HERBERT SMITH FREEHILLS

SCOTTISH INDEPENDENCE: IMPLICATIONS FOR THE NORTH SEA OIL AND GAS SECTOR

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Legal Briefings

Our take on the significant issues of any future land and maritime boundary between the rest of the UK and Scotland

The North Sea oil and gas industry has played a key role in Scotland’s economy since the 1970s. While annual oil production peaked in 1999 and North Sea tax revenues have fallen considerably in the last five years, Scotland's oil and gas industry, including related services, is still of great importance to its economy, representing more than 10% of GDP.

The prospect of a second independence referendum, like the first in 2014 (see our Routes and obstacles to a second Scottish independence referendum briefing), raises a number of issues for the North Sea oil and gas sector. This briefing takes an initial look at some of those issues.

HOW WILL SOVEREIGNTY OVER NORTH SEA OIL AND GAS BE DIVIDED?

The location of any future land and maritime boundary between the rest of the UK and Scotland will be a significant issue. Under relevant international law, coastal states have sovereign rights to exclusive exploration and exploitation of the natural resources within their Exclusive Economic Zone (**EEZ**), as well as over offshore wind, wave and tidal and carbon capture, usage and storage (CCUS) projects. The maritime boundary between Scotland and the continuing UK will therefore determine the jurisdiction of both sides over North Sea oil and gas reserves.

There is no agreed maritime boundary currently. The 1982 UN Convention on the Law of the Sea (**UNCLOS**) sets down the approach to delimitation of maritime boundaries between adjacent coastal States. UNCLOS encourages parties to reach agreement, and contains mechanisms for the resolution of disputes, commonly based around the line of equidistance. While resolution is pending, UNCLOS provides that States must "*make every effort to enter into provisional arrangements of a practical nature and, during this transitional period, not to jeopardise or hamper the reaching of the final agreement. Such arrangements shall be without prejudice to the final delimitation*". As a practical matter therefore, the continuing UK and Scotland may reach interim arrangements such as a joint development zone. Co-operation between regulatory bodies should help ensure consistency in the regulatory environment and that licensed activity is recognised in both jurisdictions. In the longer term, it may be possible for the continuing UK and Scotland to negotiate an intergovernmental framework similar to the framework already entered into between the UK and Norway in respect of infrastructure and fields that straddle the UK-Norwegian EEZs. For more information on international law issues arising in the case of Scottish independence please see our briefing on Scottish independence: the international law implications briefing.

NORTH SEA OIL REVENUES AND THE FISCAL POSITION OF AN INDEPENDENT SCOTLAND

The fiscal position of a hypothetical independent Scotland has been significantly affected by North Sea tax revenues over time. If such North Sea revenues are excluded, an independent Scotland's underlying fiscal position relative to the rest of the UK has remained remarkably stable over the last 20 years (with deficits averaging about 7% higher most of the time – see column (E) in the table below). For 2019-20 it was 6.9%. The significant worsening of Scotland's implicit budget deficit relative to the rest of the UK during the last five years is broadly attributable to the decline in North Sea revenues.

For more background on an independent Scotland's fiscal position post-independence see our briefing Scottish independence and currency: choices, issues and implications.

	A Average Scottish budget deficit excluding geographic share of North Sea revenue	B Average Scottish budget deficit including geographic share of North Sea revenue*	C Average UK budget deficit	D Average % (A) was higher than (B)	E Average that (A) was higher than (C)	F Average % (B) was higher than (C)
2000-5	8.8%	4%	1.8%	4.8%	7%	2.2%
2005-10	12.3%	5.5%	5.3%	6.8%	7%	0.2%
2010-15	13.3%	8.4%	6.9%	4.9%	6.4%	1.5%
2015-20	9.8%	9%	2.8%	0.8%	7%	6.2%

Figures calculated using Scottish Government figures (Government Expenditure and Revenue Scotland (GERS) 2019-20.

* The GERS figures which include a geographic share of North Sea revenue are illustrative of what the situation might be if Scotland had been independent. For these illustrative purposes, GERS estimate the apportionment of North Sea revenues is based on the median line principle as employed in 1999 to determine the boundary between Scotland and the rest of the UK for fishery demarcation purposes.

DECOMMISSIONING TAX RELIEF

A major concern for companies operating in the North Sea oil and gas sector will be to ensure that nothing jeopardises tax reliefs associated with future decommissioning costs. The legislation governing decommissioning costs allows participators in an oil and gas field liable to decommissioning expenditure to seek tax relief for such expenditure, through a carry back against profits arising to the participants from the field. This usually results in significant repayment of tax to present or past participators.

Companies are expected to spend between £40bn - £66bn on decommissioning until 2065. HMRC estimates in its Annual Report and Accounts 2019 to 2020 that, in addition to foregoing revenues due to tax reliefs, it will have to repay at least around £10bn of tax in respect of oil and gas field decommissioning expenditure. If future oil revenues are allocated on a geographical basis, Scotland's share of the cost is estimated to be between 83% and 94%, at a time when North Sea tax revenue is forecast to continue declining. The division of such State liabilities will be just one part of wider independence negotiations in relation to the apportionment of assets and liabilities (see our briefing on Scottish independence and currency: choices, issues and implications on this question more broadly).

THE DEBATES FROM 2014 UPDATED

How North Sea revenues should be used

For the 2014 campaign, the Scottish government proposed, as set out in its Scotland's Future white paper (**2014 White Paper**) that in the event of a vote for independence, they would establish a Scottish Energy Fund which would be both a stabilisation fund and long-term investment fund into which a portion of tax revenues would be invested when fiscal conditions allowed.

At the time, in its response, the UK Government's argument included that implementing an oil fund in a similar way to those established in countries such as Norway would imply significant tax increases or cuts to public spending, other things being equal.

In September 2016 the First Minister of Scotland and Leader of the Scottish National Party (**SNP**) established the Sustainable Growth Commission (**SGC**) to recommend policies for an independent Scotland. In the context of declining revenues since 2014, the SGC's 2018 report did not take future levels of North Sea tax revenues for an independent Scottish Government for granted. Instead it acknowledged the difficulties associated with forecasting such revenues and therefore advised that "oil revenues should be treated as a windfall fiscal bonus" rather than relied on for maintaining fiscal management. The SGC Report recommended that instead of being used for day to day spending, North Sea revenues should be set aside by an independent Scotland for a new "Fund for Future Generations" to invest in Scottish infrastructure and the green economy amongst other things.

Affordability of, and responsibility for, decommissioning tax relief

The 2014 White Paper argued that an independent Scottish Government would be committed to "providing certainty and stability on the long-term treatment of decommissioning tax relief" with decommissioning relief "provided in the manner and at the rate provided through the current fiscal regime" following independence. Indeed the Scottish Government saw the scale and value of future decommissioning work, as a significant opportunity to support future economic growth.

In response, the UK Government questioned how an independent Scottish State, with its underlying fiscal position, could fund the existing decommissioning tax relief while facing a "narrower and more volatile revenue base". The counter-argument from the 2014 White paper perspective was that the negotiations on dividing up State assets and liabilities relating to oil production and to decommissioning tax relief should balance future decommissioning liabilities against the previously accrued tax receipts which had not at that time been apportioned to Scotland on a geographic basis.

The 2018 SGC Report did not discuss this issue although, as we touch on in our currency briefing, it took quite a firm position on the dividing of assets and liabilities generally.

If the Scottish Government was to reduce the available relief, it would likely act as a significant disincentive to investment in independent Scottish State oil and gas assets.

REGULATORY IMPACT OF INDEPENDENCE

During the 2014 campaign the Scottish government proposed, as set out its 2014 White Paper, that the existing licensing and regulatory regimes would continue and that existing oil and gas licences would continue to be in force in an independent Scotland. This was intended to provide certainty to operators and investors in respect of the fiscal and regulatory regime from independence.

However, even assuming that this approach is maintained, the establishment of new Scottish regulators (for example, a Scottish Oil & Gas Authority) could, over time, lead to divergence in respect of the implementation of existing rulebooks particularly as political priorities between the Scottish and UK Governments diverge. For example, taking different approaches to achieving net zero as discussed below

NET ZERO

The retention of the existing regulatory regime, as it stands in 2021, would now also include the retention of the OGA's checkpoint system for new oil and gas licences as well as the new OGA strategy which requires owners and operators assist the government reach its net zero target.

The Climate Change (Scotland) Act 2019 commits Scotland to net-zero emissions of all greenhouse gases by 2045, 5 years earlier than the wider UK's target of net zero by 2050 in any event and is an example of the Scottish Government's ongoing attempts to differentiate itself from UK policies. The extent to which such differentiation will accelerate following independence remains to be seen. In any event, the priorities and decisions that an independent Scotland may take in relation to net zero could have a substantial impact on the future of the North Sea oil and gas sector.

It also remains to be seen whether the Scottish Government's previous commitment to retain the existing regulatory regime would extend to retention of the North Sea Transition Deal (**NSTD**) and in particular the investment commitments that have recently been made by the UK Government to support jobs and facilitate the development of new energy transition industries including for CCUS and hydrogen production – see our briefing on the NSTD for further detail. A failure to do so may undermine some of the certainty that has been promised to the sector and may lead to a further period of uncertainty whilst the new Scottish Government determines its own policy.

In the SNP's Manifesto for the 6 May 2021 Scottish Parliament election, while noting that tax and regulatory powers over offshore oil and gas are currently reserved to the UK Parliament, their policy is that "any government support for the oil and gas sector in the North Sea will be conditional upon the industry contributing to a sustainable, secure and inclusive energy transition." That statement could be read as consistent with the NSTD.

OTHER ISSUES FOR BUSINESS

Independence would have a variety of additional implications for companies engaged in the North Sea. Other briefings are available on our Scottish Independence hub including contractual implications, employment and pensions, to relevant impacts on trade rules.

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