



SCOTLAND OFFICE

Scotland and Oil

Scotland Office Background Paper

June 2009

Scotland and Oil

Introduction

This paper sets out the facts on oil revenues and public spending in Scotland. It has been produced by the Scotland Office with the co-operation of Her Majesty's Treasury and the Department of Energy and Climate Change and illustrates some of the relationships between oil prices, production, and revenues over time. It also considers the effect that oil revenues would have on the Scottish public finances, examining the effect it would have on the available budget from year to year and the cumulative fiscal position over a longer time period.

The main findings are:

- If all North Sea oil revenues had been allocated to Scotland there would only have been 9 years out of the last 27 when Scotland's finances would have been in surplus.
- Including all North Sea oil revenues the last year of surplus was in 1988-89 and since then there has been 18 years of annual deficits with Scotland's spending being greater than the tax raised in Scotland.
- Even if all oil revenues had been allocated to Scotland the total deficit would have outweighed the total surplus by £20bn since 1980-81.
- The volatility of the oil price would have a severe impact on spending plans. The halving of oil prices in the last year has had a dramatic effect on estimated oil revenues suggesting a fall of nearly half from £12.9bn last year to £6.9bn this year which would make financial planning very challenging.

The Commission on Scottish Devolution report and the evidence given to the Commission by the Independent Expert Group identified some key points and they reported that

"We were struck by the volatility of these tax receipts both historically and in forecasts. These revenues, which have varied between £1 billion and £12 billion in cash terms in the past couple of decades, are heavily correlated to the oil price, which is not influenced by either the UK or Scottish Governments, but rather fluctuates markedly because oil is a globally traded commodity."

"Scotland has over the years contributed these [oil] revenues into a general UK pot, from which it has drawn to finance Scottish public spending. In some years that has meant that Scotland's tax revenues, including a geographic share of oil taxation, have contributed more to the UK than it has received as a share of public spending, but in most years it has not. That seems to us to have been an example of the pooling of risk and resources that is represented by the social Union, and we do not think at this stage that it should be altered for the future. Additionally, as the Independent Expert Group conclude, the assignment or devolution of these revenues would be associated with a corresponding reduction in the block grant. This would then expose a large

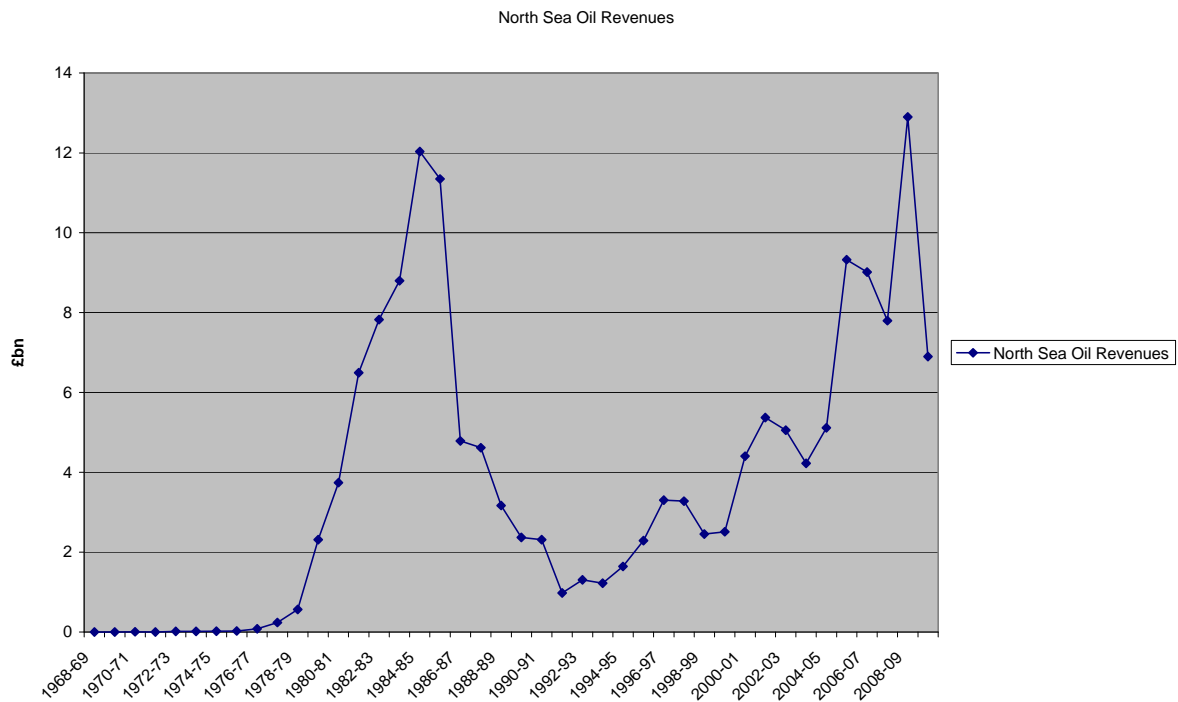
*proportion of the Scottish budget to very high levels of volatility driven by the market price of a globally traded commodity rather than the Scottish Parliament's decisions. Such volatility can be accommodated and such fluctuations absorbed more readily in the larger and more broadly based UK economy. It is also not evident how the assignment or devolution of these revenues would increase the financial accountability of the Scottish Parliament."*¹

¹ <http://www.commissiononscottishdevolution.org.uk/uploads/2009-06-12-csd-final-report-2009fbookmarked.pdf>

Data

Oil Revenues

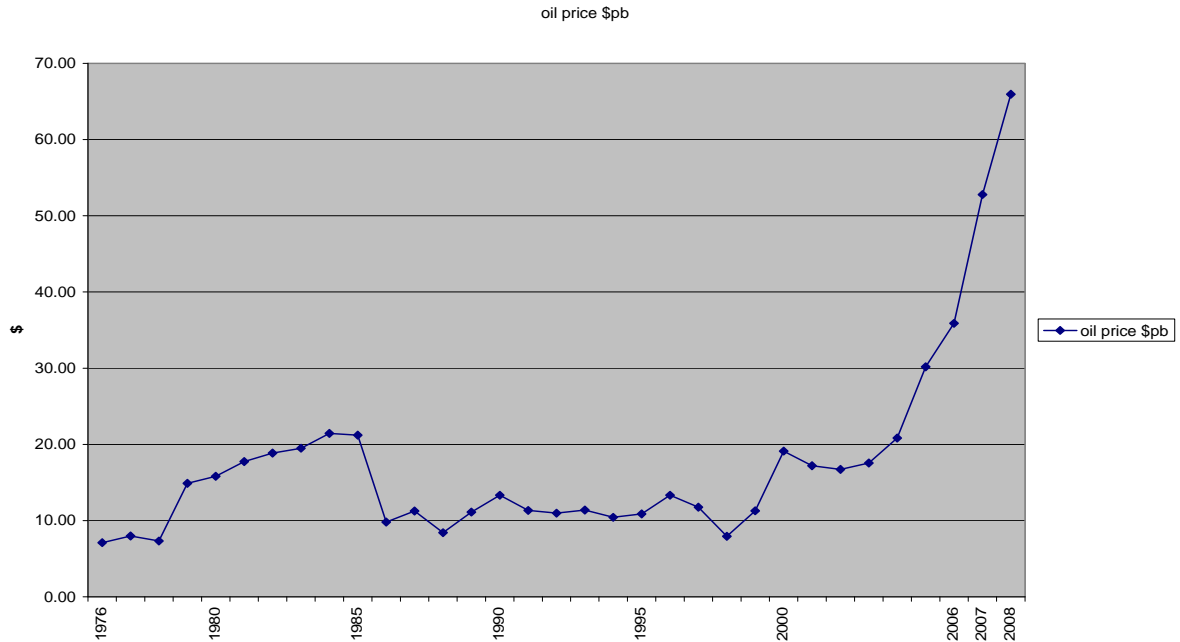
First oil was extracted offshore in 1975, but oil revenues didn't really start accumulating until 1979-80. Since 1979-80 there has been only one year when nominal oil revenues dropped beneath £1bn (1991-92), and the highest annual revenue was £12.924bn in 2008-09.



The factors which contribute to the volatility of oil revenues makes accurate forecasting difficult. The speed and scale of changes in oil prices are difficult to predict, as such it is difficult to accurately predict how future oil revenues may vary from year to year.

Oil Prices

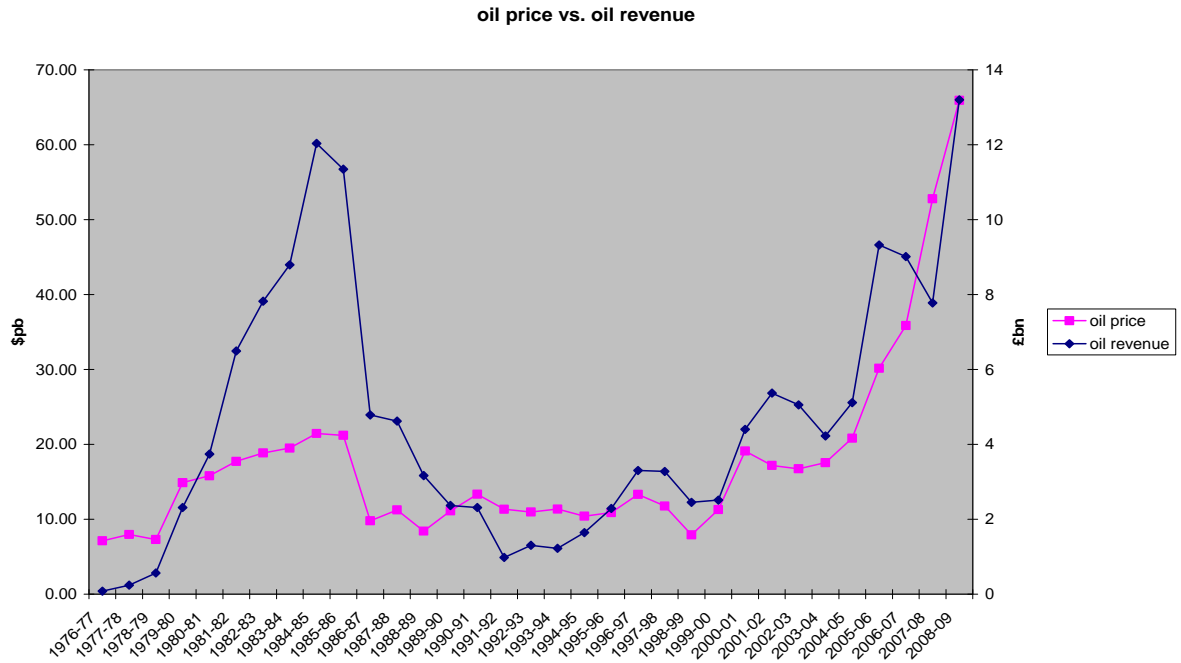
Oil prices have proven to be volatile over time and the chart below shows in nominal average annual prices this volatility. It has been particularly acute over the last few years.



Oil hit a daily high of around \$147 per barrel in July 2008, and is now trading at less than a half of that price at \$72 per barrel in June 2009. The chart below shows the particular volatility over the last few years.

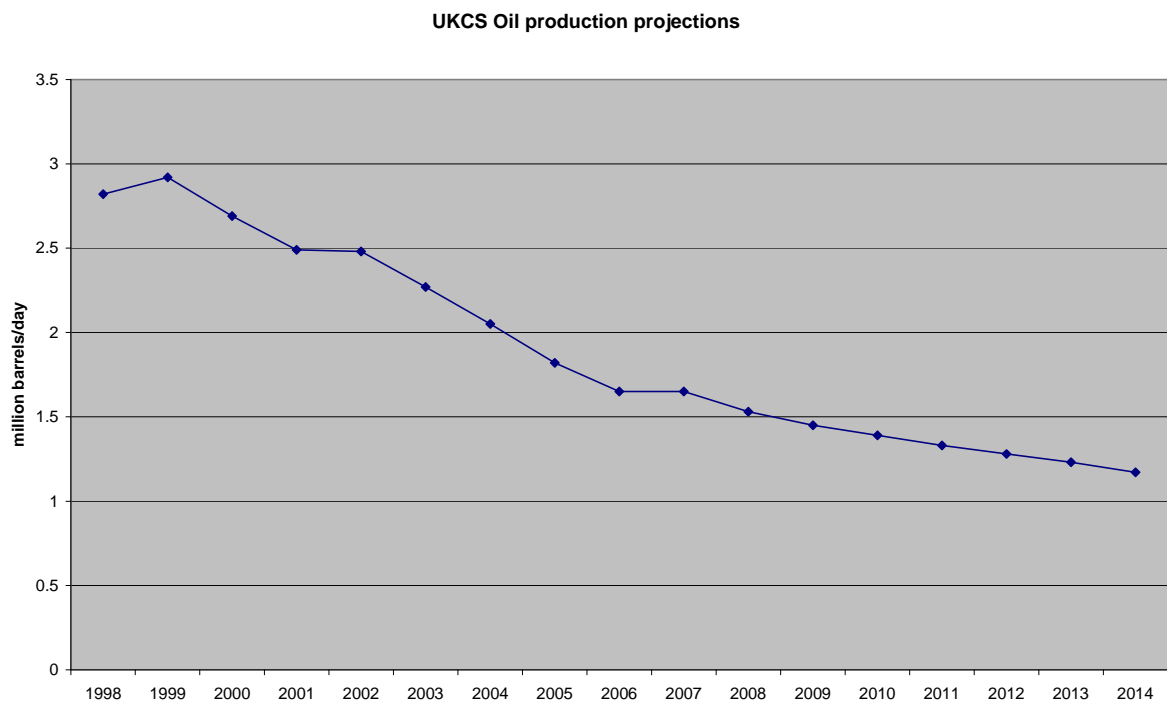


The chart below combines the previous information to show how oil revenues compare to oil prices. From the mid-1990s there is a reasonable correlation between the two, and it stands to reason that the higher the price of oil, the larger the profits there will be, the larger the tax take will be.

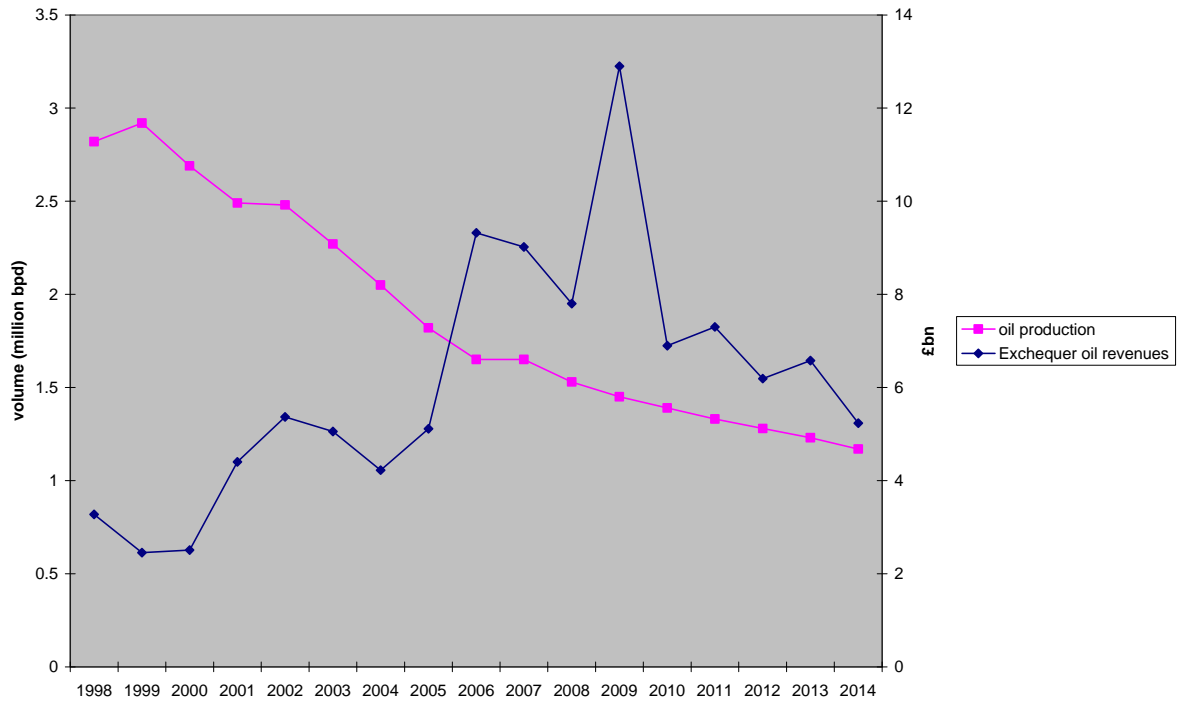


Oil Production

North Sea oil production has been steadily decreasing over the last five years which is shown with the chart below.

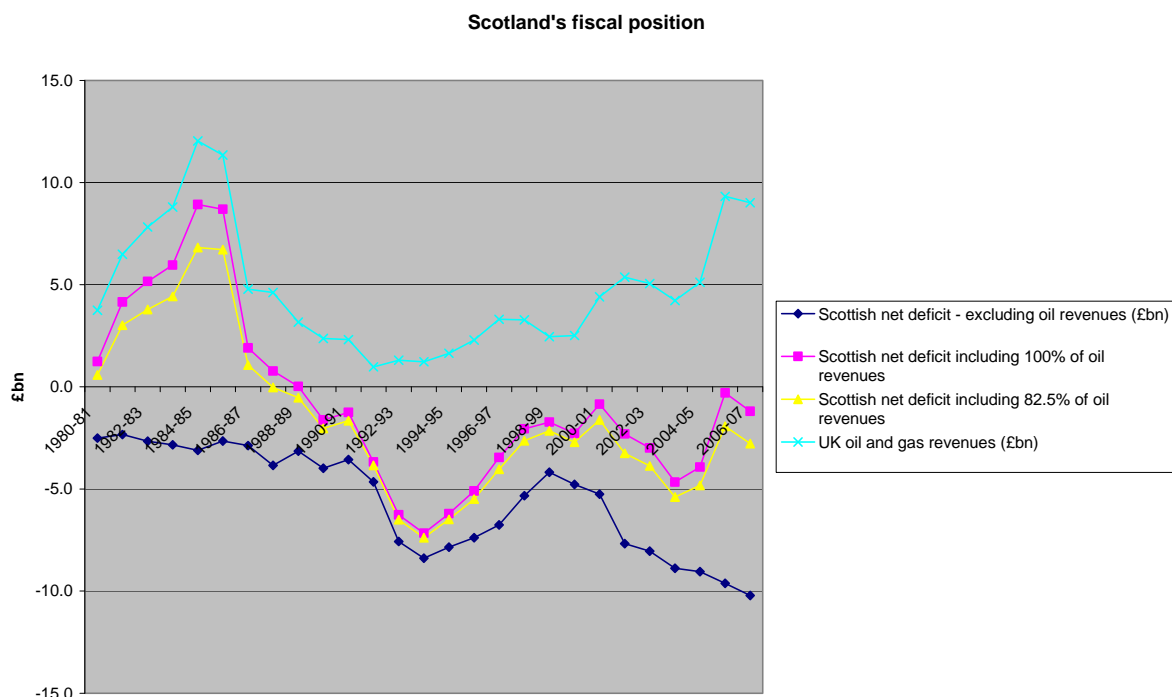


Whereas there simplistically appeared to be a reasonably strong correlation between revenue and price, this is much less so between production and revenue as the chart below shows.



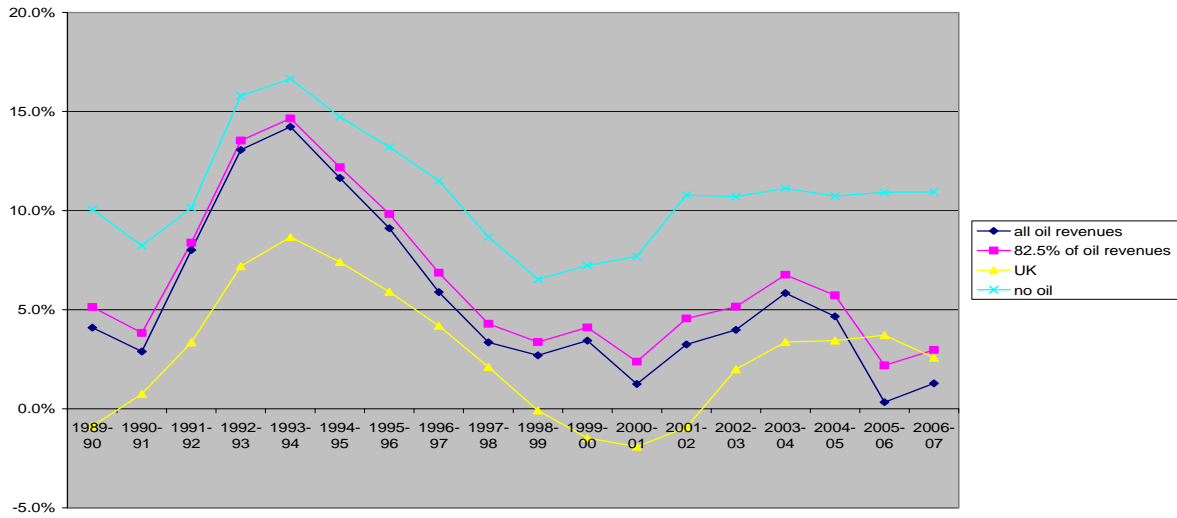
Scotland's public finances

Scotland's public finances as reported by the Government Expenditure and Revenue Scotland (GERS) figures produced by the Scottish Government have shown a deficit for every year since 1980-81. When North Sea oil revenues are allocated fully there were nine years where Scotland would have been in surplus and eighteen years in deficit, and over the whole period from 1980-81 there would still have been a cumulative net deficit of around £20bn. With all oil revenues allocated to Scotland there would still be a Scottish budget deficit, and in reality, given the geographical location of the UK's oil and gas reserves, Scotland would never receive all the UK's current oil revenues. The chart below sets out the annual net deficit over the period when including various shares of oil revenues.



In cash terms there has been a clear fiscal deficit in Scotland every year since 1989-90 (when all oil revenues are allocated to Scotland), and when debt as a percentage of GVA is considered (see chart below) Scotland is in worse position than the UK over the entire time period when no oil revenue is included in the Scottish budget. When all oil revenue is allocated to Scotland the UK is in a better position up to 2004-05, but for the two years after this point Scotland is in a better position than the UK. It should be noted that oil revenues were at a 20 year high in 2005-06 and almost double what they were the year before, demonstrating the role that oil revenues would play in Scotland's fiscal position. At this point it is worth reiterating that oil revenues dropped by over £1bn from 2006-07 to 2007-08, then are estimated to have increased by around £5bn to 2008-09 before being forecast to fall again by around £6bn to 2009-10, which will have a volatile effect on Scotland's fiscal position if oil revenue is taken into account.

Public sector borrowing as a % of GVA



(Chart shows Scottish public sector borrowing as a percentage of Scottish GVA under a range of scenarios, and includes the UK position as a comparison).

Oil fund

An oil fund works on the basis that all oil revenues are paid into the fund and only interest gained is taken out. If this same approach to an oil fund had been in place in Scotland since North Sea oil was discovered then there would have been a fiscal deficit every year – totalling almost £150bn over the last 27 years. If instead oil revenue was paid into an oil fund only once the budget was balanced then there would only have been nine years when any money would have been paid into a fund, and since 1989-90 there would have been 18 years when even with oil revenues being used to support Scotland's public finances there would still have been a fiscal deficit.

Oil revenues can be used only once, you can't spend them to offset an expenditure black hole and invest them in an oil fund at the same time.

Conclusion

- North Sea oil revenues are volatile and difficult to forecast because of movements in the price of oil, production levels and costs as shown in the data presented and the evidence from the Commission on Scottish Devolution report.
- Oil production from the North Sea is declining
- Scottish fiscal balance has never been in surplus without oil revenues, and has been in surplus for only 9 years even when all oil revenues are allocated to Scotland

Scotland has seen a public sector deficit in every year since 1980-81 when no direct share of oil revenues is allocated.

Even with all oil revenues allocated to Scotland there would have been only nine years out of twenty-seven where there would have been a surplus, none of them since 1988-89.

With all oil revenues accruing to Scotland there would still have been a cumulative net deficit of around £20bn over twenty-seven years.

Oil is a diminishing resource. Production has fallen year on year since 1999 (bar 2007, when the large Buzzard Field started production), and is currently declining at around five per cent per annum.

The price of oil is exceptionally volatile. It has fallen to a value today of less than half of what it was a year ago.

Since 2002-03 total Exchequer revenues from taxes on profits from oil and gas production have year on year fallen by 16%, increased by 21%, increased by 82%, fallen by 3%, fallen by 14%, and increased by 66% - and have over this time variously made up around a sixth to a third of the total Scottish budget. This would make forward budgeting extremely difficult for an independent Scotland

Revenues depend on oil price in dollars, the £:\$ exchange rate, production and costs. All of these vary significantly, and the only certainty is that production levels will keep falling.

In July last year sitting with the price of oil breaking new highs at \$147 a barrel and projected revenues for the current year [2008-09] at £13.2bn, finances were looking incredibly good. However, sitting today with oil prices at \$70 per barrel and projected revenues for the current year [2009-10] of £6.9bn the finances would be looking substantially different and spending plans would have had to have changed.

An oil fund would mean choices – either save the oil revenues and let the deficit increase, or reduce the deficit, although not eliminate it, and not accumulate any more.

You can't spend and save the same money at the same time. To put money into an oil fund and balance the budget would require reductions in public expenditure and/or higher taxes.

North Sea revenues are part of the UK wide corporate tax system and it is right that they accrue to the UK Consolidated Fund. Scotland benefits both from the economic activity which North Sea oil generates and from public spending in Scotland financed from the UK Consolidated Fund.

Promoting North Sea investment is a priority for the UK Government and the Budget announced a major new package of measures for boosting investment.