TAXING THE NORTH SEA

Tim Worstall

The Global Warming Policy Foundation
Note 44

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About the author

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Introduction

Some people are being very vocal about North Sea oil and gas fields. There are two issues, which are, to an extent, intertwined. They are, together, a lovely example of how chickens really do come home to roost: we are where we are because of decisions taken decades ago.

The two different issues are the rate of taxation on those fields – many feel it should be higher – and the large tax credits that oil companies are enjoying. The nett effect is that imposing higher rates of tax on the North Sea could well be a revenue loser in the near future. This is not some rehash of the Laffer Curve argument. It's a simple result of the way that the North Sea has been taxed in the past, and of course of the fact that Chancellors of the Exchequer have already spent all the money collected.

Excess profits taxes, higher taxes

We all understand demands that taxes be raised on those benefiting from the high prices caused by the war in Ukraine. It is true that these companies' past decisions to invest were not made in the expectation of such high prices – they have indeed benefitted from a windfall. It's also true that the investments have already been made, so taxing them – even excessively – is entirely possible; the oilfield or mine that is currently being exploited cannot be moved out of the taxing jurisdiction. As a result, an extant rig, field or mine can be taxed to the hilt; hence the current demands to do just that.

Indeed, it is already being done. As Harbour Energy pointed out in their most recent accounts:[*]

> Increased EBITDAX of $4.0 billion (2021: $2.4 billion) and profit before tax of $2.5 billion (2021: $0.3 billion). Profit after tax of $8 million (2021: $101 million) impacted by a $1.5 billion one off non-cash deferred tax charge associated with the [windfall tax].

The tax rate is clearly significant, bringing profits down from $2.5 billion to $8 million.[†]

So, no-one doubts that current installations can be hugely, vastly, taxed. But what is the effect of doing so? Harbour tells us, in the same release:

> [The windfall tax] has driven us to reduce our UK investment and staffing levels. Given the fiscal instability and outlook for investment in the country, it has also reinforced our strategic goal to grow and diversify internationally.

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* https://www.londonstockexchange.com/news-article/HBR/full-year-results/15867758.

† Richard Murphy, the accountant who runs the Tax Justice Network, has said that it doesn't really count though, because that $1.5 billion is future taxes to be paid. This is a surprising thing for a professor of accounting practice to say.

So, while a specific operation cannot be moved out of its taxing jurisdiction, it is entirely possible to shift the capital and expertise to somewhere that doesn't tax so much.

Which brings us to two principles of taxation. The first is about 'resource rents', and is the same reason for land value taxation, charging phone companies for spectrum and so on. Some things just exist, and there's no particular reason why any group of people organised as a company should profit from that mere happenstance. So, that existence should be taxed, and until those pips squeak.

But it is *only* that mere existence that should be so taxed. The application of effort, labour, capital, to extraction is something that people can decide to do elsewhere, so 'overtaxing' them will simply encourage them to do so, to the detriment of our tax revenue. This might not be a good idea.

It has been suggested that investors do not look at post-tax returns when deciding to invest. We even have Warren Buffett telling us so:

> I have worked with investors for 60 years and I have yet to see anyone – not even when capital gains rates were 39.9 percent in 1976–77 – shy away from a sensible investment because of the tax rate on the potential gain. People invest to make money, and potential taxes have never scared them off.

Although this is Buffett himself, it is also nonsense, as evidenced by Harbour Energy's actions: they're taking their new investment elsewhere because tax rates here are too high. Yes, we know, it's blasphemy to disagree with Warren Buffett on matters investment, but there it is. People really do invest on the basis of expected post-tax returns.

This concept is also embedded in standard economics: unexpected windfall taxes don't change behaviour (because they're unexpected), but expected taxation does. Of course, when windfall taxes become common enough that they're expected, they *will* change behaviour. Of course, Gordon Brown had at least two such North Sea taxes in his time as Chancellor. They're not that much of a surprise any longer, so they are changing behaviour more and more; 'occasional' isn't quite the same as 'unexpected', after all.

So, excessive taxation of current North Sea oil and gas fields will reduce the number of such fields opened and exploited. A useful definition of 'excessive' would therefore be a tax rate that reduces the number of new fields. Alternatively, we could define it as rates 'above those necessary to tax the resource rents alone'. Tax theory tells us that either of those definitions will take us to the same place.

So far, so obvious, and the only even slightly controversial point made is that it is *post-tax* returns that determine investments, not pre-tax. And that is so obvious that only the unthinking – or politically minded – would deny it.

The other North Sea tax issue

This then ties in with – is complicated by – the other issue at hand: complaints that the oil companies are receiving large tax credits at present. Unlike many other tax complaints – whinings about 'tax breaks' for depreciation and the like – this has the merit of actually being true. Oil companies *are* ending up with substantial tax credits.

To understand why, we first need some background. In arriving at their taxable profits, all businesses get to deduct their operating expenses from their income. Decommissioning is just one of those expenses: all sides agree that tidying up when you are finished is part and parcel of running an oil rig or a coal mine.

Normally, money for decommissioning is set aside during the life of the operation: a portion of the revenues (or profit) from the mining or extraction is put into a provision or fund that will be there to pay for remediation at the end of this particular Rape of Gaia.

However, this does *not* happen in the North Sea, because oil companies are *forbidden* from setting money aside in this way. The reason is as follows: an oil or gas company that did so would reduce the profits it was reporting, which would mean paying less tax (making provisions being tax deductable). Politicians, like everyone else, fully accept that decommissioning costs should remain with the oil companies, but oppose, with every fibre of their being, the idea that this might involve them deferring tax revenues that could otherwise be collected straight away.

So, instead of encouraging oil companies to set aside some of their profits against eventual decommissioning, politicians banned them from doing so. Shell and Exxon et al. would only be allowed to deduct the costs when they were actually incurred.

The problem with this approach is that, once an oilfield needs decommissioning, it tends to have nothing left to sell, meaning that its tax deductions are necessarily going to exceed its taxable income. When this happens it is left with what is known as a 'tax credit'. Businesses end up with tax credits all the time, typically when they make losses. In these circumstances, they can use the credit to reduce their tax bills in future years. Alternatively, in a group of companies, the credit can be transferred to a sister operation. This is the route that oil companies will use, since a decommissioned oilfield will not have any 'future years'. The credit is passed onto another, yet-to-be-decommissioned field with the same owner.

So, not only is the decommissioning oilfield not paying any tax, but other oilfields that are still in production are able to reduce their tax bill too.

The media, and particularly the Guardian, have got rather confused over this issue, convincing themselves that the taxpayer is somehow paying for the decommissioning:

> Taxpayers will foot a bill of more than £18bn for the decommissioning of the oil and gas infrastructure in the North Sea up to 2065

– made up of tax repayments and a reduction in offshore corporation tax.

But that's the *Guardian* for you. To be clear, the oil companies pay for the decommissioning, which reduces their tax bills accordingly, just as it would for any other business.

Thus the *quid pro quo* for the ban on providing for the decommissioning costs over the life of the fields was that when the bills actually arrived, there would be tax credits. The Chancellor had shifted a chunk of tax revenue forward in time. Doing so left a hole in future tax revenues, but that would be 'somebody else's problem'.

And now the big problem

This brings us to the real problem about taxing current North Sea oil and gas extraction at those excessive rates. The Treasury has already had all the tax revenue it's going to get from the old fields, has spent the extra it engineered through the ban on decommissioning provisions, and is left with a big fiscal hole to fill now the fields are closing down and are passing the resulting tax credits around their operating groups.

How can the Treasury fill the gap? It would very much prefer not to have to tax the population for its own past profligacy. It would absolutely like to tax Shell et al. instead, because oil companies have no votes and few friends.

But the only way to tax oil companies is to allow more extraction from the North Sea. However, that may prove tricky, because oil investors remain unconvinced that putting money into the UK is a good move. The medium-term outlook is not promising, with Labour talking about a ban on North Sea exploration. And even if that doesn't happen, Harbour and Apache – to give just two examples – are saying that the current tax exactions are such that they'll not be bothering with any further exploration, let alone extraction, of new fields anyway.

Thus, no new tax revenues are going to be forthcoming. Tax revenues from the North Sea will thus fall to zero and, as decommissioning costs are incurred, oil companies will end up with large tax credits, which they will use to reduce their tax liabilities still further. This all means that the chancellor will see a big reduction in revenue. It's going to be painful.

About the Global Warming Policy Foundation

People are naturally concerned about the environment, and want to see policies that protect it, while enhancing human wellbeing; policies that don't hurt, but help.

The Global Warming Policy Foundation (GWPF) is committed to the search for practical policies. Our aim is to raise standards in learning and understanding through rigorous research and analysis, to help inform a balanced debate amongst the interested public and decision-makers. We aim to create an educational platform on which common ground can be established, helping to overcome polarisation and partisanship. We aim to promote a culture of debate, respect, and a hunger for knowledge.

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