executive summary

In this summary

1 Oil and gas are two of the United Kingdom's most important natural resources, with significant reserves having been discovered on the continental shelf within the last fifty years. The government's main objective for the exploitation of these reserves has been to maximise the benefits to the nation. It has sought to achieve this by charging economic rent and by securing a fair share of the profits, whilst offering stable, attractive and economically sound investment conditions for the industry.

2 The oil and gas industry makes a substantial contribution to the economy. Since 1965, it has generated operating surpluses of £250 billion and some £91 billion direct revenue has been paid to the Exchequer. The industry is estimated to support, directly and indirectly, over 200,000 workers and production in 1999 was valued at around £15 billion, of which two thirds comprised oil and one third gas. Some 60 per cent of oil production was exported in 1999, contributing £4 billion to the balance of payments.

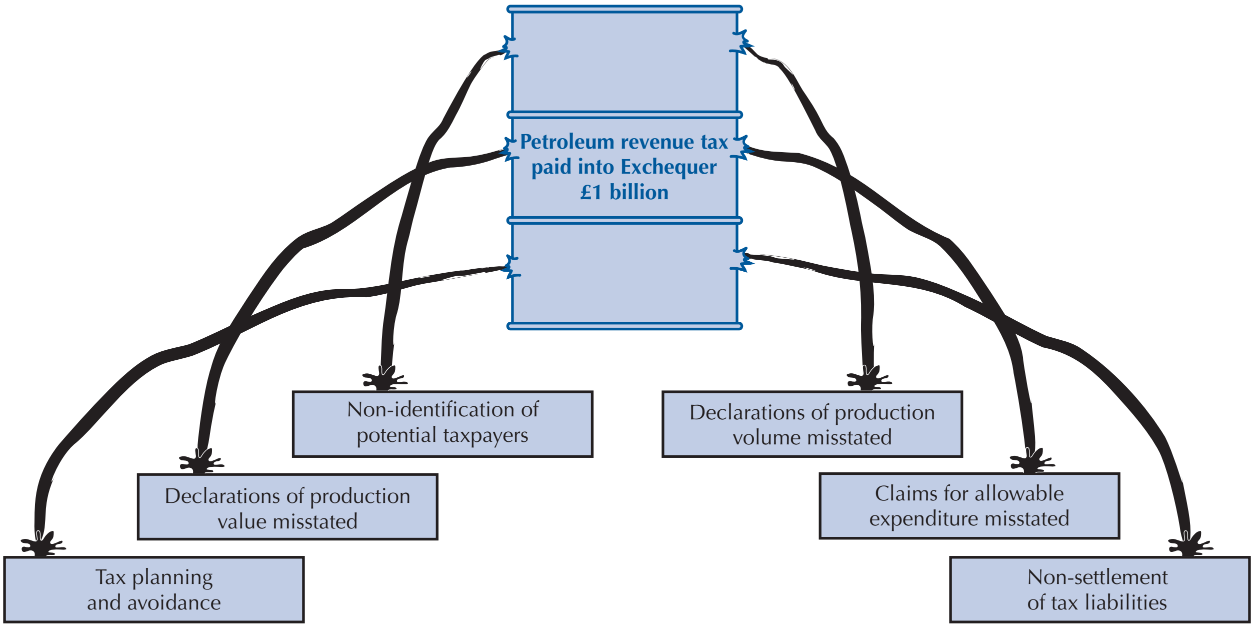
3 There remain substantial reserves of oil and gas and the oil industry predicts that the majority of fields will continue in production until after 2010. Production is estimated to be maintained until 2010 at the equivalent of three million barrels of oil per day. Eventual decommissioning costs for the oil and gas fields have been estimated to be in the region of £8.5 billion, most of which will be allowable for tax purposes.

4 Various direct taxes are levied on production. Of these, petroleum revenue tax has produced almost £42 billion for the Exchequer since it was introduced in 1975. The tax is administered by the Inland Revenue's Oil Taxation Office. It is currently charged at a rate of 50 per cent on the net profit of sales of North Sea crude oil and gas after taking account of associated expenditure. Oil companies are required to make regular payments on account and send in returns of their production and expenditure every six months. The Oil Taxation Office examines these returns and then issues formal assessments of the amount of petroleum revenue tax due. Some £1 billion tax was collected in 1999-00. Receipts are expected to increase over the next three years, although forecasts are sensitive to changes in oil and gas prices.

5 Risk management is the key to the effective administration of tax. The main types of risk are shown in **Figure 1**.

6 The National Audit Office examination focused on how the Oil Taxation Office manages risk and what assurance is provided to the Chairman of the Board of Inland Revenue on its work.

1 **Risks associated with the administration of petroleum revenue tax**



Source: National Audit Office

Production returns

7 The main risks attached to the valuation of oil and gas production are that the volume or value of production could be understated, leading to an under-recovery of petroleum revenue tax. There are particular risks because many contracts are between related parties. In such cases, the petroleum revenue tax liability is assessed on the basis of the estimated open market value for the product rather than the declared contract price.

8 We found that the Oil Taxation Office was managing the risks effectively through its examination of production returns. It takes some assurance from the work of the Department of Trade and Industry's Metering Inspectorate, which carries out independent checks on metering arrangements, although our review indicated that there is scope for the Office to work more closely with them. For example, the Inland Revenue should consider securing access to returns made to the Department of Trade and Industry of deliveries by pipeline to assist it in the validation of the production returns provided for petroleum revenue tax purposes.

9 As regards the valuation of production, we confirmed that the Oil Taxation Office's management of the risks associated with the identification and valuation of oil production sold under non arm's-length contracts was effective and that its work to estimate open market prices to be applied to such contracts had been carried out in accordance with the statutory requirements laid down by Parliament. However, we question whether the statistical basis prescribed in the legislation used to estimate open market values for crude oil is the most appropriate one to use in circumstances where there are often very few transactions on a particular day. We also consider that there is scope for the Department to improve the methodology by which it currently estimates open market values for butane and propane. We therefore recommend that the Oil Taxation Office reviews its approaches.

Expenditure claims

10 Companies can offset certain expenditure against their petroleum revenue tax liabilities. The Oil Taxation Office carries out work to obtain assurance that the expenditure falls within the terms of the legislation governing the tax. The Department has traditionally taken assurance from reviews of companies' accounting and internal control systems, from examinations of claims, and from reconciliations of claims with audited accounts, but it has recently refocused its approach towards a more formal analysis and prioritisation of risk and is targeting its compliance work accordingly.

11 The Oil Taxation Office was addressing the main risks in its examination of claims, but there was scope to improve the way this work was recorded. And although the Department had made progress in addressing delays by companies in submitting reconciliations between expenditure claims and their accounts, there remains a backlog of outstanding reconciliations, dating as far back as 1991. This backlog, and the fact that the reconciliations are usually with accounting information taken from companies' ledgers rather than with their audited financial statements, has limited the assurance available to the Office from this check.

12 We therefore recommend that the Oil Taxation Office examines the merits of alternative sources of assurance. In the short term, the recent integration of its work with that of the Department of Trade and Industry's Oil and Gas Royalties Office should be used to identify opportunities to develop the way in which the Oil Taxation Office manages the risks attached to expenditure claims. The Inland Revenue should also consider, as a longer-term option, the costs and benefits of requiring companies to provide returns certified by their external auditors, which is a requirement in Norway and for royalty returns.

Collection of tax

13 The Inland Revenue is managing collection risks effectively. The petroleum revenue tax system minimises the risk of non-collection by requiring monthly instalments of tax, with a balancing payment when tax returns are filed. Some 96 per cent of the tax due is collected on account. At the last year end, the Department had collected over 99.75 per cent of the tax assessed to be due.

Quality of compliance work

14 While the Department has succeeded in collecting assessed tax liabilities, it is also important to ensure that tax assessments are accurate. The quality of work undertaken is crucial to the effective management of risk. The Oil Taxation Office builds in quality through its staff selection procedures, and training and development activity. It has also been exploring how to assess the quality of its work as part of the Inland Revenue's Compliance Quality Initiative. It has introduced quality monitoring arrangements for its corporation tax work but it has made slower progress on petroleum revenue tax, due to the complexity of the tax, limited staff resources, and difficulties in identifying external assessors with the skills required to carry out reviews. It carried out an initial round of reviews in summer 2000. In view of the importance of quality assurance, we recommend that it builds on this initial work to develop its approach.

Performance measurement and reporting

15 The Oil Taxation Office is accountable to the Chairman of the Board of Inland Revenue through the Director of the Department's International Division. The Office makes formal reports on progress each quarter, concluding with an annual report. These arrangements are supplemented by regular meetings and contacts on important issues. Its key performance targets include clearing correspondence and assessments within defined timescales.

16 The Oil Taxation Office's business aims are the prompt and accurate assessment and collection, or repayment, of revenues properly due. Its key performance targets do not currently address some of its business aims, for example the accurate assessment of tax; and primary responsibility for the prompt collection of sums due lies with one of the Inland Revenue's Accounts Offices. We recommend that the Department examines how targets could be expanded to provide a more comprehensive view of performance in administering petroleum revenue tax.

Overall summary

17 Our examination of the Oil Taxation Office's administration of petroleum revenue tax has provided assurance that the Inland Revenue is managing the risks associated with this tax, and the work the Department is carrying out to develop its approach to risk assessment should help ensure that resources are directed at areas of higher risk. The Department should use the opportunities offered by the assimilation of the work of the Oil and Gas Royalties Office and explore the scope for closer working with the Department of Trade and Industry's Metering Inspectorate in developing its approach.

18 There are clear reporting lines through which the Oil Taxation Office provides Inland Revenue senior management with regular accounts of progress against targets. The Department should build on these arrangements to obtain assurance on the Office's performance against all its key business aims, including the quality of work carried out on petroleum revenue tax.