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The Energy and Climate Change Committee

The Energy and Climate Change Committee is appointed by the House of Commons to examine the expenditure, administration, and policy of the Department of Energy and Climate Change and associated public bodies.

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Summary

It is vitally important swiftly to decarbonise the UK economy if the country is to meet its obligations to tackle climate change, and clearly the use of fossil fuels must diminish. But within the timescale for these changes to take place, the UK will still need to use the oil and gas resources remaining in the UK continental shelf. With much of our current electricity generating capacity set to close over the next decade, the UK Government is right to focus on achieving affordable, secure and sustainable energy supplies as a key challenge. Within this, and especially during a period when international political or economic turbulence will continue to pose a genuine risk of disruption, the importance of domestic oil and gas production is obvious and the Government should do what it can to help ensure that the exploitation of these resources is as efficient as possible.

When determining policy on UK oil and gas the Government's priority should be security of supply, within the context of moving to a low carbon economy. However, proper account must also be taken of both the immense tax revenues paid by the industry and the 350,000 people whose employment rests upon it. Given that the sector predicts falling capital expenditure could destroy at least 14% of those jobs over the next two years, the Government must find a way to support UK oil and gas production in the current difficult economic climate.

While UK production peaked in 1999 and is now declining by around 5% annually, significant volumes are still being recovered and the UK remains an important player. Estimates for future levels of UK oil and gas production range however from 11 billion to 37 billion barrels of oil equivalent (boe), so while domestic reserves will almost certainly remain the single most significant contributor to this country's security of energy supply for at least another decade, the final quantities recovered will closely reflect how well or otherwise the Government formulates effective tax, regulation and licensing policy to govern the sector.

The oil and gas industry operating on the UK continental shelf currently faces a quadruple whammy of high costs, low prices, lack of affordable credit and a global recession. Unless the fiscal and regulatory regime is well designed and highly attractive then the likelihood is that the UK may not recover anything like as much of its reserve as would be desirable. So while we fully support the Government's objective of maximising the economic recovery of UK oil and gas resources, we also believe that within this framework Ministers need to articulate a strategy setting out how production levels are to be maintained.

The difficulties currently faced by oil and gas companies in accessing affordable lending and the bleak prospects this heralds for investment in the oil and gas industry pose an issue of grave concern. If the industry's worst case scenario is realised in 2010, then 50,000 jobs could disappear and production would fall significantly. The success of the steps announced in the recent budget will be judged by whether they help stop the downward slide in capital investment and any consequent contraction.

To address this problem DECC, through BERR and HM Treasury, must continue to engage with banks to ensure the UK continental shelf remains at the forefront of minds in

the banking sector. Ministers must set out what steps they are taking specifically to help oil and gas companies access affordable credit and confirm that they are keeping the availability of such credit under close review.

We are not convinced that the field allowance and other measures announced in Budget 2009—albeit welcome—are sufficient either to create the competitive environment needed by the industry or to provide a strong enough incentive to exploit fully remaining UK gas and oil resources. With regards to the field allowance, we are particularly concerned that this measure may fail to stimulate the predicted extra 2 billion barrels of oil hoped for by the Chancellor. It fails to incentivise incremental investment in existing sites and does nothing specifically to encourage investment west of Shetland. Qualification criteria are too stringent and unless its scale can be extended, the allowance will provide no significant incentive for investment even in new fields. When reviewing the operation of this allowance the Government must reconsider the merits of more wide-ranging and generous reforms of the fiscal regime such as a capital uplift or a reduction in the supplementary charge, calculating and setting out the predicted effects on tax revenues and on investment in the industry.

With regard to the area west of Shetland, the UK must appreciate the importance of this resource. While we understand the Government's desire not to impose common carrier arrangements for a shared infrastructure to exploit those resources, Ministers must ensure the industry moves promptly to agree both a timescale for such infrastructure and arrangements to govern its use.

The Government should instigate and fund a comprehensive survey of the marine environment and its wildlife west of Shetland in order to evaluate the full potential effect of intensive oil and gas recovery activities in the area. Likewise, the Government must work with the oil and gas industry to facilitate a systematic and ongoing plan of marine wildlife surveys to fill gaps left by earlier surveys of the UK continental shelf.

We note that generally the industry has a good record of adhering to environmental regulations. However, concerns were raised with us about how far some companies promise to follow environmental best practice but then do not do so once licenses are issued. In the absence of specific evidence we cannot judge how widespread or sporadic this problem may be but we encourage those with concerns to raise them with DECC and expect such claims to be investigated fully.

We welcome the Government's initiative in the area of carbon capture and storage, a technology that may offer a major opportunity to use existing infrastructure and skills in the North Sea with beneficial outcomes. We look forward to the outcomes of the study into CCS commissioned jointly with the Norwegian government.

Introduction

1. In his first statement to the House as Secretary of State for Energy and Climate Change, Ed Miliband MP set out three long-term challenges to be tackled by his new Department: ensuring that the UK has energy that is affordable, secure, and sustainable; bringing about the transition to a low carbon Britain; and achieving an international agreement on climate change at Copenhagen in December 2009.[1] As a Committee, it is our job to scrutinise the Department of Energy and Climate Change's work in all three areas. In this first Report our focus is relatively narrow: we examine the contribution of the UK offshore oil and gas industry to meeting the challenge noted by the Secretary of State of delivering the UK's energy needs; we analyse the difficulties and opportunities confronting the industry; and we make recommendations designed to ensure that the resources remaining in the UK continental shelf (UKCS) are efficiently realised.

2. There are tensions between the objectives of achieving affordable and secure energy and reducing carbon emissions. If we are to move towards a low carbon economy, our reliance on fossil fuels needs to diminish. This transition is a necessary one which we support wholeheartedly. But it will not happen overnight; and it is in the UK's interests to exploit its remaining oil and gas resources in a strategic manner, both to help achieve a secure supply of energy and to support the many workers and companies reliant on the industry. Many of those involved in the industry will in time, we hope, be able to use their skills and expertise to capitalise on opportunities presented by the transition to a low carbon economy through supporting, for example, the development of the UK's offshore renewables and carbon capture and storage sectors. These are issues we will return to in a large-scale report on *low carbon technologies in a green economy* later this year. However, in this report we concentrate on a more tightly-focused remit: what should be done to ensure that the remaining reserves in the UKCS are exploited to the greatest benefit?

3. We held three evidence sessions during our inquiry and heard from representatives of the large and small players in the industry, the RSPB, Professor Alexander Kemp of Aberdeen University and Mike O'Brien MP, the then Minister of State at the Department of Energy and Climate Change (DECC). We are grateful to our witnesses – particularly to Professor Kemp who has also served as a Specialist Adviser to the Committee and assisted us in the production of this Report – and to the other companies and organisations which submitted written evidence.

4. We visited Aberdeen to take oral evidence from Professor Kemp and from Oil & Gas UK, the principal representative body for the industry. In addition we attended a breakfast briefing meeting hosted by the Scottish Council for Development and Industry (SCDI) which brought together more than fifty individuals working in the oil and gas sector or in related businesses, with whom we were able to hold extremely useful informal discussions. We also visited Subsea UK, the body representing operators, suppliers, contractors and others working in the subsea supply chain, and benefited from a very interesting presentation and discussion about the industry. We are extremely grateful to Subsea UK, and the SCDI and their guests for their input into our inquiry.

1 HC Deb, 16 October 2008, col 939.

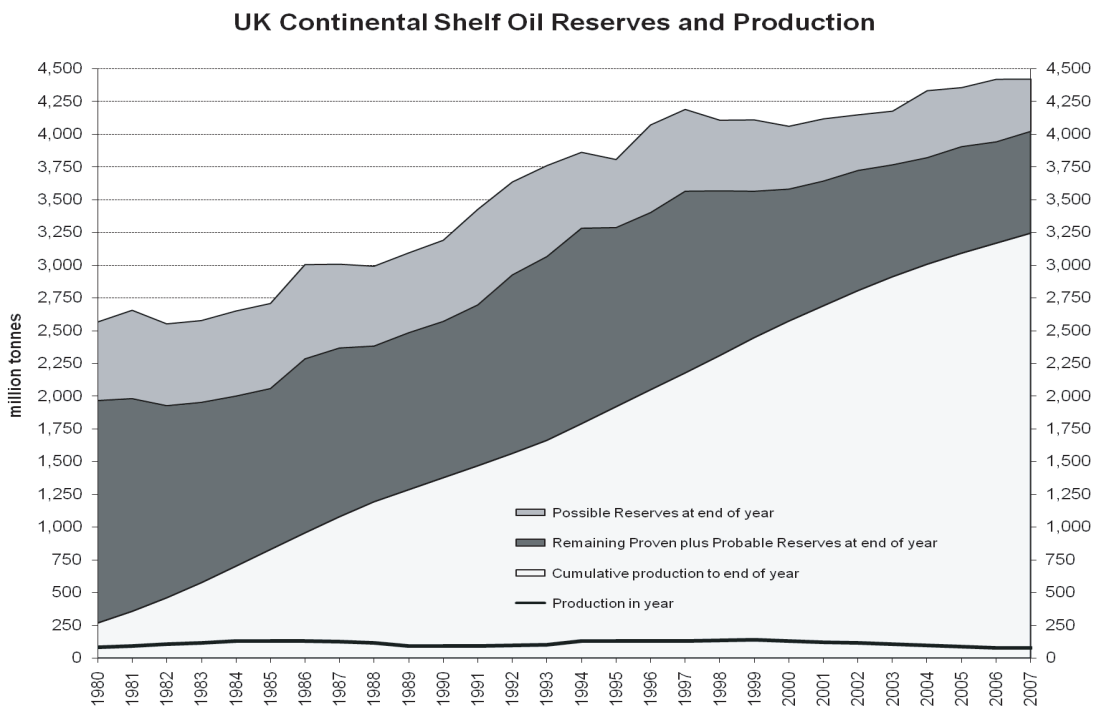
1 UK oil and gas production

Production to date

5. More than 38 billion barrels of oil equivalent (boe) of oil and gas have been produced in the UK over the last 40 years and, although levels of peak production were reached in 1999 and are now declining at a rate of approximately 5% annually, significant volumes are still being produced: 1 billion boe of oil and gas were recovered in 2007. The UK is 8th in the world ranking of gas producers, 18th in the ranking of oil producers and 13th for oil and gas combined.[2]

6. The charts below, provided by DECC, show the annual and cumulative levels of UK oil and gas reserves and production since 1980.[3]

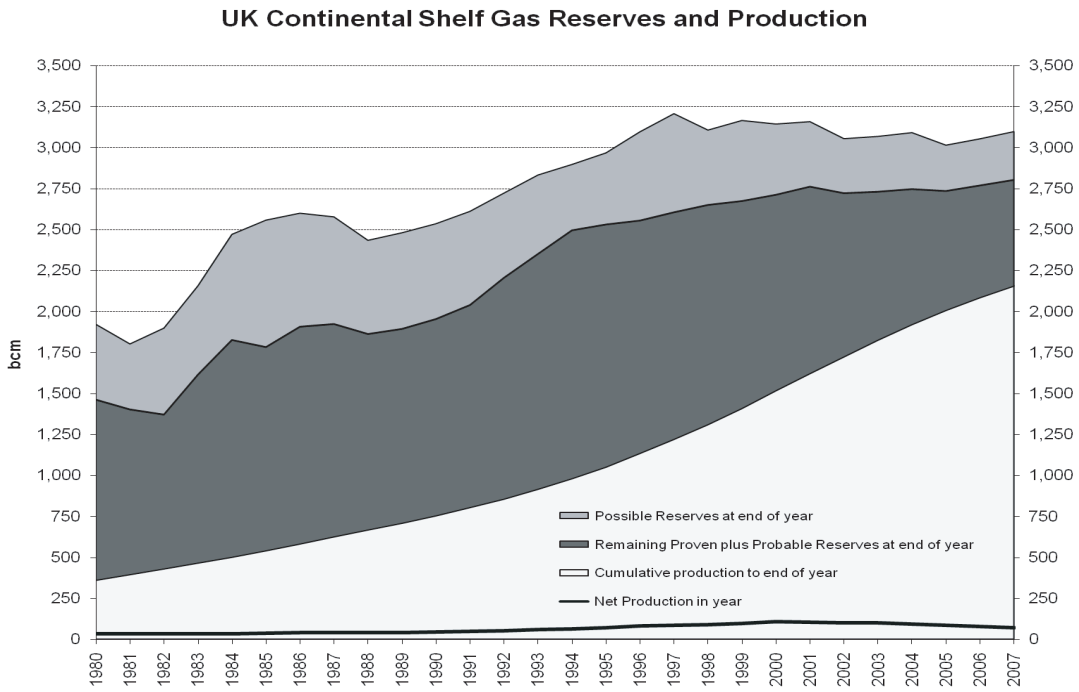
Chart 1



2 *Oil & Gas UK 2008 Economic Report*, p 7.

3 Ev 80, Annex 1.

Chart 2



Contribution to UK energy security

7. In 2007 the UK was self sufficient in oil (producing 583 million boe and consuming 575 boe) and produced three quarters of its gas requirements (70 billion cubic metres (bcm) were produced and 91bcm consumed).[4] Oil & Gas UK told us that "the industry is the single most significant contributor to this country's security of energy supply, today providing 70% of our primary energy needs". It states that 70% of the UK's primary energy will need to be provided by oil and gas in 2020 and "with up to 25 billion barrels of oil and gas still to recover, in 2020 the UK could still be producing oil and gas in sufficient volumes to supply 65% of our oil needs and a quarter of UK gas demand – enough gas to cover all that we need for our homes, for example - provided capital investment can be sustained at £5 billion per annum and the production decline rate held at 5% per annum". The organisation concludes that "maximising the recovery of the country's own reserves is therefore essential for future UK security of energy supply".[5]

8. The Government accepts that oil and gas is a "key component" in terms of energy security and that energy security "will become an increasingly important factor".[6] In a

4 *Oil & Gas UK 2008 Economic Report*, p 7

5 Ev 108, para 2.1.

6 Q 173

recent speech to the *Powering Scotland* conference, the Minister set out the energy security context:

> A quarter of our current electricity generating capacity may close over the next decade, as nuclear plants reach the end of their scheduled lifetimes and as coal-fired and oil-fired plants close by 2016 under the European Large Combustion Plants Directive. At the same time, oil and gas from the North Sea is declining. It remains an important energy resource which we must continue to maximise, but clearly our imports of gas and oil will increase. The UK will compete for fossil fuels in a global market where global demand for energy is increasing and competition for resources is intense.
>
> Energy supply is an increasingly important part of any nation's security.
>
> Last month's dispute between Russia and the Ukraine underlined the importance of diverse energy sources and diverse routes of supply.
>
> We can't become overly dependent on any one source of energy. [7]

9. The prospect of the UK having to rely on imported energy sources is not new. In 2003 the Institution of Civil Engineers produced a report predicting that by 2020 there could be a potential 80% shortfall in meeting the country's energy demands from current supplies and which pointed to the "possibly cataclysmic effects of becoming reliant upon unsecured, imported fuel supplies". The report predicted that, because of the closure of coal-generating plants and the absence of new nuclear facilities, the UK's requirements would have to be met by "gas-fired power stations, importing 90 per cent of their fuel". Their conclusion was that "Britain's future energy plans lack[ed] both diversity and security of supply".[8]

10. **The Government is right to focus on security of energy supply as a key challenge for the UK. Much of the UK's current electricity generating capacity is set to close over the next decade, and there is a continuing risk of disruption to energy supplies internationally as a result of political and economic turbulence. In this context the importance of domestically produced oil and gas is obvious and the case for Government doing all it can to help maximise economic production is compelling.**

Contribution to the economy and employment

11. The benefits of a thriving oil and gas industry go beyond security of energy supply. Oil & Gas UK told us that "in the current fiscal year, oil companies will pay £13 billion to the Exchequer, which is the equivalent of around 30% of UK corporation tax receipts. Activity in the supply chain contributes a further £5-6 billion from payroll taxes, national insurance contributions and corporation tax".[9] The organisation's 2008 *Economic Report* estimated that oil and gas production had resulted in £248 billion (in 2007 prices) being paid in tax

7 Speech by Mike O'Brien MP, 10 February 2009, http://www.decc.gov.uk/en/content/cms/news/powerscotland_speech/powerscotland_speech.aspx

8 https://www.ice.org.uk/knowledge/newsdetail_ice.asp?PressID=238&NewsType=Press&FacultyID=3

9 Ev 109, para 2.1.4.

revenues since 1968.[10] It also states that "indigenous oil and gas production has an important role in reducing dependency on imported fuel. The UK's balance of trade in goods and services… was again in deficit last year by some £49 billion. The deficit would have been increased significantly, to around £78 billion, had it not been for the production of indigenous oil and gas".[11]

12. A review of employment commissioned by Oil & Gas UK found that in 2007 an estimated 350,000 jobs were provided by expenditure in the UKCS, consisting of 34,000 employed directly by oil and gas companies, 230,000 within the wider supply chain and 89,000 supported by economic activity induced by employees' spending throughout the economy. It estimated that an additional 100,000 people were employed in export activities by supply chain companies. Oil & Gas UK notes that there are clusters of high levels of employment, "most notably in Scotland. Just four parliamentary constituencies in Aberdeenshire account for 39% of total employment supported by the industry. Other regions with sizable employment are Eastern England (5%), North-West England (6%) and London and the South-East".[12] The Department's evidence notes that there has been an increase in employment in the industry of about 30% since 2004.[13]

13. Employment in the industry is contingent on ongoing investment. Oil & Gas UK estimates that each £1 billion of investment in the UKCS provides around 20,000 jobs. We examine the issue of investment below, but in terms of its effect on employment we were concerned to note Oil & Gas UK's statement that "with capital expenditure forecast to fall by up to £2.5 billion over the next two years, this could mean a loss of up to 50,000 jobs.[14]

14. **The Government's priority when determining policy on UK oil and gas should be security of supply, within the context of moving towards a low-carbon economy. However, proper account also needs to be taken of the immense tax revenues paid by the industry and of the 350,000 people whose employment is reliant upon it. We are concerned to note that the industry predicts that falling capital expenditure could lead to the loss of 50,000 of those jobs over the next two years. This strengthens the case for the Government to investigate further ways by which it can support UK oil and gas production in the current difficult economic climate.**

Future production levels

15. DECC's written evidence states that its "overall objective for the management of [the UK's oil and gas] resources is to maximise their economic recovery over time, and to maximise the consequent benefits to the UK economy and to UK employment".[15] Estimating future levels of oil and gas production accurately is not straightforward. There are two key factors: the extent of remaining oil and gas resources; and the likelihood of

10 *Oil & Gas UK 2008 Economic Report*, p.8

11 Ibid, p.9

12 *Ibid*, pp 14-15.

13 Ev 75, para 70.

14 Ev 113, para 3.5.7.

15 Ev 66, para 2.

those resources actually being produced. DECC told us that it publishes annual estimates of the UK's oil and gas reserves, compiled from the companies' estimates of their fields' reserves. The reserves are categorised as "proven" (corresponding to a 90% probability of production); "proven plus probable" (50% probability of production); and "possible" (10% probability of being produced in full). "Proven plus probable" is assumed to be the central estimate of reserves, and DECC estimates that such reserves remaining at the end of 2007 were 780 million tonnes of oil and 647 billion cubic metres (bcm) of gas.[16]

16. Additionally, DECC publishes estimates of "Potential Additional Resources" (PARs: discovered volumes not currently considered producible for technical or commercial reasons) and "Undiscovered Resources" (potentially recoverable resources not yet tested by drilling). Both categories are reviewed annually and elements in them reclassified if appropriate: for example, PARS may be reclassified as reserves in the light of changed technical or economic circumstances.[17]

17. DECC has made lower, central and upper estimates of the UK discovered oil and gas resources as set out in Table 1.[18]

Table 1

Summary Table Giving Ranges of UK Discovered Hydrocarbon Resources

(Reserves plus Potential Additional Resources, as at end 2007: billion barrels of oil equivalent)

Oil and Gas	**Lower**	**Central**	**Upper**
Fields in production or under development	5.5	8.2	11.4
Other significant discoveries not fully appraised	0	1.6	3.2
Reserves	5.5	9.8	14.6
Potential Additional Resources	0.9	2.3	4.7
Total Discovered Reserves and Resources	6.4	12.1	19.2
Cumulative production to date	37.5		

18. In addition to the **discovered** reserves and PARs set out in Table 1, DECC's mid-range estimates of **undiscovered** resources are 5.2 billion boe ("corresponding to a reasonable estimate of what might be found based on current knowledge") and 8.7 billion boe ("corresponding to a reasonable estimate of what might be found with better understanding of the basins or better technology"). Taking these various estimates together, DECC's evidence states that "our current best estimate of remaining recoverable hydrocarbon resources from the UKCS is of a figure of around 20 billion boe. But it is of course entirely possible that the development of better understanding and technological change will in the event enable higher figures to be reached".[19]

19. If this estimate of 20 billion boe of remaining recoverable resources is correct it means that a considerable amount of oil and gas – about 50% of that produced over the last 40

16 *Ibid*, paras 4 and 5.

17 *Ibid*, para 7.

18 *Ibid*, para 8.

19 Ev 67, paras 9 and 10.

years – remains to be exploited. But two caveats need to be noted: the range of estimates of remaining resources is wide and actual production could turn out to be at the low end of it; and just because the oil and gas is there to be recovered does not mean it necessarily will be recovered.

20. In terms of remaining resources, as Professor Kemp notes, "there is… a wide range of possibilities and the current DECC estimates for the remaining potential involve a low of 11bn boe and high of over 37bn boe".[20] Explaining why DECC considered 20bn boe to be the best estimate within this range, the Minister told us "I am going for the middle measurement… All these things are, in a sense, estimates… If you talk to someone in the oil and gas industry, they will say 25 billion barrels. We say round about 20 billion, but it is between about 11 and 37, and until, in a sense, we have exploited it, we are not going to definitely know because you may… have reserves there but if they are not commercially accessible, then they are not going to do a lot of good".[21] We asked the Minister what the impact would be on security of supply if the lowest estimates turned out to be accurate. He said "we would have to import more, so we would be much more dependent on the world market for oil and gas. We have good import facilities, so that in a sense is not going to cause a massive problem. It would be regrettable, because we want to see if we can maximise the extent to which the UK can benefit from its Continental Shelf, but we have created gas and oil import facilities".[22]

21. We were told that "a feature of the maturing UKCS is the (inevitable) increasing reliance on production from fields of more recent vintages… But the newer fields are not only on average smaller than older ones but their decline rates are much faster". This would lead to a "brisk" production decline rate "unless substantial numbers of new fields and incremental projects can be brought on stream year by year to counter this inherent trend. Given the likely sizes of the new fields as many as 20 new fields coming on stream per year plus a substantial number of incremental projects would be insufficient to halt the production decline. Given the financial and physical constraints on the industry it is most likely the average number of new field developments will be less than 20 per year over the longer term, and considerably less at current oil prices".[23]

22. Evidence from UK Oil & Gas also suggests that future production will fall. In terms of exploration and appraisal (E&A), it found that 109 E&A wells were drilled in 2008 and that 67 E&A wells were planned for 2009, of which 34 were firm (i.e. with rig commitment). However, a year earlier it was expected that 113 wells would be drilled in 2009; and only 10 E&A wells were expected to be drilled in 2010 – down from a prediction of 30.[24] This big picture is confirmed by the experience of individual operators: Alan Booth, CEO of a small listed company, Encore Oil, told us "we are not in the market at the moment… For the last

20 Ev 94, para 3 (a).

21 Q 174.

22 Q 175.

23 Ev 94-95, para 3 (d) [Professor Kemp]

24 Ev 113, para 3.5.2. and *Oil & Gas UK 2008 Activity Survey*, pp 18-19.

15 months my company…drilled seven wells. Next year we will likely not be drilling any wells."[25]

23. Given the importance of production rates, the variation in the possible future outputs and the impact those different scenarios will have on UK energy policy we believe there is a strong case for Government and industry developing a strategy to maximise production levels. The Government told us that "aspirational" targets were set in 1999 by the Oil & Gas Industry Task Force (OGITF), the predecessor body to PILOT (the joint programme operated by the Government and industry aiming to secure the long-term future of the industry). The targets set in 1999, to be met by 2010, were:

- investment sustained at £3 billion per annum from UKCS activity
- production at three million barrels of oil equivalent per day (mboepd)
- prolonged self-sufficiency in oil and gas
- a 50% increase in exports in oil and gas supplies products [by 2005]
- £1 billion additional value from new businesses
- supporting up to 100,000 jobs more than there otherwise would have been

The following additional target was added in 2002:

- In 2010, the UK is the safest place to work in the worldwide oil and gas industry.[26]

24. Performance against these targets has been mixed. DECC told us that since 2000 UKCS capital expenditure has comfortably exceeded £3 billion per annum and that the target for a 50% increase in oil and gas supplies products was "exceeded by a considerable margin". The Department also noted that "the renewables, and particularly offshore wind, market will predominantly be serviced by the oil and gas supply chain and generate a substantial diversification opportunity", thus helping to meet the target for additional value from new business, and that employment in and supported by the industry has risen in recent years. However, production in 2010 is now expected to be at 2.4 mboepd only, against the target of 3mboepd; DECC has said that "the UK is expected to become increasingly reliant on imported oil and gas"; and that the UKCS is still behind Australia and Asia in terms of safety.[27]

25. While some of these targets have been missed we think that setting them has been beneficial in terms of strategic planning of energy security issues and as a benchmark for performance. We accept the point made by DECC that, while the target of 3mboepd has not been realised, "these aspirational targets were useful in providing a focus for many of the initiatives which have borne fruit in the last decade. The aspirational nature of the vision target for production in 2010 is emphasised by the fact that the supporting analysis

25 Q 26

26 Ev 84-85, paras 2-5

27 Ev 85-89, para 6

against which it was set indicated production declining to a maximum of 2.2mboepd", compared to the 2.4mboepd now expected.[28]

26. **Estimates of future levels of UK oil and gas production cover a wide range: from 11 billion barrels of oil equivalent (boe) to 37 billion boe according to DECC. The Government cannot influence the amount of oil and gas remaining in the UK continental shelf. But the policies it pursues in relation to tax, regulation and licensing all have an impact on the attractiveness of producing oil and gas from the UKCS and therefore on production levels. The Minister told us it would be regrettable if oil and gas production was at the low end of the estimates, with a consequential need to import more oil and gas. We think this is an understatement, given the contribution of the UK oil and gas industry to security of energy supply, tax revenues and employment. We support the Government's objective of maximising the economic recovery of UK oil and gas resources but believe that it now needs to articulate a strategy setting out how it intends to achieve that objective with realistic but stretching targets for future production levels.**

Investment levels

27. Actual levels of future production will be contingent on investment. As Oil & Gas UK put it to us: "the success of the North Sea or the UKCS offshore generally comes down to attracting and spending capital".[29] The SCDI told us that "current business plans will see the UKCS only providing about 12% of the nation's oil and gas demand in 2020. However, with sustained investment, this could increase to 40%".[30] Oil & Gas UK have estimated that approximately £1 billion of investment is required to develop and bring on-stream each 100 million barrels of production.[31] So the decisions taken by companies now about investment will directly impact upon the contribution of the industry to meeting the UK's energy demands in the future. And while the industry has an excellent track record of investment, the current outlook is worrying.

28. Levels of capital investment are falling. In 2006, estimated capital investment in the industry was at a peak of £5.6 billion; in 2008 it was down to £4.8-5 billion.[32] Oil & Gas UK contend that "in an unconstrained world, capital investment in 2009-12 could be sustained at or around £5 billion per annum based on the existing portfolio of opportunities, albeit higher oil and gas prices would be required to support many of these investments. However, current market condition combined with the lack of access to capital or equity markets will significantly suppress investment". This leads the organisation to conclude that "it is difficult to see investment forthcoming in large quantities for anything but the most attractive of projects at this time". Rather than the £5 billion annual investment which might be made "in an unconstrained world", Oil & Gas UK estimate that "capital investment in 2009 will fall to a range of £3.5 – 4.5 billion and could decline to £2.5 – 4 billion in 2010. This projection is consistent with the investment response seen in the

28 Ev 86, para 6

29 Q 141

30 Ev 121, para 4

31 Ev 110, para 3.1.1.d

32 Oil & Gas UK 2008 Activity Survey, p 12

period 1998-2000, during the last sharp downturn in oil price, where it took two years for the full impact to be felt".[33]

29. Falling levels of investment have an adverse impact upon production levels and numbers employed in the industry. Precise predictions are difficult, and require a range of assumptions, but if Oil & Gas UK's worst-case scenario of £2.5 billion investment is realised in 2010 – against the £5 billion they say might be invested in "unconstrained conditions" – then, using the industry's figures for the effect of investment on production levels and employment, this would equate to 250 million barrels of production foregone and 50,000 fewer jobs. Declining investment can also hasten the decommissioning of infrastructure which might otherwise have been used to enhance production. As Professor Kemp told the Committee, "the way to maximise economic recovery from the North Sea is to get a very steady stream of investment going. My worry at the moment is if it falls down for two or more years then we could be on a slippery slope and there will not be enough incentive to maintain the infrastructure and then it will be too late".[34]

30. **We are very concerned at the bleak prospects for investment in the oil and gas industry. If the industry's worst case scenario is realised in 2010, 50,000 jobs could be lost and production could fall by millions of barrels. The Government must do what it can to facilitate investment, and the success of the steps announced in the recent budget must be judged by whether they help stop the downward slide in capital investment.**

31. Levels of investments are determined by a range of factors, including: the availability of credit and equity; costs of production; the market price of oil and gas; and the attractiveness of the fiscal regime in which the market operates. The oil and gas industry is facing a particularly challenging set of market circumstances regarding the first three factors; and it has also claimed that the UK's fiscal regime makes it an unattractive environment in which to invest. We look at each of these factors below.

33 *Ibid*

34 Q110

2 Market conditions

The availability of credit and equity

32. Oil and gas companies are finding it increasingly difficult to access the credit and equity they require, and the banking crisis has exacerbated an already difficult situation. Oil & Gas UK told us that "small oil companies needing debt capital to finance development activities are unable to secure it. Large oil companies are taking a conservative approach and many are reviewing budgets in light of the uncertainties caused by the recession and the banking crisis… Supply chain companies advise us that banking facilities are being withdrawn or charged at new prohibitive rates, potentially placing solvent businesses under threat of liquidation".[35]

33. The Scottish Council for Development and Industry (SCDI) told us of the concerns the industry has about the availability of funding and the adverse effects this is likely to have:

> In the latest Aberdeen and Grampian Chamber of Commerce Survey 50% of operators and 54% of contractors rated access to capital and loans as very important. All operators and 87% of contractors shared the view that the current credit issues would lead to more mergers and consolidation in the UKCS and all believe it will have an adverse effect on working capital and activity, leading to the deferment and cancellation of capital expenditure. The prevailing view is that this much tighter lending environment is likely to persevere for some time.[36]

34. The Oil & Gas Independents' Association told us that only one British bank – Lloyds/HBOS – is lending to oil and gas companies; and that even that bank is not lending to new operators:

> At the minute the only one lending in the North Sea at the minute is the merged Lloyds/HBOS. It has a very good oil and gas franchise. It built it up. I represent a small company, and we have relationships with HBOS which we built up. We have a facility with them, which we are just going to roll over, which is going okay at the minute, but if we came in as a new borrower the door would be closed. We would like more banks to lend in the North Sea - we have one, and there may be a few French banks - but really banks that have large businesses here lending to small oil companies to develop the fields.

Furthermore, despite lower interest rates, companies' borrowing costs have not reduced because banks are increasing fees.[37]

35. DECC acknowledges that there are "difficulties" resulting from the problems experienced by banks, but the Minister made the point in oral evidence that larger companies tended to be relatively unaffected and that many of the smaller companies operating in the industry were not reliant on British banks:

35 Ev 113, para 3.5

36 Ev 127, para 45

37 Qq 33-34

> We do not envisage any serious problems for the large companies. Many of the smaller companies are not UK based and get their finance from elsewhere in any event, but where there are companies that have used RBS and HBOS, we have seen the Bank of England interventions in January, and to some extent in October, and we have also had the work that is being done by UKFI to manage our involvements in those, and it is clear that the North Sea and the UK continental shelf more generally has been an area which has brought great profits and benefits, by and large, so they tend to be good investments. The difficulty is they also tend to be long-term investments, and at the moment many of the banks are concerned about their liquidity and are less anxious to tie up money for long periods. Is there likely to be a difficulty round this? Yes, but let us not exaggerate it, in the sense that the bigger oil companies and gas companies will be fine. The smaller ones, by and large, will be the ones that have difficulties, but not all of them are going to be reliant on UK banks…. We have been engaging to ensure that we monitor very carefully what is happening in the industry, who have got problems (some of them are a bit reluctant to tell us whether they have or not) and what the problems are, and we have also been engaging, not ourselves but through the Treasury and BERR, with the banks in order to ensure that the importance of the UK continental shelf is at the forefront of the minds of the banks.[38]

36. **We welcome the Government's recognition of the difficulties faced by oil and gas companies in accessing affordable lending and the fact that DECC, through BERR and HM Treasury, is engaging with banks to ensure that the UK continental shelf "is at the forefront of the minds of the banks". However, given the problems oil and gas companies are having in achieving affordable borrowing, it does not seem that such engagement is having any conspicuous success. DECC Ministers should set out, with their Treasury and BERR counterparts, what steps the Government is taking specifically to help oil and gas companies access affordable credit from banks and keep under review the availability of such credit.**

Production costs

37. Another challenge faced by the industry is the persistence of high technical costs, despite the falling price of oil and gas. Professor Kemp's evidence referred to "the dramatic worldwide cost escalation which has followed the large oil price increases" over the last four years and, in particular, "the spectacular increase in drilling rig hiring rates".[39] Oil & Gas UK's 2008 activity survey estimates that

- Capital costs to develop new fields continued to increase in 2008 and were typically 10-15% higher than in 2007, at around $16/boe;
- The capital cost per barrel for brownfield (incremental) developments rose more sharply, and was 15-20% higher than in 2008; and

38 Q192

39 Ev 93, para 1

- The cost of developing and producing a barrel of oil or gas equivalent in 2008 was 12% higher than in 2007, at around $29/boe.[40]

38. The survey also notes that there has been a decline in capital efficiency in recent years, with the cost of developing a barrel of oil or gas now around three times higher than in 2002. It states that "although capital investment has risen, the total volume of oil and gas being developed has declined" and estimates that while total capital investment increased by half between 2002 and 2008, only a third of 2002 levels of oil and gas were being developed in 2008; it concludes that "this trend may have been acceptable as oil prices rose; however it is clearly unsustainable in the current environment".[41]

39. We were told that the reasons for these dramatic cost rises were increased global demand for oil combined with reductions in capacity caused, for example, by hurricanes in the Gulf of Mexico.[42] Given the global downturn it is reasonable to expect that inflationary pressures on oil and gas production costs should decline. Malcolm Webb, Chief Executive of Oil & Gas UK, told us that he expects costs to fall and that "there are signs that they will fall. We need to be careful about not believing that is going to happen overnight, it will be a slowish process and that is what history tells us, that when we have been through these periods of recession before it will take some time for the costs to come down, and we are working on that. The whole of the industry is taking a responsible attitude towards that."[43] The Oil & Gas Independents' Association told us "we have got prevailing costs from last year, when oil was $147 a barrel; and those costs as far as drilling is concerned, have not come down yet. We are still looking at perhaps $400,000 a day for a rig."[44]

Access to infrastructure

40. An issue related to costs which is of great importance to smaller companies especially is their access to infrastructure. As the Oil and Gas Independents' Association told us "increasingly, we are finding smaller accumulations in the North Sea, and they cannot support their own dedicated infrastructure, so we have to be able to tie them back to existing infrastructure, which has to be there. Ultimately, it drives exploration. If you are expecting to find relatively modest pools, you have to know there is an efficient way of getting it to the shore."[45] The Association has serious concerns about the operation of the industry's Code of Practice relating to infrastructure access, which they believe is hampering their ability to operate. They said that in order to maximise potential it might be necessary to put access rights for various companies on a statutory basis and to:

> simplify the process for producing… new (mostly smaller) fields via existing infrastructure, ensure that the owners of the infrastructure do not extract a disproportionate share of the value by creating delay or offering inappropriate tariffs and liabilities in relation to the risks they take. The current voluntary Infrastructure

40 *Oil & Gas UK 2008 Activity Survey*, p 15

41 *Ibid*

42 Q 140

43 *Ibid*

44 Q 4

45 Q 5

> Code of Practice (ICOP) is NOT making any significant differences and many bad behaviours and practices still remain. This actively discourages exploration and appraisal for new fields as the risk reward balance is significantly skewed in favour of the infrastructure owner rather than the risk taker. Legislation for guaranteed access terms or "common carrier" status should be seriously considered.[46]

41. Oil & Gas UK said that some parts of the Code work well but accepted there were problems. They told us

> The Code of Practice was an attempt in 2004 to get the various parties together who recognised that the future of the UKCS very much depends on those smaller fields coming in and making use of the existing infrastructure … The Code of Practice has worked well in a number of [areas] …. The one piece of the Code that has not been working particularly well, and we all recognise that, as all access to infrastructure is negotiated access between the parties we put in place a mechanism to give a backstop to that negotiation in the event that it did not come to a conclusion on its own. The backstop was effectively for the party wanting access to make use of the existing legislation and ask the Department for a determination from the Secretary of State. It is that piece that is not working particularly well. I think the key issue there was if you were going to ask for that you needed to have confidence that you were going to get an answer that was both workable in the longer term and available to you within a useful timescale and it was comprehensive enough that you could make use of it. There have been question marks over all of those things, which we have been working on. I have to say we were actively looking at this over the course of the back end of last year and still are looking at how we can move this forward. It is very much a work in progress. [47]

42. The organisation also accepted that some deals had stalled as a result of the Code not operating effectively. The main problem seems to be that if a negotiation is not making progress it is up to one side to take the issue to the Secretary of State for, in effect, arbitration. This is not happening because, as the Independents' Association paraphrased a comment that was put to them by one party to such a negotiation, ""we didn't want to upset the other side"".[48] The Association's representative concluded that, while he was not naturally in favour of intervention, this was an area where greater participation by the Government would be welcome.[49]

43. DECC accepted that there were problems with the voluntary Code but said that while the Secretary of State had not made any formal determinations a number of disagreements had been resolved "out of court" and that the guidance issued by the Secretary of State had had an impact.[50] The Minister did not support the idea of a statutory common carrier system.[51] This option was also rejected by Oil & Gas UK, who told us that "retrofitting

46 Ev 102, para 1.3.2

47 Q 129

48 Q 8

49 Q 10

50 Q 185

51 Q 187

common carrier arrangements onto these existing pipelines is going to be hugely complicated, hugely expensive and I cannot believe [it] is the right way forward".[52]

44. **Smaller companies in particular are having difficulties accessing the infrastructure they require in order to produce oil and gas because in some cases of unrealistic demands by the infrastructure's owners. The industry's voluntary Code of Practice is not working well in this respect and, while we are not yet convinced of the case for a comprehensive statutory "common carrier" system of access, we do think that Government has to take a more active part in ensuring the successful outcome of negotiations about access arrangements. DECC and the industry should make it a priority to strengthen the voluntary arrangements so that they do not hamper the ability of companies to operate. If a voluntary code cannot be made to work more effectively serious consideration should be given to introducing a common carrier system.**

The price of oil and gas

45. Oil prices remained within the $50-80 per barrel range throughout 2006 and until autumn 2007, when they began to rise steeply, peaking at $147 in July 2008. They then fell, reaching a five year low of $32 in February 2009. By mid-May prices had increased once again to $60. Gas prices largely followed oil over the same timescale, with variations for short-term factors such as the weather.

46. As well as impacting upon the short-term competitiveness of the industry, the price of oil is, along with the fiscal regime, one of the key factors determining levels of investment (and hence future rates of production). Professor Kemp has analysed the likely effect on levels of production and investment up to 2035 of three different prices for oil and gas: (1) $80 per barrel and 70 pence per therm (in constant real terms); (2) 60$ and 50 pence; and (3) $40 and 30 pence. In terms of production levels, we were told that

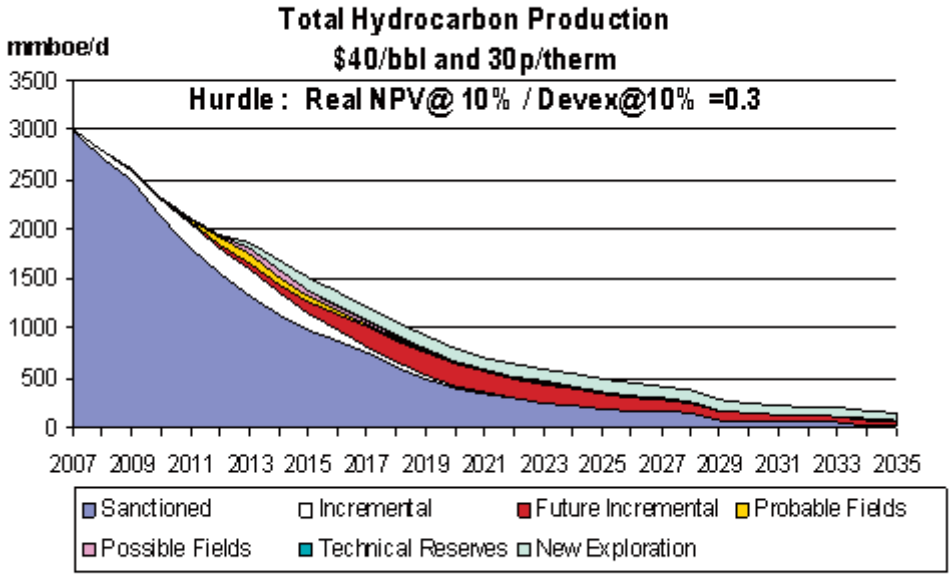
> under the $40,30 pence scenario total hydrocarbon production falls off very rapidly indeed, and ultimate recovery from the UKCS is very much less than the potential as seen by DECC. In fact in the period 2008 – 2035 only 10 bn boe are recovered. Under the $60,50 pence case the decline rate is much less pronounced and in the period 2008 – 2035 15.5 bn boe are recovered. Under the $80,70 pence case production falls slowly and in the period 2008 – 2035 19.6 bn boe are recovered.[53]

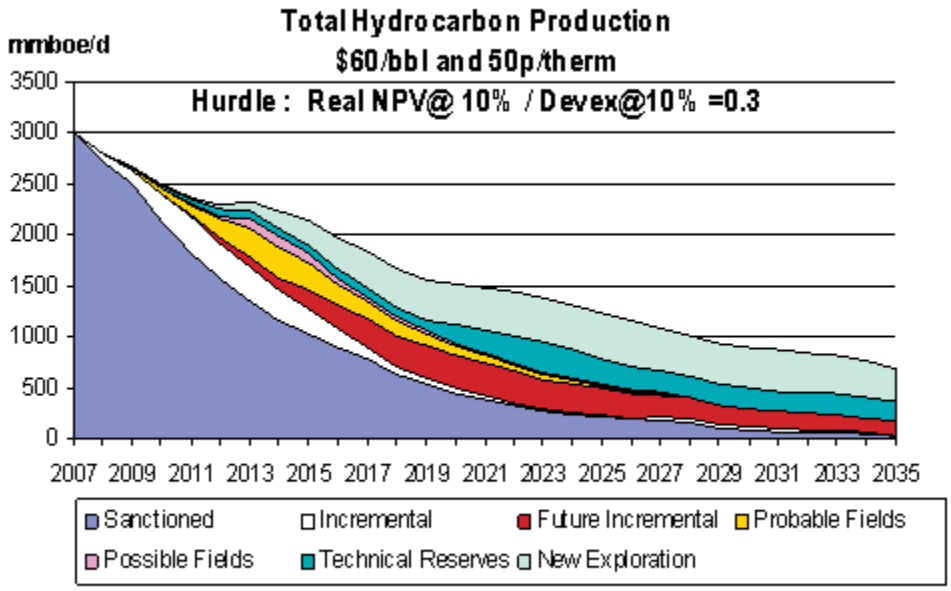
The charts below show predictions for production levels under each pricing scenario.[54]

52 Q 131

53 Ev 95-96, para 4

54 Ev 96


Total Hydrocarbon Production
$40/bbl and 30p/therm
mmboe/d
Hurdle : Real NPV@ 10% / Devex@10% =0.3
3500
3000
2500
2000
1500
1000
500
0
2007 2009 2011 2013 2015 2017 2019 2021 2023 2025 2027 2029 2031 2033 2035
Sanctioned
Incremental
Future Incremental
Probable Fields
Possible Fields
Technical Reserves
New Exploration


Total Hydrocarbon Production
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Possible Fields
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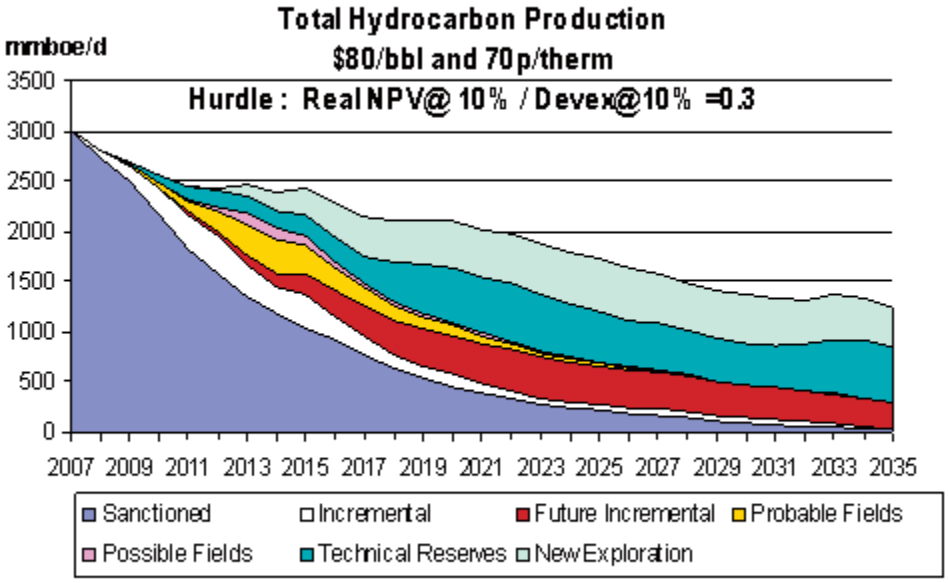
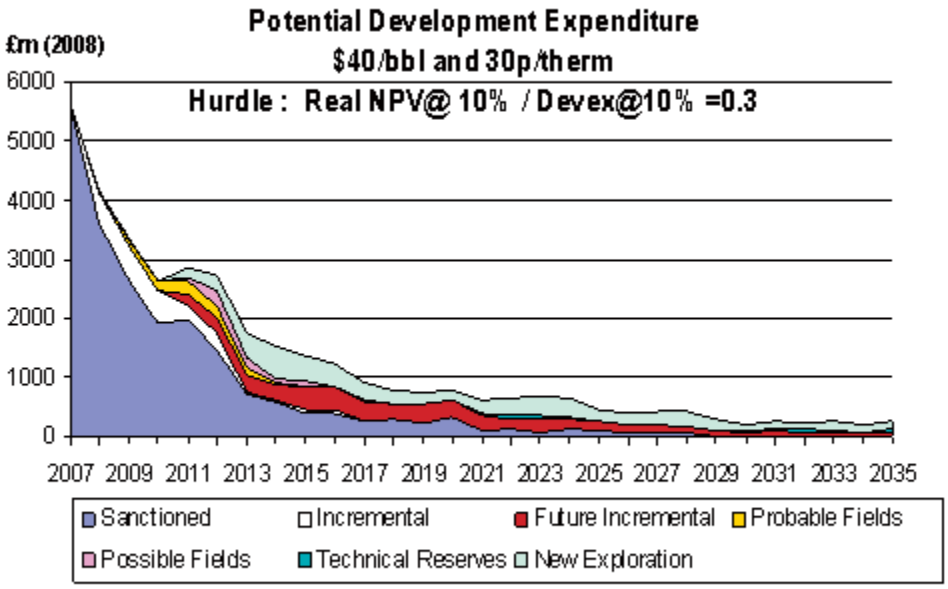
New Exploration

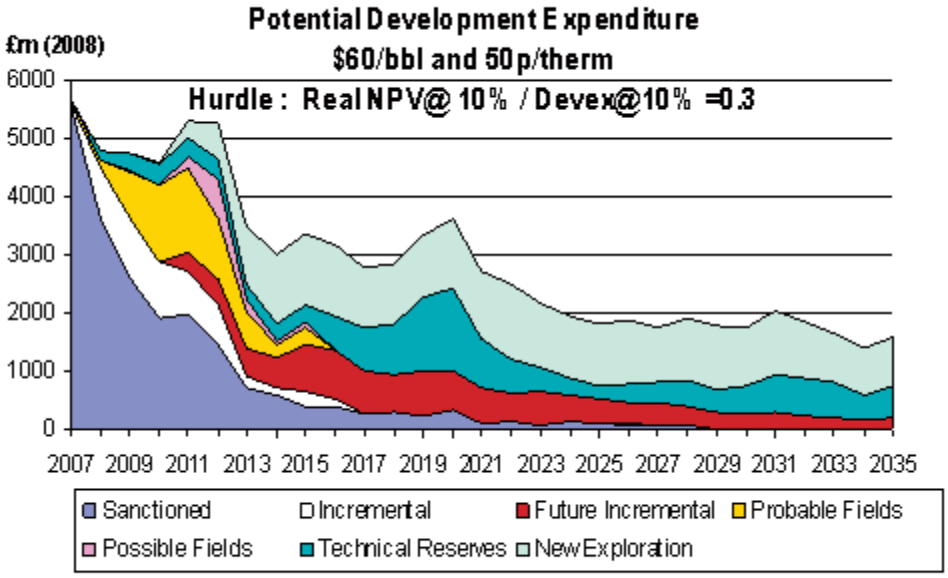


47. A similar story is told for levels of investment under each price scenario:

> there is a dramatic fall in investment under the $40,30 pence case: many new projects are not viable. Under the $60,50 pence case investment falls moderately over the next few years and more noticeably in the longer term. Under the $80,70 pence case investment holds up well for a very considerable number of years.[55]

55 Ev 97, para 5


Potential Development Expenditure
$40/bbl and 30p/therm
£m (2008)
Hurdle : Real NPV@ 10% / Devex@10% =0.3
6000
5000
4000
3000
2000
1000
0
2007 2009 2011 2013 2015 2017 2019 2021 2023 2025 2027 2029 2031 2033 2035
Sanctioned
Incremental
Future Incremental
Probable Fields
Possible Fields
Technical Reserves
New Exploration


Potential Development Expenditure
$60/bbl and 50p/therm
£m (2008)
Hurdle : Real NPV@ 10% / Devex@10% =0.3
6000
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Sanctioned
Incremental
Future Incremental
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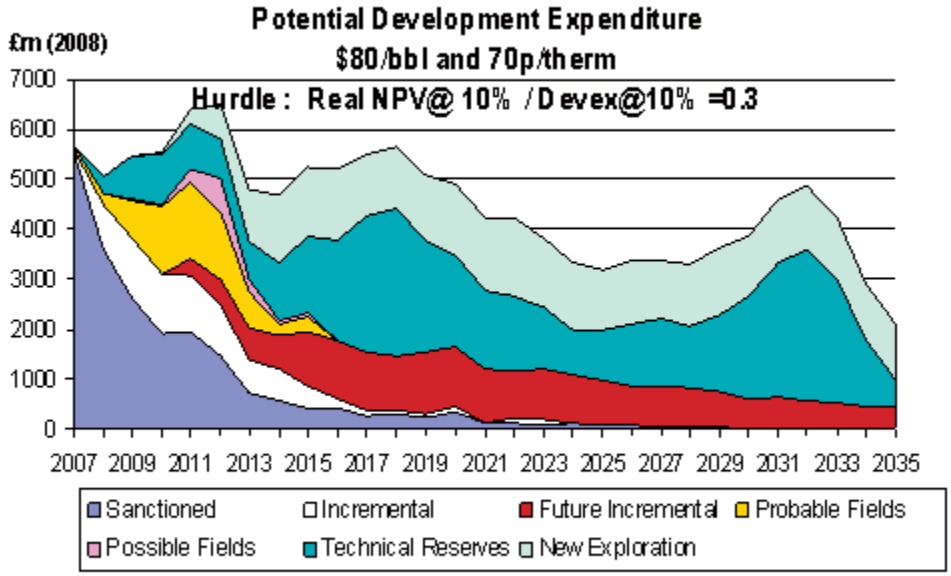
Possible Fields
Technical Reserves
New Exploration



48. Future trends in prices will therefore have a very significant impact on levels of investment in and production from the UKCS. Professor Kemp told us "it does not look to me as if the price is going to come up much in the next couple of years".[56] The International Energy Agency's recent Oil Market Report stated that "Prices recently have tracked expectations for the global economy, seeking signs of demand recovery. However, pervasively weak market fundamentals could limit further gains for now". It also revised downwards its forecast for 2009 global oil demand to 83.4 mb/d, 2.4 mb/d below 2008. It concluded that "the pace of contraction is close to early 1980s levels, with a growing consensus that economic and oil demand recovery will be deferred to 2010."[57]

Overall market conditions

49. The juxtaposition of a global recession; high production costs; lack of affordable credit; unstable and – currently – low prices make current market conditions extremely difficult for companies in the oil and gas industry and its lengthy supply chain. As Professor Kemp put it, "there is a kind of pincer movement between the price coming down and the cost per barrel going up. On top of that we have the financial sector problems which make it very difficult for the small and medium-sized companies to get external finance, whether debt or equity."[58] Referring to the situation as at January 2009, when oil prices were at $40-45/bbl, Shell UK told the Committee "these most recent price ranges are at levels we have not seen since 2004-05, however the cost environment has changed somewhat, with costs and supplementary corporation tax double to when we last had oil prices at oil prices at $40-45bbl".[59] While prices have to an extent recovered (to around $60/bbl at mid-May

56 Q 103

57 *Oil Market Report*, International Energy Agency, 10 April 2009, p 1

58 Q 103

59 Ev 130, para 2

2009), the fundamental point – that prices are relatively low and that costs and taxes are not – is still valid.

50. **The oil and gas industry operating in the UKCS faces high costs, low prices, lack of affordable credit and a global recession. The Government cannot unilaterally solve these problems. But that makes it imperative that where it can make a difference – in facilitating credit from banks for example and, even more crucially, in establishing a fair and sustainable fiscal regime – it does so.**

3 The fiscal regime

51. Profits arising from the extraction of oil and gas in the UKCS potentially fall within two fiscal regimes: petroleum revenue tax (PRT) and ring-fenced corporation tax (RFCT), which also incorporates supplementary charge (SC or SCT). **PRT** is a field-based tax and can produce an assessable profit or an allowable loss; the latter may be taken forward and set against later profits from the same field. It does not apply to fields given development consent on or after 16 March 1993. **Corporation tax** on upstream oil and gas is levied at 30%. A **supplementary charge** of ten per cent on adjusted ring fence profits was introduced in 2002 and increased to 20% in 2006. Adjusted ring fence profits are the amount of profit or loss arising from any ring fenced activities, excluding any financing costs. Fields not paying PRT will thus be liable to a marginal tax rate of fifty per cent.

52. This fiscal regime has led to very significant tax receipts for the public purse. Oil & Gas UK's 2008 Economic Report estimated that, over the previous four decades, the industry had provided £248 billion in tax revenues to the UK Exchequer and that 2008's high prices would result in tax receipts of around £15 billion for the fiscal year (assuming an average price of $110 for 2008), with a further £5-6 billion in tax receipts added from UK supply chain activity, primarily from Corporation Tax and payroll contributions.[60] However, the regime is unpopular with those subject to it. Oil & Gas UK told us that "the current fiscal regime is no longer fit for purpose. It appears to be designed to maximise short-term revenues for the Treasury at the risk of long-term recovery of reserves and security of energy supply."[61]

53. Oil & Gas UK has argued – unsurprisingly perhaps - that the overall tax burden on the mature UKCS must be reduced and that "difficulties in attracting and maintaining investment in the UKCS for projects of all kinds have been suddenly and materially increased." It goes on to argue:

> When the oil price was last in the $40-$45 per barrel range, new developments were subject to a tax rate of 40%, but are today liable to 50%. Certain mature fields are subject to a marginal tax rate of 75%. The mismatch of tax rate and current business environment is detracting from the value of investment and is contributing to the dampening of that investment. Government help is urgently needed for both established companies and the new smaller businesses that have been explicitly encouraged into the basin by Government policy. Material improvements in the current tax regime are now required to stimulate additional capital investment both through the current downturn and in the longer term.[62]

54. BP told the Committee that while in recent years the UKCS fiscal regime had not been "draconian or uncompetitive in global terms", the difficulty was "that it has not adapted sufficiently to the needs of a mature basin. One of the characteristics of a mature basin is that geographically and commercially, every aspect of the operation becomes much more

60 *Oil & Gas UK 2008 Economic Report - Summary*

61 Ev 111, para 3.3

62 Ev 111-112, para 3.3

difficult. Many of these aspects are beyond human influence; but this means that those which are capable of adjustment (i.e. regulatory and fiscal) become even more significant."[63] Therefore, BP argues that one key factor for maximising the potential of remaining reserves is:

> A competitive and less complex fiscal regime which recognises the growing challenges facing the North Sea industry and the need to reduce the tax burden on a sustainable basis as the basin continues to mature.[64]

55. The complexity of the fiscal regime was also highlighted by the Independents' Association, which also argued for the regime to be predictable in order to inspire confidence in potential operators:

> The UK fiscal regime is extremely complex and a result of 40 years of constant tinkering. It was developed when fields containing hundreds if not billions of barrels were being found. It is now recognised as a fiscal environment with significant risk of (adverse) change. For investors to invest they will always make assumptions about the stability of the tax system prior to investing. The UK does not fare well in this regard, particularly as it requires very significant upfront investments over a number of years prior to cash flow. One actual example would be an exploration investment made on the basis of a 30% tax regime in 2001, which then changed to a 40% regime whilst the discovery was being evaluated for development, and finally became 50% when the bulk of the development capital (totalling $3bn) had already been committed. Is this an environment that encourages sustainable and long term investment? The industry understands that the UK needs a fair return on the development of its resources, however we need to consider a tax regime that is above all *predictable*, [and which] encourages new investment in maximising the development of remaining hydrocarbons from the basin…[65]

The concept of a Value Allowance and the introduction of the Field Allowance

56. The Government has recognised that the fiscal regime needed to adapt and, following a consultation launched at the 2008 pre-budget report, introduced measures in the 2009 Budget designed to support investment in the UKCS. DECC told us that

> Central to this package is the introduction of a new "Field Allowance" (described in the consultation document as a "value allowance"). This will give incentives to encourage investment in small or technically challenging fields, which could assist in unlocking around 2 billion barrels of the UK's remaining oil and gas reserves. It will be targeted at new small fields, with an allowance set at £75 million, and at challenging new High Pressure High Temperature or Heavy Oil fields, with the allowance set at £800 million. The introduction of the Field Allowance marks a significant change to the approach of the North Sea Fiscal Regime. The Government

63 Ev 55, para 4

64 *Ibid*, para 5

65 Ev 103, para 3

> believes it has the potential to make an important contribution to the competitiveness and attractiveness of investments in the UKCS.[66]

In the Budget statement the Chancellor told the House that he was "bringing forward incentives to encourage smaller fields to be brought into production, which could lead to an extra 2 billion barrels of oil and gas that would otherwise remain under the North sea."[67]

57. The Government's Budget Note 10 further explains the operation of the Field Allowance:

> A new 'Field Allowance' is to be introduced which will provide certain categories of new field with a fixed allowance which can, over time be offset against the supplementary charge payable by the companies involved in the field. Once that allowance is exhausted the field will, in effect, pay the full North Sea rate of tax. The speed of exhaustion will depend on the profitability of the company – i.e. if oil prices rise then, all other things remaining equal, the allowance will be exhausted more quickly. The field allowance applies to small fields, ultra heavy oil fields and ultra high temperature/high pressure fields:
>
> • the field allowance for small fields is £75 million for fields with oil reserves (or gas equivalent) of 2.75 million tonnes or less, reducing on a straight line basis to nil for fields over 3.5 million tonnes. In any one year the maximum field allowance (for a field with total allowance of £75 million) is £15 million;
>
> • the field allowance for ultra heavy oil fields is £800 million for fields with an American Petroleum Institute gravity below 18 degrees and a viscosity of more than 50 centipoise at reservoir temperature and pressure. In any one year the maximum field allowance is £160 million; and
>
> • the field allowance for ultra high temperature/pressure fields is £800 million for fields with a temperature of more than 176.67 degrees Celsius and pressure of more than 1034 bar in the reservoir formation. In any one year the maximum field allowance is £160 million. [68]

58. Before the detailed measures were announced in Budget 2009, the concept of a field allowance (known as a value allowance in its earlier iteration in the 2008 consultation document) was given a qualified welcome by some witnesses to our inquiry. The BG Group told us that the allowance "could lead to security of supply benefits with oil and gas volumes that would not otherwise have been produced becoming commercially viable… [and] that high pressure, high temperature (HPHT) fields that are expensive to drill and technically challenging and small field discoveries close to existing infrastructure could benefit in particular from a Value Allowance".[69] Oil & Gas UK's evidence said that it was "a

66 Ev 83, para 3

67 HC Deb, 22 April 2009, col 246

68 2009 Budget Note 10, *North Sea Fiscal regime: Incentivising Production,* HMRC, 22 April 2009

69 Ev 50

welcome step in the right direction" but argued that "additional and bolder" steps were required.[70]

59. However, other witnesses were less convinced of the benefits of such an allowance. BP told us the "Value Allowance by itself cannot make the material difference required in the current economic and oil price environment. It will also further complicate the already excessively complex fiscal regime, counter to BP and industry advocacy of simplification and the desired move towards a level playing field for investment decisions."[71] Shell said that, while it saw "some merit" in the value allowance proposals, it thought that "Government is missing major opportunities in not targeting both new developments AND incremental investment in existing fields. Bringing on incremental production is a huge challenge in the current environment and we believe that Capital Uplift[72] is a more effective measure to bring incremental projects on-line. We believe the VA proposal benefits only a small portion of the UKCS portfolio, in addition to being complicated and prohibitively expensive for Government to make a real difference. Moreover, it does not address brownfield expenditure, where the largest opportunity sits".[73]

60. Other witnesses agreed that it was important to support further incremental production in fields already in production, and that the value allowance as proposed by the Government would not achieve this. Centrica told us:

> There is more to be gained from maximising recovery from existing fields than there is from developing new marginal sources of oil and gas. HM Treasury's proposals for a value allowance appear to incentivise the development of new marginal fields over the exploitation of existing opportunities, ignoring the advantages of existing infrastructure. Centrica supports a broader capital uplift allowance, which would incentivise both new and existing fields on a comparable basis.[74]

Oil & Gas UK – while, as we noted above, calling the value allowance a step in the right direction – said that "to have any effect, it must be material in scale for both new and incremental investment."[75] BP also emphasised the important of encouraging incremental investment: "incentives must be made available to encourage incremental investment options in existing fields through the provision of capital uplift".[76]

61. In its 2008 consultation document, the Government made it clear it did not support this proposal, for the following reasons:

> —an across the board uplift would represent a blunt instrument as it would apply to all capital expenditure, including already sanctioned expenditure. It would not

70 Ev 112, para 3.3.4-5

71 Ev 55, para 10

72 Shell's evidence states that "Capital Uplift is an incentive offered by government to encourage the contractor to maximize investment. It is an additional amount of cost recovery on capital expenditures over and above amounts spent e.g. if a company spends $1,000,000 in recoverable capital expenditures and there is a 10% capital uplift in the contract, the company will be allowed to recover 110% of actual spending or $1,100,000". Ev 130, para 4

73 Ev 130, para 4

74 Ev 62, para 2.1.2.5

75 Ev 112, para 3.3.4

76 Ev 55, para 11

therefore effectively target support on those fields facing the greatest challenges within the UKCS.

—it would involve significant deadweight cost. Whilst it was argued in the course of the discussions that this deadweight cost could be offset by the resulting increased production, more detailed analysis has suggested that this is unlikely to be the case. This proposal would therefore also undermine the principle of maintaining a fair return to the UK taxpayer.

—implementation of such an incentive would be neither simple to design or operate. Giving relief for 125 per cent of capital costs would require either a fundamental rewriting of large parts of the capital allowance rules (to take account of relieving more than 100 per cent of cost) or the introduction of a whole new relieving mechanism for the additional 25 per cent uplift. Either would require large amounts of additional legislation, and additional ongoing compliance obligations for both HMRC and companies. [77]

62. Another option put to us as a favourable alternative to a value allowance was a reduction in the supplementary charge (SC or SCT). Total E&P told us:

> There is a strong argument for the reduction of SCT rather than a complex Value Allowance determination which is proposed by HM Treasury. A simple reduction in SCT would be unambiguous, simple and give a direct signal to industry that Government is committed to helping sustain the UKCS. This is for us the major point. Taking into account the lack of visibility of future prices, decisions to proceed with new projects are difficult to take and such a signal from government would have a real impact.[78]

BP agreed, telling us "a more appropriate fiscal reform would be a straight forward and significant reduction of the rate of SCT, which would achieve more effectively and simply the objectives held out in the Value Allowance proposal."[79]

63. The Government considered the case for a reduction in the supplementary charge in its 2008 consultation document, but did not favour this option:

> The Government does not believe that an across the board reduction in the rate of SC would be desirable. This would act to give the greatest incentive to those projects with the greatest profitability, which by definition are those that least require support, and therefore would result in significant deadweight costs. Moreover, whilst the Government recognises that some new fields may require additional support…the Government believes that overall the fiscal regime is appropriately balanced and set at the correct level to ensure a fair return to both producers and consumers.[80]

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77 *Supporting Investment: A Consultation on the North Sea fiscal regime*, November 2008, HM Treasury and HM Revenue and Customs

78 Ev 135, para 3

79 Ev 55, para 10

80 *Supporting Investment: A Consultation on the North Sea fiscal regime*, November 2008, HM Treasury and HM Revenue and Customs

64. Having set out its stall against a capital uplift and a reduction in the rate of supplementary charge, the Government announced in Budget 2009 that a field allowance was to be introduced. Following this announcement we received further evidence from some in the oil and gas industry setting out their reactions. BP said that "the provisions in the Budget will fail to have any significant effect upon BP's planned activity levels in the UKCS. We do not oppose the Value Allowance, now defined as Field Allowance, as formulated in the Budget; but it does not go nearly far enough to assist our own activities or indeed, we would argue, the wider interest of the Industry and the nation".[81] They criticised the field allowance because, they argued:

- It does not provide any assistance for fields currently in production or for the area west of Shetland. Thus, they state that "the sharp fall in UKCS platform drilling activity already witnessed during the first quarter of 2009 will soon translate into accelerated production declines in those fields where infill drilling has been reduced or ceased".[82]
- There are excessively high qualifying criteria for the allowance, especially regarding high pressure/high temperature (HPHT).

65. The latter point, regarding HPHT, led BP to a highly critical conclusion concerning the field allowance provisions:

> we expect that this measure will have a negligible impact on UKCS investment. Indeed, it seems that only one HPHT undeveloped discovery in the North Sea satisfies the stipulated temperature and pressure criteria, both of which must be met in order to qualify. It certainly won't affect BP's behaviour as none of our five HPHT discoveries meets this onerous criteria. The reality appears at odds with the Chancellor's statement that the Field Allowance would encourage the development of up to a further 2 billion barrels of oil equivalent. If the Government had accepted Industry's proposals in respect of the HPHT qualifying criteria, this measure could have made a significant medium term difference to industry investment. As it stands, this appears impossible.[83]

66. Oil & Gas UK welcomed the allowance as a recognition by government "that it needs to reduce the tax burden to stimulate investment in the mature UKCS".[84] They also said that the allowance was a "modest step forward and will offer some limited incentives for the development of marginal fields". However, their evidence stated that:

> our members tell us that it will do very little to improve the UK's competitiveness or attractiveness for investment when competing for capital on a global scale. Given the limited scope and extent of the allowance, it is only likely to accelerate the development of one or two marginal small fields over the next couple of years. We certainly do not see it reversing the decline in capital investment.[85]

81 Ev 57, para 5

82 *Ibid*, para 6

83 *Ibid*, para 7

84 Ev 115, para 2.1.1

85 Ev 116, para 2.1.5

In addition to the specific points below concerning HPHT and incentives for new fields, the organisation was concerned that the allowance:

- Does not apply to existing fields and so will "do nothing to address the collapse in investment in brownfields, nor will it reactivate drilling campaigns which have currently halted";
- Will have a negligible effect on exploration activity; and
- Will not encourage production west of Shetland or tight gas development.[86]

The Oil and Gas Independents' Association have also told us that the Government should look at extending the allowance to assets west of Shetland and non-conventional gas.[87]

67. Oil & Gas UK agreed with BP that the qualifying threshold for HPHT - at 15,000psi and 350F - is too high and noted that the original thresholds proposed were pressures of 10,000psi and 300F. They were also concerned that the threshold for ultra heavy oil fields is prohibitive. They state that "in both heavy oil and even more so for HPHT, these are tighter technical limits than were proposed by Oil & Gas UK and many of our members have expressed strong reservations about the allowance's efficacy in light of their opinion that it is only likely to have very limited impact."[88] The Oil and Gas Independents' Association have also called for the HPHT criteria to be less stringent.[89]

68. Oil & Gas UK are also concerned that the allowance will have limited success in encouraging new fields. They estimate that the allowance will typically increase the economic value of new small field developments by around £8 million on a discounted post-tax basis, which they say should be compared to the scale of investment – typically between £100 – 200 million which the allowance is trying to encourage. They note Professor Kemp's estimate that the allowance for small fields could add around 400 million boe over the life of the UKCS.[90] To put that figure in context, it equates to approximately 2% of the 20 billion boe which is DECC's best estimate of remaining recoverable hydrocarbon resources from the UKCS. It is a fifth of the additional production which the Chancellor said his budget proposals could stimulate.

69. The general consensus amongst our witnesses - that the field allowance's beneficial effects will be limited – was shared by Shell UK. While, like others, they were pleased that the Government had recognised the difficulties faced by the industry, they were concerned that "the proposed scope, criteria and levels for the incentives set out in the 2009 Budget are not enough to reverse the projected decline in capital investment in the UK continental shelf (UKCS) and will not have adequate impact on the UK's competitiveness and attractiveness to win global investment. We believe the measures will result in only a

86 *Ibid*, para 2.1.6

87 Ev 107

88 Ev 116, para 3.1.4

89 Ev 107

90 Ev 116, paras 3.1.2-3

relatively limited increase in activity in the UKCS."[91] Analysing the potential impact of the allowance on their entire UKCS portfolio, Shell found that:

- Only one development prospect would potentially qualify for the Field Allowance for small fields, but that the allowance is too small for it to be a deciding factor in capital allocation
- Only one field might qualify for the ultra Heavy Oil fields allowance, and again the impact on the project's economics would not move the project out of the marginal category
- The ultra High Pressure High Temperature allowance will have a significant effect on only one block.

For these reasons, the company concluded that the allowance "will only potentially incentivise a very small portion of our portfolio and we believe it is unlikely that these measures will generate the additional two billion barrels of oil predicted by the Chancellor".[92]

70. Shell UK, like other witnesses, felt that the allowance's impact will be limited as it does not incentivise investment in brownfield sites. They made the case that "in the present economic climate bringing on incremental production on producing fields is hugely challenging. Efforts to extend field life and increase recovery of existing fields are more marginal than in past years due to lower oil price, smaller targets and high reservoir complexity" and therefore argued that it was a "critical priority" for government to align an incentive for brownfield developments alongside the Field Allowance as presently proposed.[93]

71. **We welcome the introduction of the field allowance in so far as it acknowledges that the tax burden on companies operating in the UKCS needs to be altered in order to stimulate vital investment. However, we are very concerned that the allowance seems to be flawed in a number of fundamental ways. The main problem is that it does not incentivise incremental investment in existing sites. Furthermore, we are concerned that: it is likely to be ineffective in encouraging investment west of Shetland; the criteria for qualifying for the allowance are so stringent (especially with regard to HPHT) that its effect will be minimal; and its modest scale is such that it will not provide a significant incentive for investment even in new fields. We share the concerns of witnesses that the allowance will not stimulate the production of the 2 billion extra barrels of oil hoped for by the Chancellor.**

72. **The Government should review the operation of the allowance in its first year of operation and be prepared to extend its scope and widen the qualifying criteria in light of that review. In any event, we think there is a very strong case for widening the allowance so as to provide a meaningful incentive for investment west of Shetland and to encourage HPHT opportunities. Furthermore, much of the UKCS remaining**

91 Ev 133, para 3

92 *Ibid*, paras 4- 6

93 Ev 133-134, paras 7-8

reserves are in fields which are not new but which will not be further exploited unless the fiscal regime makes incremental investments more attractive. This is especially the case in PRT-paying fields where the overall tax rate is 75%.

73. **We note the Government's reasons for pressing ahead with a value or field allowance, rather than options which appear to have the benefit of being less complex and of incentivising a wider range of production, such as an across-the board capital uplift or a reduction in (or the removal of) the supplementary charge. We recommend that in reviewing the operation of the field allowance and assessing its effectiveness in increasing investment the Government be prepared to reconsider the merits of these bolder moves. It should calculate and set out the predicted effects on production and tax revenues of a capital uplift or a reduction in supplementary charge alongside the effects on investment in the industry. We recognise that the nation should receive a return in the form of both economic production and tax revenues from the UKCS.**

Other measures in the Budget

74. DECC told us that the budget provisions relating to the North Sea fiscal regime "also include measures to assist asset trades and give companies the certainty and stability they need to underpin investment. In brief, in addition to the new Field Allowance, the package of reforms announced at Budget comprises:

- Changes to the chargeable gains regime within the North Sea ring-fence to remove chargeable gains entirely from licence swaps and making gains exempt where disposal proceeds from ring fence assets are reinvested within the UKCS.
- Changes to the North Sea fiscal regime to remove potential barriers to projects that re-use North Sea infrastructure for non-ring-fenced purposes including gas storage, carbon capture and storage and wind energy.
- Amending the petroleum revenue tax (PRT) regime to ensure that companies whose production licences have expired are still able to access PRT decommissioning relief where appropriate.
- Changes to the PRT regime to reduce the administrative burden it imposes, simplify compliance and repeal obsolete legislation."[94]

75. Our witnesses generally welcomed such measures. Oil & Gas UK said that the change to the chargeable gains regime should "help encourage asset trading which has slowed down significantly in recent years."[95] Shell UK welcomed "the encouraging announcement with respect to North Sea asset transfers. All of the measures contained within the Budget to assist asset trades i.e. changes to the chargeable gains regime, amending PRT etc … provide very helpful certainty and stability. It was also encouraging that the Change of Use issues identified in the November 2008 PBR were included in the Budget papers with the additional good news that HMRC are now willing to accept that the cost of Cushion Gas in Change of Use projects will, as requested by Industry, be treated as plant for the purposes

94 Ev 83-84, para 4

95 Ev 117, para 3.2.1

of Plant and Machinery Capital Allowances. Finally we were also encouraged that the PRT decommissioning concern from Industry (post licence expiry decommissioning cost) was also addressed in the Budget."[96] BP too welcomed these technical measures as "necessary improvements for which we are grateful. Unfortunately, however, they are not material in terms of encouraging additional investment."[97]

76. **The Government was right to listen to the concerns of the industry regarding specific issues relating to the chargeable gains regime, the re-use of North Sea infrastructure for non-ring-fenced purposes and the operation of the Petroleum Revenue Tax. The changes announced in the Budget regarding these areas are modest but welcome.**

77. A specific change to the fiscal regime sought by the industry was for smaller companies to be able to benefit from tax allowances at an earlier stage. Oil & Gas UK said it would welcome "accelerating the payment of accrued, but so far unrelieved, tax allowances to smaller companies. [This]…would release much needed capital to small companies for investment in the basin at minimal cost to the Government. The Government has pursued a laudable policy to attract these smaller companies into the basin. It should throw this inexpensive lifeline to them now and not simply abandon them".[98] Following the Budget, the organisation was disappointed that "the government… failed to act on our proposals to provide cash relief of unexpensed "Ring Fence Expenditure" which would have helped small companies and given a much needed boost to exploration".[99]

78. DECC's memorandum noted the operation of the "Ring Fence Expenditure Supplement (RFES) [which] assists companies that do not yet have any taxable income for corporation tax or the supplementary charge against which to set their exploration, appraisal and development costs and capital allowances. The RFES increases the value of unused expenditure carried forward from one period to the next by a compound 6 per cent a year for a maximum of six years. It applies to all unrelieved expenditure from 1 January 2006. This is intended to help support new entrants into the basin".[100]

79. **We note the case presented to us by industry representatives for accelerating the payment of accrued but unrelieved tax allowances to smaller companies and their argument that the lack of equity and debt financing makes this particularly desirable. We urge the Government to estimate the costs and potential benefits of this proposal as a means of tackling the impact of the credit crisis on investment in the UKCS.**

80. The Budget's provisions regarding the field allowance and the technical matters noted above are welcome as far as they go. Industry representatives were positive about the dialogue that has gone on with Government.[101] However the evidence we received from

96 Ev 134, para 9

97 Ev 57, para 9

98 Ev 112, para 3.3.5

99 Ev 116, para 2.1.8

100 Ev 73, para 60

101 E.g., Shell UK, Ev 134, para 11.

most industry representatives argued that the measures announced in the Budget do not go far enough:

> The government failed in the recent Budget statement to take the necessary strategic action that will encourage the maximum recovery of its indigenous oil and gas reserves and ensure that these precious resources can play a full role in helping to meet the UK's future energy needs. Time is running out and corrective action now needs to be taken. (Oil & Gas UK)[102]

> There is still a material risk that UKCS investment will fall sharply over the next couple of years. While this is not related exclusively to the Fiscal Regime, it is clear from BP's perspective that the Budget's fiscal package will make no difference to our own investment plans. We expect the same applies to the industry as a whole. (BP)[103]

> Overall Shell U.K. Limited welcomes the measures in the April 2009 Budget as a step in the right direction. However we believe it is not enough to reverse the projected decline in capital investment in the UKCS, will have little impact on the UK's competitiveness and attractiveness to attract global investment and ultimately result in a relatively limited increase in activity in the UKCS…. We are firmly of the belief that the proposed measures are not enough. The need to incentivise additional development has become even more pressing since discussions started, with the additional dimensions of an economic recession and associated challenges re access to capital and the collapse in the oil and gas prices. The effects of this are being seen by the rapid decline in the capital and exploration expenditure within the sector. We do not believe that the changes contained within the 2009 Budget are adequate to attract investment and stimulate activity at a sufficient level. (Shell UK) [104]

81. In their evidence to us the Government said that while "there is no stated "next step" for the discussions…. that should certainly not be taken as a sign that the Government considers that the process of engagement is at an end. The Government will continue to engage with stakeholders wherever necessary to ensure that the North Sea fiscal regime continues to help deliver the best possible future for the UKCS. In particular, officials from both DECC and HMT/HMRC have been asked to look further into the question of post tax decommissioning security and to discuss this complex area with Industry in the coming months."[105]

82. **We would be surprised if industry representatives did not call for a more congenial tax regime. However, it does seem to us that concern that the Government's fiscal reforms do not go far enough are genuine and legitimate. The quadruple whammy faced by the industry – of high costs, low prices, lack of affordable credit and a global recession – make this a difficult time. We are not convinced that the field allowance and other measures announced in Budget 2009 – albeit welcome – are sufficient to create the competitive environment needed by the industry nor that they will provide a strong**

102 Ev 117, para 4.6

103 Ev 57, para 8

104 Ev 134, paras 10-11

105 Ev 84, para 5

enough incentive to exploit fully remaining resources. We note and welcome the Government's commitment to further engagement and hope that, should the measures so far announced prove to be inadequate, more wide-ranging and generous reforms of the fiscal regime will be forthcoming. A key part of the UK's energy security strategy and the prospects of the 350,000 people who work in or with the UK oil and gas industry depend on it.

4 West of Shetland

83. The most significant remaining areas of prospectivity in the UKCS are in the area to the west of Shetland and the Hebrides, which is estimated to hold potentially 3 – 4 billion barrels of oil equivalent (around 17% of the UK's oil reserves) and 10% to 15% of the remaining UK gas reserves.[106] We were told that 3.4 billion boe might be recovered from west of Shetland in the period up to 2035, assuming a barrel price of $80. However, weather conditions are difficult, the area is around 400 km from the nearest gas terminal, existing gas pipelines are not sufficient to support significant development in the near future and the gas discoveries made to date are not of a scale to justify the necessary infrastructure on their own.

84. The Government has recognised the difficulties faced in exploiting resources west of Shetland and established a joint Taskforce with industry in 2006 to facilitate exploration and development in the area. The industry representatives are those with gas projects with prospects of starting in the next 5 years:

Total	- operator of the Laggan and Tormore fields
Chevron	- operator of Rosebank and Lochnagar
BP	- operator of the Clair field
ExxonMobil	- operator of Tobermory
DONG Energy	- participant in Laggan, Rosebank and Tobermory.[107]

85. The Taskforce has examined options for a multi-field development with the capacity for gas export to mainland Scotland. It considered, but rejected on cost grounds, alternative means of utilising the resources, such as power generation and the production of Liquified or Compressed Natural Gas near the source of production. However, the Taskforce found four technically viable options for gas gathering hubs, three located offshore and connected by direct pipeline to St Fergus, and one onshore at the Sullom Voe terminal in the Shetland Islands. DECC's evidence describes progress:

> In September 2007 a well was drilled by Total into the Tormore prospect close to the Laggan field which identified additional gas. At the same time Chevron commenced an extended appraisal programme of their Rosebank/Lochnagar discovery in the growing confidence that they had a viable development further to the west. These developments offered better prospects for development, and the Laggan/Tormore and Rosebank/Lochnagar partners co-sponsored an independently managed process in the autumn of 2008 to test the appetite for third party investment in a basic engineering study and ultimately, in the collective project. This revealed a potential requirement for about 18 million cu. m/year of gas transportation capacity (equivalent to about 5% of UK annual demand), involving 10 licensees in 3 separate licence groups.
>
> Total have now commissioned the basic engineering study for Laggan/Tormore and the work is proceeding primarily on the basis of an onshore gas gathering hub located at the existing Sullom Voe Terminal in the Shetland Islands.

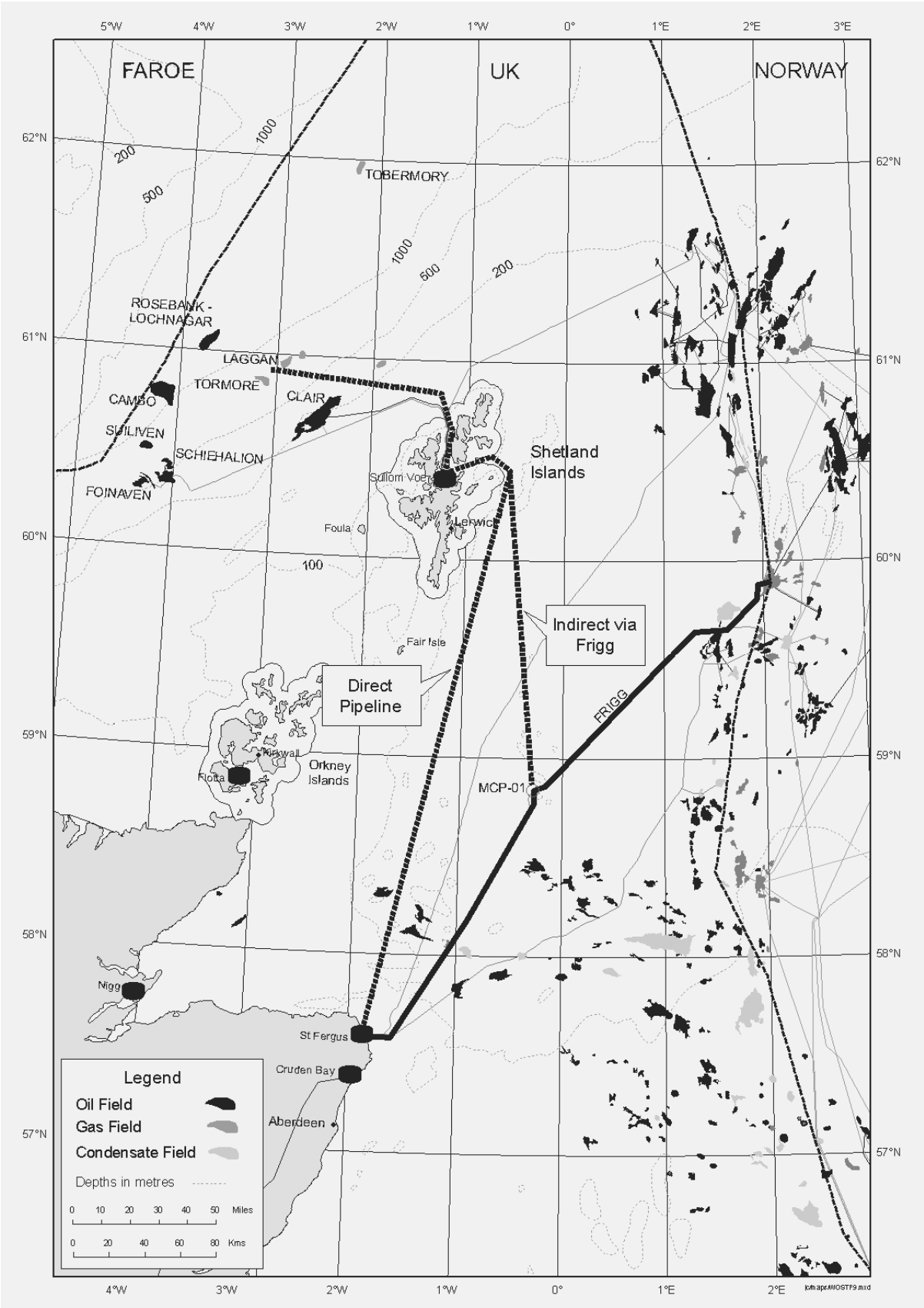
106 Ev 69,para 25

107 Ev 69-70, para 26

> For the gas export pipeline, there are two options…A direct pipeline from Sullom Voe to St Fergus on the Scottish mainland, or an indirect route using a new shorter pipeline to connect Sullom Voe to the existing, 100% Total-owned Frigg UK gas pipeline and then via Frigg to St Fergus. In either case, the pipeline is expected to have capacity for the 18 million cm/d of gas identified in the third party investment process. We understand that the partners consider that there is a commercially viable development option for Laggan/Tormore, with development sanction in September 2009 and first production in late 2013. The parties interested in developments west of Shetland are now moving towards a decision on development later this year which will be followed by a submission of a development plan to the Department for consideration. The Department considers that this collaborative process has a real prospect of providing infrastructure to deliver gas to the market in 2013/14. It will be a collective solution that reflects the requirements of players in the west of Shetland area prepared to commit to development.[108]

The map on the following page shows potential gas pipeline routes for west of Shetland developments:

108 Ev 70, paras 27–31.



Source: DECC (Ev 82)

86. Industry representatives told us about the potential for production west of Shetland, but struck a cautious note about its viability. Oil & Gas UK told us that the area could

"potentially yield up to a fifth of the country's remaining oil and gas reserves" but that despite many years' exploration and promising discoveries "development has been restrained by the deep, hostile marine environment, extreme weather and the shortage of infrastructure to transport oil and gas to market. This makes projects in the region high risk, technically challenging and therefore extremely costly."[109] They also note that the recent falls in oil and gas prices has made the area less attractive to invest in. In order to improve the attractiveness of investments they have called for "fiscal measures such as a reduction or the abolition of the supplementary corporation tax rate or tax incentives for exploration".[110]

87. One of the main barriers to production west of Shetland is the high cost of production and specifically the construction of a pipeline to connect to the mainland, which would almost certainly need to be used jointly by different companies given the relatively small scale of the individual fields. This would involve a 'cluster' development of different operators using the same infrastructure. The financing of such a joint initiative is problematic, as Professor Kemp told us:

> A common carrier could be done by investors themselves acting on their own and over-sizing it from the first fields if they were reasonably confident that later on more gas was going to be coming in from new ones. They are very cautious about that and that is quite risky and involves a lot of upfront money. In the past we had lots of discussion about common carrier gas pipelines in the North Sea that were studied at enormous length and eventually did not go ahead. The one in the North Sea did not go ahead because the banks would not finance a pipeline unless there was pretty well guaranteed large throughput from a very big field and that was not going to be the case, so the second North Sea gas pipeline did not emerge under private sector arrangements. If you want to think more radically then there could be something like a government guarantee to enable the banks to take a very generous view of things. That kind of thing is possible but brings in the question of State Aid and all of that and that would be quite complex.[111]

88. We raised the issue of a west of Shetland "common carrier" with Oil & Gas UK. While Malcolm Webb, the Chief Executive, could see advantages of scale in sharing costs in the longer term, he noted that there were difficulties in getting such a scheme off the ground and financing it until a range of fields became operational. He warned against placing the financial onus on the first companies to be active in the area, as this could make costs prohibitive and drive them away. He posed the rhetorical question:

> Do you saddle those developments with the incremental cost of a common carrier pipeline that could sink the economics of those developments? I think the answer to that is no. There is a gap there that needs to be filled if you want to do the common carrier. Who is going to pay for that? I do not think the Government is going to pay for it in the short-term. The best answer for the west of Shetland is to go back to look at some of the fiscal incentives that we can put in place to make sure we get as much

109 Ev 113, para 3.6.1-3

110 *Ibid*, para 3.6.5

111 Q 123

> as we possibly can on the back of the existing development, which means improving the economics of the development.[112]

89. Clearly, getting the necessary shared infrastructure in place to be able to exploit resources west of Shetland is a complex but key issue. Inevitably, Government will have a role to play. Broadly, there are three positions which might be adopted by the Government: as a funder or co-funder of a common carrier infrastructure, with charges or taxes then being imposed on the users; as a regulator of the shared arrangements; or as a facilitator, working with the companies trying to get voluntary arrangements which are viable and durable. The Energy Minister made it clear that he did not favour the first option:

> if the state were to intervene and fund such a common carrier, it is difficult. Although we would get taxation from it, we think that this is the sort of thing that the private sector really ought to do. The infrastructure system has worked reasonably well…in the North Sea. Moving into west of Shetland, obviously we have an area which is going to be difficult to exploit…but the state intervening to tell the companies how we are going to lay the infrastructure out, making decisions for them about it and then, presumably, charging them substantial amounts for access to it, seems to me to be not the way to go. I would suspect it will mean that many of the companies who would otherwise be looking there will say, "Look, if we could go there and decide how we want to do it, we would go, but if you are going to decide, Government, how to do it, we are not going to go."

90. The Minister was also not keen on regulating access to shared infrastructure west of Shetland:

> At the moment, west of Shetland we have got a number of companies interested, Total, Chevron, BP. They are all looking at various permutations of putting in infrastructure if they decide to carry out their exploitation there, and there are issues about whether there should be connections from Sullom Voe, whether it would then go down to St Fergus or whether it would go across to the Total pipeline at Frigg. These are all issues which I think, in the end, are commercial ones more than ones that you want to determine by regulation. As far as access to infrastructure is concerned, we have got the guidelines. Those guidelines have worked reasonably well since 2001… Do we now want to go into a situation where we put in place regulations which oblige larger companies (and it will be by and large them) to put in infrastructure and then oblige them to put particular links in for the smaller companies by law? In which case, they will simply say, "All right, if you want us to do that, we are going to charge for that and those charges will have to go somewhere or we will decide not to carry out that job because it will not be economic any more." I think you are intruding into areas where I do not think the Government necessarily needs to go at the moment.[113]

Having eschewed the option of funding or regulating a common carrier arrangement, the Minister described the Government's preferred approach as "more of a dialogue rather

112 Q 132

113 Q 187-188

than a diktat" and said "that is probably the better way of engaging, unless we have to do it some other way".[114]

91. **We understand the Government's argument for not wanting to interfere in a heavy-handed way in the establishment of a common carrier arrangement for oil and gas west of Shetland. But two things are clear: west of Shetland resources offer enormous potential – possibly a fifth of our remaining oil and gas resources; and putting in place a shared infrastructure to exploit those resources is expensive and complex. The Government should continue its dialogue with industry and agree a timescale for the establishment of such a shared infrastructure and the arrangements governing its use. If progress does not meet that timescale the Government should be prepared to take a more active role, probably through regulation but not precluding assistance with funding. The UK must appreciate the importance of the resources west of Shetland.**

92. The other mechanism by which Government might have been expected to support development west of Shetland is through the fiscal regime. As we noted above, Oil & Gas UK have requested "fiscal measures such as a reduction or the abolition of the supplementary corporation tax rate or tax incentives for exploration".[115] BP told us that it "operates the first, and currently only, fields in production [west of Shetland]….Many of the other discoveries which have been made west of Shetland are marginal and BP believes that a reduction in the fiscal burden is required if more of the potential west of Shetland is to be unlocked both from new discoveries, existing undeveloped discoveries and fields in production. The Government's proposed Value Allowance mechanism only partially addresses the basin challenges as its scope is limited exclusively to certain narrowly defined categories of new fields. It is important that investment incentives are also made available to encourage investment in existing fields and should be applied as widely as possible, including west of Shetland".[116]

93. As we have seen, no specific support was provided for west of Shetland in Budget 2009. BP, which had called for all new fields west of Shetland to be eligible for the value/field allowance, was disappointed:

> In particular, the absence of any fiscal assistance for fields currently in production – and for the area west of Shetland – deprives both BP and, we believe, the industry as a whole of the fiscal incentive which might mark a significant improvement in today's difficult conditions.[117]

Also responding to the new field allowance, Oil & Gas UK told us:

> Its impact on exploration activity will be negligible and it will not boost west of Shetland or tight gas development.[118]

114 Q 190

115 Ev 113, para 3.6.5

116 Ev 55, paras 9-10

117 Ev 57, para 6

118 Ev 116, para 2.1.6

The Independents' Association also said that all west of Shetland fields should qualify for the field allowance:

> Having created the Field Allowance we would encourage Government to look at additional qualifying targeted areas. The two areas that we would focus on would be assets west of Shetland and Non Conventional Gas.
>
> Assets in the area west of Shetland face considerable challenges with respect to weather and infrastructure - additional fiscal assistance is required to accelerate activity.[119]

94. **We support the call by industry for all fields west of Shetland to be eligible for the field allowance. This is appropriate given the difficulties inherent in exploiting the resources there. In fact, we believe it would be only of modest assistance and recommend that the Government consult with the industry on further options for incentivising production west of Shetland.**

95. Concerns were raised with us about the potential adverse effects on the environment and biodiversity of oil and gas production in the area west of Shetland and, to a more limited extent, in the UKCS generally. We turn to these next.

119 Ev 107

5 Environmental Impacts

96. DECC told us that there is a "robust regime" of environmental protection measures in place to minimise the impact of oil and gas production, much of it developed at a European level. It is also the Government's policy to implement and apply all OSPAR[120] Commission decisions and recommendations.[121] This regime, the Department told us

> Covers oil and gas development throughout its life cycle, from the initial licence application to the final decommissioning of facilities … All activities that could potentially impact on the environment are subject to rigorous assessment, and significant activities are controlled through the issue of permits, consents or authorisations. There is also an inspection and enforcement regime in place to confirm compliance with the conditions included in the environmental approvals.[122]

97. There are a number of key elements to the regime:

- A **Strategic Environmental Assessment (SEA)** is carried out before oil and gas licensing is undertaken. These assessments consider the effects of offshore oil and gas activity at a strategic level and are publicly consulted upon. Licences may be withheld if there is not enough evidence to judge the likely impact of the activity being assessed, or if mitigation of adverse impacts is not feasible.

- Once the SEA has been completed operators applying for licences are required to have, or undertake to develop an: **Environmental Management System (EMS)**, which is "designed to achieve the prevention and elimination of pollution from offshore sources; the protection and conservation of the maritime area against other adverse effects of offshore activities; and continual improvement in environmental performance"[123]; and an Environmental Impact Assessment (EIA) which has to specify the environmental sensitivities of the area for which a licence is sought.

- Specific projects need to have assessments undertaken under the aegis of relevant legislation, such as the Offshore Petroleum Production and Pipelines (Assessment of Environmental Effects) Regulations 1999 and the Offshore Petroleum Activities (Conservation of Habitats) Regulations 2001.

- Assessments are also required for any activity which might have an adverse affect on the environment, such as the use and discharge of chemicals and/or oil; seismic and other survey activity; and atmospheric emissions.

- An approved Oil Pollution Emergency Plan is required for each offshore installation.

120 Oslo and Paris Convention for the Protection of the Marine Environment of the North East Atlantic

121 Ev 70, para 32

122 *Ibid*, para 33

123 Ev 71, para 37

- The industry has to adhere to non-sectoral environmental legislation which applies to all marine activities, and not just to oil and gas.[124]

98. Oil & Gas UK acknowledged this regime and told us that "oil and gas exploration and production on the UKCS is one of the most tightly regulated sectors, subject to over 100 pieces of environmental legislation spanning a broad range of issues." [125] Individual companies gave us examples of the environmental work they are undertaking:

> Shell is spending between £1m and £1.5m per annum on environmental surveys in the vicinity of its producing installations …Surveys have revealed little or no significant long-term negative impact of our oil and gas operations on the indigenous flora and fauna. We believe that existing regulatory requirements, including Environmental Impact Assessment of new projects and discharge limits, have worked well to minimise the environmental impact of the oil and gas industry.[126]

> Total E&P takes its impact on the environment very seriously and invests substantially in improving its performance both offshore and onshore. Over £23 million has been spent on produced water reinjection, energy consumption has been reduced by up to 20% at some sites and there is a successful recycling and waste reduction programme in place.…The company acknowledges the importance of and observes regulatory obligations but would like to see greater substantiation and proof of benefit for some legislation prior to expensive implementation. This is a point raised with former government departments through Oil and Gas UK.[127]

99. The latter point made by Total E&P about the expense of implementing legislation of questionable benefit was also made by the Oil and Gas Independents' Association. It told us that

> The UK already has one of the most highly environmentally regulated hydrocarbon provinces in the world. Whilst we should continue to mandate adherence to high environmental standards and practices, we should also bear in mind that we cannot unduly burden the industry to achieve standards significantly in excess of other areas. Adherence comes at a cost, both financial and also in terms of leaving undeveloped and unrecovered hydrocarbons in the ground. Every barrel of oil or cubic foot of gas that cannot be extracted from the UK will have to be imported from an area where such environmental standards will likely not apply. We should take care not to simply shift the problem elsewhere whilst at the same time reducing our security of supply.[128]

100. While we understand the concern that environmental legislation should be proportionate and not impose unreasonable burdens, we note that, when asked in oral evidence how much of a factor environmental regulations were when deciding whether to

124 Ev 70-71, paras 35-44

125 Ev 113, para 3.7.1

126 Ev 132, paras 20-21

127 Ev 135, para 2

128 Ev 103, para 2.1

invest, and whether UK requirements are so stringent that companies move elsewhere, the Oil and Gas Independents' Association replied:

> No, I do not think so, because once you know the rules you know what your operating environment is so it will not put off companies, because it is very straightforward to operate within those guidelines - it is being a responsible citizen.[129]

101. The Joint Nature Conservation Committee, Countryside Council for Wales, Natural England and Scottish Natural Heritage told the Committee that "the current framework of regulatory control is generally good with most advice provided by the statutory nature conservation agencies being heeded".[130] However, they said that operators' compliance with the EIA process had "scope for improvement" and that some operators indicated that best practice mitigation measures would be followed but that, once a project had been approved, had not delivered on commitments. They argued that operators should have to be more specific in their Environmental Statements and that "the Offshore Inspectorate within DECC should be able to check these commitments during inspections and ensure that there is regulatory compliance. Currently, we do not think that the Offshore Inspectorate is provided with enough project-specific information to be able to effectively check compliance with approval consents."[131]

102. The Oil and Gas Independents' Association did not think that companies were avoiding their environmental obligations[132] and the Minister told us that

> We have a number of means by which we ensure that we [ensure companies meet their environmental obligations]…. They are subject to licensing conditions as to how they can carry out their work and we have got control over the terms on which licences are issued. They will normally ensure that they not only comply with those but that they are able to show that they will decommission, because that is where we get many of the problems around environmental issues. We have 40 environmental statements, six appropriate assessments under the Habitats Directive and 40 screening and scoping documents currently reviewed, around 3,000 permits issued around chemical use and oil discharge permits, drilling approvals and permits under the EU Integrated Pollution and Control and Emissions Trading Directives. We investigated and examined problems around 386 oil spill plans, so they plan what they do when there is an oil spill and we have to approve their plans. We conduct inspections and investigations of the various projects both onshore and offshore. There were 55 inspections done last year to check whether the various kit is performing at the standard that environmentally is adequate. We report cases where there have been breaches to the Procurator Fiscal in Scotland. Since 1998 we have reported 11 incidents to the Procurator Fiscal resulting in nine prosecutions. There are issues around spillage. Let me give you some figures. There are about 366 million tonnes of oil which has been produced between 2002 and 2005. During the same

129 Q 63

130 Ev 91, para 1

131 Ev 92, para 4.1-3

132 Q 62

period 362 tonnes of oil was spilt. This equates to 0.00009 per cent. That is a pretty good record.[133]

103. While the industry's environmental record overall is impressive there are particular concerns about the possible effects of developing fields west of Shetland. The RSPB told us that unlocking resources there could have adverse effects on Scotland's marine environment and recommended that certain sensitive areas be excluded from future rounds of licensing, including the area around St Kilda and the Hebrides. They told us that available data on seabirds in the area west of Shetland is old and limited and called (more generally and not just in relation to west of Shetland) for sustained environmental surveys of marine wildlife, including seabirds.[134] They also told us that, while there was a lack of systematic, sustained and comprehensive surveying of marine wildlife, there were specific areas of research underway into certain areas, funded by DECC, as part of the SEA process. However, the RSPB found it difficult to assess these exercises as there was no publicly available research plan.[135]

104. **The oil and gas industry is subject to an array of environmental regulations and its track record of adhering to them is impressive. There are concerns, however, about the potential effect of intensive activity west of Shetland. The Government should instigate and fund a comprehensive survey of the marine environment and its wildlife west of Shetland; more generally it should work with the industry to facilitate a systematic and ongoing plan of surveys of marine wildlife to fill the gaps left by earlier surveys of the UKCS area.**

105. **We note the concern raised with us that some companies commit to adhere to environmental best practice but then do not do so once licenses are issued. In the absence of specific evidence that this has happened we are not in a position to judge whether this a widespread problem, or even a sporadic one. We encourage those with concerns about where this might have happened to raise them with DECC and we would expect such claims to be investigated fully.**

133 Q 215

134 Ev 121, paras 21-22

135 Q 85

6 The future for UK oil and gas

106. As we note above there is somewhere in the region of another 20 billion barrels of oil equivalent to be produced from the UKCS. It is important for the UK's energy security policy, as well as its economy, that that resource be exploited. But although there are still such reserves, it remains the case that the UKCS is a mature region and that its resources are diminishing. In that context, and recognising the need to move towards a low-carbon economy, it is particularly important that effective alternative uses for the skills and infrastructure developed for the oil and gas industry are explored and that decommissioning is conducted efficiently.

Carbon capture and storage

107. Work has already been undertaken to assess the feasibility of carbon capture and storage (CCS) methods of storing carbon in depleted oil and gas reservoirs and subsea aquifers. Oil & Gas UK states that "CCS offers great potential for significant reduction in CO emissions. The British Geological Survey (BGS) estimates potential capacity under the North Sea at around 20 billion tonnes of CO in oil and gas fields, with an additional 20–70 billion tonnes in confined aquifers which compares with the UK's current emissions of CO of some 580 million tonnes per year."[136]

108. The Carbon Capture and Storage Association (CCSA) told us that combining CCS with Enhanced Oil Recovery (EOR) techniques provides the potential to "extend the longevity of oil and gas operations and to mitigate the steady decline in indigenous production, thereby minimising the rate at which Europe's import dependency increases."[137] CO_2 Enhanced Oil Recovery (CO_2-EOR) is a method that increases the amount of oil that is recovered from an underground oil reservoir. By pumping CO_2 into an oil reservoir, previously unrecoverable oil is pushed up to a point from which it can be recovered. The US Department of Energy estimates that this can produce an additional 30 to 60 per cent of the original amount of recoverable oil.[138] Once all of the recoverable oil has been reached, the depleted reservoir can act as a storage site for the CO_2.

109. The CCSA told us that the technology for CO_2-EOR has been technically (and commercially) proven in other parts of the world but that economic conditions and a consequential lack of infrastructure have prevented it being used in Europe. However, they say that the technique offers a number of benefits:

> Firstly… CO_2 storage operations may continue after EOR operations have ceased. Thus, investment in EOR has the potential to make incremental storage capacity available for later use that would likely otherwise not be developed. In this way, EOR projects could quite feasibly bring CCS deployment forward by many years.

136 http://www.oilandgasuk.co.uk/issues/environment/emissions.cfm

137 Ev 60, para 2

138 http://www.midwesterngovernors.org/Publications/CCS_EOR.pdf

> Secondly, EOR can similarly contribute to the investment in pipeline infrastructure helping to enable other pure CCS storage operations. In this way we believe EOR has the potential to make a contribution to the cost of early CCS demonstration projects.
>
> Thirdly, EOR can provide an effective route to long-term, secure CO_2 storage. Lifecycle CO_2 emissions from EOR operations are usually limited since operators have to pay for the CO_2 they use and are therefore naturally incentivised to recover and recycle any produced volumes.[139]

110. The Government supports further work being undertaken on CCS and on 28 May 2009 commissioned jointly with Norway a study of the role of the North Sea in providing storage space under the sea-bed for carbon dioxide from European countries. The study will look at "how quickly the base of the North Sea could be needed for carbon dioxide storage and what the UK, Norway and other countries have to do to get it ready in time."[140] Also, DECC told us that one of the Budget's changes to the North Sea fiscal regime would have the effect of removing "potential barriers to projects that re-use North Sea infrastructure for non-ring-fenced purposes including …carbon capture".[141]

111. Despite these welcome developments there appears to be confusion amongst some in the industry about how they can best exploit the potential offered by CCS within the existing licensing arrangements. Alan Booth of the Oil and Gas Independents' Association told us that his company had obtained a hydrocarbon extraction licence for a field which subsequently proved to be uneconomic for extraction but which might be suitable for CO_2 storage. However, he said that (despite the assistance of DECC officials) there was "no regime" which would allow him to convert the licence into one for CO_2 storage and he therefore had to return the licence.[142]

112. We put these points to the Minister, who recognised the importance of the issue:

> We want to ensure that for carbon capture and storage there is a clear licensing regime and that they are able to get a licence to carry out carbon capture and storage. As we develop our commercial capacity to do that that will need to happen. As you know, at the moment we do not have a project here or indeed anywhere in the world which is of a substantial commercial nature involving carbon capture and storage. What we want to do is put in place a regime which will enable carbon capture and storage to take place, issue licences to enable it to take place, ensure that it is properly inspected, that it is safe and that we have a system which will encourage the development of an industry in the future. I believe that in 20 years' time we will see a worldwide industry involving carbon capture and storage…. [143]

Simon Toole, head of DECC's Licensing, Exploration & Development Branch, told us that

139 Ev 60, para 3

140 DECC press release, ***UK-Norway to study role of North Sea in CO2 storage*, 28 May 2009**

141 Ev 84, para 4

142 QQ 16-18

143 Q 220

> There is a licensing regime coming into place early next year, but the Crown Estate is already preparing and will have the power from 6 April this year to start issuing leases for the areas. If your concern is that people who want to get hold of an area on which to do studies and work on carbon capture and storage are being frustrated by the licensing regime, we have been working very closely with the Crown Estate and very shortly they will be able to get into a dialogue with the Crown Estate to get hold of the territory that they might wish to use.[144]

113. **We welcome the Government's initiative in the area of carbon capture and storage, a technology that may offer a major opportunity to use existing infrastructure and skills in the North Sea with beneficial outcomes. We look forward to the outcomes of the study into CCS commissioned jointly with the Norwegian government. We are also pleased to note that issues raised with us about the licensing regime for CCS are being addressed and we recommend that DECC maintains close dialogue with industry to ensure that the regime works and that the UK can benefit from the potential offered by North Sea CCS.**

Decommissioning

114. DECC's evidence highlights the scale of the decommissioning operation to be undertaken in the UKCS:

> The industry has begun to decommission the 500 installations and 35,000 kilometres of pipelines on the UKCS but with UK oil and gas continuing to supply around 70% of our prime energy demand, decommissioning work will be spread over the next 40 or more years. The cost of this work is currently estimated at £23 billion with individual installations costing from £5m to £300m.[145]

It notes that this work is undertaken in accordance with OSPAR Decision 98/3 which bans the disposal of offshore installations at sea other than in exceptional cases. All decommissioning projects require an environmental impact assessment which must detail potential emissions and consumption of natural resources and energy.[146]

115. However, Oil & Gas UK believe the decommissioning regime is ineffective. It told us:

> Decommissioning of offshore installations and pipelines is regulated by the Petroleum Act 1998, with the current owners being jointly and severally liable. Whilst companies make full and proper provision for the costs in their accounts … such provisions are not allowable against taxation, even when put into a special trust fund, and the current regulatory construct is fast becoming a barrier to investment.
>
> Oil & Gas UK has been instrumental in setting up the Decommissioning Security Agreement which identifies the liabilities of parties concerned and how these should be secured against default. However, the Government's position on the types of security, whose use it has encouraged, is not satisfactory.

144 Q 221

145 Ev 78, para 94

146 *Ibid*, paras 96-97

> The Government has relied upon the corporate covenants of investment grade companies and bankers' letters of credit. The urgent need for a wider range of securities has been particularly exposed by the current banking crisis, with reports of banks disputing annual renewals of securities and limiting the size of security they are willing to post, or even denying it altogether.
>
> The problem is compounded by the requirement to post the letters of credit on a pre-tax basis. This means that the companies have to provide securities up front for a sum which includes the amount which the Government pledges it will ultimately provide by way of tax relief. This in turn unnecessarily reduces the funds a company has available to invest.[147]

In order to address this issue, Oil & Gas UK has recommended that the Government allow companies the option of:

"a) corporate covenants, for the larger investment grade companies

b) letters of credit, on a post-tax basis

c) accepting that payments made into dedicated trust funds to be used solely to meet the cost of decommissioning are a valid and tax deductible business expense, which, regrettably and unfairly, they currently are not. This is in marked contrast to the new regime for future decommissioning liabilities in the nuclear power industry".[148]

116. The trade organisation was disappointed that the Government did not take such steps in the Budget, but noted that the issue was still under consideration:

> The government is yet to address our request that they accept decommissioning security on a post tax basis but has written offering to consult further on this, which we welcome and will pursue.[149]

117. **We note the industry's argument that the tax treatment of decommissioning securities is problematic and hampering investment. We look forward to the outcome of the consultation the Government is undertaking on this matter and may return to it if it is not resolved satisfactorily.**

Exports

118. Our report has concentrated on oil and gas production in the UKCS. However, the supply chain which supports that domestic production – estimated to include some 5 – 10,000 companies[150] – is a major exporter of goods and services to the oil and gas industry internationally. In 2008 it was estimated that the value of such exports was £5 billion annually,[151] equivalent to a quarter of total exports of goods and services by the UK's

147 Ev 115, paras 3.10.1-4

148 *Ibid*, para 3.10.5

149 Ev 116, para 2.1.7

150 *Oil & Gas UK, 2008 Economic Report*, p 13

151 Ev 109, para 2.1.3

energy sector.[152] It is clear that the skills and expertise developed to support production from the UKCS can continue to make a very significant contribution to oil and gas production internationally and to jobs and incomes within the UK. **We would welcome the Government's assessment of the export potential of the industry that has developed to support the UKCS and an indication of how it plans to build on this potential.**

152 Oil & Gas UK, 2008 Economic Report, p 13

Conclusions and recommendations

Production to date

1. The Government is right to focus on security of energy supply as a key challenge for the UK. Much of the UK's current electricity generating capacity is set to close over the next decade, and there is a continuing risk of disruption to energy supplies internationally as a result of political and economic turbulence. In this context the importance of domestically produced oil and gas is obvious and the case for Government doing all it can to help maximise economic production is compelling. (Paragraph 10)

2. The Government's priority when determining policy on UK oil and gas should be security of supply, within the context of moving towards a low-carbon economy. However, proper account also needs to be taken of the immense tax revenues paid by the industry and of the 350,000 people whose employment is reliant upon it. We are concerned to note that the industry predicts that falling capital expenditure could lead to the loss of 50,000 of those jobs over the next two years. This strengthens the case for the Government to investigate further ways by which it can support UK oil and gas production in the current difficult economic climate. (Paragraph 14)

Future production levels

3. Estimates of future levels of UK oil and gas production cover a wide range: from 11 billion barrels of oil equivalent (boe) to 37 billion boe according to DECC. The Government cannot influence the amount of oil and gas remaining in the UK continental shelf. But the policies it pursues in relation to tax, regulation and licensing all have an impact on the attractiveness of producing oil and gas from the UKCS and therefore on production levels. The Minister told us it would be regrettable if oil and gas production was at the low end of the estimates, with a consequential need to import more oil and gas. We think this is an understatement, given the contribution of the UK oil and gas industry to security of energy supply, tax revenues and employment. We support the Government's objective of maximising the economic recovery of UK oil and gas resources but believe that it now needs to articulate a strategy setting out how it intends to achieve that objective with realistic but stretching targets for future production levels. (Paragraph 26)

Investment levels

4. We are very concerned at the bleak prospects for investment in the oil and gas industry. If the industry's worst case scenario is realised in 2010, 50,000 jobs could be lost and production could fall by millions of barrels. The Government must do what it can to facilitate investment, and the success of the steps announced in the recent budget must be judged by whether they help stop the downward slide in capital investment. (Paragraph 30)

The availability of credit and equity

5. We welcome the Government's recognition of the difficulties faced by oil and gas companies in accessing affordable lending and the fact that DECC, through BERR and HM Treasury, is engaging with banks to ensure that the UK continental shelf "is at the forefront of the minds of the banks". However, given the problems oil and gas companies are having in achieving affordable borrowing, it does not seem that such engagement is having any conspicuous success. DECC Ministers should set out, with their Treasury and BERR counterparts, what steps the Government is taking specifically to help oil and gas companies access affordable credit from banks and keep under review the availability of such credit. (Paragraph 36)

Production costs

6. Smaller companies in particular are having difficulties accessing the infrastructure they require in order to produce oil and gas because in some cases of unrealistic demands by the infrastructure's owners. The industry's voluntary Code of Practice is not working well in this respect and, while we are not yet convinced of the case for a comprehensive statutory "common carrier" system of access, we do think that Government has to take a more active part in ensuring the successful outcome of negotiations about access arrangements. DECC and the industry should make it a priority to strengthen the voluntary arrangements so that they do not hamper the ability of companies to operate. If a voluntary code cannot be made to work more effectively serious consideration should be given to introducing a common carrier system. (Paragraph 44)

7. The oil and gas industry operating in the UKCS faces high costs, low prices, lack of affordable credit and a global recession. The Government cannot unilaterally solve these problems. But that makes it imperative that where it can make a difference – in facilitating credit from banks for example and, even more crucially, in establishing a fair and sustainable fiscal regime – it does so. (Paragraph 50)

The concept of a Value Allowance and the introduction of the Field Allowance

8. We welcome the introduction of the field allowance in so far as it acknowledges that the tax burden on companies operating in the UKCS needs to be altered in order to stimulate vital investment. However, we are very concerned that the allowance seems to be flawed in a number of fundamental ways. The main problem is that it does not incentivise incremental investment in existing sites. Furthermore, we are concerned that: it is likely to be ineffective in encouraging investment west of Shetland; the criteria for qualifying for the allowance are so stringent (especially with regard to HPHT) that its effect will be minimal; and its modest scale is such that it will not provide a significant incentive for investment even in new fields. We share the concerns of witnesses that the allowance will not stimulate the production of the 2 billion extra barrels of oil hoped for by the Chancellor. (Paragraph 71)

9. The Government should review the operation of the allowance in its first year of operation and be prepared to extend its scope and widen the qualifying criteria in

light of that review. In any event, we think there is a very strong case for widening the allowance so as to provide a meaningful incentive for investment west of Shetland and to encourage HPHT opportunities. Furthermore, much of the UKCS remaining reserves are in fields which are not new but which will not be further exploited unless the fiscal regime makes incremental investments more attractive. This is especially the case in PRT-paying fields where the overall tax rate is 75%. (Paragraph 72)

10. We note the Government's reasons for pressing ahead with a value or field allowance, rather than options which appear to have the benefit of being less complex and of incentivising a wider range of production, such as an across-the board capital uplift or a reduction in (or the removal of) the supplementary charge. We recommend that in reviewing the operation of the field allowance and assessing its effectiveness in increasing investment the Government be prepared to reconsider the merits of these bolder moves. It should calculate and set out the predicted effects on production and tax revenues of a capital uplift or a reduction in supplementary charge alongside the effects on investment in the industry. We recognise that the nation should receive a return in the form of both economic production and tax revenues from the UKCS. (Paragraph 73)

Other measures in the Budget

11. The Government was right to listen to the concerns of the industry regarding specific issues relating to the chargeable gains regime, the re-use of North Sea infrastructure for non-ring-fenced purposes and the operation of the Petroleum Revenue Tax. The changes announced in the Budget regarding these areas are modest but welcome. (Paragraph 76)

12. We note the case presented to us by industry representatives for accelerating the payment of accrued but unrelieved tax allowances to smaller companies and their argument that the lack of equity and debt financing makes this particularly desirable. We urge the Government to estimate the costs and potential benefits of this proposal as a means of tackling the impact of the credit crisis on investment in the UKCS. (Paragraph 79)

13. We would be surprised if industry representatives did not call for a more congenial tax regime. However, it does seem to us that concern that the Government's fiscal reforms do not go far enough are genuine and legitimate. The quadruple whammy faced by the industry – of high costs, low prices, lack of affordable credit and a global recession – make this a difficult time. We are not convinced that the field allowance and other measures announced in Budget 2009 – albeit welcome – are sufficient to create the competitive environment needed by the industry nor that they will provide a strong enough incentive to exploit fully remaining resources. We note and welcome the Government's commitment to further engagement and hope that, should the measures so far announced prove to be inadequate, more wide-ranging and generous reforms of the fiscal regime will be forthcoming. A key part of the UK's energy security strategy and the prospects of the 350,000 people who work in or with the UK oil and gas industry depend on it. (Paragraph 82)

West of Shetland

14. We understand the Government's argument for not wanting to interfere in a heavy-handed way in the establishment of a common carrier arrangement for oil and gas west of Shetland. But two things are clear: west of Shetland resources offer enormous potential – possibly a fifth of our remaining oil and gas resources; and putting in place a shared infrastructure to exploit those resources is expensive and complex. The Government should continue its dialogue with industry and agree a timescale for the establishment of such a shared infrastructure and the arrangements governing its use. If progress does not meet that timescale the Government should be prepared to take a more active role, probably through regulation but not precluding assistance with funding. The UK must appreciate the importance of the resources west of Shetland. (Paragraph 91)

15. We support the call by industry for all fields west of Shetland to be eligible for the field allowance. This is appropriate given the difficulties inherent in exploiting the resources there. In fact, we believe it would be only of modest assistance and recommend that the Government consult with the industry on further options for incentivising production west of Shetland. (Paragraph 94)

Environmental impacts

16. The oil and gas industry is subject to an array of environmental regulations and its track record of adhering to them is impressive. There are concerns, however, about the potential effect of intensive activity west of Shetland. The Government should instigate and fund a comprehensive survey of the marine environment and its wildlife west of Shetland; more generally it should work with the industry to facilitate a systematic and ongoing plan of surveys of marine wildlife to fill the gaps left by earlier surveys of the UKCS area. (Paragraph 104)

17. We note the concern raised with us that some companies commit to adhere to environmental best practice but then do not do so once licenses are issued. In the absence of specific evidence that this has happened we are not in a position to judge whether this a widespread problem, or even a sporadic one. We encourage those with concerns about where this might have happened to raise them with DECC and we would expect such claims to be investigated fully. (Paragraph 105)

The future for UK oil and gas

18. We welcome the Government's initiative in the area of carbon capture and storage, a technology that may offer a major opportunity to use existing infrastructure and skills in the North Sea with beneficial outcomes. We look forward to the outcomes of the study into CCS commissioned jointly with the Norwegian government. We are also pleased to note that issues raised with us about the licensing regime for CCS are being addressed and we recommend that DECC maintains close dialogue with industry to ensure that the regime works and that the UK can benefit from the potential offered by North Sea CCS. (Paragraph 113)

19. We note the industry's argument that the tax treatment of decommissioning securities is problematic and hampering investment. We look forward to the outcome of the consultation the Government is undertaking on this matter and may return to it if it is not resolved satisfactorily. (Paragraph 117)

20. We would welcome the Government's assessment of the export potential of the industry that has developed to support the UKCS and an indication of how it plans to build on this potential. (Paragraph 118)

Formal Minutes

Wednesday 11 March 2009

Declarations of interest:

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Sir Robert Smith declared the following interest: Shareholdings in Shell; and Vice-Chairmanship of the All-Party Group for the offshore oil and gas industry.

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Wednesday 17 June 2009

Members present:

Mr David Anderson
Colin Challen
Charles Hendry
Judy Mallaber
John Robertson
Sir Robert Smith
Paddy Tipping
Mr Mike Weir
Dr Alan Whitehead

In the absence of the Chairman, Paddy Tipping was called to the Chair in accordance with the resolution of 20 May 2009.

Draft Report (UK offshore oil and gas), proposed by the Chairman, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 119 read and agreed to.

Summary agreed to.

Resolved, That the Report be the First Report of the Committee to the House.

Ordered, That the Chairman make the Report to the House.

Ordered, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

Written evidence was ordered to be reported to the House for printing with the Report, together with written evidence reported and ordered to be published on 11th and 19th March and 25th March.

[Adjourned till Wednesday 1 July at 9.00am

Witnesses

Wednesday 11 March 2009

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Steve Jenkins, Chairman, Oil and Gas Independents' Association, **Alan Booth,** Chief Executive Officer, Encore Oil**, Martyn Millwood Hargrave,** Chief Executive Officer, Ikon Science — Ev 1

Martyn Harper, Head of Sustainable Development and **Dr Sharon Thompson,** Senior Marine Policy Officer, Royal Society for the Protection of Birds — Ev 9

Thursday 19 March 2009

Professor Alexander Kemp, University of Aberdeen — Ev 16

Malcolm Webb, Chief Executive and **Paul Dymond,** Operations Director, Oil and Gas UK — Ev 22

Wednesday 25 March 2009

Mike O'Brien MP, Minister of State**, Simon Toole,** Head of the Energy Development Unit Licensing, Exploration and Development, and **Jim Campbell,** Director of the Energy Development, Department of Energy and Climate Change — Ev 32

List of written evidence

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3	BG Group	Ev 50
4	BP	Ev 54,56
5	British Rig Owners' Association	Ev 57
6	Carbon Capture and Storage Association (CCSA)	Ev 60
7	Centrica	Ev 60, 64
8	Department of Energy and Climate Change	Ev 66, 83,84
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12	Oil and Gas UK	Ev108, 115
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14	Scottish Council for Development and Industry (SCDI)	Ev 121
15	Shell	Ev 129,133
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