

Confidential filing

Moss Mountain cracker project.

ENERGY

324

MAY 1981

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22.5.81							
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vb

Envy

17 August 1981

The Prime Minister has seen Mr. Fletcher's minute of 10 August, about the Moss Morran cracker project. She was pleased to hear this good news.

MAP

John Wilson, Esq.,
Scottish Office.

CONFIDENTIAL

MS

FROM THE MINISTER FOR INDUSTRY AND EDUCATION



SCOTTISH OFFICE
NEW ST. ANDREW'S HOUSE
ST. JAMES CENTRE
EDINBURGH EH1 3SX

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Prime Minister

Ann Min
Mr Hodgson
10 August 1981

MS
Good news: the Moss Morran cracker is going ahead.

On 8 July George Younger's Private Secretary reported to yours on the stage reached in the discussions between Ministers and Esso Chemicals on the future of the Moss Morran cracker, a project which the Company, and its partner Shell, considered they might have to abandon in the light of their latest assessment of its viability.

Our letter of 8 July listed the areas in which Government assistance had been sought and the manner in which we had been able to give satisfactory assurances on two of the issues - local rating and BGC's locus in the ethane market. The outstanding issue, to which the Companies attached critical importance, was the basis of the valuation for taxation purposes of the ethane being bought by Esso Chemicals from its inter-affiliate, Esso Petroleum. The Companies stressed that such deals should be treated on a par with those at arm's length.

In an effort to reach a fair and satisfactory outcome on this issue Peter Rees and his officials have worked particularly hard over the past week on the basis of detailed information they sought from the Companies, with the satisfactory outcome that a suitable modus vivendi has been reached.

Esso Chemicals and Shell have now informed me that, along with the other assurances Ministers have given, they now feel sufficiently confident to proceed with the project. Recognising the economic and political significance of this project and what it represents in terms of utilisation of North Sea resources, this news will be warmly welcomed not only in the immediate area of Fife but throughout the country as a whole.

To have reached this conclusion has required substantial effort by all the Departments involved and I would like to express our gratitude for the help we have had from Peter Rees and also from Hamish Gray and Kenneth Baker.

Alex Fletcher
ALEX FLETCHER
Approved by the Minister
and signed in his absence

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Energy
Prime Minister 2

The Treasury are prepared to make a concession on PAT

Treasury Chambers, Parliament Street, SW1P 3AG

for Mossmorran. I

T P Lankester Esq
Private Secretary
No 10 Downing Street
LONDON
SW1

don't know whether it will do the trick.

17 July 1981

Dear Tim

mf

TZ 17/7

Godfrey Robson wrote to you on 8 July. He mentioned that the Minister of State was considering a proposal by Esso that ethane for Mossmorran should be valued at the price it would have fetched if it had been sold to BGC under Esso's 1975 contract for specification gas. The Minister has now considered this and you may be interested to see the enclosed copy of a letter he has sent to the Secretary of State for Scotland.

I am sending a copy of this letter (without enclosure) to Godfrey Robson, Ian Ellison and Julian West.

Yours ever
R. Warden

R WARDEN
Private Secretary

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Treasury Chambers, Parliament Street, SW1P 3AG

The Rt Hon George Younger MP
 Secretary of State for Scotland
 Scottish Office
 Dover House
 Whitehall
 LONDON
 SW1A 2AU

17 July 1981

John Secretary of State

ESSO'S MOSSMORRAN CRACKER

Following our meeting with Esso and Shell on 8 July, I have been reflecting sympathetically on whether there was any further concession that might be made to them, in the fiscal area, to make the Mossmorran project sufficiently attractive to induce them to continue with it. To recapitulate, as I said at the meeting I do not think that exemption of ethane used for petrochemical purposes from PRT and SPD would be justified. It would be costly (some £1½ billion to £1½ billion) and it would be almost impossible to operate in such a way that the benefit accrued to the users rather than the producers of feedstocks - not, in every case, the same. Even if we could overcome these objections we would be immediately faced by demands from users of other feedstocks like LPG's and naphtha for an extension of the exemption to them. Without such an extension firms like ICI and BP could legitimately complain that we were discriminating in favour of their competitors; with such an extension the cost and administrative complexities would be enormously increased. We could not venture down this road without a much wider analysis of the case for special support for the petrochemical industry than has so far been done.

The case for action therefore narrows to special measures to help Mossmorran alone. So far we have been considering three options:

- (i) Exemption for Mossmorran ethane by allowing Esso to widen their 1975 Brent specification gas contract with BGC to include all the ethane from the field with a supplementary agreement by BGC to sell it back to Esso for a small turn: you will recall that this was somewhat half-heartedly suggested by Esso at the meeting. I have looked sympathetically at this but the Inland Revenue advise me that it is very doubtful whether such an arrangement would be effective to secure exemption under present law and I do not think we should encourage Esso or BGC to try it out, especially given BGC's current resistance to steering by the government and Esso's desire for certainty.

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(ii) We have already told Esso we were considering legislation to allow ethane sold for petrochemical purposes between inter-affiliates to be valued on a similar basis to long-term arm's length deals. We are now reasonably confident that we can come up with a suitable legislative formula. The Inland Revenue would be happy to see Esso at any time to discuss this proposal in more detail. At the meeting on 8 July Esso took this further and suggested that if we could accept the Brent contract for specification gas as the proper price analogue, that would probably persuade them to proceed. This contract would certainly be one piece of evidence to be considered but I do not think we could regard it as the sole, or even necessarily a very compelling piece of evidence.

(iii) Direct assistance under the Industry Act. This would have the merit, if it were possible, of being the cleanest course with the least undesirable precedents for the tax system elsewhere. The cost could be more accurately tailored to what Esso need to make Mossmorran viable and the risks of costly spillovers to others taxpayers in unintended and uncontrolled ways would be reduced.

Another possibility that has occurred to us relates to royalty refunds under Section 41(3) of the Petroleum and Submarine Pipelines Act 1975. These have always been intended to be used as the discretionary instrument for fine-tuning the North Sea fiscal regime. I do not know whether it would be possible to use the Secretary of State for Energy's powers in this case - there may well be serious problems - but if it were, the amount could be tailored to Esso's needs and restricted to the special circumstances of Mossmorran.

It is not for me to urge course (iii) on you but you and Kenneth Baker might like to consider whether Industry Act assistance is possible within your existing PESC limits. Similarly Hamish Gray might like to consider whether royalty refund is possible or attractive. As far as tax is concerned, I suggest we might tell Esso that we feel we would be able to introduce legislation to value ethane on the basis of long-term arm's length contract for petrochemical use (ie excluding fuel use) made at the same time as the Esso contract. The BGC specification gas contract would be one analogue which would be considered but could not be the only piece of evidence or necessarily a very compelling piece. The Inland Revenue are ready to discuss this with Esso at any time.

I am sending a copy of this letter to Kenneth Baker and Hamish Gray.

*Yours sincerely
P. Rees*

PETER REES

(Approved by the Minister of State and signed in his name)



SCOTTISH OFFICE
WHITEHALL, LONDON SW1A 2AU

BF 17.7.81
(pm)

Am. Stewart

*Further report on
Moss Morran negotiations.*

CONFIDENTIAL

Tim Lankester Esq
Private Secretary
No 10 Downing Street
LONDON SW1

*Please may I be kept in close touch.
MS*

8 July 1981

12 877

Dear Tim,

*(Am Stewart)
Transmit with letter dated 12.11.77*

Catherine Bell wrote to you on 21 May reporting the approach from Esso Chemicals about its Moss Morran cracker project: unless Government assistance was forthcoming, they said that changed circumstances might force them to cancel the project.

Officials in the Departments concerned have gone over the Esso case in great detail and at a meeting on 23 June, which my Secretary of State chaired, the company listed the various difficulties which it was facing. They concentrated on four areas in which they sought Government assistance. These were (i) exemption of ethane used from petrochemicals from the increased tax burden of petroleum revenue tax and the special petroleum duty, (ii) clarification of the British Gas Corporation's (BGC's) role in the market and assurances that supplies of ethane additional to the feedstock from the Shell/Esso Brent field would be available to them at prices consistent with the development of a greenfield site, (iii) some relief on local authority rates, and (iv) ratification of the existing contract under which Esso Chemicals buys ethane from Esso Petroleum.

Following consultations with the Chancellor and colleagues in Industry and Energy, my Secretary of State again met the company on 1 July when he indicated that the Government were prepared to consider with the company the legislative changes which would be required, and which could be introduced in the 1982 Finance Bill, in order to put sales between affiliates of the same company, such as Esso Petroleum and Esso Chemicals, on the same footing for taxation purposes as "arms length" deals between wholly separate companies. On local authority rates the company were assured that we were aware of the anomaly in rating practice which placed petrochemical plants in Scotland at a disadvantage by comparison with those in England and Wales and that we would be introducing legislation - before rates fell to be paid on the Moss Morran cracker - to remedy the position. Mr Hamish Gray reassured the company that neither the Government nor BGC envisaged entering the market on a large scale and that, therefore, there was every prospect of supplies being available to the petrochemical industry, which we were keen to encourage, at prices which would be determined by market forces. BGC's energy requirements would be limited. The one area in

Do not understand the rating point.

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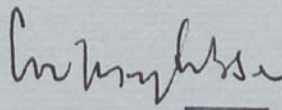
which it was made clear that the Government could not give assistance, because of the high cost involved and its wider implications, was Esso's request for exemption from taxation of ethane used in petrochemicals. In outlining the assistance we were prepared to give, my Secretary of State stressed that in the event of the project going ahead, we would expect UK industry to be given every opportunity to compete for the work.

The company, accompanied this time by Mr Raisman, Chairman of Shell and Mr Whalley, Managing Director of Shell Chemicals, called again this morning. They acknowledged that the assurances given would be of considerable help but maintained that some concession would be necessary to offset the cost of PRT/SPD introduced since the project was first conceived. They proposed that the basis for tax should be the alternative price which would be obtainable if, in the event of the project not going ahead, the gas liquids were sold to BGC under an existing contract. Mr Peter Rees has agreed that the Inland Revenue would be prepared to examine this and we have undertaken to give the company a decision in principle within the week.

You will appreciate that we would regard the possibility of the cancellation of the Esso order with grave concern. North Sea developments and the prospects of downstream activities have constituted an area which we have long held out as one of considerable potential growth. Cancellation of the project would be a serious blow in itself, but would also have repercussions on other potential petrochemical developments, for instance those associated with the proposed gas gathering pipeline. We shall therefore continue to consider ways in which we might meet the company's requests and we shall be looking urgently at their latest proposal in relation to the contract price: we very much hope that it will prove possible to do something on this. I will keep you informed of developments.

I am copying this minute to John Wiggins (Treasury), Ian Ellison (DI) and to Julian West (Department of Energy).

Yours truly,



GODFREY ROBSON
Private Secretary



Energy

NOTE OF A MEETING HELD AT NO.11 DOWNING STREET AT 6.00 P.M. ON
MONDAY, 30 JUNE 1981

Present:

Chancellor of the Exchequer
 Minister of State (C)
 Secretary of State for Scotland
 Minister for Industry and Education, Scottish Office
 Mr Baker, Minister of State, DOI
 Minister of State, Department of Energy
 Mr Dalton - IR
 Mr Crawley - IR
 Mr Middleton
 Mr Wicks
 Mr Bryant - DOI
 Mr Freemantle - Department of Energy
 Mr McClaron - Scottish Office

R

The meeting considered what steps the Government could take, and whether they should take them, to improve the economic prospects of the ethylene cracker which Esso and Shell proposed to build at Mosmorran, which was in danger of being abandoned because of adverse developments in costs and revenues. The meeting had before it a letter dated 26 June from the Secretary of State for Scotland, and letters dated 26 June from the Secretary of State for Industry and the Minister of State at the Department of Energy.

2. The Secretary of State for Scotland explained that Esso were looking for some alleviation in the amount of rates which would be payable on the project; exemptions of ethane from PRT and SPD; assurances that BGC would not be competing with Esso for marginal supplies of ethane; and a more favourable valuation, for tax purposes, of the ethane to be used in the project. He was prepared to give Esso the reassurance they were seeking on rates. He did not believe the company had any real hope that the Government would exempt the ethane from PRT and SPD and he was not pressing for this. The position regarding assurances about marginal supplies of ethane did not seem

/very promising. The real



very promising. The real issue was whether the Government should act to remove an unintended anomaly, as he saw it, whereby the ethane contract between Esso Petroleum and Esso Chemicals, who were inter-affiliates, would be treated less favourably, for tax purposes, than if the contract had been on an arms-length basis. Esso were seeking an undertaking from the Government by 30 June that the transfer price adopted in the inter-affiliate contract would be that used for tax valuation purposes. It would be indefensible for the project to be made impossible because of an anomaly. The project's economics had been adversely affected in a number of ways since the original decision to undertake the project 2½ years before. The fact that Esso were still looking at the project, and the impression he had received from the discussions with the company, led him to believe that they were serious, though he recognised that even if the Government were to accede to their requests on rates and ethane valuation the rate of return on the project would fall short of the 6 per cent for which the company was believed to be looking. The project represented just the sort of activity downstream of North Sea oil which the Government should be encouraging. In his view, every effort should be made to eliminate the unintended tax anomaly, so as to be able to offer Esso a more favourable valuation for tax purposes of the ethane contract. Given the importance of the project - Esso were already spending £4 million a month - and the companies stated deadline, it was essential to reach a decision at the meeting as to whether the Government would accede to the company's requests.

3. It was explained that Esso were in effect asking that the inter-affiliate contract price be accepted as the basis for tax for many years ahead even though no transfers under the contract would actually be made until mid-1980's. A limited statement of reassurance had been made at the meeting between Ministers and Esso on 23 June, which would not have entirely removed uncertainty, and Esso had indicated that it was insufficient to meet their concern. The company had been asked whether a commitment to disregard fuel value in valuing ethane used at Mosmorran for petro-chemical purposes would help. Esso had said it

/would not be sufficient.



would not be sufficient. The assurance on valuation which they were looking for could not be provided under existing legislation. The Revenue thought that it might be possible - though, at this stage, they could not be certain - to devise legislation which would have the effect of regarding, for tax purposes, a contract between affiliates as if it were an arms-length contract. This would probably involve specifying the characteristics of a notional arms-length contract and then comparing an actual inter-affiliate contract with this to see whether it could reasonably be regarded as being, for tax purposes, the same as an arms-length contract. Legislation providing for the setting up of a notional contract would have implications for the tax rules on transfer pricing generally, and these would need to be considered carefully. The content of fresh legislation could not be tailored specifically to the Mosmorran project: it would have to be generally sensible and defensible. There could be no certainty that the ethane contract between the Esso affiliates would benefit, in terms of a valuation for tax purposes more favourable to Esso, from the legislation. While the Revenue had been aware of the Mosmorran project for some time, they had had no reason to ask for or become familiar with details of the project. In order to reach a view as to whether the Mosmorran ethane contract was such as to enable it to benefit from any new tax rules for inter-affiliate transactions, they would have to consider how the Esso contract and similar contracts were arrived at. This would, almost certainly, involve putting questions to Esso and would take some time. The Revenue would not be able to say how long it would take to formulate and obtain Ministerial endorsement of the general principles for new legislation, and then to examine the ethane contract against these, without further examination of what would be involved.

4. In discussion, the following were the main points made:-
 - i. It was generally agreed that Esso would be behaving unreasonably if they expected an instant assurance from the Government on the valuation for tax purposes of the

/ethane. The best



ethane. The best the Government could do - and this would be quite reasonable - would be to say to the company that the Government would consider urgently whether it could legislate in next year's Finance Bill to change the basis of the tax valuation of inter-affiliate ethane contracts and would give the company an indication of the Revenue's likely view of the contract. Rejection of this approach by Esso would suggest the company was looking for a way of shifting responsibility for abandoning the project onto someone else.

- ii. It was strongly argued that the Revenue should examine the Esso contract as soon as possible, so as to give the company the earliest possible indication of the Revenue's likely view.
- iii. The view was expressed that Esso in the United Kingdom had probably received instructions from its parent in the United States that unless a very early indication that the economics of the project could be substantially improved, in order to secure an acceptable rate of return, could be given, the project would be cancelled. It was questioned whether the change in the basis of valuation, for tax purposes, which had been suggested, and from which it could not be absolutely certain that Esso would benefit, would be sufficient to persuade Esso to continue with the project. A political judgement was needed as to whether the Government wanted the project to continue, and, if so, measures to achieve this should then be devised. It was pointed out, however, that, even on this analysis, an assessment would have to be made of the likely costs and benefits of Government assistance in this case compared with others.
- iv. It would be important, in setting up a notional contract, against which inter-affiliate contracts could be assessed, to avoid treating inter-affiliate contracts better than arms-length contracts. Arms-length contracts often contained a hardship clause to allow for reopening if there were significant changes in the underlying economics for either party. If new
/legislation were to



legislation were to meet this point, the Revenue would be able to give assurances about a bench mark price, which would vary according to the circumstances. The Revenue would not be able to give an assurance as to the absolute valuation for tax purposes, which it seemed Esso were looking for. On the other hand, the contract linked the price of ethane to naphtha which had a market price, so the issue was reduced to one of whether the link between ethane and the price for naphtha was reasonable.

- v. It was strongly argued that if the Government did assist Esso, by making the tax valuation of ethane more favourable to the company and in other ways, all possible pressure should be brought to bear on the company to place at least 75 per cent of its orders with the UK process plant industry. It was recognised, however, that the Government almost certainly did not have powers to oblige Esso to do this, but would have to rely on moral suasion.

5. The Chancellor, concluding the meeting, said that, in addition to the concession on rates which the Secretary of State for Scotland was prepared to make, Treasury Ministers would consider with the Revenue whether, in addition to disregarding fuel value in valuing ethane used at Mosmorran for petro-chemical purposes, acceptable legislation could be devised to enable inter-affiliate contracts to be treated, for tax purposes, as if they were on an arms-length basis, and whether this would enable the Mosmorran ethane contract to be reasonably valued in a way advantageous to Esso. The Revenue would give, during the course of the following day, an indication of how long they thought it would take to formulate acceptable general principles, on the basis of which legislation could be drafted, and the time it would take to assess the ethane contract against these principles. The Secretary of State for Scotland would seek to defer the meeting with Esso, scheduled for 30 June, to 1 July, and should indicate, though without commitment, to Esso

/the course of action

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the course of action which the Government had in mind. It would be up to the company to say whether it continued to be interested in the project on this basis.

R.I.T.

R I TOLKIEN

1 July 1981

Circulation:

Those present
Chief Secretary
Financial Secretary
Minister of State (L)
Sir D Wass
Mr Ryrle
Mr Burgner
Mr Battishill o/r



Mr. Lancaster

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With the Compliments

of the

Minister of State's

Private Secretary

*Richard Tobin mentioned
your interest*

L. Warden

Treasury Chambers,
Parliament Street,
SW1P 3AG



Gray

Treasury Chambers, Parliament Street, SW1P 3AG

The Rt Hon George Younger MP
 Secretary of State
 Scottish Office
 Dover House
 Whitehall
 LONDON
 SW1

Dear George

30 June 1981

MOENORRAN - TAX VALUATION

Geoffrey Howe undertook at the meeting yesterday evening to consider urgently what could be said to Esso at this stage about the possibility of legislation to deal with their problem on the tax valuation of interaffiliate transfers of ethene. I attach a draft of what we think can be offered. We have given the matter very careful consideration, and the statement is designed to be as helpful to Esso as we can prudently be. I do not think it is possible to go further than this.

I understand that the meeting with Esso has now been arranged at Dover House tomorrow (Wednesday 1 July) at 5 pm. Mr Dalton will be present, and you may think it helpful that he should make the statement on these lines.

I am sending a copy of this letter to Kenneth Baker and Harish Gray.

Peter Rees

PETER REES

Statement on tax valuation issue for meeting with Esso

There are two assurances which the Government is prepared to give beyond the statement in clarification of existing law made at the last meeting.

First, in valuing ethane used for petrochemical purposes the Revenue would not expect to have regard to the value of ethane sold for energy use. (This may be an acceptable interpretation of existing law, but, if this were found not to be so, the Government's intention would be to legislate to this effect.)

Second, the Government is prepared to give sympathetic and urgent consideration to the possibility of legislation in next year's Finance Bill to ensure that interaffiliate transfers of ethane for petrochemical purposes should so far as possible be put in a similar position for valuation purposes as arm's length transfers. This would probably involve legislation to shift the reference point for valuation to that of a hypothetical arm's length longterm contract made at the time when decisions on the disposal of the ethane are made. Even at this stage it is clear that there would be many problems in devising legislation that would have the desired effect without serious risks of unforeseen and unacceptable consequences. These will be looked at urgently in consultation with Esso and the industry. The Government hope to be in a position to say whether they see these problems as resolvable, and, if so, to indicate the form of legislation for this purpose in more detail within the next few weeks and certainly before the Summer Recess.

Once the principles of such legislation were established, the Revenue would consider urgently how the Esso contract would fall to be treated under it, were it enacted. (Preliminary discussions, could be started at once, if Esso so wish.) The position might

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take some time to establish, since it would be necessary to examine in some detail how the contract price was arrived at, and also to consider the position of Shell (as Esso's partners in the same project) and any other indicators of the current market for ethane for petrochemical use. The full co-operation of the companies in providing relevant information would be necessary. Subject to this the Revenue would give the matter priority and would ensure that there was no unnecessary delay on their part in reaching a view.



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HMT
S.

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Energy

10 DOWNING STREET

From the Private Secretary

22 May 1981

AF 17.6.81

Thank you for your letter of 21 May to Tim Lankester, reporting the position on the Mossmorran cracker project.

The Prime Minister was grateful for this report. She has noted that a joint paper will be put to the Ministers concerned in the middle of June. I should be grateful if you could keep us informed of developments.

I am copying this letter to John Wiggins (HM Treasury), Julian West (Department of Energy) and Godfrey Robson (Scottish Office).

W. F. S. RICKETT

Mrs Catherine Bell,
Department of Industry.

af



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TELEPHONE DIRECT LINE 01-212 3301
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Secretary of State for Industry

21 May 1981

Tim Lankester Esq
Private Secretary to the
Prime Minister
10 Downing Street
London SW1

Prime Minister

2

The Departments concerned
intend to put a paper on
this to their ministers by
mid June.

WN
21/5

Dear Tim

I think that the Prime Minister will wish to be aware that Esso Chemical Company have informed this Department and also the Scottish Office and the Department of Energy, at Permanent Secretary level, that they may decide to abandon the Mossmorran cracker project in Scotland, unless special Government help can be made available. You will recall that the Process Plant Association has recently been pressing the Government to ensure that the bulk of the orders for equipment for this project should be placed with UK manufacturers.

2 The cracker is the second part of a combined Shell/Esso project to use gas from the Brent field: the first part is a fractionator to separate the natural gas liquids, which Shell are building. Esso say that, although at the time of decision in 1979/80 they had seen some disadvantages in embarking on this greenfields project, these were outweighed by the advantages. Since then, however, a number of adverse changes have occurred which have reduced the estimated return on their capital expenditure to a level which would not be acceptable to their share-holders. These include a sharp deterioration of market prospects for petrochemicals because of high oil prices and surplus ethylene production capacity in Europe; a likely increase of 50 per cent in project costs; an increase in the rates bill, because of the basis on which outside industrial plant in Scotland is assessed; doubts about the availability of additional ethane at an acceptable price (this will be needed from the proposed gas gathering scheme, because of an estimated reduction in supplies from Brent); and the increased burden of Petroleum Revenue Tax and the Special Petroleum Duty.

3 In their meetings with the three Departments, Esso have indicated, that because of these changes, the project is no longer economically viable. They would like to continue with it if a way could be found of restoring their estimated return. They have suggested, therefore, that this could be achieved if the Government could help by lessening the tax burden and guaranteeing the availability of the additional ethane needed at an acceptable price. Esso are looking for a decision by the end of June.



Officials in the Departments concerned are examining closely the various complex issues raised by Esso and plan to put a joint paper to their Ministers about mid-June, prior to a meeting with the company at Ministerial level. For the moment, Esso's news is being treated as strictly in confidence: apart from the Departments, Esso have told only their partners, Shell. Esso may have difficulty in keeping it quiet and this is an added reason why the Prime Minister should know now.

I am copying this letter to the Private Secretaries of the Chancellor of the Exchequer, the Secretary of State for Scotland and the Secretary of State for Energy.

Yours ever

Catherine

CATHERINE BELL
Private Secretary