Fiscal regimes: UK vs Norway

The UK and Norwegian oil and gas industries share many characteristics, including age, location and their increasing maturity. However, despite these similarities, recent activity trends and future potential varies considerably as fiscal and regulatory differences continue to mould these two countries’ industries. Here, Luke Davis, an analyst at Infield Systems, reviews E&P trends in the North Sea and discusses how fiscal regimes play a key role in shaping the industry.

According to energy economist Dr Carole Nakhle, the basic proposition of an oil and gas taxation regime is to ‘acquire for the state in whose territory the resources lie, a fair share of the wealth accruing from their extraction, whilst encouraging investors to ensure optimal economic recovery of those resources’. Whilst this sounds relatively straightforward, the difficulty lies in striking a balance between government and industry objectives. In other words, if the state becomes too greedy it risks discouraging investment and damaging the long-term potential of the reserve base.

So, how do the UK and Norwegian systems stack up? In the UK, E&P companies are subject to ring-fenced corporation tax plus a supplementary charge on profits – the former is applied at a rate of 30% and the latter 32%. In Norway, corporation tax is applied at a rate of 28%, whilst an additional special tax increases government take to 78%.

Although these taxes are applicable to the majority of field developments on the UK continental shelf (UKCS) and Norwegian continental shelf (NCS), distortions to these rules exist in order to incentivise exploration activity. This is currently achieved in one of two ways – either directly by providing relief on exploration wells or indirectly through development incentives that increase the value of future discoveries. The UK opts for the latter, with a field allowance promoting development activity on small, high-pressure, high-temperature and deepwater fields; whilst Norway opts for the former, with a unique tax refund system that protects operators from 78% of the cost of a dry exploration well.

Fiscal stability

Aside from headline tax rates and incentives, another key difference between the UK and Norway is the relative stability of the latter’s fiscal regime. Indeed, the UK government has spent many years tinkering with the system, introducing increasingly onerous rates and various incentives. This culminated in 2011, when the Chancellor shocked the industry with the third major tax rise in nine years as the supplementary charge increased by 12%. Overnight the shares of UK E&P companies nose-dived and investor confidence followed. However, in Norway the story is very different. Indeed, whilst headline tax rates are higher for new developments, they haven’t been changed in over two decades and this has provided investors with the stability required to make long-term investment decisions in what is a very capital intensive industry.

The net result of these fiscal differences – where Norway places a higher tax burden on new field developments, but offers protection against exploration failure – is that the UK has a far greater number of small and marginal field developments, but a relatively weaker level of exploration activity – see Figures 1 and 2.

Since UK and Norwegian development costs are comparable, fiscal differences must account for the fact that small discoveries are so much more attractive in the UK. Indeed, unlike Norway, small reserves play a production-critical role in the UK due to the country’s maturity and recent lack of major discoveries. Moreover, Figure 1 suggests that small reserves are more valuable under the UK fiscal regime.

From an exploration and appraisal perspective, last year’s increase to the UK supplementary charge will have dented investor confidence. Whilst it is hard to isolate and quantify the effect this has had on exploration activity, it no doubt contributed to the downturn in 2011. Moreover, the effects could be longer lasting. Indeed, whilst 1Q2012 drilling activity was up marginally compared to the same period last year, numbers remained well below the five-year average, which also fell quarter-on-quarter.

Across the maritime border in Norway, the introduction of exploration incentives in 2005 has significantly increased E&A activity. Whilst returns have been relatively slow in coming, 2011 finished as a highly successful year. Indeed, discoveries such as Johan...
Sverdrup, Skrugard and Havis have underlined the continued prospectivity of the NCS. However, small fields remain less attractive in Norway due to lofty headline tax rates – although an exception exists where an operator ties back the development to its own infrastructure. Indeed, small reserves in Norway (<30mn barrels) have been developed via subsea tie-back or extended reach drilling where the operator owns both the target field and the tie-back – there are few exceptions to this rule.

In the UK, the story is very different. Not only are subsea tie-backs often developed by one operator and tied back to another’s infrastructure, but many are developed with fixed platform technology. In the UK, over 200 small fields have been developed; in Norway this figure is just 30.

Future activity
So, how does the future look for activity in the North Sea? The UKCS industry breathed a sigh of relief when the 2012 Budget revealed no further tax hikes. In fact, the Chancellor announced additional relief for small and deepwater fields and introduced legislation that will guarantee significant tax breaks on the cost of decommissioning old infrastructure (see Petroleum Review, May 2012). Whilst these announcements have been well received, some say that they constitute a short-term fix and incentives that target exploration would be better placed to extract the maximum potential from the UKCS.

In Norway, recent exploration successes should encourage E&P companies to invest on the NCS in search of further large discoveries. However, like the UK, exploration successes will become more limited as the region matures further. As this process of maturing progresses, the average size of discoveries will fall and the Norwegian fiscal regime may have to be adjusted to make small and more challenging targets more attractive to investors.