Scottish Independence and the Oil & Gas Industry

By Uisdean Vass
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Introduction

We dedicate our Autumn Newsletter to the Scottish referendum on Independence to be held on 18 September. Our firm, which has seven offices all over England and one in Aberdeen, Scotland, takes no position on the merits of “Yes” or “No”.

However, being one of the pre-eminent North Sea Oil & Gas law practices, we are highly interested in the consequences for the North Sea Oil business if there is a “Yes” vote. Our Aberdeen-based oil and gas partner, Uisdean Vass, has followed this issue with interest for years and also has wide comparative experience in regimes such as Norway, Nova Scotia, Louisiana and Texas which are to some degree models for how an independent or autonomous Scotland might run a new Scottish petroleum jurisdiction.

In the essay below, we also look at what the consequences may be if there is a “No” vote. While more powers are promised to Scotland if there is a “No” vote we think that there will only be modest changes to the oil and gas regime, at least at first.

As you read Oilpatch, which talks about our activities, you will see that we are taking the opportunity to discuss the Scottish referendum position with clients and contacts in London, Norway and the USA. Please feel free to join the discussion with us.
Implications for the UK Oil & Gas Industry

After one of the longest political campaigns in British political history, the end is in sight. On 18 September, 2014, the Scottish people will vote on whether Scotland should leave the union and become an independent country. A “yes” vote would serve to create two separate countries, Scotland and the remaining United Kingdom (“RUK”) of England, Wales and Northern Ireland. Such a vote would have enormous strategic, political and economic implications in the UK and will have effects beyond its borders. This article, in the main, will focus on the implications for the UK Oil & Gas Industry in the event of a “yes” vote.

1 The Mechanics
Let us assume that there is a Yes vote on 18 September.
What then happens is that the Scottish and UK Governments will negotiate the terms of Scottish independence. The Scottish Government targets independence by March 2016. There will be no second referendum on the terms negotiated and agreed by the governments. By virtue of the Edinburgh Agreement of 15 October 2012, both governments have pledged to respect the referendum result and negotiate in good faith thereafter. Note: the Scottish Government will negotiate the terms of Scottish Independence while remaining a part of the UK.

2 Difficulties of Process
This referendum process has been very difficult because there is no recent precedent for the break-up of an advanced Western country and many issues by their nature can only be clarified after a Yes vote. More than that, it is vital to remember that no single issue will be decided in isolation. There will be a negotiation “hopper” of issues, and few issues will be so important for Scotland as those involving Oil & Gas.

3 Stance of the Oil Business
Remaining with political neutrality the main UK oil and gas trade association Oil & Gas UK has sensibly declined to support either campaign. Many UK oil and gas workers live in, or operate out of, Scotland and their views are diverse. 2014 has been a year of particular flux in the UK oil and gas business as the very influential Wood Review, which proposes root and branch changes to offshore oil and gas licensing, was issued in February 2014. For our analysis of Wood, click here. A fourteenth onshore oil and gas licensing round has also been announced. Draft regulations implementing the new EU Directive on Offshore Safety are also out for comment and these will have a major impact.

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4 Policy of Scottish Government

The current Scottish Government’s powers are derived from the UK Scotland Act of 1998 and its successor legislation. Presently the Scottish Government has little or no regulatory authority over upstream oil and gas. Clearly, this will change dramatically should Scotland leave the Union.

The Scottish Government has, understandably taken a lively interest in the UK Oil and Gas business and has set forth its policy approach in a paper entitled “Maximising the Return from Oil and Gas in an Independent Scotland, July 2013” (“Scotland 1”).

Like the UK Government, the Scottish Government has endorsed the proposals of the Wood Review. Most recently (July 2014) the Scottish Government’s Independent Expert Commission on Oil & Gas came out with its detailed report entitled “Maximising the Total Value Added” (“Scotland 2”) which endorsed and indeed amplified Wood. We therefore have a fairly clear idea of the approach the Scottish Government would take towards the Oil and Gas Sector.

5 Delineation of Scottish Continental Shelf (SCS)

The biggest petroleum issue will be the delineation of the SCS, and this raises three separate areas of negotiation, which might be called East, North and West.

5.1 East

Most producing North Sea oilfields are in the Central and Northern North Sea to the east of Scotland. Off the South East of England, there is the old producing Southern Gas Basin which will clearly lie in the RUK sector. On the Eastern side the current United Kingdom Continental Shelf (UKCS) is bounded by well-defined Dutch, German, Danish and Norwegian sectors. How will this large continental shelf area be carved up?

If Scotland and RUK were separate countries, then International law would apply. The primary rule in such situations is that the littoral states should resolve the delineation issue by negotiation. But what if this proves too challenging? Without entering into a long legal analysis, the basic rule is one of equidistance tempered by special factors. By analogy (because Scotland will not be a sovereign state during the negotiations) these rules can be applied to establish the SCS in this case. There is however also guidance closer to home. The Scottish Area (Civil and Criminal) Jurisdiction Order 1987 provides that Scots law...
applies to installations located north of a horizontal line (see diagram) (“1987 Line”) extending due east of the border town of Berwick-on-Tweed. If adopted as the southern frontier of the SCS, this would give over to Scotland every producing oilfield in the Central North Sea. While the 1987 Line is not a resource line, all of the oilfields north of it are serviced from Aberdeen, which might count as a special factor.

As an alternative, another line drawn by the Scottish Adjacent Waters Boundary Order 1999 (“1999 Line”) (see diagram) is the present southern boundary (on the east side) of the Scottish maritime and fisheries jurisdiction. The Scottish Government presently has responsibility for this. This is a resource line which is also a median line. Median lines are also equidistance lines. While there are some old producing fields south of the 1999 Line and north of the 1987 Line (Uncertain Area), their economic value is not of huge importance.

We would suggest that it is unlikely the maritime boundary on the eastern side will move north of the 1999 line.

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5.2 North
To the North the UKCS has clearly defined northern frontiers with Norway and Faroes (autonomous Danish). In this northern area lie the Orkney and Shetland Islands (Northern Islands) which Scotland acquired from the Kingdom of Denmark in 1470. These Northern Islands will, like the rest of Scotland, vote in the referendum on 18 September. However, because culturally and ancestrally the Northern Islands have close ties with Scandinavia, some have suggested that in the event of a strong “No” in the Northern Islands as against an overall Scottish “Yes”, the Northern Islanders might wish to seek further autonomy within Scotland, or stay with RUK or even declare independence.

The unlikely option of the Northern Islanders’ independence would heavily impact on the area of the SCS. Staying with RUK might be problematic for the Northern Islanders as British island groups such as Man and Channel Islands have only a territorial sea of twelve nautical miles.

However, in recognition of the Northern Islands special place and importance to the Scottish independence case, the Scottish Government has promised further autonomy to the Northern Isles and Western Isles.

5.3 West
Scotland’s likely western boundary is not thought to be a great issue. Scotland is likely to inherit the UK’s existing boundary with the Irish Republic.

5.4 Overall
Given the evidence, the great majority of the UK’s present producing offshore oil fields will fall into the SCS.

6 Decommissioning Liabilities and Tax
6.1 Background
The great oilfields of the Central and Northern North Sea were largely discovered and brought on to production in the 1970’s and 80’s. At that time, heavy fixed structures were used for production. Many of these old fields are facing decommissioning. Because of the Brent Spar debacle in the mid – 1990’s, Western Europe has entered into a regional treaty on decommissioning called OSPAR. This imposes strict rules meaning that all structures must, unless a specific derogation is granted, be lifted and disposed of on land.

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and to be fully addressed is that petroleum fields whose development plans were approved before March 1993 are subject to Petroleum Revenue Tax (PRT) which is Ring-Fenced by field and chargeable at 50% of gross revenue subject to certain deductions.

In addition to PRT, all UK licensees are subject to Ring-Fenced Corporate Tax (at 30%) and Supplementary Charge (at 32%) unless there is an available field exemption for Supplementary Charge.

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6.2 Tax Treatment

Such massive decommissioning costs need careful tax treatment. The UK offers no yearly tax relief for sums paid into sinking funds for decommissioning costs (unlike other jurisdictions). Instead, for purposes of PRT, decommissioning expenditure (made at the end of field life) can be taken against profits arising from a field all the way back to first profit. With the other two taxes, decommissioning expenditure can be taken back against profits going back to a date in 2002.

The upshot is that the UK Government is currently liable (through tax credits) for a large share of the cost of decommissioning. The industry regards this UK Government obligation as a huge asset.

The Scottish Government currently pledges to respect the existing tax structure and to honour the decommissioning tax credit obligations of the UK Government. However, given that the great majority of tax revenues from the old fields will have been spent across the Union (ie pre-independence), the Scottish Government will seek to negotiate a substantial contribution from RUK for credit relating to production in the UK era. See Scotland 1, at page 45.

7 Other Tax Issues

7.1 Ring-Fenced Corporate

Ring-Fenced Corporate Tax and Supplementary Charge are ring-fenced as to upstream profits so profits and losses made in different fields by the same licensee can be taken together to reduce taxable revenue.

In the event that a new Scottish jurisdiction is formed it may be that profits and losses become isolated in separate legal systems. This important issue will need to be clearly dealt with to give business certainty.

7.2 Scottish Permanent
Establishments
In the event that Scotland becomes independent, businesses making money through activities in Scotland or the SCS will have to form entities or permanent establishments in Scotland for tax purposes.

7.3 Impact on UK Tax Treaties
Though beyond the scope of this article, companies currently engaging in activities in Scotland in reliance on UK Tax or Investment Treaties will need to consider the impact of Scottish independence on those treaties. But to give one example, the current UK/Norway Tax Treaty has extensive provisions on the oil and gas sectors as well as related transport and personnel services.

7.4 General Corporate Taxes/Individual Tax
It should be emphasised that only petroleum licensees (ie oil companies) are subject to the three-fold petroleum tax system described above (PRT/Ring-Fenced Corporate and Supplementary Charge). Those companies engaged in the storage and transportation of oil can be subject to Ring-Fence Corporate Tax. All other companies, including oil service companies, are subject to regular Corporate Tax the highest rate of which is currently 21%.

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The Scottish Government proposes to keep personal Income Tax at broadly current levels. Unionist critics are sceptical.

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8 A Scottish Petroleum Jurisdiction

8.1 Existing Licences

The Scottish Government is committed to grandfathering all existing UK petroleum licences. Depending on where the dividing line may be drawn on the East side it may be necessary to divide existing licences into SCS and RUK sectors. If actual producing fields are dissected by the dividing line, then there will be a need for cross-border unitizations unless the boundary is re-drawn to avoid such outcome.

8.2 General Approach

The approach of the Scottish Government to the offshore petroleum regime is very similar to that taken by the Wood Review. They seek to emphasise tax stability and tax realism in order to preserve confidence in the UKCS. Like the Wood Review, Scotland 2 emphasises the importance of good stewardship of existing fields. Scotland 2 looks beyond the Wood Review however in that its overarching goal is to maximise Total Value Added (TVA) to the Scottish economy. TVA is defined as: (i) value arising directly from the upstream oil business in wages, profits and taxes; (ii) value arising from the wages, profits and taxes from the supply chain (service sector); and (iii) value arising from the extra induced activity of the supply chain in export markets and other non-oil sectors. The authors of Scotland 2 are not satisfied that there is as yet a way of properly calculating TVA. It should be added that Scotland 2 does not envisage using local content rules to maximise TVA as this would be contrary to EC rules, in so far as they will continue to apply to Scotland.

The authors of Scotland 2 are in favour of further incentivising new developments by the use of tax exemptions. However, they favour an exemption system based on economic factors rather than physical or chemical factors (which now pertains).

8.3 Overall

The future picture of the SCS would currently appear to be of a closely regulated but still market-driven petroleum sector incentivized by tax policy, with an emphasis on stewardship and TVA. Scotland, like the RUK, will continue to have the challenge of how to get successful exploration rates up without affecting tax revenues. The trajectory of the Wood Review will continue with some further innovative departures.

9 What if it’s a “No?”

By virtue of the Scotland Act of 2012, Scotland will in the event of a “No” vote receive further tax raising powers by 2016. All of the three main Unionist parties favour devolving further tax raising powers to Scotland. The coalition of Unionist parties in the referendum, called Better Together, have made it clear that a “No” vote is not a vote for the status quo but a vote for further Scottish devolution within the Union. However, there is no agreement between the Unionist parties on what the further powers may be. Perhaps the most far reaching, the Conservative Party, proposes devolving power to raise (personal) Income Tax to Edinburgh. But currently no Unionist party proposes the devolution of either (regular) Corporate or Oil & Gas Tax to Edinburgh. And further, currently no Unionist party proposes Oil & Gas devolution for Scotland on the lines enjoyed by Texas or Louisiana or for that matter, Northern Ireland or the Falkland Islands. But the future is a foreign land, they do things differently there and in the fullness of time, change will surely come about.

The truth is that it is hard to see what the precise consequences for the Oil business would be if there is a “No” vote but the likelihood would be little or no change at least in the immediate term.”
Oilpatch

• On 26 August, we co-sponsored an AIPN evening event in Aberdeen at which Uisdean Vass spoke on “Scottish Independence and the Oil business”.

• On 3 September Uisdean presented on “Scottish Independence, the Oil Business and Norway” to an audience in Oslo.

• On 9 September, Uisdean will present on “Scottish Independence, the Oil Business and the USA” to an audience in Houston, Texas.

• On 10 September, Uisdean will present the same topic to the Oil Committee of the American Bar Association.

• On 11 September, Richard Cockburn will present on “Scottish Independence and the Oil Business” in our London office. Please click here if you wish to attend.

• Bond Dickinson is working with Tees Valley Unlimited to arrange a tour to meet energy service sector companies, and to view their facilities, on Teesside on 23 September 2014. We have offices in Teesside and in Newcastle which work closely with other offices, especially Aberdeen and London, to provide a seamless specialist oil and gas service covering all of the major oil centres in the UK. If you would like to participate in this tour, please contact Richard Cockburn but note that places are now very limited.

• Energy partner, Stuart Carter will be attending the AIPN conference in Budapest in October where he will speak on the FCPA and the UK Bribery Act, comparing and contrasting between the two and of their impact on JV activities.

• We advised long-standing client Sumitomo Corporation, one of the World’s largest integrated trading companies, on the sale of Summit Petroleum Limited and its subsidiary companies to Ithaca Energy for $170 million. Ithaca Energy has, through the corporate entities, acquired interests in three producing UK on shore and off shore oil fields, Pierce, Cook and Wytch Farm. We also advised on the pre-sale reorganisation, under which other UK interests, including in the Elgin-Franklin field, were transferred to a new Sumitomo subsidiary, Summit Exploration and Production Limited, retaining the staff and head office of the London operation. Oil and Gas M&A specialist Simon Hewes led the corporate team who advised Sumitomo. He was assisted by Corporate Finance Senior Associate Joe Lewis and Oil & Gas Associate Laura Petrie, with assistance from real estate, employment, tax and other specialist lawyers.

• Oil & Gas partner Stuart Carter, assisted by Solicitor Katie Rich, recently acted for Serica on the farmout to HRL of a share of its interest in Blocks 113/26b and 27c, and a further sale of interest in Block 113/22.

• Oil & Gas Senior Associate John McSparran assisted by other members of the Oil & Gas Team acted for Serica Energy on its agreement to purchase BP’s share in the Erskine Field.