On 19 July 2013, the UK Government published a consultation document on the introduction of tax incentives for investment in UK shale gas exploration and production.

Exploration for shale and unconventional hydrocarbons is in its early stages in the UK, with no commercial production having taken place. Shale gas projects carry a different economic profile to conventional offshore upstream oil and gas projects. For example, typical shale gas projects are likely to incur significant ongoing capital expenditure, while conventional upstream projects tend to carry high initial capital costs followed by a peak in production shortly after first oil, a plateau production period and eventually a declining tail, followed by decommissioning.

As the existing UK oil and gas tax regime is framed around the conventional offshore upstream industry in the UK North Sea (summarized below), the UK Government has been engaging the industry to determine the suitability of the current regime to shale gas and unconventional hydrocarbon projects.

Following these discussions, the UK Government has demonstrated its support for the development of the shale gas industry in the UK by proposing some targeted tax incentives for the industry in the recently released consultation document.

While key questions over the design of the shale gas tax incentives remain, investors in the sector should draw confidence from the framework set out in the consultation and accompanying bold statements made by the Chancellor of the Exchequer that the UK Government is supportive of the development of shale gas in the UK.

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Where a company is engaged in upstream oil and gas activities in the UK, these activities are treated as a separate trade (the "ring fence" trade) distinct from other activities carried on by the company.

As well as being subject to the normal principles of UK corporation tax, profits or losses from a ring fence trade are also subject to an additional set of specific rules that govern the way these activities are taxed.

Generally, profits derived from ring fence activities in the UK are subject to ring fence corporation tax (RFCT) and supplementary charge (SC) at 30% and 32%, respectively, giving rise to an effective tax rate of up to 62% on those profits. Profits relating to fields that received development consent before April 1993 may be subject to an additional layer of tax (Petroleum Revenue Tax) that can raise the overall effective tax rate for these profits to 81%.

In recognition of the fact that the high marginal tax rates are potentially prohibitive to new investment in oil and gas projects in the UK, the UK Government introduced specific reliefs (field allowances) designed to encourage investment in new small and technically challenging projects, which would otherwise be commercially marginal.

The field allowances provide for a level of production income to be earned from certain fields without being subject to supplementary charge at 32%, provided the field meets the eligibility criteria based on certain physical characteristics (e.g., small, ultra-heavy oil fields, ultra-high pressure). The profits remain subject to RFCT at 30%.
Planned measures for the shale gas industry

The UK Government confirmed in the 19 July 2013 consultation document that the shale gas industry will operate within the existing ring fence regime, with related profits being subject to RFCT and SC at 30% and 32%, respectively. This will be welcome news for companies currently engaged in conventional upstream oil and gas activities in the UK, because they should be able to claim immediate relief for costs relating to shale gas exploration and development against income from existing UK oil and gas production.

The UK Government has also proposed some targeted incentives for shale gas and other unconventional hydrocarbon projects in the UK, in the form of a “pad” allowance and an enhanced Ring Fence Expenditure Supplement (RFES) regime.

**Pad allowance**

The proposed pad allowance will work in a similar manner to existing field allowances to incentivize early investment in UK shale gas. As with the existing field allowances, the pad allowance exempts a portion of production from SC – such that this portion of profits will only be subject to RFCT at 30%. Remaining profits will then be subject to a marginal tax rate of 62%.

The consultation proposes that the level of pad allowance available in any given period will be calculated by reference to the level of capital expenditure a company incurs in respect of a pad and will be restricted to the level of shale gas production income (not profit) generated from the pad, with unused amounts carried forward for use in future periods. The Government has announced that the pad allowance will provide a “generous regime,” although the amount of pad allowance that would be provided for each GBP of expenditure has not been set. In this regard the consultation recognizes that this proportion could vary over time and will be set with the Government’s overarching objectives in mind, in particular to incentivize early development. To inform this decision, the Government has requested evidence from companies on the potential economics and commercial framework of shale gas projects.

As the shale gas industry should operate within the existing UK upstream ring fence tax regime, we would expect that once it is activated, the pad allowance should be available for use against a company’s entire adjusted ring fence profits (i.e., whether related to shale gas or not).

**Ring fence expenditure supplement (RFES)**

RFES allows for unrelieved ring fence losses at the end of an accounting period to be uplifted by 10% for a maximum of six accounting periods.

As announced in Budget 2013, the Government is also committed to extending the availability of RFES for shale gas and other onshore unconventional hydrocarbon projects from 6 to 10 accounting periods, in recognition of the longer payback period for such projects.
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