HM Treasury

Fiscal reform of the UK Continental Shelf:

response to the consultation on an investment allowance

March 2015

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Foreword

It is vital that we have a North Sea fiscal regime which is fit for purpose for the long term, over the remaining life of the basin. Even before the weakening of the oil prices in the second half of 2014 we had recognised the importance of adapting the fiscal regime for a maturing basin. This is why at Autumn Statement we announced a comprehensive plan for radical reform setting out long-term principles and specific actions for the future to ensure a more competitive, simple and predictable fiscal regime.

These proposals were welcomed by industry, with particular support for the proposed basin-wide investment allowance. You asked us to prioritise this measure and we have delivered, fast-tracking consultation and the design process to ensure that we were able to introduce this measure at Budget 2015.

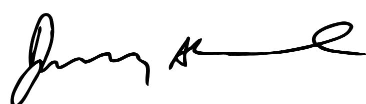
Building on the success of the field allowances we introduced, which have incentivised over £14 billion of new investment over the last two years, the investment allowance greatly simplifies the regime and provides certainty of the tax treatment of new prospects far earlier in the investment lifecycle than the suite of 7 offshore allowances it replaces.

The Office for Budget Responsibility expect that the package of measures we have announced at Budget 2015 will encourage over £4 billion of additional investment within five years, leading to oil production in 2019 15% higher than it would have otherwise been, sustaining the valuable companies and workers who add so much to the UK economy.

The rapid implementation of this allowance along with the further bold and immediate action we have taken at Budget 2015 will demonstrate to the international investing community that the UK Continental Shelf is a great place to do business.

We have taken this action to secure the future of the industry, but the changes required for the industry are not solely in government hands. There are many challenges for industry to address and the government expects to see significant improvements in production operations, cost-efficiency and commercial practices in line with the objective of maximising economic recovery and in the spirit of the tripartite approach between government, industry and the OGA.

We thank respondents for their engagement in the investment allowance consultation, without which we would not have been able to introduce the allowance so quickly. Due to the rapid turnaround between the consultation and Finance Bill 2015 we were not able to address every point raised through the consultation in the legislation being introduced now. However, this document sets out our policy intent for future legislation. We look forward to continuing the dialogue with the industry and the new Oil and Gas Authority as we seek to address these further issues, working together to ensure that we have the best fiscal and regulatory regime possible to secure the future of the UKCS.



Rt Hon Danny Alexander MP
Chief Secretary to the Treasury

Priti Patel MP
Exchequer Secretary to the Treasury

1 Introduction

1.1 The government is committed to the future of the North Sea and the role it provides in supporting hundreds of thousands of jobs, supplying a large portion of the UK's primary energy needs and making a significant contribution to UK GDP. The government believes that the UK Continental Shelf (UKCS) is at a key point in its life and that ensuring continued production from our nation's valuable resources will protect critical existing infrastructure and encourage work to bring about further economic discoveries. Sir Ian Wood, who led an independent review of the UK offshore oil and gas recovery and its regulation in 2013-2014, has been clear regarding the importance of the fiscal regime, a vital component to ensure maximising economic recovery.

1.2 The oil and gas industry is the largest industrial investor in the UK. The government is particularly keen to support those companies that are actively investing. Over recent years, the government has introduced a suite of field allowances to enable more marginal projects to go ahead. These have been very successful at driving additional investment, but have added complexity and may have led to distortions in the regime.

1.3 The government undertook a review of the oil and gas fiscal regime in 2014. Its conclusions, and a plan for the long-term future of the regime, were set out at Autumn Statement 2014. With a significant majority of both new field approvals and incremental investments of recent years benefitting from an allowance, government decided that there was a strong case for applying a more comprehensive allowance across the basin.

1.4 Stakeholders were clear that their priority in respect of the Autumn Statement 2014 announcements was this investment allowance. Following discussions with the industry immediately after Autumn Statement 2014, government took the decision to advance a consultation on this measure, in order to enable implementation of the investment allowance at Budget 2015.[1]

Consultation process

1.5 This document summarises the responses received during the consultation carried out by the government between 22 January 2015 and 23 February 2015. It also sets out the government's responses, the outcomes of the consultation and next steps.

1.6 The government is grateful to all respondents who took the time to provide comments on the proposals. Responses were received from oil and gas companies, devolved administration, academic contributors, representative bodies and professional services firms. The government received 55 responses; each respondent is listed in Annex A. As part of the consultation process, the government also held several working groups with companies and tax professionals to discuss the details of the proposals. The discussions in these meetings have been reflected in this response.

1.7 Having considered all responses, the government announced at Budget 2015 the introduction of the investment allowance for qualifying expenditure incurred on or after 1 April 2015. Due to the speed of implementation, with the agreement of industry, government have delivered a simple mechanism encompassing the core principles of the allowance. This core measure will need to be refined as time allows.

[1] https://www.gov.uk/government/consultations/fiscal-reform-of-the-uk-continental-shelf-consultation-on-an-investment-allowance

2 The investment allowance

2.1 At Autumn Statement 2014, the government introduced a capital expenditure-linked allowance for projects of a high pressure high temperature nature, which is being legislated for within Finance Bill 2015. This initiative, and the mechanism used to effect it, were welcomed by industry. The government is proposing that a similar capital expenditure-linked allowance, the investment allowance, be introduced across the basin. This approach will give greater support to challenging projects and reward investment at all stages of the industry lifecycle.

Objectives

2.2 Moving a further step away from allowances based on physical characteristics of a field, the new allowance will also ensure greater certainty on future tax treatment and simplify the regime. As set out in the consultation document, the government will adopt an approach that:

- rewards investment, providing certainty on eligibility at an early enough phase in the investment cycle in order to influence long-term investment decisions
- enhances the case for investment in the basin, and specifically supports the development of near-field and brown field projects
- rewards successful exploration and appraisal – to give companies an incentive to think further than existing fields to nearby discoveries and prospects, consistent with maximising economic recovery principles
- is flexible enough to respond automatically to changes in investment costs
- uses existing mechanisms for delivering relief as far as possible
- simplifies the existing regime
- ensures a fair return for the nation, taking into account the guiding principles in the government's 'Driving investment' paper published in December 2014,[1] and
- ensures that the measure is not open to abuse and is affordable

The investment allowance

2.3 As set out in the consultation document, the investment allowance would operate similarly to existing field allowances, by exempting a portion of a company's profits from the supplementary charge – reducing the effective tax rate on that portion from 50% to 30% at current tax rates.

2.4 The amount of profits exempt from the supplementary charge would be based on a proportion of the qualifying expenditure a company incurred in relation to a field. In the consultation document the government proposed that qualifying expenditure would include capital expenditure (excluding decommissioning costs). The government also stated that it would welcome evidence to support the consideration of additional types of spend to the extent respondents were of the opinion that there were key investment activities which fall outside of capital expenditure.

[1] https://www.gov.uk/government/consultations/review-of-the-oil-and-gas-fiscal-regime-a-call-for-evidence

2.5 The government proposed that qualifying expenditure for the purpose of the investment allowance would not include any expenditure qualifying under the cluster area allowance or onshore allowance but that these allowances would continue to operate in parallel to the investment allowance.

2.6 Companies would start to generate and hold the allowance as soon as they incurred qualifying expenditure. Generation of the allowance would not be dependent on receiving field development plan approval from the Oil and Gas Authority (OGA) or the Department of Energy and Climate Change (DECC).

2.7 Costs incurred prior to the effective date would not contribute to the generation of the allowance. A key aim of the measure is to incentivise prospective investment rather than compensate historical spend.

2.8 The government had originally proposed that the amount of investment allowance activated (i.e. made available to set off against profits) in any accounting period would be no more than the amount of the company's share of production and tariff income from the asset (field or infrastructure) in connection with which it incurred the expenditure. Providing a direct link between the qualifying expenditure and the revenues derived from those investment activities was a key design feature and necessary to reward behaviours and decisions that led to success.

2.9 The government did not propose to allow companies to transfer generated allowance between different fields (or other areas determined by the OGA).

2.10 As with the onshore and cluster area allowances, the government did not propose introducing a 5-year minimum activation period, which was a feature of other field allowances. This will enable companies to benefit from the allowance sooner after incurring qualifying expenditure, rewarding that investment in a more direct manner.

2.11 The government proposed that the allowance, when activated, would be available to be used against all of a company's adjusted ring fence profits. It would not be restricted to set off against profits from the field in which the expenditure was incurred.

2.12 Any activated allowance not used to reduce the Supplementary Charge otherwise payable by a company in a particular accounting period would be carried forward within that company and available for use in the next accounting period.

Question 1: Would the proposed approach achieve the government's objectives set out in paragraph 3.4 (of the consultation document, replicated at paragraph 2.2 in this response)?

2.13 Respondents welcomed the proposed approach and the majority confirmed that it would meet all the objectives set out in the consultation document. In particular they identified the simplification and scalability as key factors for the measure to be a success. Many thought that the proposed approach would be preferable to existing allowances (especially compared to the brown field allowance), bringing earlier certainty and simplicity to the tax treatment of their projects.

2.14 Respondents believed that in order to best fulfil the stated objectives an early effective date should be implemented.

2.15 Some respondents felt that moving to a capital linked general allowance would greatly encourage new entrants who would not have to depend on actively seeking access to an existing or new specific allowance for their prospect.

2.16 Removal of the difference in treatment between existing and new fields was cited by many as a positive feature, encouraging good asset stewardship. Conversely, some expressed concern that it would remove the incentive to develop particularly small fields which the current level of support afforded through the small field allowance would have made commercial. Others stated that the changes would favour investment in non-Petroleum Revenue Tax (PRT) fields as opposed to PRT fields and that this could potentially distort investment choices important for the future of the UKCS.

Box 2.A: Government response in respect of question 1

- **The investment allowance will be introduced in Finance Bill 2015 with effect for qualifying expenditure incurred on or after 1 April 2015.**
- The government welcomes industry's support for its objectives and confirmation that the overall structure of the proposed approach helps to achieve these objectives.
- The government agrees with respondents that the proposition would be an improvement on the current suite of field allowances and particularly the brown field allowance, removing some of the uncertainty and making the allowance easier to benefit from, from a practical perspective.
- The government acknowledges representations regarding the application of the investment allowance to particularly small, "capex light" fields. The government believes that the level of support which the investment allowance would provide to these accumulations is appropriate. Further changes to the fiscal regime announced at Budget 2015 will make both non-PRT and PRT prospects more attractive.
- **Specific concerns in respect of fields approaching, but which have not yet reached, Field Development Plan (FDP) approval will be dealt with through revised transitional arrangements.**

Question 2: Are there alternatives or variations to the proposed approach that would better meet the government's objectives?

Mechanism

2.17 Although most respondents strongly welcomed the capital base of the allowance some felt that this would lead to inefficient behaviour with the company incentivised to enter into "capital heavy" arrangements. Some suggested that a cap be introduced for the allowance at the point of FDP approval based on anticipated spend. They believed that this would prevent wastage and allow government to verify the quantum of claims and how reasonable the work proposed to be carried out was.

Exploration

2.18 Many respondents did not think that the proposition went far enough in respect of exploration. The benefit of the allowance on successful exploration and appraisal would potentially be significantly discounted depending on companies' tax profiles and the expected production profile of the relevant asset. It was observed that the allowance did not offer any de-risking of projects ending in technical failure. To encourage and de-risk the downside of exploration, several respondents believed that the allowance should be generated on all exploration and appraisal and be available for activation at the company, rather than field income level (immediately or after 3 years).

2.19 Suggestions to broaden exploration scope included that all activities within 5km of the boundary of a determined field be brought within the scope of the allowance. Some felt that a better way to help exploration would be to survey frontier areas and make this information freely available to potential licensees.

2.20 An alternative suggestion was for a cluster type arrangement to be introduced to allow allowance generated from qualifying expenditure to be activated by income at the wider cluster level.

Interaction between field type and investment allowance available

2.21 Many companies felt that particular small fields, including single well tie-backs, would have access to a lower amount of allowance under the investment allowance compared to the current small field allowance of £150 million. Suggestions to remedy this potential issue included providing a floor for the allowance of £150 million for every new field, or for an enhanced rate of allowance to be applied to small / challenging fields.

2.22 Some respondents suggested that larger fields required greater support in order to achieve the same absolute benefit to their expected rate of return. The suggestion was that an enhanced rate be available to larger fields.

Interaction between type of spend and Investment Allowance available

2.23 Some responses stated that the Investment Allowance should differentiate between the type of qualifying expenditure incurred and that spend which enhances recovery rate at the molecular level, or other technologically innovative work should attract an enhanced rate of allowance.

Group considerations

2.24 Under the proposal the utilisation of activated allowances was restricted to the company level (as with the existing field allowances), rather than on a consolidated group basis. Responses were received from many companies in respect of their existing group structures. Certain groups contain multiple companies each holding a single licence interest due to separate historical acquisition or the requirements of key financiers. It was noted that many are unable / unwilling to adapt their structure due to the need to retain access to tax history at the company level to obtain effective decommissioning tax relief. The suggestion to alleviate this issue was to allow companies to surrender activated allowances in a manner similar to group relief.

Interaction with decommissioning relief

2.25 Responses also included representations on the impact of decommissioning loss relief carry back. Where ring fence losses are carried back they may displace field allowances claimed and this would also be true for the investment allowance. Companies would be able to obtain effective and permanent relief were they able to generate a tax credit for the displaced allowances or if the legislation was changed to permit the carry back of decommissioning losses against notional Supplementary Charge profits post consideration of the allowances claimed.

Transactions

2.26 Respondents were unclear on how the proposition would operate in instances where all or part of a company's licence interest was disposed of. Suggestions included that the vendor be permitted to transfer unactivated allowance upon the sale of their licence.

2.27 Some felt that there should be flexibility in the amount of allowances which would transfer – similar to the purchase price allocation to plant and machinery per current transactions in

respect of assets qualifying for capital allowances. Some asked for the mechanism to be a transfer of allowance rather than a purchase price allocation so that the unactivated allowances transferred would not be limited to the size of the allocation.

2.28 Requests were also received that the infrastructure bought as part of a licence transaction should be capable of generating the allowance, particularly where the vendor requires the assets to be sold packaged with a licence interest.

Onshore and other fields

2.29 Some respondents were unclear on the applicability of the proposition to certain types of field including onshore and transboundary with another country. A suggestion was that these fields should receive the benefit of the allowance if they were not benefiting from any surviving allowances (e.g. the Cluster Area Allowance and Onshore Allowance).

Infrastructure

2.30 Some companies asked that the benefit of the investment allowance on infrastructure should flow to those taking the majority of the risk of that investment (see the section on question 9 for further discussion and the government response on this matter).

Box 2.B: Government response in respect of question 2

- The government believes that cost efficiency is critical to the future of the UKCS and will work closely with the OGA to deter inefficient practice or planning. The notion of a cap being placed on the allowance which could be generated from qualifying spend is at odds with the objective of rewarding investment and remaining flexible to changes in costs. It would also add significant administrative burden.
- The government accepts that there is a need to address the current lack of exploration activity. It believes that there are a number of approaches which could be taken. The support for a programme of seismic and geophysical surveys announced at Budget 2015 will facilitate the provision of good quality seismic information in under-explored areas.
- Inclusion of successful exploration spend attributable to a determined field is necessary to properly recognise the spend leading to that field's development. This has not been broadened to include any unsuccessful / wider exploration for Finance Bill 2015.
- The government will conduct further work in conjunction with the OGA on the need for and potential options for supporting exploration.
- One of the main objectives for the investment allowance was to simplify the system and remove potential distortions in respect of investment decisions. The government believes that introducing a range of rates and / or minimum "floors" in respect of certain types of fields or types of spend would detract from this, reintroducing the complexity which is often cited as a crucial barrier to entry under the existing regime.
- Technologically innovative work should fall under existing measures to encourage research and development.
- The government believes there is a case that limiting the use of activated allowance to the legal entity level could result in certain group structures benefiting to a greater extent than others. This issue is not isolated to the investment allowance, also applying to the cluster area and onshore allowances.
- The government agrees that it will be important for successors to retain access to the allowance on genuine investment expenditure incurred by their predecessor. **Legislation will be introduced in Finance Bill 2015 to require the transfer of unactivated allowances upon licence transactions. The relevant proportion (with reference to a company's change in field interest) of unactivated allowances will transfer in these transactions**. This approach is prescriptive in order to protect the Exchequer.
- **The government confirms that qualifying expenditure in respect of onshore fields which are not within the scope of the onshore allowance, and the UK portion of transboundary fields, will be within the scope of the investment allowance.**
- Infrastructure is dealt with in our response regarding questions 3 and 9.

Question 3: Is the definition of qualifying expenditure sufficiently clear and is the scope wide enough? Are there other types of expenditure which, if included, would help to meet the government's objectives? If so, please provide evidence to support your case.

2.31 The vast majority of respondents agreed that capital expenditure was a good foundation for qualifying expenditure, as the capital / revenue divide is a familiar concept for companies and stakeholders would have the benefit of a substantial body of case law which has helped outline the boundary between these.

2.32 Most respondents, in written and oral representation, requested a broader definition of qualifying expenditure to include discretionary, non-routine operating expenditure acting to increase or preserve production / recovery of hydrocarbons. A variety of purpose tests were proposed, many of which were similarly structured and, broadly, sought the inclusion of expenditure which acted to:

- Increase the amount of hydrocarbons expected to be won; or
- Increase the potential for earning tariff receipts; or
- Improve the rate at which oil can be won or transported to the United Kingdom or another country; or
- Prevent or materially reduce a decline in that rate; or
- Materially reduce recurring operating costs with a view to extending the economic life of an asset; or
- Defer decommissioning or
- Gather information to aid the ability to continue producing or drilling

2.33 Many respondents noted, although successful exploration and appraisal was included in the scope of the allowance proposed in the consultation document, that unsuccessful exploration would be outside the scope.

2.34 Some respondents were not clear on whether leases for major production and drilling assets were within scope of the allowance. A couple of respondents noted that they did not believe that payments in respect of leases for assets fulfilling a non-capital purpose would be included (such as floating hotels and potentially Floating Production, Storage and Offtake vessels). Several respondents noted that they would not want the allowance to differentiate between the lease of and purchase of assets.

2.35 A couple of respondents asked for a clearance process to be put in place to remove any element of doubt.

2.36 Some respondents suggested that too broad a definition would lead to ongoing maintenance costs being included. They explained that encouraging routine operational expenditure through the investment allowance would not provide value for money for the Exchequer.

Box 2.C: Government response in respect of question 3

- The government welcomes the fact that capital expenditure (as per the cluster area allowance) is seen as a good core principle for qualifying expenditure.
- **The government's ambition is to expand the scope of qualifying expenditure to include activities which aid maximising economic recovery** and has received good evidence on the types of expenditure and activity which would not typically be encompassed within capital, but which companies believe will need to be incentivised in order to maximise economic recovery.
- The government understands from evidence presented that the discretionary non-capital expenditure that industry are seeking to include will amount to around 5% of total expenditure.
- The government acknowledges the virtues of a general purpose test for additional types of spend and is mindful of the reduced administrative burden and simplicity of process in order to determine areas for inclusion.
- The government is also conscious that this presents a key risk to the Exchequer and that insufficiently robust legislation could expose this measure to exploitation. A broadly drafted purpose test could lead to the inadvertent inclusion of a wide-range of spend. Therefore, the **Finance Bill 2015 legislation will permit the Treasury to include additional spend by subsequent regulation through either a robustly drafted purpose test or through specific inclusion of certain additional activities. The government will prioritise this over the coming months.**
- The government expects that lease payments for assets serving a capital purpose should fall into qualifying expenditure. It expects that lease payments for assets serving a non-capital function would not be within qualifying expenditure but does not want to encourage an asset purchase business model over a leasing model so **will seek to include this expenditure through secondary legislation in 2015.**
- Given that discretionary expenditure is expected to be a relatively small proportion of a company's total expenditure and the generosity of a universal capital based allowance, government does not expect that temporary exclusion of this type of spend will adversely impact investment decisions, particularly in light of the broader package of measures announced at Budget 2015.
- A specific clearance process will not be introduced as the government believes that this would increase complexity, administrative burden and uncertainty until the point at which a decision is received.

Question 4: Will the allowance introduce any additional administrative burdens for businesses? If so, are there options the government could consider to reduce this burden?

Question 5: Do you agree that current arrangements to protect the Exchequer are sufficiently robust for the investment allowance? Do you think there are any additional measures that would be helpful in this regard?

2.37 The majority of respondents stated that there would not be any additional administrative burden.

2.38 Of those who identified potential additional administrative burdens (predominately the field by field tracking of qualifying expenditure and allowance), each stated that this would be manageable and proportionate to the benefit presented by moving to the investment allowance. Most explained that existing accounting systems should be able to deal with any new data requirements. Steps identified for government to take to minimise the burden would be:

- Publishing clear guidance on the process for agreeing material completion (see question 10) and boundaries of investment expenditure.
- Not introduce a clearance process which would create a delay and add further uncertainty prior to receipt of clearance.

2.39 Other areas where administrative burden could be heightened would be in determining and proving who the ultimate spending party is in respect of infrastructure and in cut-off analysis where the effective date falls part way through an accounting period.

2.40 All responding stakeholders agreed that the current legislative framework to protect the Exchequer is adequately robust. Many claimed that the burden of risk falls heaviest on the industry and even though the government shares an element of risk, the Exchequer is sufficiently protected.

2.41 One area of risk outlined by several respondents was in the definition of qualifying expenditure and whether this would lead the system open to abuse if there was too much room for flexible interpretation.

Box 2.D: Government response in respect of questions 4 and 5

- The government is keen to ensure that changes to the tax regime do not introduce any unnecessary or disproportionate administrative burdens. The government welcomes industry’s view that this allowance does not introduce such burdens.
- The government agrees with respondents that current arrangements to protect the Exchequer are sufficiently robust and acknowledges concerns regarding the potential inadvertent inclusion of routine operational expenditure. As such the necessary time will be taken to ensure that legislation can be put in place to prevent inclusion of spend which would be inconsistent with government’s policy objectives. As with other taxes, HM Revenue and Customs (HMRC) will continue to monitor this position as the industry develops and the allowance is used.

Level of allowance

2.42 The consultation document did not propose a specific proportion of capital expenditure that would set the level of the allowance.

2.43 In setting this rate, the government said that it would consider the objectives set out in paragraph 2.2 in particular the need to create a key driver of new investment and provide a simple but effective alternative to the current system of field allowances. Respondents were also asked to provide information on the economics of example projects (new, ongoing and brown field investments as well as exploration) within the proposed scope to inform the government's decision on the appropriate rate.

Question 6: Can you provide evidence on the potential economics of specific projects which would benefit from the allowance, particularly projects which are eligible for existing allowances? This could include (but is not limited to):

- the likely capital expenditure and operating expenditure profiles of project
- the likely production and production income profiles
- exploration and appraisal costs and the number of wells companies plan to drill
- whether you factor exploration and appraisal risk into your economics and, if so, how; and
- whether you expect to have other ring fence profits over the next 5 years, if you plan to invest over that timeframe

2.44 Many companies included evidential data, graphs and tables demonstrating the economics of specific projects. Key conclusions from these were:

- Many examples were provided of projects not expected to occur under the existing fiscal regime (with and without expected access to field allowances) which would take place if an investment allowance was brought in at a rate of between 62.5% and 75%.
- Brownfield projects were particularly evident in this population including tens of potential development wells in respect of reserves which would be "stranded" under the existing regime.
- Companies provided evidence that several additional projects would become commercial on the assumption that the Supplementary Charge was reduced to 20% alongside the introduction of an investment allowance at 62.5%
- Some projects were demonstrably worse off under an investment allowance set at a rate of 62.5%, specifically small fields which were particularly "light" in capex
- Evidence was provided of the investment allowance having a significant effect on the IRR and NPV of projects. Even where investment hurdles were not passed as a result of the investment allowance alone it was felt that they would be significantly more likely to occur.

Box 2.E: Government response in respect of question 6

- The government has considered representations on the appropriate level of the allowance in order to encourage significant investment and decided that, in line with the rate for the cluster area allowance, **the investment allowance will be set at a level of 62.5% of qualifying expenditure**. The Office for Budget Responsibility forecast that this, along with the other measures introduced at Budget 2015, will encourage £4 billion of incremental investment over the next 5 years.
- Our response regarding the capex light small fields in presented in Box 2H.

Scope

2.45 Previous field allowances have attracted investment in new fields, while the brown field allowance had encouraged projects delivering incremental recovery in existing fields. It was proposed that new investment, in both new and existing fields, including infrastructure within the ring fence tax regime, would be within scope of the investment allowance. It would therefore drive incremental investment in existing projects (including those associated with critical infrastructure) in addition to new projects. It was proposed that the investment allowance would cover areas which industry had singled out for attention i.e. brown field projects and near-field (tieback) developments.

2.46 In the consultation document the government recognised the vital role which infrastructure plays by sustaining existing production and facilitating new opportunities. It was proposed that the inclusion of infrastructure subject to the ring fence tax regime would encourage the further development and retention of these crucial assets.

2.47 As all fields which would previously have been eligible for a field allowance would be within the scope of the new investment allowance, the government proposed removing all existing offshore field allowances. Existing fields which already qualified for a field allowance, however, would be transitioned to the new investment allowance.

Question 7: Do you agree with the government's proposed approach to include new investment in new and existing fields within the scope of the measure?

Question 8: Do you agree with the government's proposed approach to include new/existing fields which qualify for the existing system of field allowances? Do you think there are any potential risks or unintended consequences of removing these projects from the scope of all current field allowances and instead providing the projects with the proposed investment allowance?

2.48 All the respondents who answered this question agreed that it was appropriate for the allowance to be generated on new and existing fields and were also encouraged by the inclusion of infrastructure.

2.49 Inclusion of existing fields removed a potential distortion in treatment between these classes of field and new fields, putting all reserves on a level playing field, consistent with maximising economic recovery in the most efficient way.

2.50 Several respondents suggested that it was more mature fields which required greatest support in order to provide companies with the viable option of life extension rather than cessation of production and subsequent decommissioning. Some also expressed the view that

this design feature would be beneficial for the Exchequer in the long term due to the incremental projects which could be promoted.

2.51 Some respondents were unclear as to whether existing commitments under FDPs which were not eligible for an allowance under the old regime would be included within scope.

2.52 The majority of respondents felt that it was best to include fields which were within the scope of existing allowances in the investment allowance (subject to appropriate transitional arrangements, providing these fields with access to an equivalent amount of investment allowance). Evidence was provided for several projects which would be at least as well off if the investment allowance was to replace field allowances and noted that certainty on the availability of the investment allowance would send a positive signal for new investments.

2.53 Many expressed the preference for switching onto the new system as soon as possible in order to achieve the objective of simplicity and certainty and noted that parallel systems would create confusion.

Box 2.F: Government response in respect of questions 7 and 8

- The government is encouraged by the response to the inclusive scope with respect to which fields will have access to the allowance, and the agreement that fields with an existing field allowance should move into the investment allowance as soon as feasibly possible. The government's response to question 10 sets out further details on changes to specific transitional rules.
- It appears that any risks and unintended consequences of transferring fields with existing field allowances into the investment allowance treatment will be substantially mitigated through transitional arrangements which preserve the quantum of historical allowances.
- Existing commitments under FDPs which were not eligible for a field allowance will attract the allowance for any qualifying expenditure incurred on or after 1 April 2015.

Split between participants

2.54 Existing field allowances for new fields are divided between participants in a field in proportion to each company's share of equity in the field. Given the structure of the new allowance, the government proposed that each participant would generate their own allowance based on the qualifying expenditure they incur. Under this approach, a participant that did not incur any qualifying expenditure would not generate any allowance. This was consistent with the approach adopted for the onshore and cluster area allowances.

Question 9: Do you agree that the investment allowance should be split between participants in a project based on actual expenditure incurred by each participator? If not, what do you consider to be a more appropriate method to split the investment allowance between participants?

2.55 The vast majority of the respondents who answered this question agreed that allocating the allowance between participants based on the spend they incurred was the fairest method.

2.56 Many noted the departure in this approach from that applied under the existing field allowance regime, but were largely of the opinion that this was the correct direction of travel

and that associating the allowance with the spend was more equitable. This would, in particular, be the case where companies were in "carry" arrangements with one party bearing a disproportionate quantum of capital expenditure on exploration or development activities. Under the investment allowance the carrying party would have access to a greater proportion of the allowance than under the existing allowance system – this was thought to be a virtue of the proposed changes rather than a hindrance. Some also noted that this shift in approach could be reflected in future commercial arrangements.

2.57 A key point of contention in the response was the basis under which infrastructure spend should be allocated and the interaction with various forms of commercial arrangement present on the UKCS. Most respondents agreed that under tariffing arrangements it was the infrastructure owner who bore the risk of capital expenditure on infrastructure assets and should therefore be entitled to generate the allowance. Where an infrastructure user funded the purchase or work in respect of an identifiable asset for their own benefit respondents were largely in agreement that the user bore the risk of this cost and that they should obtain access to the allowance.

2.58 Companies were, however, completely divided in respect of "cost share" arrangements where the amount payable by the infrastructure user was calculated with reference to the cost incurred by the infrastructure to the owner. Many stated that, in their opinion, the infrastructure owner should be entitled to the allowance as they incur the cost in the first instance and make the ultimate decision about whether this investment takes place. Many argued the opposite, stating that the user bore all the risk of this amount and any overruns and that consequently the ultimate spender was the user rather than the owner.

2.59 Many infrastructure users stated that although they bore the entire risk of this capital expenditure they were, nevertheless, not provided with sufficient information by the infrastructure operator to determine this amount and that this lack of transparency in commercial arrangements would leave them at a disadvantage relative to those in arrangements where costs were clearly denoted. Several felt that, were this to be the case and the allowance was not available to them that the benefit of the allowance should be passed on nonetheless, as access to infrastructure at affordable rates was a key constraint to further investment.

Box 2.G: Government response in respect of question 9

- The government welcomes respondents' confirmation that allocating the allowance on the basis of capital spend was the preferred approach. It is understood that to the extent this impacts the relative values of field interests between co-venturers that this will be reflected by commercial arrangements.
- Good stewardship of infrastructure will be vital to the future of the UKCS. It has become clear to government from the fiscal review in 2014 and this consultation that there is sensitivity around how infrastructure is operated and charged to users, particularly for assets in a "cost share" phase.
- Only one of the user and the owner should have access to the investment allowance in respect of every pound of allowance, duplicating this benefit would not be consistent with the objectives of this allowance. Industry do not have a united position on this and no consensus was apparent in written representation received.
- From discussions with the OGA and evidence received we believe that in such cost share arrangements it should be the user – as the party who, during this phase, pays for and bears the risk of capital investment – that should benefit from the allowance.
- What has also been apparent is that users are not confident that they have adequate visibility of the costs passed onto infrastructure users in this arrangement to allow them to claim investment allowance (with capital costs aggregated with operational expenditure). This leads to the risk that the owner of the infrastructure reduces their effective tax rate through the investment allowance and does not pass this benefit through to the user in full, particularly where the user is effectively locked into a long term contract.
- In the period to Budget 2015 it has not been possible to put in place legislation that deals with this allocation satisfactorily. **It is a government priority to address this issue in more detail. Infrastructure is critical to the protection of existing production and development of new prospects**. Legislation in Finance Bill 2015 will include infrastructure spend within qualifying expenditure, but in order to restrict the benefit of the allowance for owners without production income, **tariff income will not be included within the definition of relevant income for the purpose of activating generated allowance.**
- **The government's ambition in respect of this is to obtain a mechanism to allocate the investment allowance fairly, to those bearing the risk of capital cost on infrastructure (or to put in place a process through which the benefit of the allowance is passed on to those bearing the cost and risk)**, and permit tariff income to activate generated allowance in addition to production income. Further work will be carried out on this.
- **It is understood that this work may draw on elements wider than the tax system and Treasury / HMRC will be working closely with the OGA on this matter.**

Transitional arrangements

2.60 It was proposed that, from the effective date, new fields and incremental projects would no longer qualify, respectively, for field allowances for new fields or for the brown field allowance.

2.61 Existing fields in receipt of a field allowance would still be entitled to that quantum of relief from the Supplementary Charge under the new regime. Any activated field allowance at the effective date would be carried forward to the new regime for use as under the existing regime.

2.62 It was proposed that for existing fields in receipt of a field allowance, any unactivated field allowance would be converted into the investment allowance as at the effective date (converted allowance), which would be available to be activated immediately by production income from that field. The company would be able to set-off this allowance for Supplementary Charge purposes as normal. Again, this would ensure that the value of the existing field allowance was preserved for such fields.

2.63 It was originally proposed that qualifying expenditure incurred in relation to existing fields after the effective date would generate investment allowance but only to the extent that the total investment allowance generated exceeded the licensee's share of the total field allowance(s) for which that field has qualified (the original field allowance). As such fields in receipt of an existing field allowance would, under the proposals, be able to generate incremental investment allowance in certain circumstances.

2.64 It was acknowledged that companies might have spent significant amounts on developing fields prior to the effective date which would not yet have provided production against which they would be able to activate their converted allowance. Under the mechanism at paragraph 2.63 they would not be able to access the investment allowance until the allowance generated by their post-effective date qualifying spend exceeded their original field allowance.

2.65 To accommodate this, the government originally proposed that the OGA would be empowered to determine a date at which the programme/project(s) described in the relevant FDP/FDP addendum(s) had/have been "materially completed" on a field-by-field basis. After this date, qualifying expenditure incurred in relation to the field would generate the investment allowance, even if the allowance generated since the effective date had not exceeded the original field allowance in respect of that field. It was proposed that the OGA would consider applications for such determinations from any of the licensees with interests in the applicable field and publish a list of fields where this date has passed. This would ensure that new projects in respect of fields which had already received field allowance would not be penalised in comparison to projects on new/existing opportunities commencing after the effective date.

2.66 It was proposed that first commercial production be used as a proxy for material completion, with the exception of clearly phased projects where much of the originally contemplated spend was scheduled to occur after first production. This would prevent companies from accessing investment allowance on spend clearly associated with previous investments, which were ongoing but not complete, and for which the spend would not have generated an incremental investment allowance under the mechanism described at 2.63.

Question 10: Do you think these transitional arrangements are appropriate? If not, please indicate what you think would be suitable arrangements, providing evidence to support this.

2.67 The majority of respondents felt that the proposed transitional arrangements were appropriate and that transitioning as swiftly as possible was important to the objective of simplicity.

2.68 Several responses stated that the proposed transitional arrangements could jeopardise projects in the pipeline (i.e. at the Front-End Engineering & Design stage but pre-FDP approval) which would have met the criteria for an existing field allowance but would not generate an

equivalent amount of Investment Allowance. Several suggested that companies should have access to a window within which they could elect to receive the previous allowance.

2.69 An issue was also raised that the proposed transitional arrangements could mean that further incremental projects on fields which had already been granted a brown field allowance would not attract investment allowance as soon as projects on fields which had not previously had access to an allowance. This could distort decisions and result in certain incremental projects being delayed.

2.70 Some respondents stated that the definition or interpretation of "material completion" was important and that, while the consultation document and working group meetings had provided some clarity on this, they would like to see further guidance on this matter.

Box 2.H: Government response in respect of question 10

- The government was encouraged to hear that the proposed transitional arrangements were welcomed.
- The government accepts that there is a case for additional support for projects which commenced under an expectation of a field allowance being available which could feasibly receive a smaller allowance under the investment allowance model.
- To this end, the legislation in **Finance Bill 2015 will contain a provision to allow new fields authorised prior to 31 December 2015 to be treated as if they were granted this approval prior to the effective date (1 April 2015).** As such they will be entitled to an investment allowance at least equal to the field allowance which they would have received under the previous suite of field allowances.
- The government believes that incremental projects will play a vital role in sustaining the production of existing fields and existing infrastructure. Tracking relevant expenditure at the field level for fields currently in receipt of the brown field allowance could result in the diversion of capital to less economic projects on other fields which would receive investment allowance at an earlier date. This is not consistent with the government's objectives.
- To this end, a revised approach for brown field transitional arrangements will be included in Finance Bill 2015. **Spend will be tracked at the project level for the purposes of determining whether new investment allowance will be generated.** As such, companies will be able to sanction concurrent incremental projects on a field which is already in receipt of a brown field allowance and will be able to generate new investment allowance on that new project immediately.
- In order to prevent companies exploiting this change, companies will not be permitted to activate brown field allowance which is converted to investment allowance until the later of expected first production from those associated incremental reserves and completion of any key element(s) of the brown field project.

A List of respondents

Aberdeen and Grampian Chamber of Commerce

Aberdeen Centre for Research in Energy Economics and Finance

Allianz GI

Antin IP

Apache

Azinor Catalyst

Bayerngas UK

BG Group

BP

BRINDEX

CBI

Centrica

Chevron

CNR

ConocoPhillips

CW Energy

Dana Petroleum

DONG Energy

ENI UK

EnQuest

Esso Exploration and Production UK

EY

Fairfield

GDF Suez

JX Nippon

KPMG

Maersk

Marathon Oil

MOL

Nexen

Oil and Gas Independents' Association

Oil and Gas UK

OMV

Oil Taxation Action Committee

Parkmead Group

Perenco

Petrofac

Premier Oil

PWC

RWE

Scottish Government

Shell

Siccar Point Energy

SSE

Statoil

Steam Oil

Suncor

Talisman Sinopec

TAQA Bratani

Tees Valley Unlimited

Total E&P UK

UKOITC

Xcite Energy Resources

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