Estimates of the Remaining Exchequer Cost of Decommissioning UK Upstream Oil and Gas Infrastructure (July 2021)

The Exchequer cost considered here arises from refunds of previously tax paid (when losses as a result of decommissioning expenditure are "carried back" against past profits) and lower levels of tax on current or future profits (which are reduced by current, carried forward or future decommissioning costs).

The Oil Taxation Act 1975 allows participators in an oil and gas field liable to Petroleum Revenue Tax (PRT) to carry back losses almost indefinitely against profits it has previously made from the field or which previous participators in the field had made. This may result in the repayment of tax.

With respect to Offshore Corporation Tax – comprised of Ring Fence Corporation Tax (RFCT) and Supplementary Charge (SC) – the Corporation Tax Act 2010 allows for a company's decommissioning loss to be carried back against its own historical profits dating back to April 2002. Again, this may result in a repayment of tax.

Exchequer liabilities from decommissioning

The OGA has estimated that the total industry costs between 2020-21 and 2064-65 for decommissioning all UKCS oil and gas infrastructure are £51 billion.[1] The Exchequer cost of tax relief from this expenditure currently projected by HMRC is £18.3 billion.[2] This is made up of £9.4 billion[3] from tax repayments and a reduction in Offshore Corporation Tax [i.e. RFCT plus SC] of £8.9 billion. Decommissioning expenditure reduces company profits and hence lowers the overall tax take.

The estimates reported above are taken from *HM Revenue and Customs Annual Report and Accounts 2019–20* (5 November 2020). Extracts from that publication follow with **emphasis** added:

> **Petroleum Revenue Tax**
>
> Petroleum Revenue Tax (PRT) is a 'field-based' tax charged on the profits arising from individual oil and gas fields that were approved for development before 16 March 1993. The rate of PRT was permanently set at 0% effective from 1 January 2016 but it has not been abolished so that losses (such as losses arising from decommissioning PRT-liable fields) can be carried back against past PRT payments.
>
> **Exchequer liabilities arising from oil and gas infrastructure**
>
> There are two taxes levied on companies exploring and producing oil and gas from the UK Continental Shelf (UKCS): Petroleum Revenue Tax (PRT) and offshore Corporation Tax (CT),

1. 2019 prices. The OGA's latest (July 2021) central estimate of the post-2020 cost of decommissioning all UKCS oil and gas infrastructure is £48 billion in 2020 prices.
2. Nominal prices with discounting.
3. This is shown in HMRC's annual report and accounts as a provision. Repayments of PRT and CT are £3.6 billion and £5.8 billion, respectively.

the latter comprising of two elements: Ring-fenced Corporation Tax and Supplementary Charge.

The legislation governing the losses from decommissioning costs (Oil Taxation Act 1975) allows participators in an oil and gas field liable to PRT to carry-back decommissioning losses almost indefinitely against profits it has previously made from the field, or which previous participators in the field have made. This may result in the repayment of PRT. With respect to offshore CT, the Corporation Tax Act 2010 allows for a company's decommissioning loss to be carried back against its own historical profits dating back to April 2002. Again, this may result in a repayment of offshore CT.

Provision for oil and gas field decommissioning

The provision is estimated as the appropriately discounted sum of all forecast decommissioning repayments over the expected lifetime of the North Sea oil and gas fields. Repayment profiles are derived from the output produced by HMRC's North Sea Forecasting Model developed at the individual company and field level. There has been no significant change in the model since last year.

A provision of £9.4 billion has been identified in 2019-20 based on the estimated tax repayments of PRT £3.6 billion (£2.9 billion in 2018-19) and offshore CT £5.8 billion (£5.4 billion in 2018-19) by HMRC to companies incurring losses from decommissioning expenditure over the period to 2065.

The key determinants of the provision estimate are future decommissioning costs from the Oil and Gas Authority's (OGA) Asset Stewardship Survey, economic determinants (including oil & gas prices, production and the US Dollar/Sterling exchange rate) from the Office for Budget Responsibility's (OBR) July 2020 Fiscal Sustainability Report (FSR) as well as the discount rates from HM Treasury.

There has been a £1.1 billion increase in the overall provision since last year. The impact of the lower forecast oil and gas prices used this year was to increase the provision due to increased forecast repayments, but this effect was partially offset by reduced decommissioning costs in nominal terms. This is consistent with the target of reducing overall UKCS decommissioning costs referenced in the OGA Decommissioning Strategy.

The provision utilised in-year is the tax repayments in 2019-20 due to decommissioning expenditure.

Uncertainty around the estimate of the provision

The largest impact on the size of the provision, and biggest source of uncertainty in estimating it, is future decommissioning costs. Annually, the OGA estimates the total costs of remaining oil and gas decommissioning for the UKCS, including newly sanctioned projects, and changes to the portfolio of potential, as yet unsanctioned projects.

Recognising the uncertainty around this, the OGA gives a range for expected decommissioning costs for UKCS oil and gas infrastructure over the remaining life of the North Sea basin.

The £9.4 billion provision included in the Trust Statement is calculated using the OGA's central estimate for decommissioning costs of £51 billion in 2019 prices. Using the OGA's lower (£40 billion) and upper (£66 billion) decommissioning cost estimates would instead give provision estimates of £7.5 billion and £12.4 billion respectively.

The main economic determinant which drives the provision are oil and gas prices. The model uses projections from the OBR where available and then applies a growth rate to project prices for later years. By using the July 2020 OBR FSR projections account has been made for the oil price fall in March 2020. Compared to the baseline oil and gas prices, a ten per cent increase (decrease) would decrease (increase) the provision by £0.8 billion (£0.7 billion).

The provision is also impacted by interest rate and foreign exchange rates as follows:

a) An increase in the discount rate will reduce the present value of the provision. An overall increase in the discount rates of 50 basis points will decrease the overall provision by £0.6 billion. The same decrease in discount rates would increase the provision by £0.6 billion.

b) As oil prices are denominated in US Dollars, the overall provision is impacted by changes in the US Dollar/Sterling exchange rate. A 10 cent appreciation in the US Dollar gives rise to higher Sterling oil prices resulting in a £0.5 billion decrease in the provision. A 10 cent depreciation of the Dollar results in a £0.5 billion increase in the required provision.

The likely impact of COVID-19 is included in the provision. Key economic determinants have been sourced from the OBR's FSR published in July 2020 as noted above and forecast decommissioning costs relate to the requirement for owners of oil and gas installations and pipelines to decommission their offshore infrastructure at the end of a field's economic life.

Provisions and contingent liabilities

HMRC recognises a provision in the Trust Statement where it considers that it is probable that it will need to repay taxes already received in the current and previous financial years, in accordance with accounting standards. …

- Oil and gas field decommissioning costs, where companies decommissioning oil and gas infrastructure in the North Sea are entitled to recover tax previously paid in relation to profits from those oil and gas fields. As of 31 March 2020, HMRC estimates that it will have to repay £9.4 billion of tax in relation to oil and gas field decommissioning (2018-19: £8.3 billion). This is the estimated amount that HMRC will repay to oil and gas companies and is based on an estimate of the decommissioning costs that they will incur in future periods. In 2019-20, companies recovered £0.5 billion of Petroleum Revenue Tax (PRT) from HMRC in relation to decommissioning losses. In addition to repayments of PRT, HMRC estimates that it will forgo a further £7.4 billion of future tax income because of decommissioning expenditure reducing taxable profits.

Decommissioning Relief Deeds

At Budget 2013, the government announced it would begin signing decommissioning relief deeds. These deeds represented a new contractual approach to provide oil and gas companies with certainty on the level of tax relief they will receive on future decommissioning costs. As part of the terms of becoming a participator in a licence in the UK or on the UK Continental Shelf, companies have a statutory obligation to decommission their operations properly once oil and gas production has ceased. Between October 2013 and March 2021, the government entered into 98 decommissioning relief deeds with oil and gas companies to guarantee the basis on which tax relief for decommissioning is available; 96 of these deeds were in force at the end of March 2020. The deeds have been signed by the government and eligible companies. Any company that has carried on a ring-fence trade, and the associates of those companies, are eligible to be party to a deed.

The deeds indemnify the companies for changes in tax legislation or the default of joint-venture partners in respect of their decommissioning activities, allowing them to claim relief from HM Treasury potentially otherwise available to the field from HMRC through the tax system. The deed provides companies with greater certainty in respect of decommissioning tax relief and allows them to adopt post-tax securitisation arrangements for the future costs of decommissioning. The deeds thus support the government's objective of maximising economic production of oil and gas reserves in the UK Continental Shelf. They are designed to free up capital that otherwise would have been held in reserve against possible changes in tax rules. As of March 2021, Oil & Gas UK estimated that £8.1 billion of capital had been unlocked for reinvestment as a result of the deeds.

HM Treasury has not disclosed the potential financial value of the Decommissioning Relief Deeds because it is unquantifiable, given the absence of comparable data to use in any calculation. The crystallisation of any liability is dependent on the financial health of the companies (and their joint-venture partners) that are party to the deeds. The government has not made any changes to the tax regime that would generate a liability to be paid under any decommissioning relief agreements.

HM Treasury recognises a provision when a claim is notified and the amount can be measured reliably. Since inception of the deeds, only one claim has been made. Six payments, totalling £148.6 million, relating to that claim had been made by the end of March 2020. HM Treasury's 2020-21 accounts will recognise a provision of £258.1 million in respect of decommissioning expenditure incurred as a result of a company defaulting on their decommissioning obligations. The value of the provision represents the best estimate of the outstanding costs to settle the claim. The majority of this provision is expected to be realised over the next three years. It relates to amounts estimated to be payable to MCX Dunlin and MCX Osprey in respect of decommissioning expenditure in relation to the Dunlin cluster of fields, created as a result of Fairfield Energy defaulting on their decommissioning obligations. The decision to decommission the Dunlin cluster was a commercial decision made by Fairfield Energy, MCX Dunlin and MCX Osprey after reaching agreement with the Oil and Gas Authority that maximum economic recovery had been achieved for these assets. The provision is based on 50%[4] of the estimated remaining decommissioning costs which would otherwise have been paid by the defaulting party, plus an estimate of any PRT relief that would be due on those costs, discounted for the time value of money.

4. The rates of RFCT and SC relief under the DRD in an imposition are, respectively, 30% and 20% of the decommissioning costs, regardless of the tax paid by the claimant or the defaulter.