Technology Tax Experts

E: info@mmp-tax.co.uk
T: +44 (0)207 458 4108

MMP Tax Ltd, 83 Victoria Street
London, SW1H 0HW

www.mmp-tax.co.uk

Nico Heslop and Laura Kiddoo
Environment and Transport Taxes Team
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

submitted by email to:
shalegas@hmtreasury.gsi.gov.uk

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Dear Sirs,

Consultation on proposals for a tax regime for shale gas

I write to you with MMP Tax's formal response to the government's consultation on proposals for a fiscal regime for shale gas.

About MMP Tax

MMP Tax provides specialist technology-based tax consultancy for corporate clients. Specific areas of our expertise include tax reliefs for research and development, patents, the creative sectors, specialised capital allowances, and corporate investments.

At MMP Tax we combine specialist knowledge of technology tax reliefs with practical experience in engineering and scientific disciplines. We apply these skills in a client-centric way to ensure our clients submit robust and verifiable claims.

The directors of MMP Tax have more than 30 years of direct experience in technology tax relief from a technical and consulting perspective, in addition to wide-ranging experience in industry. MMP Tax currently has representation on the HMT-HMRC Working Groups for R&D Tax Relief, the Patent Box, and the Above The Line-RDEC Working Group for R&DTR. MMP Tax also made a formal response to the Creative Sector Tax Relief consultation last year, and the Visual Effects Tax Relief consultation earlier this year.

Although we have no direct operating experience in the oil and gas sector, we do have several clients who operate in upstream and downstream environments. We understand these sectors and the tax issues that affect them. Nonetheless, we have concentrated our responses to the consultation proposals on issues that specifically relate to the tax implications of the proposals.

MMP's Overall Position

The nascent onshore UK shale gas industry has significant potential to improve our energy security, reduce the cost of energy, and create prosperity through new jobs and increased tax revenues. We support the proposals in this consultation as a means to encourage existing firms and new entrants to invest the money and resources into the critical exploration phase that will determine whether shale gas can deliver on its potential for the UK.

It could also be argued that these initiatives are long overdue. The UK has had an onshore oil and gas industry for more than a century. Over 2,000 wells have been drilled onshore – many of them hydraulically fractured – and more than 300 of these wells are currently operational and produce in excess of 20,000 barrels of oil equivalent per day from 120 sites[1]. There is already a large community of operators and suppliers in the UK that rely on the onshore oil and gas industry for their income.

And the offshore UK oil and gas industry has not only generated significant value-add for UK GDP in the form of investment, employment, and wealth creation, but it has also been a pioneer in new and advanced technologies and become a world-leader in its respective field.

Geologists have also known about the existence of areas such as the Bowland-Hodder shale gas formation for many years. Although, of course, there is a very material difference between gas-in-place resource estimates and the actual reserves that will be economically accessible.

So, the onshore shale gas industry might already have successfully established itself if initiatives like this had been in place earlier.

As such, we support the main proposals and we consider that they will help to achieve the government's policy objectives – namely a broad-based, safe and effective commencement of onshore shale gas production.

Furthermore, oil and gas is inextricably linked into high-value and knowledge-based sectors such as engineering and electronics and software. These links are typical of knowledge-based sectors and represent the real value in modern production value chains.

This knowledge-based capital is in areas such as R&D, exploration research, and extraction technologies. This knowledge drives high-value jobs not only in the core oil and gas industry, but also in the related industries that supply and support the sector.

Consequently, it makes total sense that the government continues to focus targeted tax incentives on industries where the UK has a leading position and where the industry is likely to grow and contribute to the UK's stock of knowledge-based capital.

Our response to the consultation is based on our own direct experience of the operation of technology tax reliefs in areas such as R&D Tax Relief, the Patent Box, the Creative Sector

[1] UK Onshore Operators Group

Tax Reliefs, Film Tax Relief, and our involvement in the various other innovation tax relief HMT-HMRC Working Groups, and on feedback from our own client network in the upstream and downstream oil and gas sectors.

Overall, MMP Tax is concerned about:

- **The quantum of relief** – ie. the rate of relief must be sufficiently generous to rise above the **noise level** so that corporate investment decisions about new exploration projects are positively impacted by the relief, whether by capital-rich oil majors, or capital-hungry new entrants into the sector.
- **Long-term certainty** – the scheme must involve long-term commitment by the government to allow companies to take long-term investment decisions.
- **Visibility** – the scheme must be sufficiently simple, easy to administer, and well publicised so that companies are aware of it and are incentivised to use it.

<u>Our Response to the Consultation Questions</u>

We have focused our response on areas where we have substantive opinions rather than deal with each specific question raised in the consultation document.

We have also focused on the tax practicalities for the proposals. The industry respondents to the consultation will doubtless provide far more detailed supporting evidence from an operational and industry perspective, so we have concentrated our responses on the actual tax, finance, and administrative implications for the current proposals.

As such, we offer answers to the following consultation questions:

Question 1 Would the proposed pad allowance achieve the objectives set out in chapter 3?

MMP *Yes, with a caveat – see our answer to Q.2 below*

Question 2 Are there variations to the pad allowance option that would better meet the objectives outlined in chapter 3? If so, please provide evidence to support your case.

MMP *Yes; we suggest that a payable cash back credit is awarded in exchange for the surrender of losses. If it was considered that this would unduly benefit cash-rich oil majors, then a distinction could be drawn between new industry entrants and existing participants, or between SMEs and Large Cos.*

Overall, a payable cash credit in exchange for surrendered losses would have three main benefits:

1. *It would give immediate cashflow support to companies having to cope with the high upfront costs associated with shale gas projects.*
2. *It would enhance the attraction and credibility of the scheme.*
3. *It would really impact the smaller new entrants – those companies most likely to struggle with the upfront cash flow implications of shale gas investment.*

We base our response to this question on our experience of the payable R&D Tax credit which has operated successfully for more than a decade for SMEs, *and is now being extended to large companies with the new payable R&D Expenditure Credit.*

We have also considered whether the rate of the pad allowance could be varied depending on the location of the pad (eg. a higher amount for a pad located in the Jurassic Weald compared with a pad in the Bowland-Hodder basin) and based on acknowledged differences in yield and/or capital infrastructure at the pad locations.

However, on reflection we consider that this debate is best left to the actual industry participants and we offer no opinion on a location-based variation in the pad allowance.

Question 4 Do you agree that, for the purposes of the pad allowance, capital expenditure should cover expenditure that would attract 100 per cent first year capital allowances?

MMP *Yes*

Question 5 Will the pad allowance introduce any additional administrative burdens for businesses, particularly the need to track expenditure on a pad-level? If so, are there options the government could consider to reduce this burden?

MMP *No; the proposals are consistent with the existing Ring Fence rules. There is always a degree of administrative burden for companies in optimising their benefit for tax reliefs, but these proposals will not add to the administrative burden.*

Question 6 Do you agree that current arrangements to protect the Exchequer are sufficiently robust for the pad allowance? Do you think there are any additional measures that would be helpful in this regard?

MMP *Yes; current arrangements should protect the Exchequer.*
The only additional measures that we would suggest are to ensure the relevant HMRC Oil and Gas teams receive sufficient training to understand and implement the new proposals.

Question 8 Do you agree with the government's proposed approach of extending the pad allowance to cover all onshore unconventional hydrocarbons?

MMP *Yes: this would encourage exploration and extraction of other petroleum-based resources, with the associated benefits in energy output and energy security. It would also encourage the development of the technology and research that accompanies oil and gas extraction.*

Question 10 Do you think there is a case for extending the allowance to all onshore hydrocarbon projects? If so, please provide evidence to support your case.

Might there be risks associated with this option?

MMP *Yes, in the sense that targeted tax reliefs do generate positive returns for both the Exchequer and the economy at large[2] so, by broadening the scope, it will bring more firms and more projects into the net which will multiply the benefits for both private and public sectors.*

Question 11 If the allowance was extended to all onshore unconventional hydrocarbons, or to all onshore hydrocarbons, do you think there are any potential risks or unintended consequences of removing these projects from the scope of all current field allowances and instead providing the projects with the proposed pad allowance?

MMP *Yes, potentially there are risks; the return on investment models for these projects will have been impacted by the known field allowance criteria at the outset of each project, and so by changing the allowance structure it would impact the ROI of the project and would therefore impact the project owner's timeframe and desire to operate the project.*

The change should only be made if it can be shown clearly that the new regime would be more beneficial than the existing regime.

Question 12 Do you have views on the impact of the tax regime on the longer-term potential for offshore shale gas or oil production?

MMP *Our view is that it will not impact the offshore sector. It will simply be viewed as an added incentive for the oil and gas sector as a whole. If there are economically viable offshore projects, then those projects will still go-ahead. The new shale gas proposals will not replace or substitute investment into offshore projects. The proposals will bring more investment into the sector as a whole, and will generally have a halo effect: e.g. new onshore shale gas techniques and technologies may end up being utilised on offshore shale gas projects.*

Question 13 Do you think that the five-year minimum activation period, which is a feature of existing field allowances, is appropriate for the pad allowance given the objectives set out in chapter 3? If not, can you provide evidence in support of an alternative rate of access to the allowance?

MMP *See our answers to Q2 and Q10 above. Based on our experience of R&D Tax Relief we would suggest that the simplest and most generous scheme is allowed to be accessed as quickly as possible to create the biggest incentive in an industry which, if the US trends are correct, is likely to have shorter project timespans than conventional oil and gas fields.*

As such, we would recommend that full access to the allowance is allowed right from the start.

[2] HMRC Evaluation Study of Impact of R&D Tax Relief – HMRC KAI Direct Business Taxes, November 2010

Question 14 Do you agree that the allowance should be split between participants in a pad based on actual expenditure incurred by each participator? If not, what do you consider to be a more appropriate method to split the allowance between participants?

MMP *We do not consider that a split based on expenditure is the correct approach.*

We consider that a split based on equity shares is the correct method. Knowledge capital is likely to be as important as physical and financial capital in the initial exploration and development phases of onshore shale gas extraction – particularly where smaller new entrants end up partnering with the oil majors.

Equity shares represent an equitable and true reflection of the respective contributions by the partners in a project. As such it represents the most logical and fairest way to allocate the benefits from the proposed tax regime between the partners.

Question 15 Will companies be able to disaggregate their onshore unconventional hydrocarbon losses from wider company losses in order to make the further four RFES claims? Would doing so pose a disproportionate administrative burden?

MMP *Yes, but this will pose an administrative burden and will complicate the factors behind investment decisions. Anything which adds to the complexity of an investment decision can potentially lead to the reduction or deferral of that decision.*

This is another reason why we suggest scrapping the RFES extension (see our answer to Q16. below).

Question 16 Are there alternative approaches the government could consider for the administration of the extension of the Ring Fence Expenditure Supplement for onshore unconventional hydrocarbon projects?

MMP *Yes; we would suggest the proposed extension of the Ring Fence Extension Supplement is scrapped. Instead, we would advocate a higher headline rate of pad allowance. This is for the following reasons:*

1. *Extending the RFES beyond the current 6 periods means the RFES is suddenly more complicated and harder to administer and is inconsistent with its application across non-shale gas projects.*
2. *The benefit of the extension is harder to quantify and is less visible and therefore less attractive. As such it will be less effective at meeting the government's policy objectives for the shale gas fiscal regime.*
3. *A higher headline rate for the pad allowance means the shale gas tax relief would be very simple and very attractive and would attract publicity and attention – all of which will help the government to achieve its objectives for the shale gas fiscal regime.*

Question 17 Do you agree that the extension of RFES should apply to all onshore unconventional hydrocarbon projects, using the definition set out in section 4.3?

MMP *No: see our answer to Q16 above.*

Conclusion

The UK is a world-leader in the oil and gas industry. The government wants to encourage participation from new entrants (eg Cuadrilla, iGas) and the oil majors in onshore shale gas exploration and production. The oil and gas sectors are driven by knowledge-based capital which will create higher skilled and higher value jobs. It is also export-orientated and innovative, bringing external skills and overseas investment into the UK economy.

Direct government tax relief intervention will encourage the majors and new entrants to invest in the exploration and development phases of shale gas. From a technology perspective, the UK has a comparative advantage in these sectors and this type of government intervention will continue to support the UK's position as a leading participant in the knowledge and technologies that drive the global oil and gas industry.

From a supply perspective, it will also boost the country's available energy reserves and energy security for years, perhaps even decades.

The consequential beneficial effects from the successful development of a UK onshore shale gas industry would include reduced energy prices, extensive job creation, higher tax revenues, and reduced dependence on overseas energy sources.

In conclusion, we wholeheartedly support the introduction of a fiscal regime for shale gas.

Yours sincerely,

Peter D-P

Peter Denison-Pender, Director