitable and punitive to recent investors who have paid full value to take ownership of UKCS assets and despite representations to Treasury no transitional arrangements to mitigate the impact are forthcoming.

The specific value impact of this tax increase and the threat of further change to the fiscal regime have adverse effect on the confidence of Maersk Oil as to the relative merits of the UKCS as a region for future investment.

The UK Government/HM Treasury needs to nurture investment by companies such as Maersk Oil to enable optimal recovery of oil and gas resources from the UKCS to benefit from the resulting economic activity and tax take.

Michael Engell-Jensen
Maersk Oil North Sea UK Limited

20 June 2006

Attachment 1

MAERSK OIL

Background

Maersk Olie og Gas AS (“Maersk Oil”) is a company owned by A.P. Moller—Maersk A/S, and is part of the A.P. Moller—Maersk Group. Maersk Oil was established in 1962.

Business activities

Maersk Oil is a Top-20 international oil and gas company operating an average oil production of more than 550,000 barrels per day and sales gas production of some 900 million cubic feet per day. The company has an equity share production of some 500,000 barrels of oil equivalent per day from activities in Denmark, Qatar, Algeria, United Kingdom and Kazakhstan.

Exploration activities are ongoing in the North Sea (Denmark, United Kingdom, Norway and Germany), North Africa (Algeria and Morocco), West Africa (Angola), the Middle East (Qatar and Oman), South America (Brazil, Colombia and Surinam) and Central Asia (Turkmenistan).

Maersk Oil’s international activities are carried out directly or through wholly owned subsidiary companies.

Denmark

Offshore Denmark in the Danish sector of the North Sea Maersk Oil is operating 14 oil and gas fields on behalf of Dansk Undergrunds Consortium (DUC). 300,000 barrels of oil and up to 1 billion cubic feet of sales gas. Partners in DUC are A.P. Moller—Maersk, Shell and Chevron.

Qatar

Maersk Oil is operating the Al Shaheen Field offshore Qatar. Current daily production averages some 240,000 barrels of oil.

Algeria

Maersk Oil participates in production from three major fields and associated satellite fields located onshore Algeria in the Saharan desert. Current daily production averages some 450,000 barrels of oil.

United Kingdom

Maersk Oil is operating five producing oil fields offshore UK in the British sector and participating in another five producing fields. Current daily production averages some 130,000 barrels of oil.

Kazakhstan

Maersk Oil is operating two oil fields onshore Kazakhstan. Current daily production averages some 6,000 barrels of oil.

Health, Safety and Environment

It is the policy of Maersk Oil to conduct its activities in such a manner that health and safety of its employees and other persons on work sites under its management be of prime concern at all times and under all conditions and with the protection of the environment in mind.

People and jobs

Maersk Oil currently has a staff of more than 2,000. In addition the activities provide substantial business and employment opportunities for contractors and suppliers.

Technology

A substantial part of Maersk Oil's production is from tight reservoirs, which prior to the 1980's were deemed unattractive due to low production rates. Maersk Oil's innovative application of advanced state-of-the-art horizontal drilling and well technology combined with the cost efficient development concepts and operations has been the key to technical and commercial success.

www.maerskoil.com

Attachment 2**A.P. MOLLER-MAERSK IN THE UK**

Overall the A.P. Moller—Maersk A/S (“APMM”) group employs a staff of some 10,000 in the UK, either through The Maersk Company (“MCO”) or through other APMM owned entities such as Norfolk Line, Netto Stores, Svitzer WijsMuller and Rosti.

Recently the oil and gas activities in the UK has been further enhanced by Maersk Oil's acquisition of Kerr-McGee's UK interests and activities with a staff of more than 500, mainly based in Aberdeen and at offshore production sites.

Established in 1951, MCO has been a British ship-owner since 1972 and now ranks second in size in the UK with 42 UK flagged vessels, with many British nationals. A further 19 new-buildings have been planned over the next 2.5 year period. In addition, MCO manages 16 vessels owned by 3rd parties.

Within the container business, MCO is by far the largest UK operator, following acquisition of P&O Nedlloyd (“PONL”), with an estimated market share of 18%. Through either wholly owned subsidiaries or operating division, MCO is involved in ship owning, liner agency, supply chain management, drilling rig management and operation, offshore support, intermodal activities, and haulage.

MCO's latest full-year estimate 2005:

— Group Turnover:	GBP 651 million (excluding PONL)
— Container Business:	GBP 280 million (excluding PONL)
— Other Shipping:	GBP 180 million
— Oil and gas related:	GBP 191 million

MCO is a major long-term investor in the UK generally with estimated total investment in excess of GBP 1 billion in the period 2006–10.

In addition to the above, Maersk Oil expects investment in the UK in the period 2006–11 to total some GBP 0.72 billion, in addition to operational expenditures.

Memorandum submitted by Amicus

1. Amicus is the UK's second largest trade union with 1.2 million members across the private and public sectors. Our members work in a range of industries including, manufacturing, financial services, print, media, construction and not for profit sectors, local government, education and the NHS.

1.1 Amicus welcomes the opportunity to give its views on the effects of the recent 10% increase in supplementary tax (2006) on the Oil and Gas Industry and the effects on jobs and the economy.

1.2 Amicus plays a lead role in the oil and gas industry and are the largest union operating in the sector. Amicus enjoys recognition with the Offshore Contractors Association (OCA), United Kingdom Drilling Contractors Association (UKDCA), United Kingdom Floating Production Operators Association (UKFPOA) as well as some Operators and catering companies. The recognition deals cover over 15,000 of the offshore workforce. Presently it is estimated that there are over 21,000 offshore workers in the United Kingdom Continental Shelf (UKCS).

2. *Executive Summary*

2.1 Amicus is of the firm belief that presently there is no detrimental impact on the Oil and Gas sector or the local and national economy as a direct result of the latest 10% increase in supplementary tax.

2.2 We adopt the position that the latest increase should be viewed in terms of affordability and given the present price of oil it is not unreasonable to adopt the view that the recent increase is affordable.

2.3 We do however have major concerns for the future of the industry, jobs and of course the positive contribution made by the oil and gas industry to the local and national economy, should there be a dramatic and sudden decrease in the price of oil.

2.4 Amicus proposes that due consideration be given to the suggestion of a new tax regime for the industry which is both simple and transparent. A system that will allow long term stability in terms of activity in the North Sea. A system that will be diverse enough to react to fluctuations in oil prices. We believe that by adopting this approach it will assist the industry in moving forward and away from the current boom and bust situation that it currently faces.

3. *Supplementary Tax Background*

3.1 It was in 2001 when the Chancellor introduced a 10% supplementary tax into the oil and gas sector. This was met by strong opposition from the oil companies and contractors. Amicus believes that it should be noted that the role of the contractors in this industry on various matters, including taxation, is limited and often curtailed by their relationship and dependency upon the operators. Given this, it is wholly expected that the contractor's views on this issue are likely to be aligned with that of the Operators Association (UKOOA).

3.2 Notwithstanding this with the introduction of the supplementary tax in 2001, operators and their association UKOOA threatened to withdraw from PILOT and withdraw co-operation with the Government because they had not been consulted on the introduction of this tax.

3.3 Amicus believes that there could and should have been better communication with the industry prior to the implementation of the supplementary tax.

3.4 In 2001 Amicus adopted the position not to support the oil industries lobby to Government following the introduction of the supplementary tax. The Oil Industry did seek the support of AEEU, a founder union of Amicus, however the support was not given due to the actions of major operators in sourcing construction work from overseas resulting in UK construction yards losing out.

4. *Effect of Introduction of Supplementary Tax in 2001*

4.1 Given the annoyance of the Operators at the introduction of the supplementary tax, Amicus is of the firm belief that we witnessed a game of "Political Football" in the pursuing years.

4.2 We witnessed Operators withdrawing and withholding investment. This we believe was done to send a strong message to Government; it certainly wasn't done on basic financial grounds given that the price of a barrel of oil was on the increase at that time. In fact statistics will show that there was greater drilling activity in the early 90's when it was around \$19 per barrel. The operator's refusal to invest in exploration drilling resulted in over 1,500 jobs being lost in this sector in 2002–04. Over 20 drilling rigs were anchored/stacked in Invergordon. Drilling companies were asked to tender for what little work there was, often at less than break-even rates.

4.3 It should be recognised however that not all Oil Operators were adopting the same approach. Some smaller and newer operators, such as Talisman, were keen to acquire acreage to carry out exploration drilling but were unable to obtain the acreage to allow them to do so. A situation existed whereby much of the North Sea acreage was in the portfolios of the four major operators who refused to work it.

4.4 This prompted Amicus to suggest that government explore the possibility of an "inactivity tax" in the hope that exploration drilling could be kick started.

5. *PILOT Initiatives*

5.1 It was clear that immediate action was required. There are three major initiatives, which whilst accepted on a voluntary basis by operators, are none the less the result of a strong Government approach towards the unacceptable position of the operators.

5.1.1 Code of practice on access to infrastructure.

5.1.2 Stewardship of field.

5.1.3 Fallow block—Fallow discovery introduction.

5.2 Amicus accepts that these initiatives played a part in the upturn in drilling activity in the UKCS and are vital to the maximising recovery agenda.

6. *Supplementary Tax increase 2006*

6.1 It is accepted that the three PILOT initiatives referred to above are not the only reasons for higher activity in the UKCS and that the increased value of a barrel of oil has been the major incentive for the Operators actions. In 2005 the average price was \$56 per barrel, and this year it has yet to fall below \$60 per barrel. Earlier this year it reached a record high at \$75 per barrel. There is a likelihood of the price per barrel climbing even higher, with some reports suggesting a price in excess of \$90, dependent on developments in Iran, demand in the Far East and the behaviour of Russia in its control of supply to Europe.

6.2 Oil companies have in the last two years posted record profits and it is expected that 2006 will be the best year to date. This is of course good news as it allows the companies to address their investment portfolios for the UKCS. Whilst no company will openly divulge the exact details of how their investments are evaluated, due to commercial sensitivity, it is known that the window for evaluation is based on the price of oil being in the region of \$20–\$25 per barrel, while some have indicated that they look at \$28. It is therefore clear that the industry is currently enjoying a “boom”.

6.3 It is against this background that the Treasury announced the further increase of 10% in the supplementary tax earlier this year. Whilst Amicus did not lobby Government for an increase in tax, it is, in our opinion, affordable at this time. It is for this reason that Amicus once again refused to support the industry lobby to have this tax overturned.

6.4 Amicus believes that the public pronouncements from the industry association UKOOA which followed this announcement was an over reaction designed to put pressure on government. Its suggestions that this tax increase would stimulate an exodus from the North Sea and deter investment in new fields have proved to be false. Although it was reported at the time that Shell, one of the largest oil operators in the North Sea, was cutting its exploration drilling portfolio as a direct result of the tax increase, prompting Amicus to write to the Energy Minister calling for an immediate investigation, it later transpired that Shell have not and did not intend to cut back its drilling activity. It would appear that at the time the Shell story suited the UKOOA position.

6.5 It is therefore important to examine the reality of the effects of the increase. In terms of activity in the North Sea, we are seeing the highest activity for a number of years. There appears to be absolutely no adverse effect in terms of drilling activity. In fact the forecast for rig utilisation is very good for 2007–08. It is accepted that beyond this it is dependent to a large extent on the price of oil.

6.6 In terms of jobs, not just in Scotland but the whole of the UK, some six months after the implementation of the tax increase, Amicus is not aware of any company, operator or contractor, that is not in a constant recruitment mode. It is widely acknowledged that the industry faces a massive skills and people shortage. This has resulted in a number of initiatives being taken forward by individual companies and the industry as a whole. Amicus, along with other trade unions are presently engaged in positive dialogue with companies to examine the possibility of using non UK labour. One company alone has advised that for the shutdown period this year they will be looking for over 1,000 suitably qualified staff.

6.7 It follows that, given points 1 and 2 above, the local and national economy is healthy in relation to the contribution from the Oil and Gas sector at this time.

6.8 It has also recently been reported by the DTI that the interest shown for the next licensing round in the UK is at its highest level in 35 years.

6.9 On Wednesday 28 June 2006 Venture Production announced a five year term drilling investment in the North Sea worth £200 million.

6.10 Amicus have been consistent in its opinion in relation to the effect of the 10% increase in taxation, whilst others have required more time to consider their position. However by way of evidence to support our submission we draw the Committee’s attention to a recent report commissioned by UKOOA which stated: “As many as 15,000 jobs will be created in the UK offshore oil and gas industry this year on the back of a £1 billion surge in investment by companies”. This clearly suggests that the predicted negative impact resulting from the 10% tax increase this year has failed to materialise.

7. *The Future*

7.1 Amicus fully supports a positive and vibrant approach to the Oil and Gas industry which we believe has a vital role to play in the future energy supply for the UK. Amicus has set out in detail its position on future energy supply and demand in its submission to the Government’s consultation on the Energy Review.

7.2 We believe that it is vital that to continue to promote exploration drilling for the long term future of the Oil and Gas Industry. Amicus acknowledges that discoveries are smaller than in previous years and therefore financially less attractive to operators. Furthermore, the areas yet to be drilled pose more problems in terms of accessibility. It is for these reasons that Amicus strongly believes that Government needs, as a matter of urgency, to examine financial incentives for companies to take on board the initial risks.

7.3 Amicus recognises that the long term future of the industry is dependent on investment. Therefore, whilst accepting the need for Government to apply appropriate taxation, Amicus advocates that the time is right to have a simpler and more transparent tax regime. Amicus supports the rational that when times are good and company profits are at record levels then taxation should be at its highest.

7.4 We do however have a concern that the industry could be in very serious difficulty if the price of oil should dramatically drop and the tax take remain unchanged. This would have an obvious negative and serious effect on the economy and we would once again see many members face losing their jobs.

7.5 With this in mind Amicus suggests that a Treasury working group examine the possibility of introducing in the future a simpler, transparent tax regime that would take account of the fluctuations in oil prices. Amicus would welcome the opportunity to participate fully in any group formed for this purpose.

Alan Harvey
National Officer
Amicus Process Sector

30 June 2006

Memorandum submitted by Shell UK Limited

Shell is pleased to respond to this inquiry into the implications of recent tax increases for the North Sea oil and gas industry. Shell has been working in the North Sea since 1964, and is an operator for around a quarter of the UK's oil and gas production.

In our response to the Energy Review consultation in April, we set out a vision in five parts: energy efficiency, energy diversification, best use of indigenous resources, reducing carbon emissions, and solutions through people. (See copy of cover letter that accompanied the Shell submission to the Energy Review consultation attached.) It is in this context that we respond here, drawing on one part of the vision; the 'best use of indigenous resources'.

EXECUTIVE SUMMARY: KEY POINTS

In any future energy supply and demand scenario, indigenous oil and gas will play a significant part in meeting the UK's primary energy demand.

Indigenous oil and gas should therefore feature at the heart of UK energy policy.

The UKCS is a maturing province. The industry faces the challenges of increasing difficulty of access, high costs—including a rapid increase in supply chain costs this year, and increasing competition for global investment funds.

Fiscal stability is a key factor in attracting long-term investment to the UKCS. The December 2005 SCT increase was the third significant tax change for the industry in three years. Increasing taxation runs counter to maximizing economic recovery and enhancing security of supply.

Any reduction in investor confidence in the UKCS is likely to result in a rapid and irreversible loss of skills and equipment to other parts of the world—at a time when both are in short supply.

We continue to believe it would be appropriate for the Government to restore investor confidence by committing to review the increase in the Supplementary Corporation Tax rate.

THE IMPORTANCE OF UK OIL AND GAS

1. Shell recognises the energy challenge to ensure sufficient, clean, affordable and secure energy both nationally and internationally, in the short-term and into the long-term future.

2. As the DTI's Energy Review consultation document recognises, the UK is still one of the global top 10 producers of oil and gas, and will remain a major player for many years.

3. UKOOA estimate oil and gas met 75% of the UK's primary energy demand in 2005, and demand is forecast to increase significantly by 2020. Based on the DTI's "favourable to coal" scenario data, oil and gas is forecast to contribute 78% of primary energy demand in 2020.

4. It is worth noting that, globally, Shell scenarios indicate that gas could overtake oil as the main fuel of choice by around 2025.

THE NEED FOR AN APPROPRIATE REGULATORY AND FISCAL ENVIRONMENT TO MAXIMISE INDIGENOUS OIL AND GAS PRODUCTION

5. The UKCS is a vital national asset and a significant contributor to the UK's security of supply. Although the UK has become a net importer, there is much still to be achieved in the UKCS.

6. While about 34 billion barrels of hydrocarbons have been produced to date, UKOOA estimates that around 16–27 billion barrels are still to be produced, provided the right regulatory and fiscal conditions are in place.

7. The contribution to the national exchequer is about £10 billion of taxes paid in the fiscal year 2005–06. The contribution to the balance of payments is about £20 billion. About 365,000 jobs in the UK depend on the UKCS. And the UKCS creates a key platform for British based companies throughout the supply chain to win business internationally.

THE CHALLENGES OF THE UKCS AS A MATURING BASIN

8. Oil and gas in the UKCS is increasingly difficult to find and produce, as the remaining potential is distributed over ever smaller accumulations and in more technologically-challenging areas. This requires a greater spend on technology, and smaller finds mean higher unit development costs.

9. Some other cost differences between the UKCS and other provinces around the world include: a greater burden of regulation in the UKCS than in other provinces; higher labour costs due to typically higher levels of operational expenditure by contractors; a harsher environment that typically requires larger rigs at a higher cost.

10. Added to this, suppliers' costs have risen rapidly. In significant sections of the UK supply chain rates have risen to match current oil prices.

11. Take the costs of securing rigs for example: In mid-2004, the average fixture rate to secure a jack-up rig was around \$55,000 a day. In April 2006, the rate for the same rig had more than trebled to \$176,000 a day.

12. Or to take the example of a semi-submersible rig; in mid-2004 fixture rates were around \$50,000/day. By April 2006 these had increased more than seven times to \$365,000. (Source: ODS Petrodata, North Sea Rig Report.)

13. Casing and tubular products used in the drilling of wells is another area where prices have doubled in the last 18 months, partly due to forces outside our industry which have driven up the costs of important commodities such as steel. In the wider economy there is rising inflation.

INCREASING TAXATION RUNS COUNTER TO MAXIMIZING ECONOMIC RECOVERY AND ENHANCING ENERGY SECURITY OF SUPPLY

14. As Shell and industry have consistently stressed to government, fiscal stability is a key factor in attracting investment to the maturing UKCS.

15. This was the third significant tax change for the industry in three years. The SCT measure alone budgeted for the removal of £6 billion from the industry in the next three years.

THE IMPACT OF CUMULATIVE TAX MEASURES ON INVESTOR CONFIDENCE

16. At current oil prices, it is unlikely that activity levels will drop this year. Contracts for 2006 were committed to prior to the 2005 Pre-Budget Report.

17. However, the cumulative implication of the tax measures on top of rapidly increasing costs are having a significant negative impact on project economics, to the extent that a number of projects are being reviewed.

18. The latest 10% increase in the SCT rate equates to a 17% reduction in our post-tax cash flow. This is significant for any company and is a substantial burden on future investment. The commitment of the Treasury to a strategic review of UKCS taxation together with industry is very important against this background.

19. The competitive position of the UKCS with respect to the rest of the world has been eroded.

20. It is well known that human and engineering resources are in tight supply worldwide. Once these resources leave the UKCS it is difficult to get them back.

21. The DTI's Energy Review consultation document states that maintaining investment in further exploration and development in the UKCS remains a priority. It states the difference between the UKCS attracting investment and not doing so is estimated to be the difference between meeting half of the UK's oil and gas needs by 2020 instead of just 10%.

CONSIDERATIONS LOOKING AHEAD

22. Shell is pleased the Government noted the importance of a positive climate for investment and the need to maximize economic recovery in the UKCS in the March 2006 Budget.

23. We continue to believe it would be appropriate for the Government to support this and restore investor confidence by committing to review the increase in the Supplementary Corporation Tax rate.

24. The Ring Fence Expenditure supplement (RFES) that was announced in the budget alongside the SCT increase is intended to act as an investment incentive. It is aimed at companies that do not yet have any taxable income against which to offset their exploration and appraisal capital allowances. We need to be clear that the benefit to industry is estimated at only £5 million in 2008–09.

25. We welcome the Government's recent consultations with the oil and gas industry, including the Treasury's discussions to gather views on the current structure of the North Sea fiscal regime, in particular on issues that impact the stability of the regime as the basin continues to mature. We have and will provide input to these where we can usefully contribute.

26. We are fully supportive of the PILOT process and we would like to see a renewed focus on working within PILOT to identify win-win proposals that can provide the long-term investment climate required in the UKCS.

27. Industry would like to be able to engage more effectively with the Treasury so that decisions might take into account the lifetime of existing infrastructure and the closing window of opportunity to maximize economic recovery from the UKCS.

28. In our response to the Energy Review, we suggested the government should examine whether there is scope for enhancing the coordination across government of all aspects of energy policy under one Minister; general energy policy, the exploitation of indigenous resources, climate change, international agreements for exploitation of the North Sea, transport fuels, carbon capture and storage, planning consents for energy related activities and incentives for research and deployment of new energy and carbon mitigation technologies.

29. There are matters that necessarily fall elsewhere, such as fiscal policy and international relations aimed at securing energy supplies. Enhancing coordination could involve, for example establishing cabinet level responsibilities for delivery of all aspects of energy policy.

30. The Government's commitment to no further increases in North Sea taxation for the lifetime of this Parliament is noted, but it is important to stress that the energy business is a long-term business, and projects of 10, 15 or many more years duration require long-term investment decisions and supporting stability.

ABOUT SHELL IN THE UK

31. In the UK, Shell is engaged in the business of Exploration and Production, Oil Products, Chemicals, Gas and Power, Renewables and other activities. With centres in the north-west of England, Scotland and London, Shell provides more than 8,000 direct jobs and 80,000 indirect jobs across the United Kingdom.

32. The UK is a core area for Shell:

- FTSE top 10 company
- Shell in the UK paid \$1,209 million in tax for full year 2005
- Shell spent approximately \$4.5 billion with UK suppliers in 2005
- Global Retail, Shipping and Aviation businesses are based in London
- Shell has approximately 1,000 petrol stations in the UK
- Is an operator for around a quarter of the UK's oil and gas production
- Provides 15% of the UK's oil products
- If you have any queries regarding this submission, please contact:

Alex Rhodes
External Affairs
Shell U.K. Limited

30 June 2006

Letter to Energy Review Team, Department of Trade and Industry from Shell International Limited

ENERGY POLICY REVIEW CONSULTATION

Shell is pleased to respond to the Energy Review consultation. Set out in the attached⁶ is Shell's response to the questions asked and comments invited. Our response is quite extensive and we have tried to synthesise our points into a "vision in five parts", as follows:

- *Energy efficiency*: Energy efficiency measures are required across all sectors, whether power generation, the built environment or transport. Measures should be based on market incentives but would also include encouragement of more energy-efficient behaviours and regulation, where appropriate.
- *Energy diversification*: Diversification of energy supply is the proper response to risk and uncertainty. Diversification provides resilience. Competitive market forces should be used to the full.
- *The best use of indigenous resources*: It should be ensured that the maximum oil and gas production is achieved from the UK Continental Shelf and also that best use is made of indigenous renewable resources, particularly offshore wind.
- *Reducing carbon emissions*: Carbon emissions are reduced through energy efficiency, through "greener fossil fuels" including carbon capture and storage, and through the use of renewable energy, including bio fuels and wind. Emission trading schemes play a vital role.
- *Solutions through people*: The support of the public is needed. Energy efficiency and low carbon behaviours need to be encouraged. People are fundamental to the science, technology and engineering that will be required.

In support of the goals of the Energy Review, Shell has expertise in the following areas:

- *Exploration and production of oil and gas*: Shell is a leading North Sea operator and is firmly committed to the North Sea for the long-term. "North Sea" comprises UK and non-UK sectors. Shell's participation in the North Sea as a whole offers benefits of integration.
- *Clean coal technology*: Shell has a leading technology for clean gasification of coal, which better enables carbon capture and storage. To date, for example, 14 licences have been sold in China.
- *Gas to liquids*: Shell has leading gas to liquids technology, based on a plant in Malaysia that has been in production since the early 1990s. A much larger plant is planned for Qatar.
- *Carbon capture and storage*: This comprises a wide range of technologies. Shell is involved in developments across this range. Shell recently announced a joint venture with Statoil for a major carbon capture and storage project in the Norwegian Sector of the North Sea.
- *Wind*: Shell is one of the top 10 players in the wind industry. With partners, Shell is hoping to build what would be one of the world's largest offshore wind farms in the Thames estuary. Shell also has wind operations in North America, in Holland and is hoping to develop wind operations in China.
- *Bio fuels*: Shell is the world's largest marketer of bio fuels. Shell is involved in joint ventures on second-generation bio fuels using crop waste and biomass.
- *Thin-film solar*: Shell has leading thin film solar technology that is now being further developed in partnership with St Gobain. Thin-film solar seems to offer the best long-term prospects.
- *Hydrogen*: Shell is working in partnerships in North America, Iceland, Europe and Asia on hydrogen developments for transport.
- *Leading fuels and lubricants*: Shell is recognised as an industry leader in advanced fuels and lubricants. Shell's association with Ferrari in Formula One racing exemplifies this.
- *Emissions trading*: Shell made the first trade on the UK and the European emissions trading systems and is a significant supporter of such market-based systems for carbon mitigation.

We look forward to participating in the discussions on energy policy through the review period

Dermot Grimson
Head of UK External Affairs

14 April 2006

⁶ Not submitted.

Memorandum submitted by Oil and Gas Independents Association Limited

THE OGIA

The Oil and Gas Independents' Association is a group of 31 oil companies (approx 25% of the total) actively engaged in exploration and production in all areas of the UKCS. Our membership (see list in Annex 1) includes a wide spectrum of companies from UK divisions of large well-established multinational organizations through to small start-ups and from companies with an active exploration drilling capability to purely financial investors.

In 2005 our members participated in :

- 28 of the 78 (36%) UKCS exploration and appraisal wells spudded

In the 23rd Round our members received licence awards as follows:

- Participated in 61 of the total of 152 awards
 - 29 out of 69 (42%) Traditional Licence Awards (16 as operator)
 - 30 out of 77 (39%) Promote Awards (27 as operator)
 - 2 out of 6 (33%) Frontier Awards (both as operator)

OGIA's membership is, in general terms, more focused on investing in the discovery, appraisal and development of new sources of hydrocarbons on the UKCS than exploiting legacy assets.

OGIA does not represent the major production operators on whose behalf UKOOA are making a separate submission.

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EXECUTIVE SUMMARY

1. *Importance of Investment and Resources*

The realisation of the potential of the UKCS requires the Oil and Gas Industry to continue to invest wholeheartedly in people, equipment and opportunities to maximise the remaining life of the North Sea.

2. *Importance of Exploration*

Exploration, which represents an estimated 9 billion boe of remaining potential, is inherently risky. If the UKCS remaining potential is to be realized then exploration investors need to be confident of the non-negotiable incentive of an appropriate and proper reward.

3. *Importance of Investor Perception (including investors from overseas)*

Hostile tax changes, of which there have been three in the last four years, create perceptions that the government is more interested in short-term revenues than developing an industry for the long term. Board-level perceptions are crucial in company's decision-making processes.

4. Importance of Supply Chain

The UKCS must remain attractive to the supply chain not just to the operators. Since the 2005 PBR some contractors have rebalanced their resources away from the UK. Ultimately without a supply chain there are no prospects for the basin.

5. Competition for Resources (“Cancelled Projects” issue)

Each company has a portfolio of opportunities from which to prioritise via risk benefit analysis. Portfolios need to be worked and replenished aggressively to assure a flow of future projects. Policies which lead to portfolio stagnation will result in the UK failing to realise its potential.

Projects that have been worked up to sanctionable status are rarely cancelled.

6. Importance of Medium Term

The present fiscal regime encourages short-termism from the industry and is resulting in an increased proportion of development wells and a decreased proportion of exploration wells. Plans for ‘06 were already fixed at the time of the PBR last December but it will be future years that are impacted

Oil and Gas currently provide 25% of total CT receipts. From 2010 onwards:

- where will government find these billions?
- how will Government deliver on fuel poverty?
- how will Government provide for security of energy supply?

Policy choices made in 2005–06 raise issues in all these areas.

7. In summary the OGIA is looking to a predictable fiscal regime that—

- Supports international competitiveness in a basin recognised to be mature.
- Provides for predictability with regard to PRT.
- Attracts the required investment and resources to enable full development of UKCS Oil & Gas Reserve Potential.
- Recognises that oil pricing is volatile and beyond the control of UK government and the offshore industry, recognises all costs and cost movements (including the cost of financing) and does not deter investment at lower oil prices.
- Delivers clarity on the treatment of decommissioning in a way that reduces risk and does not distort investment.
- Delivers a regime that is fair, and competitive against other energy sectors and other business sectors.

MAJOR TAX INCREASES IMPACTING OIL AND GAS SINCE 2002

- 2002—Introduction of 10% SCT.
- 2004—Advanced phasing of CT payments, solely for Oil & gas Industry.
- 2005—Doubled SCT to 20%.

THE SCALE AND CONTRIBUTION OF UK OIL AND GAS

1. In 2004 the UK was the world’s 4th largest gas and 13th largest oil producer. The UK has been a net oil exporter for 25 years and is expected to remain so until at least 2010. By reducing the need for imports the UK upstream industry currently reduces the balance of payments deficit by about £35 billion per year.

2. Upstream oil and gas companies contribute over £12 billion pa in taxes and pay a quarter of all Government CT receipts. The upstream industry currently invests above £10 billion per year.

3. To end 2004, 34 billion barrels of oil and gas equivalent had already been recovered from Britain’s hostile offshore environment and almost £350 billion had been invested, contributing over £200 billion in tax revenues without risking any public money. (Most statistics referenced above from UKOOA’s 2005 Economic Report, ref 5, updated where available.)

4. Until recently UK surplus indigenous gas production has reduced gas and electricity prices to some of the lowest in Europe (still lower in real terms than in 1985) with a dramatic reduction in the number living in “fuel poverty” because of rising incomes and decreasing fuel bills, particularly as a result of low gas prices (reflected indirectly in electricity prices using gas as a power station feedstock as well as directly through low

gas prices). Furthermore HM Treasury claims to be directing some of the “windfall” SCT receipts into Winter Fuel Payments so there have been three ways in which the upstream Oil and Gas industry has contributed to alleviating fuel poverty.

CHALLENGES AND OPPORTUNITIES FACING THE UKCS UPSTREAM INDUSTRY

5. The UKCS is a high cost, geologically complex mature basin.
6. Finding costs (\$/bbl) are high in the UKCS, twice those in the Netherlands and five times those in Norway over the 1994 to 2003 period on a pre-tax basis (source UKOOA). Norway and Netherlands offer greater tax relief on exploration so on a post tax basis the comparisons are even worse. Under the current tax regimes, post-tax UK \$/bbl finding costs are 12 times those of Norway for a company currently paying tax (and the multiple is even higher for those start-up companies not yet paying tax) and 2.2 times those of Netherlands (source CW Energy Associates).
7. Operating costs, already high in the UKCS, are under constant pressure and currently increasing sharply. Recent high levels of activity, driven largely by high oil prices, have created additional pressure on the supply chain and led to an approximate doubling of the cost base overall, more in some areas.
8. Typically new developments are modest in size with high development costs but they allow existing infrastructure to remain economically viable for longer, extending recovery from the host field.
9. Drilling rigs, and other vital resources, are currently leaving the North Sea in search of more attractive contracts elsewhere. Historically, the rig market is global, and rig owners prefer to place their equipment where there are best returns, often defined by length of contract in a stable regime—not the situation in the UKCS at present. And once resources leave the UKCS it is extremely difficult ever to attract them back.
10. However the UKCS has advantages with good access to extensive infrastructure, a shared sense of urgency within the industry, a wide diversity of investors (139 vs. 30 in Norway despite the latter having much bigger reserves), a dynamic sector of new entrants and ready access to gas markets.
11. Commercial developments, championed by the dti, and adopted by the oil and gas companies, have made ullage in this infrastructure more readily available. If some projects are delayed beyond the lifetime of the infrastructure they will not simply be postponed but lost for ever. Hence the importance of near-term exploration and appraisal.
12. Much of HMG seems to have little understanding of how oil companies take investment decisions and their concerns about risk. Risk in UKCS terms relates not just to geology, reservoir, reserves and recovery but also to exploration, development, operating and decommissioning costs, product price, environmental constraints, future tax regimes etc. Companies are conscious that in countries dependent on petroleum for wealth/foreign earnings there has been far less interference in the industry than there has been in the UK.
13. The tax changes of 2002, 2004 and 2006 have eroded the competitiveness of the UKCS which the 2005 PBR Regulatory Impact Assessment (RIA, ref 6) failed to address. Furthermore the RIA ignores the supply chain completely (stating “The options set out above will affect 120 or so entities undertaking oil and gas exploration and production activities in the UK or on the UKCS”, so failing to acknowledge the impact on the contracting industry which is a much larger employer in the UK than those 120 companies).
14. The UKCS must remain attractive to the supply chain not just to the operators. Since the 2005 PBR some contractors have rebalanced their resources away from the UK (ref. Alistair Locke, Abbot Group 10.1.06, ref 7). Ultimately without a supply chain there are no prospects for the basin.

UK INVESTORS

15. Increasingly many listed UK based Oil and Gas companies do not invest in the UKCS (eg: Cairn, SOCO, JKK etc) or have a minimal proportion of their investments in the UK (eg: Premier, etc).
16. This is despite the fact that the vast majority of their directors, management and senior staff are British, whose formative careers were in the UKCS.

INTERNATIONAL INVESTORS

17. Investors in the UKCS are usually allocating funds between a portfolio of worldwide opportunities.
18. Hostile tax changes, of which there have been several in the last few years, create perceptions that the government is more interested in short-term revenues than developing an industry for the long term. Board-level perceptions are crucial in company’s decision-making processes.

LACK OF ALIGNMENT BETWEEN INDUSTRY AND POLITICIANS/CIVIL SERVANTS

19. The Oil and Gas Industry works to a long term timetable.

20. A consortium formed to bid for a licence will perhaps take over 25 years to progress from discovery (though only a minority of prospects achieve commerciality) through production to decommissioning.

21. It appears to business that politicians' timescale is too short term (five years max). The government's poor track record on long-term infrastructure issues such as pensions, transport, energy, housing and water supports this concern.

22. The widely criticized White Paper on Energy in 2003 is a particular example. The outcome of the recent dti Energy Review (widely understood to be pre-destined) is a particular concern.

THE PROBLEMS

23. In 2002 when the Supplementary Charge was introduced the UKCS was ranked below 30 among the most economically attractive basins in which to do business.

24. By removing value from the fields at that time the Supplementary Charge made exploration economics worse, but was partly offset by accelerated depreciation for those companies in a tax-paying position (but not start-ups for example).

25. Rising prices have improved field economics, but have also led to rising costs worldwide. Prices appear to have peaked but cost escalation is increasing, apparently at an ever faster rate.

26. In 2004 the phasing of CT payments from the upstream oil industry were advanced to give a windfall benefit to HMG.

27. The further increase in Supplemental charge in December 2006 removed 16% of the value from most fields. This damages the viability of small marginal prospects and high risk plays.

28. The closing window of opportunity caused by the limited life of existing infrastructure makes it imperative to explore for and develop the many small prospects near this infrastructure so that product can be brought to shore before the infrastructure is decommissioned.

29. As production from the host and existing user fields declines unit costs for new fields increase which makes their development less attractive, and early exploration and development even more urgent.

30. Small gas fields are particularly at risk because they rely on pipeline infrastructure to take product to market whereas oil can be shipped by tanker in some cases.

31. While we recognise the need for the state to secure a fair economic rent from the UKCS we believe that the Supplementary Charge is a very blunt instrument which has helped to drive resources, including rigs, away from the UKCS and has made the economics of many marginal prospects unattractive. Although we see no reason to single out the oil and gas exploration industry for super-taxation, as an interim measure, targeted allowances will help overcome the adverse effect of the super-tax.

SOME POSSIBLE SOLUTIONS

32. Suggested ways to counter the adverse economic impact on exploration are:

- (i) Play-opening exploration wells to be rewarded by consequent developments having an exemption from the Supplementary Charge (SC), and/or enjoy other tax incentives so as to accelerate payback of costs + cost uplift to reflect risk.
- (ii) All new fields should be eligible for an oil allowance of (5) million tonnes.
- (iii) Gas production from new fields should be exempt from the SC.

33. These targeted allowances will help encourage risk taking in the search for new oil and gas basins, will remove the impact of super-taxes on many marginal prospects that should not bear them, and will help improve security of gas supplies as indigenous production declines. Together these improvements should help to:

- (i) restore confidence not only among operators but also, importantly, among the key suppliers and contractors to our industry
- (ii) improve production and security of energy supplies
- (iii) enhance job opportunities, particularly in Scotland
- (iv) promote technological innovation
- (v) provide more security to those who are trying to build an export business on the back of a strong domestic business
- (vi) and strengthen the Scottish and UK economy.

INVESTMENT—THE LIFE BLOOD

34. Estimates of full life cycle UKCS potential suggest we are just over half-way through, approx 34 billion boe has been produced to date and a further 23 billion boe remains of which approx 9 billion boe is classed as “Yet-to-Find”—ie: not yet been encountered by the drill bit (ref 21).

35. The realisation of these volumes assumes that industry will continue to invest wholeheartedly in people and equipment to maximise the remaining life of the North Sea. There is also some allowance for the expectation that technology will continue to advance. It may not be obvious to the casual reader that these numbers are inherently fragile.

36. To maximise recovery from existing fields one must renew and maintain equipment and conduct infill drilling. Such incremental investment to sweat existing assets requires a proper assessment of uncertainty and, as fields become ever more mature, requires increasing effort for decreasing reward.

37. Exploration, which represents 9 billion boe of remaining potential, is inherently risky (and subject to all the above uncertainties). If the UKCS remaining potential is to be realized then exploration investors need to be confident of the non-negotiable incentive of an appropriate and proper reward.

38. As the basin becomes increasingly mature all investment becomes closer to the margin. While fields found many years ago may in the past have been robust to low product prices, high costs or increased taxes, they are now vulnerable to such factors and these might result in their early abandonment.

39. Investors look to policymakers to sustain the fiscal & regulatory environment that will support their increasingly marginal investment decisions. The confidence of investors (many of whom are headquartered overseas) is key. This can be addressed by reassuring investors that if product prices should fall materially from current levels there would be a re-examination of the level of SCT, a re-assurance HMT has so far refused to offer. Other measures worthy of consideration include:

- encouraging investment in new technologies such as HP/HT and heavy oil, perhaps through some sort of “early adopter allowances” and boosting R&D credits,
- the Removal of SCT on tariff receipts akin to the removal of PRT on those receipts,
- provide a level playing-field for new entrants through increasing the interest rate on unrelieved field losses.

40. There is also a timing issue. Any loss of momentum to secure these remaining reserves will lead to them slipping permanently beyond our grasp. This is due to the design life of host infrastructure which may come due for retirement or abandonment by—say—2020 which may be sooner than the life of a new discovery made in—say—2010. Additionally the later such new discoveries are made the greater their unit cost to produce and the more likely they are to fail an economic test.

41. There is an analogy here with the UK coal industry—the closure of mines in the 1980s led to the permanent loss of reserves and skills which may soon, in the context of high energy prices and reduced security of supply, be confirmed as regrettable.

42. The UKCS industry has recognized the excellent efforts of the dti in recent years and a variety of initiatives, launched co-operatively, in partnership with industry have resulted in a welcome resurgence of exploration effort.

UKCS OIL AND GAS POLICY

43. Companies that invest in the UKCS to produce oil and gas generally have many alternative petroleum basins around the world to choose where to invest. Most companies have more opportunities than they have resources to develop those opportunities (Ref Sheila McNutly in FT, 5.4.06, ref 8). Therefore they have to prioritise their investment opportunities. This is done on a basis of perceived risk and return.

44. The oil price is an international factor which is essentially the same throughout the world. With the advent of LNG projects and the increasing gas pipeline links between Europe and the UK the UK gas price is no longer just a local issue.

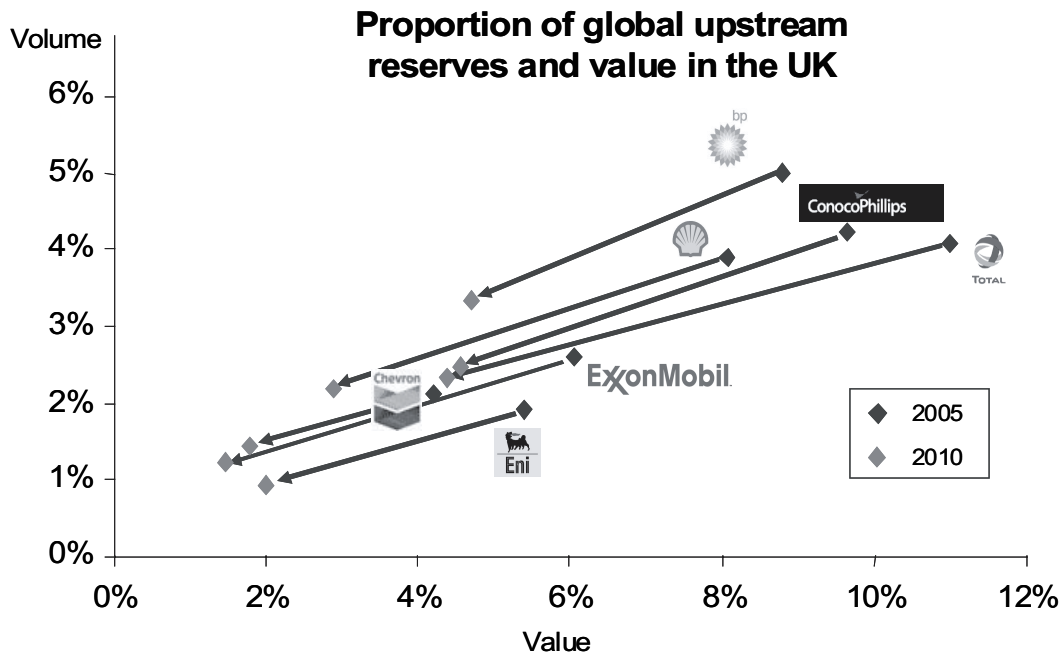
45. Hence high product prices do not necessarily encourage investors to increase their investment in the UKCS. If the UKCS tax regime is perceived as regressive and if there are concerns at the tax increases of 2002, '04 and '05 investment in the UK may be reduced in favour of other countries perceived as more attractive.

46. Oil companies have sophisticated ways of estimating technical risk and uncertainty, but where commercial and regulatory issues are concerned, confidence is key.

47. Therefore the UK needs a fiscal and regulatory regime which is perceived by oil companies as being stable, internationally competitive and encourages the maximum economic recovery of UKCS oil and gas reserves. This requires different parts of Government, the contracting industry and the oil companies will all have to work together more effectively than in the recent past.

48. Currently the UKCS provides jobs, security of supply, a balance of payments benefit and, not least, a very significant source of revenue for the Treasury. As we go down the UKCS decline curve we will lose some, and, in the long term, all four of these benefits.

49. The challenge to policymakers must be to ensure that the UK manages this decline in a manner that maximizes our total UK benefit. To achieve this goal the messages that Government sends to industry must be delivered in a way that industry can understand and relate to.



50. Fig 2 (above)—“The UK will have declined in importance by 2010 for the Majors” Source: WoodMackenzie (ref 9)

51. UK Energy Policy must also respond to the needs of the new breed of investor now arriving in the UK. For most of the life of the North Sea the great majority of investment has been funded by the international majors. However in other international provinces this has been commonly found to fall to 50–60% in late life. WoodMac (Fig. 2 above) has forecast that the importance of the North Sea to established majors is due to halve over the next five years (ref 9). However a number of new arrivals, especially from continental Europe, North America and the Far East, are keen to increase their UKCS activity and have been active in acquiring assets from the majors recently. There has also been a wave of start-up companies, encouraged by the Promote License, Fallow Acreage and Fallow Discovery initiatives that seek to bring new ideas and energy to the sector. The dti have been keenly aware of, and have actively encouraged, these new entrants.

52. The oil and gas industry’s supply chain has been an ongoing success story with particular impact in Scotland. The contracting industry has always been innovative and the UKCS has provided a valuable test bed. Looking to the future we need to foster the jobs and activity that can be supported by an increase in exports, but government support to date has been disappointing.

53. Unless we maximise indigenous production, in particular of gas, energy prices will rise further which will reduce UK plc competitiveness and profits and hence tax revenue.

OIL AND GAS, THE OFFSHORE INDUSTRY AND THE ENVIRONMENT

54. Natural gas has more than anything else, enabled the UK to achieve major improvements in its environmental performance and exceed its Kyoto commitments. The decrease achieved in UK CO₂ emissions from 1990 to present (see Consultation Document page 22⁷) has arisen primarily from the UK closing (or at least downscaling) its reliance on coal fired electricity generation capacity and moving to gas (the “dash for gas”).

55. Gas produces approximately 70% of the CO₂ per GJ of heat output as oil and 50% as coal. (Source Open University, ref 10). Natural gas also contains very little sulphur so switching to gas generation enabled the UK to meet its targets for reducing SO₂ emissions which contribute to acid rain without having to fit expensive flue gas desulphurization to existing coal-fired power stations. CO₂ emissions from power generation fell from 198 million tonnes in 1990 to 147 million tonnes in 1997 (source dti, ref 4) but this was more than compensated for by rising emissions in the transport sector.

⁷ Not published.

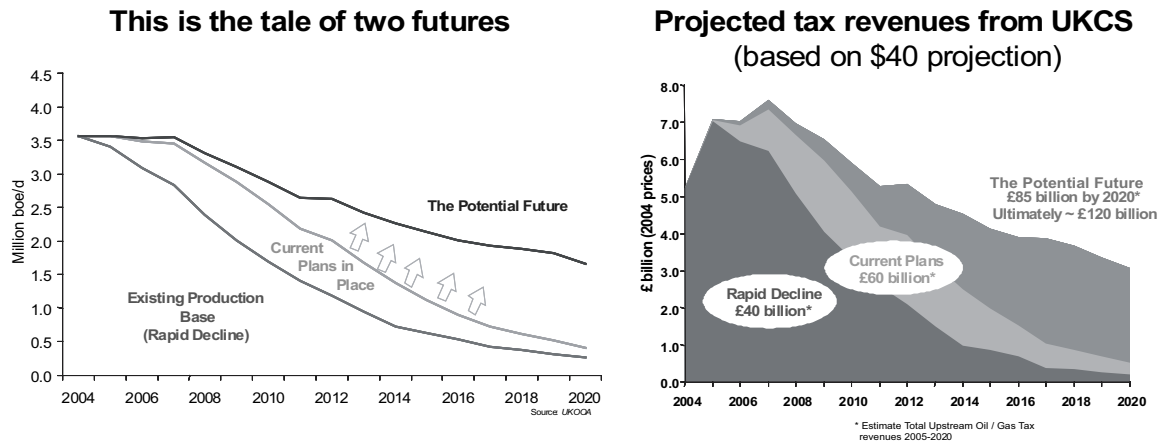
56. It is the UK Upstream Industry that has found and produced this gas. In conducting our offshore operations the upstream industry has a generally good track record of environmental performance and continuing improvement in regard to tightening regulations, voluntary codes of practice and innovative market mechanisms (eg early adoption of emissions trading).

Attachment 1

SUMMARY OF OGIA SUBMISSION TO DTI ENERGY POLICY REVIEW, APRIL 2006

1. Fundamental changes to the UK energy supply mix will take some 20 years.
2. Until then hydrocarbons will continue to be the main contributor to the UK's primary energy requirement.
3. It is very much in the UK's national interest to maximize the contribution of our indigenous oil and gas resources. Exploration has a key role in this endeavour. The UK needs a fiscal and regulatory regime that:
 - (a) attracts investment funds in competition with other petroleum basins around the world,
 - (b) recognises and responds to long project cycles and to technical and commercial risk and uncertainty, and
 - (c) is integrated across all government departments.
4. The Government should recognize that the current UKCS fiscal regime actively discourages the risk-taking that is necessary to discover and exploit the UK's remaining unfound oil and gas resources. It does this by taxing those who produce from relatively low risk legacy assets that have already "paid out" in exactly the same way as those who wish to take significant financial risks to discover new sources of hydrocarbons.
5. The OGIA believes that a fiscal regime should be developed that encourages and rewards those who are prepared to take the necessary risks to find and develop the UK's remaining undiscovered resources.
6. With such a regime in place the UKCS upstream industry would be focused on maximising its contribution towards the UK's economic needs through:
 - (a) increased efforts in exploration,
 - (b) development of marginal discoveries,
 - (c) exploitation of existing fields, and
 - (d) extending the life of existing infrastructure.
7. The appointment of a Secretary of State for Energy, a position of cabinet rank, heading a Department of Energy and acting as a single point of contact between industry, government and other stakeholders, would greatly assist alignment and stability in pursuit of these objectives.
8. The contribution, to the Scottish economy in particular, of the oil and gas supply chain (and potentially a similar supply chain in renewables) and the future potential for exports should not be underestimated by government.
9. If government policy does not evolve to encourage investment in indigenous oil and gas then either fuel poverty will get much worse or the government will have to find very large resources from elsewhere to make up for the contribution that the Oil and Gas industry has made.

EXTRACT FROM OGIA SUBMISSION TO DTI ENERGY POLICY REVIEW, APRIL 2006: ACTION REQUIRED TO ADDRESS FUTURE GAS IMPORTS REQUIREMENTS



Source: UKOOA

1. The above UKOOA slide illustrates the tremendous potential of moving from the curve labeled “Current Plans in Place” to the one labeled “The Potential Future” which is something the Industry (both the contractors and the oil companies) and the dti are working very hard to achieve.

2. The dti estimates (ref 21) that more than 23 billion boe remains to be recovered from the UKCS and there are substantial rewards for the UK if we can sustain the attractiveness of the UKCS.

3. The Consultation document reads “By 2020 we are likely to be importing around three quarters of our primary energy . . .” (Consultation Document p 5). This seems very pessimistic unless it is government policy to discourage future investment in the UKCS and accept this 75% import dependency and the significant loss of UK taxation revenue and employment and the impact on the UK balance of trade which it implies. Provided industry and government create the conditions where investment can flourish in the UKCS, OGIA believes indigenous production of oil and gas can provide around half the UK Primary Energy supply in 2020.

4. The industry values the good work of the dti in the last five years in particular in promoting the use of fallow acreage and discoveries, the arrival of new entrants, the opening up of infrastructure systems, the establishment of a trans-median line agreement with Norway, the promotion of good stewardship etc.

5. Government should establish fiscal and regulatory frameworks which actively promote investment to maximise the production of the UK’s own oil and gas reserves. This will require the UKCS to be internationally competitive with other petroleum basins worldwide and the government to regain the confidence of (largely overseas) investors. Current fiscal policy is demonstrably unstable and will not in its current state achieve the desired result.

6. The investment environment will benefit from recognition by the Treasury of the fundamental difference in risk profile between exploration and production. Retaining an identical tax regime for legacy fields and for exploration that can contribute significantly to “the better future” may result in the major investment being directed towards the low risk exploitation path, which has less growth potential. Such a direction would be unlikely to maximize the production of the UK’s indigenous reserves.

Annex 1

LIST OF OGIA MEMBERS

1. Atlantic Petroleum UK Ltd
2. Black Rock Oil & Gas PLC
3. Bow Valley Petroleum (UK) Limited
4. Carrizo Oil & Gas Inc
5. Challenger Minerals Inc
6. CIECO Exploration and Production (UK) Ltd
7. Corsair Petroleum Ltd

8. DONG UK Ltd
9. E.ON Ruhrgas UK Exploration and Production Ltd
10. Elixir Petroleum Ltd
11. Encore Oil PLC
12. Endeavour Energy UK Ltd
13. EOG Resources
14. GDF Britain Ltd
15. Granby Oil & Gas plc
16. Hunt Petroleum UK Ltd
17. Icen Oil & Gas Ltd
18. Ingen Process Ltd
19. Marubeni Oil & Gas (UK) Ltd
20. Nautical Petroleum AG
21. Newfield North Sea Limited
22. Nippon Oil Exploration and Production UK Limited
23. OMV UK Ltd
24. Oranje-Nassau (U.K.) Ltd
25. Scotsdale Ltd
26. Summit North Sea Oil Limited
27. Svenska Petroleum Exploration UK Ltd
28. Veritas DGC Limited
29. Virgo Exploration Ltd
30. WHAM Energy Ltd
31. Wimbledon Oil & Gas Ltd

Annex 2

OGIA CONTACT DETAILS

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Annex 3

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Annex 5**GLOSSARY**

Barrel	35 UK gallons = 42 US gallons
boe	barrels of oil equivalent (oil, plus gas expressed as energy equivalent barrels)
boe/d	boe per day
mmboe/d	millions of boe/d
billion	thousand million

An excellent conversion calculation facility can be found at <http://www.fabianltd.com/convert>

CCS	Carbon Capture and Storage
LNG	Liquefied Natural Gas
UKCS	UK Continental Shelf
Upstream	Exploration and Production of oil and gas
Downstream	Transportation, Processing/Refining and Marketing of Products
PBR	Pre-Budget Report
RIA	Regulatory Impact Assessment
PRT	Petroleum Revenue Tax
CT	Corporation Tax
SC/SCT	Supplementary Charge / Supplementary Corporation Tax

Memorandum submitted by Scottish Enterprise

1 INTRODUCTION

Scottish Enterprise welcomes the opportunity to submit evidence to the Scottish Affairs Committee's inquiry into Effects of Tax Increases on the Oil Industry.

As Scotland's main economic development agency, this response focuses firmly on the potential impacts to Scotland's economy as a result of the recent tax increases.

Growing Scotland's economy is the Scottish Executive's top priority. The Framework for Economic Development sets out the Executive's overarching economic development strategy and the recently refreshed "Smart, Successful Scotland" (SSS) sets out an enterprise strategy for Scotland.

Scottish Enterprise's (SE's) mission is to help the people and businesses of Scotland succeed. In doing so, we aim to build a world-class economy.

2. POTENTIAL IMPACTS OF RECENT TAX INCREASES TO SCOTLAND'S ECONOMY

In partnership with major operating and service companies in the oil and gas industry, the Scottish Enterprise Energy Team has for many years supported the economics research undertaken by Professor Alexander G Kemp and Linda Stephen at the University of Aberdeen.

We believe that their approach to modelling of the industry, coupled with their highly developed and up to date database of production facilities and reserves, make them the most reliable source of forecasting for the oil and gas industry. We have therefore adopted their latest North Sea Study Occasional Paper No 101 entitled "Prospects for Activity Levels in the UKCS to 2035 after the 2006 Budget" issued April 2006 as the basis of our consideration and response to the Scottish Affairs Committee Consultation.

Professor Kemp's paper considers three oil and gas price scenarios for the basis for its projections:

High—oil at \$40 per barrel of oil equivalent (\$/bbl)/gas at 36 pence per therm

Medium—oil at \$30 per barrel of oil equivalent/gas at 28 pence per therm

Low—oil at \$25 per barrel of oil equivalent/gas at 24 pence per therm

A striking conclusion of the paper is the relatively small size of the remaining undeveloped fields and incremental development opportunities in the UK Continental Shelf, accompanied by high unit lifetime costs. From this it would appear that any increase in taxation will directly influence future investment decisions in this province.

The paper measures the effects of the 2006 Budget tax increase in terms of its consequence on field investment, field operating costs, and production in the long term to 2035. Using the range of cases outlined above, cumulative field investments are forecast to be reduced by between £900 million and £2 billion, with operating expenditures reducing by between £950 million and £1.75 billion.

The oil and gas industry works on long development timescales, and this reduced investment is therefore not expected to occur until after 2010–12. The rate of reduced investment then increases with time.

These reductions in projected investment are cumulative over the period 2006 to 2035, and they may not appear excessive when related to current levels of investment in the UKCS. However it is clear that anything that may deter sustained investment and commitment from oil and gas operating companies is a serious threat to the supply and service chain which contributes so significantly to the economies of Scotland and the UK.

Scotland's oil and gas businesses have developed world class technologies and service provision which make them highly respected in global energy markets. SE research estimates that, on average, Scottish oil and gas specialists now deliver over a third of their annual turnover in international markets.

This very encouraging and increasing level of global growth is being achieved by the innovation and technology development of Scottish businesses—and these credentials are directly attributable to their experience in the North Sea.

From an economic development perspective, it is therefore essential that the domestic North Sea market is maintained for as long as possible. It is here that our supply and service specialists develop and sustain their competitive advantage.

It seems inevitable that this second increase in supplementary Corporation Tax will contribute to shortening the lifespan of our domestic industry, and will result in reducing levels of capital and operating investment in the years to come. In turn, this will reduce the opportunities for growth for Scottish oil and gas businesses, will deter research and development in Scotland, will reduce innovation in service provision, will reduce industry confidence, and through time must diminish the credibility of our supply chain—a major source of gross value add.

29 June 2006

Memorandum submitted by Oil & Gas UK

EFFECT OF TAX INCREASE ON THE OIL INDUSTRY

Thank you for your letter regarding the Scottish Affairs Committee's inquiry into the impact of the tax increase on UK industry; we particularly appreciated the inclusion of the complete copy of the evidence provided to the Committee.

Whilst we welcome the opportunity to review the evidence we presented to the Committee, we remain of the view that the competitive position of the UKCS has been prejudiced by the tax increase introduced in December 2005. The UK is a mature high cost oil province which will always struggle to compete against more prospective opportunities elsewhere in the world. The tax increase places an extra burden on the UKCS on top of the rapidly rising costs of operating in this basin.

The spate of tax changes over the last half decade has added to the reputation of the UKCS for Fiscal stability. This is reflected by Wood Mackenzie in their recent independent study on comparative oil and gas tax regimes which shows the UK to rank poorly on such measures.

I am however pleased to say that we are in the middle of ongoing discussions with HM Treasury regarding the future evolution of the North Sea tax regime. We hope that these will address industry concerns regarding the future of PRT, the fiscal treatment of decommissioning and the need to provide an appropriate balance taxation and investment if we are to maximise the economic recovery of the UK's oil and gas reserves.

Malcolm Webb
Chief Executive
Oil & Gas UK

2 October 2007

Letter to the Chairman from Angela Eagle MP, Exchequer Secretary, HM Treasury

Thank you for your letter of 10 July to Jane Kennedy asking whether the Treasury would like to add any further evidence to that already submitted to the Committee in the session of 31 October last year. I am responding as the Minister responsible.

I would like to reiterate that as officials stated in that session the Government is committed to a strong and vibrant UK oil and gas industry and has a specific objective to maximise the economic recovery of the UK's oil and gas reserves.

The Government believes that the North Sea fiscal regime continues to promote investment, whilst ensuring that the UK taxpayers receive a fair return from the exploitation of the UK's national resources.

The increase in the rate of supplementary charge at PBR 2005 acted to restore the balance between producers and consumers in light of the significant increases in the oil price since 2001, increases that have continued, with oil prices recently touching \$80 a barrel in September this year.

Since the evidence session last year Treasury officials, alongside HM Revenue and Customs, and the now Department for Business, Enterprise and Regulatory Reform, have continued to discuss potential structural issues within the North Sea fiscal regime with the oil and gas industry.

Alongside Budget 2007 the Treasury published a discussion paper setting out its conclusions on the discussions that had occurred since PBR 2005, and I include a copy of that document for the Committee (not printed).

Since Budget 2007 officials have continued to discuss the issues raised with Industry, and as stated in this months Pre-Budget Report, Government will now be considering its conclusions and will be publishing a consultation document in due course examining the options for further actions.

I look forward to seeing the outcome of the Committee's inquiry. I am copying this letter to the Secretary of State for Scotland.

Angela Eagle MP
HM Treasury

October 2007
