The Development of UK Oil Taxation Policy

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1. INTRODUCTION

This paper attempts to analyse the development of North Sea oil taxation since 1972-3. A complicated tax structure has evolved and the emphasis of the paper is on the reasons why the system has become so complex and why it has changed so frequently. The economic theories of politics and bureaucracies are applied to the changing tax system in order to provide some explanation of the rationale behind the changes. The extent of the changes is considerable. For example, Petroleum Revenue Tax (PRT) was introduced in 1975 at a rate of 45%. Since then, it has been increased to 60%, 70% and currently is 75%. A Supplementary Petroleum Duty (SPD) was introduced in 1981 and subsequently abolished in 1982, Advance PRT (APRT) was introduced in 1980 and is now being phased out, and the tax free oil allowance after being halved, is now restored to its original level for fields granted development consent after 1st April 1982. Many more changes in the tax system have been made. By highlighting the main pressures and influences on the governmental policy-process an understanding of the directions of likely pressures and the relative strength of these pressures may be acquired.

The first section of the paper concentrates on the 'First Report from the Committee of Public Accounts, Session 1972-3'[1] (hereafter the PAC Report). This influential document was highly critical of the existing tax system and one of its proposals was for the introduction of a specific oil tax. Following the publicity surrounding the publication of the 'PAC Report' and the world oil price increases of 1973-4, the Labour Government introduced the basic tax structure for the offshore oil industry in the 1975 Oil Taxation Act (OTA). The impact of the OTA is examined in the second section. The 1975 OTA is crucial to the analysis of this paper because it sets down the original taxation framework in the light of which all the later proposals and recommendations occur.

The third section is concerned with the present Conservative Government's record as regards oil taxation. This has been characterized by numerous modificaitons and amendments to the system.

The final section attempts to summarize these effects and draws attention to the uncertainties and inefficiencies created by a constantly changing tax régime.

2. THE PAC REPORT

Two factors in the early 1970's combined to make North Sea oil a major political issue. The discovery of sizeable oil reserves on the UKCS from 1970 onwards and the fourfold increase in the world price of oil in the winter of 1973-4 necessitated the formulation of comprehensive domestic oil policies by all the major political parties. Both these factors were necessary conditions for the politicization of North Sea oil to a degree where it became a major political issue. If sizeable oil reserves had been discovered and world oil prices had not risen as they did in 1973-4, or if oil had been found in significantly smaller quantities and the world price of oil had increase substantially, then in both cases it is unlikely that political parties would have considered North Sea oil a sensitive vote-capturing area.

Prior to 1973, concern with the tax system[2] was focused on the practical functioning of Corporation Tax and Royalties. In the 1960's and the early 1970's governments in the UK were keen to create an attractive environment which would encourage foreign oil companies to commit resources to the UK sector of the North Sea. In the early 1970's once significant reserves had been found the 'rapid exploitation'[3] policy remained. Governments were still attempting to encourage oil companies to invest in the North Sea and were reluctant to impose conditions which might firstly act as a disincentive to the companies and secondly, might lead to OPEC

retaliation in some form. The PAC Report found these considerations to be exaggerated in their importance.[4]

The system of taxation was strongly criticized in the PAC Report on the basis that Corporation Tax, as it functioned, had many loopholes and anomalies which could result in future tax revenues from the North Sea being unacceptably low. The Committee of Public Accounts maintained that, compared to other oil producing countries, the taxes imposed by the UK Government were low and company profits would be higher than elsewhere.[5]

The PAC Report noted[6] that tax losses (of around £1.5 billion for the nine major companies) had so far accrued and losses could continue indefinitely. This loss to the UK Exchequer had resulted chiefly from two factors. Firstly, oil companies in the Middle East used a posted price for tax calculations and this price had become greater than the market price. Because oil companies used the posted price as a transfer price, the companies' profits on oil production tended to be inflated, whilst profits from their downstream activities in oil consuming countries were correspondingly understated. Trading losses thus accumulated in the UK and the Exchequer did not receive tax revenues from profits of production companies where the profits were offset against the payment of tax abroad.[7]

Further criticism of the tax system was that a company operating and making profits in the North Sea could offset these profits against its other activities outside the North Sea.[8] The PAC maintain in their Report that these 'artificial tax losses'[9] arising out of loopholes in the system were unacceptable in terms of the direct revenue lost to the Exchequer and also in terms of the harmful effect on the balance of payments.[10]

In their recommendations, the PAC advocated that considerable changes be made to the existing tax system in order to 'substantially improve the effective tax yield from operations on the Continental Shelf'.[11] The PAC recommended that changes be made which would prohibit UKCS monies being pre-empted by taxes elsewhere; by controlling capital allowances for Corporation Tax or North Sea income from a spending outside the North Sea.[12] A further and very significant suggestion made by the PAC was for the introduction of a specific oil tax 'the Government ... will consider among other methods the possibility of imposing a system of quantity taxation, e.g. a barrelage tax'.[13]

Evidence received by the PAC highlighted fundamental shortcomings of the system of government control. Witnesses from the Department of Trade and Industry (DTI) maintained that under the existing taxation régime substantial revenue would accrue to the Government.[14] At the same time, the Inland Revenue estimated that the revenue likely to accrue to the Government up to 1980 would be, due to the method of transfer pricing and capital allowances, significantly less than the DTI estimates, and would probably be negligible.[15] Discrepancies such as this illustrate a lack of communication between government departments which inevitably detracts from the efficient functioning of government. Theories of bureaucracies suggest that bureaucrats in government departments may withhold information from politicians, or select the information to be passed to politicians, in order to protect their positions and power in government.

However, with different government departments performing overlapping functions, the departments may tend to withhold information from each other in order to maintain their exclusive, and therefore crucial, expertise. Thus planning decisions may be made by departments with imperfect knowledge or with inaccurate information. On this basis, senior Civil Servants advise and inform Ministers and political decision-makers. The PAC noted

that the DTI lacked information (specifically with respect to costs)[16] but this is a criticism not so much of a lack of communication between departments as of a lack of co-operation between government departments and offshore industry.

The PAC Report itself was criticized by the industry[17] because no industry witnesses were invited to submit evidence to the Committee. It has been argued[18] that had the industry been invited to present evidence to the Committee it would have been able to contest the Inland Revenue evidence and would also have outlined important North Sea cost expectations.[19]

The recommendations of the PAC implied considerable criticism of the government departments responsible for the North Sea oil tax system. Nevertheless, the types of changes favoured by the PAC would have been broadly consistent with government bureaucrats' ambitions. Extensive modification to the existing tax system as well as the introduction of an oil tax would mean an expansion of departmental work and responsibility. The PAC Report did seem to have an impact on the policy-process;[20] however world oil price increases during the winter of 1973-4 pre-empted any government action based on the PAC Report. The concern was not so much with the technical functioning of Corporation Tax on which the PAC Report concentrated. In 1974 the vote-maximizing potential of North Sea policy as a major political issue became the priority consideration of the government.

This change of emphasis can be analysed within the framework of the theory of bureaucracies and the economics of politics. Government bureaucrats in the Treasury and the Inland Revenue attempt, within certain constraints, to maximize taxation from any specific industry. It is possible that the bureaucracy's desire for taxation revenue, in order to expand its budget size, is greater than the politicians' desire for a specific sum to be raised to meet specific expenditure plans. Whilst the politician

attempts to extract revenue in order to finance certain economic and financial projects, the bureau may be simply attempting to maximize taxation revenue constrained only by what it is practically able to extract.[21] This distinction becomes less important in times when politicians' economic policies enforce the raising of considerable sums by the Government; both political and bureaucratic ambitions would then tend to coincide. Prior to the 1973-4 price increases the amount of potential taxation revenue that could be captured from the offshore oil industry, within political and economic constraints, was not being reached.[22]

The term 'taxable capacity' refers here to that amount of taxation revenue the government could appropriate from a given industry or sector. The 'taxable capacity' of an industry is determined by various political and economic factors and the perception of these factors by the voting public and by politicians and bureaucrats. Thus prior to 1973-4, the 'taxable capacity' of the offshore oil industry, as perceived by the PAC, was approximately determined by the taxation paid by oil companies in other oil poducing regions.[23] This amount was not expected to be captured by the existing taxation system. The PAC proposals were designed to ensure that the tax take was approximately equal to the oil industry's 'taxable capacity'.

The world oil price increases of 1973-4 had the effect of increasing the 'taxable capacity' of the offshore oil industry. The electorate's perception of the world oil market was such that the government believed it could increase its oil tax revenue without losing votes. Oil companies operating in the North Sea were expected to earn 'windfall' profits, UKCS oil became strategically important as a secure source of supplies to the domestic economy and political parties found it necessary to develop comprehensive oil policies. The popular attitude towards oil companies operating in the North Sea was generally unsympathetic and the government was under considerable political pressure to ensure that it had close control of oil company

activities and wanted to be seen to be in control by taxing any 'windfall' gains.

3. THE 1975 OIL TAXATION ACT

Thus the 1974 Labour Government was keen to act swiftly with regards the oil taxation system. The Government's White Paper[24] presented to Parliament in July 1974 outlined the Government's overall intentions with respect to North Sea oil policy. The government intended to take measures in order to 'secure a fairer share of profits for the nation' and to 'assert greater public control'.[25] The taxation proposals fell into two categories. Firstly, the White Paper outlined technical changes to Corporation Tax so that loopholes highlighted by the PAC Report would be closed. Artificial losses arising out of the multi-national oil companies' transfer pricing policies would be eliminated and a ring fence would be constructed in order that 'receipts from the North Sea should not be at the mercy of allowances and losses resulting from extraneous activities'.[26]

Secondly, the White Paper proposed 'an additional tax on the companies' profits from the Continental Shelf'.[27] This was intended as a specific tax on companies operating on the UKCS designed to recapture economic rent transferred to the oil companies via the discretionary licensing system. The government's intentions towards North Sea oil as stated in the 1974 White Paper were to control North Sea activities and to increase the Government's tax take. In the context of the economic theory of politics, the proposed oil tax was one important aspect of an overall oil policy, the development of which had, by 1974, become a priority government objective.

In November 1974, an Oil Taxation Bill (OTB) was published which outlined the new oil tax, the Petroleum Revenue Tax (PRT) as it was originally conceived. Although both the 1974 White Paper and

the 1974 OTB contained many of the recommendations of the 1973 PAC Report, the PAC's tentative suggestion of a barrelage tax was not considered viable. A barrelage tax, a tax similar to the 12½% production royalty, on the quantity of oil produced, was thought to be detrimental to marginal (low profit) fields as it would not take account of costs. Fears from the oil industry concerning some form of quantity tax were that since it was unrelated to profits the government would increase the tax if profits were to rise, whilst the reverse would not hold.[28] However, PRT did have elements of a barrelage tax in the sense that it was imposed on production revenues.[29]

The form PRT took in the OTB was different from that made law in the subsequent 1975 Oil Taxation Act (OTA). As stated above, the government's overwhelming priority with respect to the North Sea oil tax system was essentially political. The government needed to be publicly seen to be taxing the 'uncovenanted'[30] profits of multinational oil companies operating in the North Sea. During the report stage of the 1975 OTA negotiations took place between the government and the oil industry. In response to oil industry disquiet many changes were made to the 1974 OTB before it became an Act. The success of the oil industry, as a pressure group within the policy process, was at least partly a consequence of the uncertainties present in the offshore oil industry (for example, with respect to price and cost expectations and production estimates). The industry, in possession of expertise and information not available to the government, was in a relatively strong bargaining position.[31] However, the Government was very keen to pass an Act in order to maximize the vote-catching potential of offshore oil. This, to an extent, explains the haste (because the modified proposals concerning an oil allowance and an annual limit on tax payable, did not function as expected)[32] in which the modifications to the OTB took place.[33] The OTB was published on 19th November 1974 and on 25th February

1975 Mr Edmund Dell, then Paymaster General, announced various modifications.

The structure of PRT as a flat rate tax remained in the OTA. Because the taxable unit was the field rather than the company, it was not possible for an oil company to offset costs of an unattractive field against profits made on a more successful field.[34] It was ostensibly the disincentive effect on marginal fields[35] of the originally proposed system to which oil companies were chiefly opposed. During discussions with the companies the government introduced various changes to the tax system designed to diminish any disincentive effects of its original proposals. The modifications outlined by the Paymaster-General[36] fall into two categories of discretionary and non-discretionary provisions.

Firstly, the discretionary provision granted the Secretary of State for Energy, with the consent of Treasury officials, power to 'defer, waive or refund royalties in the whole or in part'.[37] Any refund would be exempt from Corporation Tax and PRT. The non-discretionary provisions included increasing the 'uplift' on capital expenditure for tax purposes from 50% to 75%, the introduction of an Oil Allowance and the introduction of a tapering or safeguard provision to limit PRT payments. The 75% Uplift was designed to 'give the industry a further element of front-end loading that is free of PRT'[38]. Postponing the payment of PRT has a significant effect on development, since due to the discounting of cash flows, the early years of a field's life are very important in determining the commercial viability of that field.[39] The Oil Allowance was for half a million long tons of oil per six monthly period free of PRT, subject to a cumulative total of 10 million long tons per field. Although this allowance was designed to benefit marginal fields it applied to all fields. The intention was to benefit smaller fields more than proportionately[40] but with a production period so short that the cumulative total of 10 million long tons was not reached (once the

75% Uplift had been recovered) the benefit to some smaller fields might not be as significant as originally perceived.[41] The government seemed, mistakenly, to be equating small fields with low profit fields. The Safeguard provision provided a limit on PRT chargeable and the Tapering provision was to ensure that the PRT payment did not exceed a proportion of capital expenditure. Together, the Tapering and Safeguard provisions (generally accepted as one measure) limited the payment of PRT in any calender year to 80% of annual net revenue minus 30% of cumulative capital expenditure. If this was more than the PRT calculated in the normal way then the Tapering and Safeguard limit did not apply. PRT was introduced at a 45% rate in February 1975.

In addition, included in the OTA was a restriction on Corporation Tax. A 'ring-fence' around a company's North Sea operations was constructed. As explained above, the object of this measure was to ensure that Corporation Tax payable on profits from North Sea oil production would not be diminished or deferred by losses in other areas of a company's activities. The second proposal concerning Corporation Tax changes outlined in the 1974 White Paper, i.e. with respect to 'artificial' losses arising out of transfer pricing policies of multi-national oil companies, was also implemented in the OTA.[42]

The swift passage of the OTB through the House of Commons and the characteristics of the subsequent Act emphasized many of the main features of the economic theories of bureaucracies and politics. The political and economic framework of North Sea oil had changed significantly between 1972 and 1975. In 1973-4 the national political scene was uncertain and political parties were keen to identify political issues which were high in the public consciousness; North Sea oil was thus an obvious target. As with depletion policy, there was a high degree of consensus as to the concept of PRT. PRT was an extremely complex system of taxation. It would be implemented by the Inland Revenue and overseen by the

Treasury. Government officers in these departments, as with those in the Department of Energy, would be, ceteris paribus, in favour of a complex system as their expertise and understanding would be vital to their policy decision-making superiors. These government bureaucrats would expand their powers by developing a politically important and growing function. Furthermore, their positions would be protected by their possession of information and expertise about the tax system which makes their bargaining position stronger relative to the politicians' position. Independent commentators and academics would also have difficulty in examining the system and providing a check because of its complexity and the imbalances of information.

Oil industry opposition to the OTB concentrated not on its complexity but on its stringency. This concern resulted in various amendments being incorporated in the OTB at committee stage. However, mainstream economic theory would predict that oil companies would prefer a simple, more straightforward tax régime in order that plans and forecasts could be made with greater certainty. This would apply at the most senior level in oil companies where policy decisions are taken and where simplicity would be advantageous. Similarly, within the Civil Service some senior bureaucrats may favour a simple tax system, for example to reduce uncertainty in overall economic planning. If the theories of bureaucracy are applied to the oil companies (and to their lobby organizations such as The United Kingdom Offshore Operators Association, UKOOA, and The Association of British Independent Oil Exploration Companies, BRINDEX) it becomes apparent that bureaucrats within oil companies are likely to favour a complex tax system for reasons similar to those of government bureaucrats. A complex and unstable tax system is in the common interest of tax experts in the Civil Service and in oil companies. Such complex tax systems may be manipulated by these tax experts to their advantage; moreover, such a system is good for employment and status. Hence, suggestions for capturing rent

by auctioning licences or for a simplified tax system are not well received by bureaucrats in government or in oil companies. In addition, officers within industry pressure groups attempt to justify their own positions, the existence of their organizations and their status within the industry. A complex tax system which is perpetually in a state of flux facilitates the fulfilment of these ambitions.

The Paymaster-General, Edmund Dell, maintained[43] that PRT would be reviewed and adjusted over time. Constant up-dates and reviews of policies are consistent with ambitions of tax experts in the government and also in industry. Since the bureaucrat is able to maintain his position and expand his budget over time. The speed at which the amendments to the OTB were introduced illustrates the desire of politicians to capture as much political advantage as possible from the OTA whilst North Sea oil was still at the forefront of popular awareness. It also clearly shows the unwillingness of government bureaucrats to abandon a 'bad' policy and instead to modify and amend the policy; again this is a predictable characteristic of bureaucratic behaviour.[44]

Agreement between the two major parties on the need for a comprehensive offshore tax system was enforced by official statements designed to assure the industry that the Government and the Opposition were concerned with the long term. The tax was intended to be 'a stable tax and not used as a short term regulator'.[45] This sentiment was echoed by the Opposition spokesman, Patrick Jenkin: "there is no intention here that this should be anything other than a stable tax, which will not be used for demand management purposes nor as a short term regulator".[46] In the context of the economics of politics these statements can be seen to be designed to capture votes. Both parties are perceived to give priority to long term stability and the Conservative Opposition is popularly seen to be placing the long term interests of the oil sector above party-politics by supporting the tax system.

Policy statements and proposals made in the mid-1970's can be examined in the context of the historical development of domestic oil policy. The techniques of the theories of bureaucracy and politics may be employed to understand and explain this development; here with respect to the offshore oil tax system, for example, in a Treasury Press Release,[47] Edmund Dell maintained that "the Government will stand ready to review and adjust the incidence of PRT in the event of a sustained and significant change in the price of oil in real terms". This, seemingly, would be interpreted to mean that if oil prices were to rise in real terms, PRT would be increased.[48] However, because of successive Government's desires to finance rising public expenditure there would be expected to be a 'ratchet effect' with regard to PRT changes. As oil prices rose in nominal terms, Governments have been prepared to increase the tax rate consistent with Mr Dell's statement. But when real oil prices fell (e.g. by 18% between 1975 and 1978)[49] the reverse did not happen. The 1983 oil tax changes were partly a response to a real price fall but the ratchet effect was still in existence as the tax reduction only partly compensated for lower oil price expectations.

A further example of the explanatory powers of the economics of politics and bureaucracies can be seen with respect to the discretionary safeguards included in the OTA. The Secretary of State for Energy has the discretionary power to refund all or part of the royalty payments made to the Government. Royalty revenues were to be made available to BNOC via the National Oil Account and it would be expected that both the Government and BNOC would object to the investment capabilities of BNOC being constrained by royalty refunds.[50] Whilst BNOC was funded by the National Oil Account, (prior to the privatization of its oil production and exploration functions) refunds of royalties to oil companies did not occur.

4. 1978 TO THE PRESENT DAY

The 1975 oil taxation package was constructed at a time, it has been argued,[51] when there were considerable uncertainties as to the future profitability of North Sea oil operations. By August 1978 the Government view[52] was that 'though many uncertainties remain we are in a position to take stock and it is apparent that companies are obtaining very large profits from the natural resources of the nation. We believe that the public share of these profits can and should be increased ...'. The Labour Government proposed three fundamental alterations to the offshore tax system.

Firstly, PRT would be raised from 45% to 60%; secondly, the Uplift on capital expenditure would be reduced from 75% to 35%, and thirdly, the oil allowance would be reduced from 1 million long tons per annum to ½ million tonnes per annum, (and the cumulative field total to 5 million tonnes).

These proposals were announced before the Iranian Revolution, before the Iranian oil workers strike in October 1978 and before the world oil price increases of 1979-80. Nevertheless, these proposals can in part be seen as defensive measures. The 1975 oil taxation package was implemented at a time when oil prices were expected to fall in real terms.[53] Thus it can be assumed that had oil prices in 1975 been expected to rise, or at least remain constant in real terms, the basic rate of PRT would have been higher than 45%. In 1978 it had become apparent that world oil prices, at least in nominal terms, were not going to decrease significantly as a long term trend and would probably increase as demand had started to increase after the initial post 1973-4 decreases. Thus in terms of the domestic oil industry's 'taxable capacity', in 1975 the Government had been mistaken in its oil price forecasts and was therefore not extracting revenue up to this capacity. In 1978 oil companies were seen to be obtaining large profits from their North Sea oil operations,[54] and with a

General Election imminent political parties were keen to maximize votes on clearly identifiable policy issues.

It is significant, in the context of the economics of politics, that the Conservative Opposition were in agreement (in August 1978) with the proposed tax changes.[55] It is difficult to predict how effective oil company opposition to these proposed changes would have been had the world oil price increases of 1979-80 not taken place. By the time the proposals had been included by the new Conservative Government in the 1979 Finance Act (in July), the spot price of the Saudi 'marker' was $33.13 per barrel (from $12.70 at the end of 1978) and oil prices were expected to increase further.[56] Thus the oil company bargaining position would have been relatively weak. Strong public antipathy towards multi-national oil companies would have enabled the new Conservative Administration to increase oil taxation revenue with little effective opposition from the oil industry.

There was also minimal intra-party opposition to these measures, at least partly reflecting the overall economic needs of the Government to increase its revenue. The North Sea oil tax system could be employed, within certain political and economic constraints, to increase Government revenue thus acting as a means to an end and also as an end in itself in maximizing votes on a major policy issue. The Iranian Revolution in 1979, the Gulf War in 1980 and the world oil price increases of 1979-80 resulted in North Sea oil becoming, as in 1973-4, a key political issue. Costs of information, because of constant media coverage, were low and individuals were relatively well informed. There would be popular pressure on the Government to act, which in this instance would be in line with the Government's existing plans for raising revenue.

Thus the tax changes made in July 1979 (which also included a change in licensing regulations so that Royalty payments would be

accelerated) were not in direct response to the 1979 world oil price increases but in response to a change in oil price expectations which occurred between 1975 and 1978. That oil prices rose significantly in the first half of 1979 would have strengthened the resolve of the Government to increase the tax take. It would also have made the passage of the legislation through Parliament easier due to popular support and the weakening of the oil companies' ability to pressurize the Government into modifying, or introducing concessions into, their proposals. The desire of the Government to increase its oil tax take - in order to maximize votes by controlling the activities of multi-national oil companies and responding to the public perception of the effects of OPEC-inspired price increases - coincided with an enhanced ability to implement the policy due to the perception of oil company 'windfall' profits.

In March 1980 the Chancellor of the Exchequer announced[57] that PRT would be increased to 70% for the bi-annual chargeable period ending after 31st December 1979. In addition, advanced payment of PRT would be due in the first two months of each chargeable period. The Chancellor maintained that these changes were in response to the world price of oil increasing 'dramatically' in the previous year, a change which 'has greatly favoured the oil companies' and 'greatly strengthened the industry's cash position'.[58] Thus, in response to the perception of 'windfall' oil company profits, the Government increased the tax take.

In November 1980 the Chancellor announced his intention to introduce a further tax on UK offshore oil.[59] This new tax, the Supplementary Petroleum Duty (SPD), and other changes to PRT were formally introduced in the 1981 Finance Act in much the same form as they were originally proposed in November 1980. In announcing SPD, and thus subjecting North Sea oil companies to a four tier tax system, the Chancellor invited suggestions and proposals for

alternative tax systems which would leave the Government with a broadly similar tax take from offshore oil. SPD was to operate from January 1981 to June 1982 when the overall tax régime would be reviewed.

In his 1981 Budget, Sir Geoffrey Howe outlined the full changes to the North Sea tax system. SPD was set at 20% of gross revenues less an annual allowance of one million tonnes per field. The tax would be collected monthly thus having a severe impact on company cash flows[60] (and emphasizing the Government's desires for short-term revenue). Moreover, two changes to PRT were announced. Firstly, the 35% Uplift on capital expenditure was to be restricted to the period up to PRT payback 'when an operator's cumulative incomings from a field exceed his cumulative outgoings'[61] (and later extended to include outstanding APRT liability). Previously, this Uplift applied to capital expenditure whenever it was incurred. Secondly, with respect to the tapering and safeguard provisions, they were now only to apply from the commencement of production for a length of time equal to 1.5 times the period from the start of production until PRT payback.

Thus, against the background of the oil price increases of 1979-80, the Government considered it possible to increase its tax take from North Sea oil operations. The Chancellor's invitation for proposals for a completely new tax system strengthened expectations as to future changes in the system. The changes to the Uplift and the tapering and safeguard provisions were largely technical changes because of the possibility of tax relief on capital expenditure exceeding 100% thereby encouraging inefficient capital expenditure. With respect to the tapering provision, with an increased rate of PRT (in the previous Budget from 60% to 70%), more fields would have been pushed into the tapering limit, possibly enabling the companies to receive tax relief by increasing capital expenditure in any one year.

The main criticisms of these changes concerned SPD. Because SPD was based on gross revenues and was unrelated to profits, it was considered to affect high cost fields adversely.[62] UKOOA[63] considered that the net effect of these changes would cause serious cash flow problems to companies during the declining years of a field which could lead to premature abandonment. The tax changes were seen as being 'dominated by the need to procure extra revenue very quickly'[64] seemingly a view supported by the Government's subsequent willingness to abolish SPD. The Government, by the introduction of SPD, had exceeded the perceived 'taxable capacity' of the offshore oil industry. In response to the Chancellor's invitation for proposals for alternative tax systems both the oil industry (e.g. UKOOA[65] and BRINDEX[66]) and independent analysts (e.g. the Institute for Fiscal Studies) recommended the abolition of SPD. Concerted criticism of the overall tax system, and specifically of SPD, combined with a significant slowdown in development activity during 1981 (due in part to falling world oil prices) and resulted in further tax changes being announced in the 1982 Budget.

The strength of the industry's bargaining power by 1982 had increased relative to the Government's position. In the 1982 Budget, alterations to the tax system were announced and although 'the tax changes are no more than a tinkering within an unchanged tax structure'[68] the Government did abolish SPD and there was an estimated small reduction in lifetime tax payments.[69] The IFS proposals for a new tax system were found unacceptable by both Government and oil industry for reasons which seem explainable in terms of the economic theories of politics and bureaucracies. The IFS[70] proposed fundamental and large-scale changes to the oil tax system. A Petroleum Profits Tax (PPT) would replace the then existing four tier tax system and would be levied on a field by field basis with a 'ring-fence' around each field. 'PPT would be levied in three tiers, each related to successively higher rates

of return on investment'[71] and thus would be a progressive tax with fields having a higher rate of return bearing a higher average tax rate. To accept this new tax system Government bureaucrats would be implicitly admitting their original policy had been 'wrong'. A simplified tax system might result in a loss of jobs in both government and industry and thus would be opposed on this basis. Tax experts in government and in oil companies had accumulated skill in manipulating the existing system and a new, simple tax system could diminish their relative expertise and thus their relative power and job security. The introduction of a completely new system would also reflect on the sponsors of the existing system (i.e. the Government and the relevant Ministers) and could result in the danger of losing votes to a competing policy.

However, it has been shown[72] that the IFS proposals would have had, (and indeed, would still have) a considerable impact on the offshore extraction industry. A substantial increase in North Sea activity would be likely to follow the introduction of PPT and as PPT would reduce or eradicate many distortionary effects of the existing tax system the introduction of a simplified, stable system may have reduced the workload of tax bureaucrats for the analysis of any one field's economics but increased activity would result in more fields being analysed thus offsetting what would otherwise be a reduction in the size of the bureaucracy. Similarly, the expansion of workload and budget size associated with the introduction of PPT would seem to increase the job security, power and kudos of the bureaucrat. If this is the case, then the failure to introduce PPT in 1982 (given it satisfied certain government criteria such as it maintained early tax revenues and aggregate tax takes would be unchanged) was largely due to a failure by industry and government to appreciate fully the extent of the damage to North Sea economies caused by the existing system, and therefore the scale of the benefits associated with the IFS system. Furthermore, industry concern has

focused on attempts to assist marginal fields by reducing aggregate government tax revenues whereas the IFS proposals suggested no reduction in aggregate tax revenues was necessary in order to help the marginal projects. For the industry to have endorsed the IFS proposals it would have had to acknowledge that marginal field development could be encouraged without reducing aggregate tax revenues.[73]

The main proposals outlined in the 1982 Budget were that SPD be replaced by Advance PRT (APRT) and to compensate for the resultant lowering of Government take the rate of PRT was raised from 70% to 75%. APRT operates similarly to SPD in that it is a 20% tax on gross revenue with an oil allowance of one million tonnes each year. However, APRT is allowable against PRT; thus it does not affect the total amount of PRT paid but only the timing of the payments. Timing of payments is an important consideration to the Government and illustrates its strong preference for receiving tax monies as soon as possible. A further measure proposed in the 1982 Budget was that advance payments of PRT were replaced by a system of spreading PRT payments on a monthly basis.

Industry criticism was immediate and minor adjustments were made to the Budget proposals. The main criticism that APRT adversely affects early cash flow (reducing the attractiveness of all fields) and that it should therefore be abolished, was not accepted by the Treasury. The first concession, however, was that fields would only incur APRT for five years. Secondly, for a field where PRT is not paid because profits are not great enough, instead of APRT being refunded at the end of the field's life in a lump sum (which amounts to a long term interest free loan to the Treasury) the companies would be repaid after five years.

The major North Sea oil taxation changes announced in the 1983 Budget fell into two categories. Firstly, where development approval was granted after 1st April 1982 (except for onshore

fields and Southern Basin fields) royalty payments were to be abolished. In addition, the oil allowance was to be restored to its 1978 level of 1 million tonnes per year subject to a cumulative limit of 10 million tonnes per field. Secondly, applying to all fields, APRT was to be phased out over a period of four years and abolished after 31st December 1986. Also, PRT relief could be claimed immediately on all future exploration and appraisal expenditure (without waiting for the expenditure to be declared abortive) and restrictions on PRT relief for shared assets was to be eliminated. These proposed tax changes were met with 'surprise and jubilation among the oil companies'[74] and were specifically designed to stimulate exploration and development activity. The Government's perception of the oil industry's 'taxable capacity' had been exceeded and the Government acted to ensure that activity on the UKCS would continue into the 1990's at a level acceptable to the Government. The lack of orders for the UK oil supply industry added to the government's concern of losing votes. It is not until the mid-1990's when most of the new generation of oilfields are producing oil that there becomes a significant divergence between forecasted Government oil revenues on the pre- and post-1983 Budget tax system, and if new discoveries come on-stream in the 1990's because of the tax change this will offset reductions in Government tax revenues.[75] In the context of past oil tax changes the 1983 Budget was significant as it introduced a new type of structural change. By differentiating between fields under production or development (old fields) and projects granted development consent after 1st April 1982 (new fields), the Government set an important precedent and is now able to treat the North Sea tax régime as two distinct systems.

On the more mature, old fields, production is relatively insensitive to oil price changes. Thus in the future a fall in oil prices could result in increased tax rates on old fields. Whilst for new fields, whose development is sensitive to oil price, the tax system could remain unchanged. If oil prices

strengthen and increase during the next decade the Government might consider that it is not extracting revenues to the 'taxable capacity' of the oil industry. Thus it would be expected that in the 1990's the Government may increase its take from the new fields.[76] The dual tax structure gives the Government further flexibility of taxation policy, a factor consistent with tax specialists' ambitions both in government and in the oil industry. However, uncertainty concerning future tax changes (most importantly in the medium and long term) is unlikely to have diminished as a result of the 1983 Budget.

Even after the substantial and well-received, (at last by the oil industry) changes of 1983, tax stability was not achieved. Further changes were announced in the 1984 Budget. CT was to be reduced over a period of time from 52% to 35% and the CT first year capital allowance reduced from 100% to 25% by 1986.

5. A CHANGING TAX SYSTEM

The encouragement to development which the Chancellor hoped to bring about by the 1982 tax package did not occur. Oil companies' strategic bargaining in response to the tax system may partly explain the well publicized development delays such as the Tern Field[77] (by Shell and Esso). This illustrates the possibility of tactical behaviour which may result in non-optimal allocation of resources over time. Oil industry pressure, in the form of lobbying and tactical bargaining, was a significant factor in bringing about the 1983 Budget tax changes which gave an immediate and considerable boost to North Sea activity.

Oil companies now expect tax changes which alter the economics of a project after the investment decision has taken place. The constantly changing tax system adds considerably to the uncertainties surrounding offshore oil. However, the Government believes it is important to have a degree of flexibility in its

tax policy in order to be able to respond to unforeseen shocks. Flexibility may be achieved through changes in rate of taxation or changes in various concessions and allowances but constant changes in the structure of the tax system have been seen to result in instability and arbitrary effects[78] on oilfield projects.

It may be the case, based on rational expectations with respect to a changing tax system, that fields may not be developed or development may be postponed. If the tax system is expected at some time in the future to become much more onerous then oil companies may attempt to pre-empt an increase in the tax system by postponing or abandoning development plans. In addition, expectations of tax increases will also give an incentive to accelerate depletion of fields already in production in order to produce as much as possible while tax rates are relatively low.

The tax régime in the North Sea has been changed many times since 1975. The considerable instability of the system reflects its unsuitability as an oil tax. A simple tax system would be advantageous to industry (and Government) planners and it would also facilitate independent monitoring of the system. However, a policy which is complex and is frequently amended is generally favoured by some bureaucrats within the Government, within oil company pressure groups and by certain tax experts within oil companies. Decision-makers in oil companies in many circumstances may favour simplicity and stability and some bureaucrats in Government (e.g. in the Department of Energy's Oil Division) may also be averse to an unstable system. However, the theories of bureaucracies suggest that in the policy process bureaucrats have numerous methods by which they can protect and further their interests. The relative power of bureaucrats whose self-interest is fulfilled by an unstable, complex system evidently outweighs that of the bureaucrats who may favour stability and simplicity.

Government bureaucrats' ability to influence the development of

the oil tax system has been greater than with regards other policy issues because the bureaucrats' ambitions have been broadly consistent with those of the politicians in government. Whilst the politicians are concerned with the taxation system as part of North Sea oil policy and with the effects of that policy, the concern of Government bureaucrats (e.g. in the Treasury, Inland Revenue and some parts of the Department of Energy) seems overwhelmingly for the taxation package per se.

Bureaucrats specializing in oil taxation are likely to maximize their utility functions by acquiring characteristics of oil tax policy associated with the structure and implementation of the oil tax. Thus for these bureaucrats taxation of North Sea oil is an end in itself rather than a means towards an end.

The Government's desire to obtain short-term revenue as part of its broader economic objectives is a further reason for the annual changes to the tax system since 1978. These constant changes tend to distort the link between prices and the development of North Sea oil resources. If oil companies assume that as oil prices rise, even in nominal terms, the tax rate will increase, this can act as a disincentive to investment. Oil companies consider the possibilities of future losses due to oil prices falling against future gains due to oil prices rising. If the companies expect profits resulting from oil price increases to be negated by an increased tax rate this leaves only the possibility of losses if prices fall. This acts against the desirable economic effects of a price rise, i.e. that as oil prices rise, producers are encouraged to develop more costly fields.

In response to world oil price increases the Government has been seen to be taking action over a 'national asset' and at the same time has been seen to be controlling multi-national oil company activities in the North Sea. The 1981 tax changes apparently over-shot the industry's 'taxable capacity'. In 1981 the trend in

world oil prices was downward, North Sea activity had slowed down considerably and industry opposition to the tax system was at its most vociferous. The overall effect of the 1982 Budget changes was to lessen the tax burden somewhat[79] but this did little to stimulate activity. Thus the 1983 Budget changes may be viewed in the context of activity in the North Sea and in oil related industries being unacceptably sluggish. Considerable concessions applicable to 'new' projects announced in March 1983 had the desired effect of stimulating exploration and development activity (e.g. Shell's announcement of plans to spend £800 million a year to 1990)[80] and boosted industry confidence. The economic theories of politics and bureaucracy would suggest, however, that when these 'new' fields commence production the Government may tighten the fiscal régime considerably.

Once the 'new' fields produce oil, capital expenditure will be largely sunk, putting oil companies in a relatively weak bargaining position as compared to the Government. Furthermore, it is likely that by the 1990s oil production will be in decline and the Government may attempt to moderate the pace of decline; for instance by making changes to the tax system. Indeed, this may lead to a third category of oil taxation. A new, lenient tax system for fields then (in the 1990s) about to be developed, a harsh system for fields commencing production ('new' fields in 1984), and another lenient system for mature, 'old' fields nearing exhaustion in order to lengthen their production tail.

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