National Audit Office

Report
by the Comptroller
and Auditor General

**Department for Business, Energy & Industrial Strategy,
HM Revenue & Customs, HM Treasury**

Oil and gas in the UK – offshore decommissioning

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Key facts

£45bn–£77bn
the Oil & Gas Authority's estimate of future decommissioning costs to operators

£24bn
HM Revenue & Custom's estimate of the total cost to government of decommissioning due to tax reliefs

35%
target the Oil & Gas Authority has set for operators by which to reduce their decommissioning costs by 2022

£334 billion	net tax revenues for the government from the oil and gas sector since 1970-71
£290 million	total net repayment from government to oil and gas operators in 2016-17 because tax repayments were greater than tax and licence revenues
£1.2 billion	total net payment from oil and gas operators to government in 2017-18 as tax revenues recovered along with the oil price
10 billion – 20 billion	number of barrels of oil and gas that the Oil & Gas Authority thinks operators can still recover
9	number of operators the Department for Business, Energy & Industrial Strategy has required to set money aside to ensure they have sufficient funds available to cover the costs of decommissioning
£844 million	total amount the Department for Business, Energy & Industrial Strategy has required operators to set aside to ensure they have sufficient funds available to cover the costs of decommissioning
86	number of decommissioning relief deeds HM Treasury had agreed with operators by March 2018. These deeds guarantee that operators will receive tax relief at least in line with that available under 2013 rules

Summary

1 There are currently around 320 fixed installations, such as oil platforms, in production in the UK, primarily in the North Sea. To date, oil and gas assets have enabled operators to recover more than 44 billion barrels of oil and gas. But reserves are running out, with the remaining oil and gas becoming harder to find and extract. The government has an objective to maximise the potential economic value of the UK's remaining oil and gas reserves.

2 Oil and gas operators in the UK are increasingly decommissioning their assets as they are reaching the end of their useful economic lives. Operators' expenditure on decommissioning is rising: they have spent more than £1 billion on decommissioning in each year since 2014. Decommissioning affects the government's finances because operators can recover some of their costs through tax reliefs. These enable operators to deduct decommissioning costs from their taxable profits and potentially claim back some taxes that they have previously paid. With decommissioning activity increasing, the government is paying out more in tax reliefs for decommissioning at the same time as tax revenues have fallen due to a combination of lower production rates, a reduction in oil and gas prices and operators incurring high tax-deductible expenditure. In 2016-17, the government paid out more to oil and gas operators in tax reliefs than it received from them in revenues for the first time, although revenues recovered in 2017-18 and were greater than tax relief payments.

3 The Committee of Public Accounts has recently reported on the range of tax reliefs that the government gives to people and businesses. It found that, because of gaps in its understanding of the costs, the government does not know whether a large number of tax reliefs provide value for money. We have previously reported that the government also does not collect data to enable it to assess whether tax reliefs are effective for achieving its objectives. In response to the Committee's and our recommendations, HM Revenue & Customs (HMRC) has worked to improve its understanding of tax reliefs and increased what it publishes annually about the costs of reliefs to government. It plans to set out by April 2019 how it will improve this reporting, including how it will provide information about tax reliefs for which data are not available.

4 Several public bodies are involved in oil and gas decommissioning:

- The Department for Business, Energy & Industrial Strategy (the Department) has overall responsibility for the safe, cost-effective and environmentally sensitive decommissioning of offshore oil and gas infrastructure.
- The Oil & Gas Authority (OGA) was established in 2015 by the Department to regulate the industry, promote the continued extraction of remaining resources and help operators to reduce their decommissioning costs.
- HM Treasury sets the tax rules for operators, both in terms of the tax paid on profits from oil and gas production and the reliefs available on decommissioning costs.
- HMRC administers the tax reliefs that operators receive (**Figure 1** on pages 8 and 9).

Scope of this report

5 This report sets out the landscape of oil and gas decommissioning to enable Parliament to consider whether the various government departments involved are protecting taxpayers' interests effectively. It covers:

- the role oil and gas has played in the UK economy and the government's current objectives for the sector (Part One);
- the potential costs of decommissioning that operators will pass on to taxpayers (Part Two); and
- how the government is managing the risks to taxpayers (Part Three).

Key findings

Government's objectives for the oil and gas sector

6 **Tax revenues from oil and gas have reduced over the past decade.** The sector has generated £334 billion of net tax revenues for the government since 1970-71. At its peak in 1984-85, tax contributions from the oil and gas sector totalled £30 billion and accounted for 11% of government receipts. But tax revenues have declined from a recent high in 2011-12 due to lower oil and gas prices and operators incurring high levels of expenditure that is tax deductible. In 2016-17, the government paid out more to oil and gas operators in tax reliefs than it received in revenues, resulting in total repayments of £290 million. The Office for Budget Responsibility expects net annual receipts from the oil and gas sector to recover slightly, rising from £1.2 billion in 2017-18 to a projected £2.4 billion in 2022-23 (paragraphs 1.2 to 1.4).

7 **The government wants operators to maximise the potential economic value of remaining oil and gas reserves.** It is primarily a commercial decision for operators as to whether they continue to extract oil and gas using existing assets or invest in constructing new assets to extract new reserves. The government is committed to supporting the industry to maximise extraction due to its role in the economy, supplying energy and providing employment. Since 2013, the government has introduced a series of measures aimed at making it more commercially viable for operators to continue investing in the UK. This includes reducing taxes on oil and gas production, introducing investment allowances to encourage capital investment, providing certainty about tax reliefs for decommissioning, and establishing the OGA to work with the industry to reduce costs and find efficiencies. The OGA has sanction powers (including the ability to revoke licences) if it judges operators not to be fulfilling their obligations for extracting economically viable oil and gas. The OGA estimates that the UK has 10 billion–20 billion barrels of recoverable oil and gas reserves (paragraphs 1.6 to 1.13).

8 **The government projects that oil and gas will play a smaller role in meeting the demand for energy over time.** UK oil and gas will contribute less to meeting energy demand as domestic reserves and production decline, and as the government supports cleaner forms of energy to meet its objectives to reduce carbon dioxide emissions by 80% in 2050 compared with 1990 levels. The Department projects that electricity generation from natural gas will fall by 63% between 2017 and 2035, although there is uncertainty around this as it will depend on the availability of alternative generating sources such as renewables and nuclear power. Oil and gas will remain key fuel sources in certain areas, notably transport and heating, until they can transition to electricity or alternative energy sources. The government has stated that its support for operators to maximise the economic potential of oil and gas reserves is compatible with the UK meeting its climate change objectives (paragraph 1.14).

Decommissioning costs and tax relief

9 **The OGA estimates that decommissioning the UK's oil and gas assets will cost operators between £45 billion and £77 billion.** The OGA requires operators to submit estimates of the costs of decommissioning their assets, which it uses to produce a yearly estimate of the total cost. The OGA expects operators to incur almost all decommissioning costs in the next 20 years, but with some expenditure into the 2060s. It considers decommissioning cost estimates to be highly uncertain, with 49% of estimates expected to be accurate to within -20% to +100% and an additional 40% of estimates only expected to be accurate to within -15% to +50%. The OGA expects its estimates to become more certain in future as operators learn from experience about how much decommissioning will cost (paragraphs 2.6 to 2.8).

Figure 1

Roles and responsibilities for oil and gas

Departments and public bodies use a range of levers to incentivise operators to continue extraction of oil and gas in the UK

HM Government

The government wants operators to maximise the potential economic value that remaining oil and gas reserves have in supplying energy, creating employment and contributing more generally to the economy

Key government stakeholders

HM Treasury sets tax rules

HMRC administers tax reliefs

BEIS

Responsible for oil and gas exploration and production policy and has overall responsibility for decommissioning oil and gas infrastructure

Levers to influence factors driving operator decisions

Transferable tax history (TTH)

Enabling previous asset owners to transfer part of their profit history and their record of the corresponding tax paid

Enforcement

Decommissioning Relief Deeds (DRD)

Guarantee that operators will not receive less tax relief on decommissioning than they would have under rules in place in 2013

Factors affecting operators' decision to extract UK oil and gas

The fiscal environment

The regulatory and policy environment

The government believes that tax relief on decommissioning costs and more certainty over future reliefs give operators more incentives and confidence to invest in new assets and make them less likely to decommission them early, focusing instead on continued recovery of oil and gas

Operators

Commercial viability and profit maximisation drive operators' decisions of whether, and where, to extract oil and gas

Notes

1 HMRC: HM Revenue & Customs. BEIS: The Department for Business, Energy & Industrial Strategy. OPRED: Offshore Petroleum Regulator for Environment and Decommissioning; OPRED operates from within BEIS. OGA: Oil & Gas Authority.

2 The Department oversees the work of the Oil & Gas Authority.

Source: National Audit Office analysis

OPRED

Responsible for ensuring that decommissioning is delivered in a safe, efficient and cost-effective way while minimising the risk to the environment. It does this through approving and monitoring operators' decommissioning plans

OGA

Regulates the industry, promotes extraction and helps operators to reduce decommissioning costs

Security agreements

OPRED can require operators to set aside cash if it believes they may not afford the future costs of decommissioning. To date, OPRED has agreed nine security agreements with operators (£844 million)

Setting a target for cost reduction

Operators must reduce decommissioning costs by 35% between 2017 and 2022

Factors largely outside government's control

The current oil price

Attractiveness of other oil basins

The government intends that clear regulation will provide clarity to operators on operating safely and targets to reduce decommissioning costs mean there may be more money to invest in oil and gas recovery

Higher oil prices increase operators' incentives to extract oil and gas

The attractiveness of global oil fields detracts from some operators' incentives to extract in the UK

10 To increase incentives to produce oil and gas the government has given operators greater certainty about its support for decommissioning and plans to enable operators to transfer tax histories. Operators can use decommissioning costs to offset corporation tax they have paid since 2002 and petroleum revenue tax, which is a tax on profits made on oil fields commissioned before 1993.

- HM Treasury passed legislation in 2013 that enables it to agree decommissioning relief deeds with operators. These deeds guarantee that operators will receive at least as much tax relief as was available under the 2013 tax rules. The deeds also guarantee an operator tax relief if a partner operator cannot undertake its share of decommissioning. HM Treasury introduced the deeds because it was concerned that a lack of certainty about decommissioning tax reliefs was preventing assets from being traded. It also wanted to avoid operators setting aside money to cover the risk that reliefs for decommissioning would reduce, meaning the operators would be less able to invest in continued extraction of oil and gas. By March 2018, HM Treasury had entered into 86 decommissioning relief deeds and had made payments to one operator because it was meeting a partner operator's share of decommissioning costs. HM Treasury paid this operator £45 million during 2017-18 and expects to pay it a further £299 million in future years.
- In November 2017, HM Treasury announced plans to change the tax rules so that companies buying assets could offset decommissioning costs against taxes paid in the past by the operator selling the assets. HM Treasury intends for these changes to make buying and selling assets more viable for operators, mitigating the risk that assets will be closed early, and expects them to result in a positive net impact on tax revenues (paragraphs 2.9 to 2.16).

11 HMRC estimates that tax repayments and forgone taxes associated with decommissioning will cost the government £24 billion, but this is subject to significant uncertainty. HMRC estimates that it will repay around £12.9 billion to operators in taxes previously collected due to decommissioning tax reliefs, which it discloses a provision for in its financial statements. HMRC estimates that the government will forgo a further £11.1 billion of tax income because of decommissioning expenditure reducing taxable profits. HMRC makes these estimates using the central estimate from the OGA's range of forecast costs to operators, which in 2018 was £58.3 billion. The actual cost to government of decommissioning is highly uncertain as it will depend on how much decommissioning ultimately costs operators as well as future economic conditions, such as oil prices and exchange rates, which determine profits (paragraphs 2.17 and 2.18).

12 Taxpayers are ultimately liable for the total cost of decommissioning assets that operators cannot decommission. Should an operator become insolvent or lack the financial resources to carry out decommissioning, the liability reverts to any joint or previous owners of the asset. If none exist, or there are no such operators with the ability to meet the cost of decommissioning, then the liability falls to the government. The Department discloses the risk that it is required to meet the cost of decommissioning in its financial statements as an unquantifiable remote contingent liability. The Department considers the risk of unfunded decommissioning liabilities to be low because 80% of assets are currently, or have previously been, owned by large oil and gas operators (paragraphs 2.19 and 2.20).

Management of taxpayer risks

13 **The OGA has set operators a target to reduce their decommissioning costs by 35% from its 2017 estimate of £59.7 billion by 2022.** The OGA is working with the industry to reduce decommissioning costs as part of its wider strategy to maximise the extraction of oil and gas. It has identified key priorities for reducing costs, including: establishing greater certainty about costs; developing capability in the supply chain; and clarifying the requirements of decommissioning regulations. The OGA also wants the UK supply chain to develop in a way that enables it to export skills and resources to other countries that are due to decommission assets later than the UK (paragraphs 3.5 to 3.11).

14 **The Department monitors the financial health of operators and can act to mitigate the risk that they will not be able to pay for decommissioning.** The Department tracks the financial position of operators compared with its own forecasts of the costs of decommissioning their assets. The Department can require operators to take mitigating actions, such as setting money aside to cover decommissioning liabilities, if it deems there to be a significant risk of unfunded liabilities. To date, the Department has required nine operators to set aside a total of £844 million to pay for decommissioning (paragraphs 3.12 and 3.13).

Measuring government's impact

15 **There is evidence of progress against the government's objectives although it is difficult to attribute this to its activities.** The OGA told us that, since its creation, 3.7 billion barrels have been added to its central production forecast, and that operators have improved their operating performance. Additionally, the OGA states there has been a 7% reduction in future costs to decommission assets that were included in both its 2017 and 2018 annual estimates. But it is difficult to isolate the impact of the OGA's interventions from wider influences on operators, such as economic conditions, particularly as it encourages certain behaviours by operators rather than mandating them (paragraph 3.14 to 3.18).

16 **There are gaps in the government's understanding of the costs and benefits of changes to the tax regime.** HMRC plans to publish for the first time in January 2019 the cost of decommissioning tax reliefs given since 2014-15. HM Treasury and HMRC told us they draw on a range of information, including the OGA's data, to assess whether changes to tax rules are achieving the objective to maximise the oil and gas that operators extract. This includes the number of new projects and operators' capital expenditure. HM Treasury prepares five-year revenue forecasts for all tax changes but told us it has not been able to separate out the impact of individual tax changes given the wide range of factors that influence oil and gas production. For one change – the introduction of decommissioning relief deeds – HM Treasury has reported to Parliament that these have enabled operators to invest £5.7 billion elsewhere. HM Treasury does not know whether this money has been reinvested in the UK (paragraphs 3.19 and 3.20).