

# 'Fiscal regimes for the production of conventional and unconventional gas'

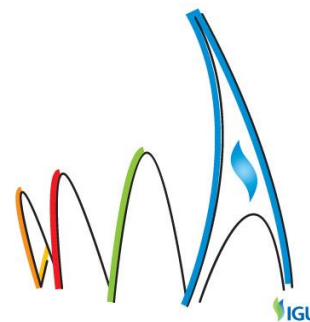
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'The decisive impact of fiscal policies on the final investment decision of E&P companies'

# WGCPARIS2015

## WORLD GAS CONFERENCE

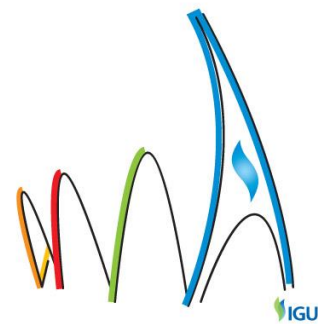
*"GROWING TOGETHER TOWARDS A FRIENDLY PLANET"*



**26th World Gas Conference | 1-5 June 2015 | Paris, France**

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### Background

To make a good final investment decision, E&P companies contemplating new or additional E&P investments in oil and gas fields, need to have a clear picture and legal certainty about the taxation on profits derived from and cost incurred on production and exploration of the respective gas field. This specifically goes for tax deduction / provision of future decommissioning cost and also for tax deductibility of production and depreciation costs. Governmental administration have to realize that they (can) have decisive impact in this respect. This especially goes given the current steep fall of oil and gas prices. Additional investment incentives from the authorities are needed to recover the full potential reserves of the North Sea. Such incentives not only are needed from an economic perspective (improvement of ROI), but also from a sustainable point of view. Without sustained investment in new and existing fields, critical infrastructure will disappear, taking with it important North Sea hubs, effectively sterilising areas of the basin and leaving oil and gas in the ground, according to Malcom Webb (CEO of trade association Oil & Gas UK).

### Methods

To conclude on opportunities for effective measures to be taken by the authorities and to make a fair and valid comparison between different tax systems, the authors compared the E&P tax systems for E&P companies active in the North Sea, being the tax systems of Denmark, the Netherlands, Norway and the United Kingdom.

### Results

The tax systems of Denmark, the Netherlands, Norway and the United Kingdom consist of the following key elements.

#### *Denmark*

The Danish hydrocarbon tax system is a two-string system combining corporate income tax (CIT) at the standard rate of 25% and a special hydrocarbon tax at a rate of 52%. The overall combined tax rate is 64%. No royalties or surface rentals are due. During the lifetime of the field future costs for decommissioning not yet can be taken into account nor added to a decommissioning provision. Certain qualifying expense are eligible for a 30% uplift allowance. Fixed assets may be depreciated based on the declining balance method against a rate ranging from 15-25%. Given the long economic life drilling rigs usually are depreciated at a rate of 17% annually.

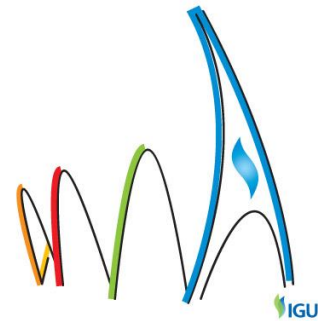
#### *The Netherlands*

The Dutch hydrocarbon tax system is a two-string system combining CIT at the standard rate of 25% and a special hydrocarbon tax called State Profit Share (SPS) at a rate of 50%. Given that 1) the SPS due is tax deductible for CIT and 2) a CIT credit is granted for SPS

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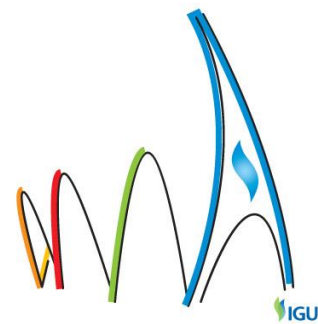
purposes, the overall combined rate is approximately 47-50%. Depending on the type of license (on- or offshore, exploration or production) surface rentals and royalties may be due. During the lifetime of the field future costs for decommissioning can be added to a decommissioning provision. The annually addition to this provision is based on an units of production method. For SPS purpose qualifying expense are eligible for a 10% uplift allowance (deemed additional deductible expense). Fixed assets are depreciated based on the units of production method over the life time of the field. As an additional incentive for the exploration and production of marginal gas fields an investment allowance of 25% on qualifying capital expense may be granted. During the crisis years depreciation at will was allowed on qualifying new investments made.

### *Norway*

The Norwegian hydrocarbon tax system is a two-string system combining CIT at the standard rate of 27% and a special hydrocarbon tax at a rate of 51%. The overall combined tax rate is 78%. Investments in offshore production facilities, pipelines and installations are depreciated over a 6 year period commencing as of the year of investment. Additional allowances aggregating to 22% for the special hydrocarbon tax are granted (5.5% per year over a 4 year period). The tax value of expense incurred for exploration activities are refundable on a yearly basis.

### *The United Kingdom*

The UK hydrocarbon tax system is a two-string system combining CIT at a rate of 30% and a supplementary charge at a rate of 30%. For fields that received development consent prior to 16 March 1993 a Petroleum revenue tax at a rate of 50% applies. During the lifetime of the field future costs for decommissioning not yet can be taken into account nor added to a decommissioning provision. A 100% first-year allowance (FYA) is available for virtually all E&P capital expenditure. Decommissioning expense are considered to be capital in nature and qualify for a special 100% allowance. However, tax relief is restricted for decommissioning expenses for Supplementary Charge purposes to 20%. The UK Government has committed that there will be no restrictions to decommissioning relief beyond this level for the lifetime of this Parliament. Special field allowance, cluster area allowance, and brown field allowance are available for, shortly put, ultra high pressure and high temperature projects, marginal fields and for qualifying incremental projects.



*Best practice based on above tax systems*

From the above it appears that the combined tax rates on E&P income derived in the North Sea area are quite significant, ranging from 50% to 78%, excluding additional royalties and/or surface rentals due. Therefore, the most obvious incentive from the authorities could be to decrease the overall combined tax rates on E&P income. As an overall decrease would be effective for both new and existing fields. Therefore, one also could choose to only apply a lower overall combined rate for new fields or for existing fields which are further developed by additional investments. Overall lower combined tax rates on E&P income could attract more investments since the return on investments would increase and breakeven point would be reached sooner.

Since E&P activities require significant capital expenditures an effective measure could be to allow for accelerated depreciation comparable to the Norwegian or UK tax system. This ensures the investor that effectively only tax will be due after full recovery of the capital expenditures made. On the contrary, if only depreciation over the life time of a field is allowed, separate from the cash flow disadvantaged, the investor also runs the risk that loss carry back rules prevent future losses to be compensated with profits derived in earlier years. Accelerated depreciation measures will have a positive effect on investment decisions to be made.

Special uplifts and allowance also can encourage new and additional investments, since such incentives decrease the effective tax rate if additional costs are incurred. Specifically these measures can be used if the authorities would like to achieve a variable effective tax rates which fluctuates with the level of cost incurred compared to the revenue obtained by the respective E&P company. Also these measures can contribute to a more sustainable footprint since by proper marginal field policy of the authorities existing fields and infrastructure will be utilized more efficient and effectively and a higher recovery rate can be achieved.

Finally, the future costs of decommissioning of E&P facilities are considerable. Therefore, in accordance with the matching principle as commonly applied for accounting purposes, an effective measure for tax purposes could be to allow for accounting a tax deductible decommission provision based on the best estimate of future decommissioning expenses during the life time of the respective field instead of only allowing tax deduction of decommission expenses once incurred.

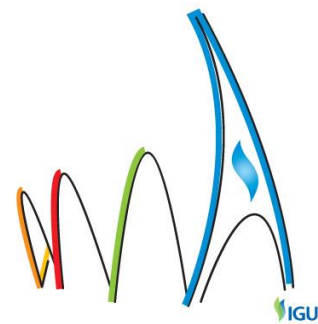
## Conclusions

Based on our comparison between the tax systems of Denmark, the Netherlands, Norway and the United Kingdom we recommend the following best practices for incentives and

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measures to be taken by authorities to increase investments in and sustainability and recovery of oil and gas fields.

- To consider to decrease the combined effective tax rate applicable to E&P income;
- To allow for accelerated depreciation of capital expenditures in new and existing fields;
- To grant special uplifts and allowance to increase the recovery of existing fields, to attract investments in new fields and to attribute to a more sustainable footprint of the existing infrastructure; and
- To allow for accounting a tax deductible decommission provision based on the best estimate of future decommissioning expenses during the life time of the respective field.

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