

Decommissioning certainty

As expected, Chancellor George Osborne confirmed in the Budget the Government's commitment to provide reassurance on the level of tax relief for the cost (estimated to be in the tens of billions) of decommissioning oil and gas fields.

This is good news for the industry and goes some way to make up for the pain from last year's Budget (when the supplementary charge on oil profits was increased from 20% to 32%).

Certainty on the tax treatment of decommissioning costs should help boost investment and M&A activity in the North Sea (particularly from smaller companies wishing to tap the remaining reserves in the more mature fields).

Tax relief

Under the current tax regime, losses incurred in decommissioning old oil and gas fields could be carried back three years. This contrasts with the "normal" position where losses can only be carried back one year. Because companies in the oil sector tend to have sufficient historic tax capacity to absorb losses, the effect of the carry-back is that the Government bears a portion (broadly, 50%) of the decommissioning costs.

The plan is for the Government to guarantee the relief regime through contract. Details of the precise nature of the contract have not been finalised – the Government will be consulting further on this in the coming months.

One possibility is a "one-way" deed, under which a future Government would be bound to pay "compensation" if it were to restrict or remove the tax relief. Another is a bilateral arrangement under which the Government would pay amounts equal to increased costs (where the tax relief is curbed or withdrawn) and the sector party would pay the Government amounts equal to increased savings (e.g. where the tax relief is enhanced) – this would have the effect of "locking in" not only the tax relief but also the current applicable tax rates (i.e. a "tax hedge").

Legal Issues

The concept of a contractual arrangement under which a sovereign state guarantees a particular tax regime is new for the UK but the concept has been used in other countries. It does raise a number of legal issues that need to be considered.

The Government's plan is to introduce legislation in 2013 to give it the necessary statutory authority to enter into the proposed arrangements. In the meantime, it will consult further on the proposals.

We would suggest that such consultation should address the following key legal issues:

- would a contractual arrangement be effective – i.e. would it work?
- could it be challenged and overturned?
- are there any State aid issues?

Looking at these issues in a little more detail:

Effectiveness

- who will be contracting on behalf of the oil sector – would it be the companies with interests in each relevant field or a representative entity?
- what will be "guaranteed" – i.e. which aspects exactly of the current tax regime will be preserved?
- how long will the arrangements be in place for?
- will the arrangements be enforceable in accordance with its terms?
- will the benefit of the arrangements be freely assignable?
- will either the Government or the industry have termination rights?

Challenge

- broadly, Parliament cannot do something that cannot be undone by a future Parliament – would a future Parliament be able to terminate or otherwise "override" the arrangements?
- might a judicial review of the contractual arrangement be brought arguing that the Government has fettered its (future) discretion? Although it seems unlikely that anyone in the industry would seek such a review, the risk that a pressure group may consider (and succeed in bringing) such a review cannot be dismissed.
- might the arrangement be criticised by the National Audit Office or the Public Accounts Committee?
- how would the arrangement work if Scottish devolution was to take place?

State aid

- the proposed arrangements may involve payments by the Government (albeit only in circumstances which the Government itself could in theory ensure would never arise). Nevertheless, because state resources may be involved, the question arises as to whether European state aid laws may apply and the extent to which these may impact on domestic fiscal sovereignty. Is there, for example, an argument that the arrangements selectively favour the oil sector?

Investment

One of the drivers behind the proposed arrangements is to encourage greater M&A activity in the North Sea. Any well-advised field purchaser would want to be assured on the issues outlined above and we suggest that these issues should be properly resolved during the consultation process.

Other Measures

The following were also announced in the Budget:

- in relation to field allowances: (a) a new allowance for particularly deep fields with sizeable reserves targeted at the West of Shetland, (b) extending the amount and scope of the allowances for small fields, (c) legislation to provide support for investment in brown fields and (d) continued consideration of potential changes to the existing allowance for high pressure high temperature fields;
- (as already announced on 06/12/2011) legislation to ensure that the supplementary charge applies to ring fence chargeable gains, and to confirm that the scope of the supplementary charge matches the scope of ring fence corporation tax; and
- (as already announced in Budget 2011) legislation restricting the rate of tax relief for decommissioning costs to 20% for supplementary charge purposes (this 20% will be the rate that will be "locked in" under the proposed contractual arrangements).

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Please contact Etienne Wong, David Lewis or Russell Wells if you would like to discuss any of the issues in more detail.

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