C/C

THIS DOCUMENT IS THE PROPERTY OF HER BRITANNIC MAJESTY'S GOVERNMENT

COPY NO 41

E (DL) (79)6

- 2 JUL 1979

CABINET

MINISTERIAL COMMITTEE ON ECONOMIC STRATEGY

SUB-COMMITTEE ON DISPOSAL OF PUBLIC SECTOR ASSETS

STATE INVOLVEMENT IN THE OIL INDUSTRY : FUTURE ARRANGEMENTS

Note by the Secretary of State for Energy

Introduction

1 As soon as we came into office I set in hand a review of the BNOC's activities and finances, starting with the question of BNOC's actual existence, why the country needed it, whether it could be dissolved and what the consequences might be if it was.

BNOC's current role comprises three main elements:

- oil trading, its access to oil deriving mainly from participation agreements negotiated with companies producing on the UKCS;
- ownership of equity stakes in UKCS licences; and related to this, its own offshore operating capability;
- its advisory role, enshrined by statute.

2 The arguments put to me for continuing with some form of state oil organisation on the lines of BNOC were that it gave the country greater security of oil supplies, that it enabled the British Government to influence oil movements and destinations without coming into open conflict with EEC requirements for free trade in oil within the Community, that it enabled the Government to know 'what was going on' in the North Sea and thus to formulate more effective policies for North Sea oil and that it gave the Government direct access to advice 'from oilmen and the front line' about exploration, development and production, as well as about trading in the world oil markets.

3 To these was added another argument - that to unravel the BNOC with its vast commitments and its extensive and complex agreements would create uncertainty and dislocation in the industry when the need was for stability.

71

4 We are entitled to treat some of these arguments with due scepticism, but the issues to which they relate are undoubtedly of the first importance for the nation. The events of recent months and the continuing deterioration in the world oil situation even while our review has been going on can leave us in no doubt about the dangers here. And while it would be a mistake to be over-influenced by immediate pressures when trying to make long-term decisions of the kind we face with BNOC, the pattern of the last few weeks, with its combination of intense public feeling and rapid moves by the Governments of major oil-consuming countries to improve their oil supply positions are probably more rather than less typical of what is to come. The tendency of the OPEC states to move away from traditional sales channels and build up government-to-government oil trade must also be recognised as a growing feature of the world oil scene.

5 There is a further dimension to consider. One of the Government's central aims is to widen the personal ownership of assets at present narrowly held in state hands, and to do so in a way which is politically irreversible. The BNOC is an obvious candidate here. At the same time the Chancellor has been looking to the BNOC to raise substantial sums through disposal of North Sea Oil assets in the current financial year to help him with his Budget calculations (I return to this point in paras 16-19). These are obviously major factors to be taken into account in deciding how we treat the Corporation.

Broad Strategy

6 Against this background I have reached the following broad conclusions about the way in which we should go:

i We are going to need a state oil organisation of some kind, both to influence oil supplies and suppliers in the increasingly difficult times ahead and to operate effectively in the new kind of world oil market conditions now fast emerging.

ii The BNOC as at present constituted does not meet our need. It is too big, it is too privileged. In some ways it has become almost too much like yet another huge oil company, with the ironic consequence that it may have been less effective as an instrument of Government policy than a more limited state organisation might have been.

iii We should now adapt the BNOC so that it serves our needs more effectively, so that unnecessary state involvement in the oil industry is reduced and so that state held oil assets should become more broadly owned and more available to private capital.

7 My detailed comments on these three points follow.

A state oil organisation and security of supply

8 Oil supply difficulties are likely to persist. There may be moments ahead when the pressure will ease but these could be followed by shortages of still greater severity. Once UK oil production is numerically equal to UK demand the understandable public expectation will be that this country should be at least cushioned, even if not totally insulated, against the full rigours of scarcity.

9 Since the major companies supplying the UK market are also UKCS oil producers, the scope for leaning on them through North Sea oil policy clearly exists. But it is very much a two-edged weapon. Anything that impedes North Sea activity is to the nation's disadvantage. Moreover direct pressure beyond a certain point on multi-nationals can be counter-productive, particularly if other Governments are all trying the same thing.

10 Direct Government access to UK oil is therefore highly important. This comes about at present in three ways, through the BNOC participation agreements (giving the option to buy about 25 million tonnes of oil in 1980), through BNOC equity oil (estimated at 5 million tonnes in 1980) and through the option of taking royalty in oil rather than in cash, involving BNOC in handling, as the Government's agent, about 2.9 million tonnes more in the first half of 1980.

11 Through the BNOC the movement of all this oil can be influenced. Moreover it can be done without legislation and without open affront to EEC rules (although the participation agreements sail fairly near the wind). Of course there is a price to pay. The more that Government intervenes the less easy it is to trade the oil on best commercial terms. Having the oil when you want it and yet trading it profitably are always likely to be in conflict. The aim must be to have arrangements which minimise the conflict through maximum flexibility.

12 I accordingly recommend that we should retain the options to buy crude oil contained in BNOC's participation agreements and to negotiate further such agreements as the need arises, eg on new licences or where BNOC disposes of an equity interest. It follows that the BNOC machinery to do this must also be kept.

The BNOC: towards a more limited organisation

13 Two of BNOC's special advantages have already been removed:

i) The Chancellor has announced that the Corporation will now be liable for PRT;

ii) I have announced the removal of BNOC's special position giving it first refusal on North Sea assignments.

I now intend that:

iii) BNOC's access to the National Oil Account should be brought to an end.

iv) In future licensing it should cease to enjoy any special rights or partnership arrangements and should merely participate as a normal commercial oil company.

v) As part of the arrangements to disengage from 6th Round licences (see para 16(ii)) it should seek to negotiate out of its carried interest arrangements where satisfactory alternative provisions can be made.

Unwinding State involvement and broadening ownership

14 How much of BNOC's extensive upstream estate should be kept? There are four main considerations. First, equity oil from BNOC's North Sea holdings is under Government influence. Although the flows are small compared with the far larger volumes accessible under participation agreements they are much less open to challenge from the EEC. Second, there is the argument that a state oil company should be involved in exploration, development and production to be 'in' on the oil industry and advise the Government. Third, where the lines of demarcation between the UK and another country are in dispute, the Government needs to be able to establish a presence in order to strengthen its claim. Fourth, there is a balance to be struck between selling off BNOC's oil assets outright and selling equity in the enterprise, or in the part of it that remains. The more we do of the former, the less easy is the latter.

15 Weighing these points (and I examine the advisory aspect further in paragraph 22) I conclude that we should move carefully torwards widening the role of private capital in the North Sea partly by disposing of certain assets and partly, thereafter, by selling shares in BNOC interests.

A Disposals and 'Slimming Down'

16 Some tidying up and reduction of BNOC interests is desirable straightaway to adapt the organisation in the way we need:

i) BNOC interests in the Viking Gas field and the Statfjord field could be sold; (see Annex 1 for approximate sums involved).

ii) BNOC is grossly overcommitted to exploration, particularly of Blocks licensed in Rounds 5 and 6. As part of speeding up North Sea momentum again I would like to see many of these assigned elsewhere.

17 On the results of my Department's review alone I would leave disposals there for the time being, especially in the light of the sensitive and fast changing world oil scene and the public view that might be taken of assets passing into the hands of non-British companies.

18 However, the Chancellor of the Exchequer has been pressing me to go somewhat further in the light of his immediate Budgetary needs. I would therefore be prepared

to go beyond 16(i) and (ii) above and either try to persuade or direct the BNOC to sell off further oilfield interests up to the target of 'at least £200 million' for which the Chancellor is looking, providing, of course, that the legislative difficulties can be overcome and that this is consistant with our overall decisions for the future of BNOC.

19 It is possible that this would still leave a viable undertaking which could attract private capital (see para 20). But I would wish colleagues to be fully aware of the strong reaction which even such limited disposals might provoke, and not just from political opponents. And I would urge that the timing of such disposals must be dictated by the market, and steps taken to ensure that as far as possible the assets are transferred to British hands and remain in them.

B Bringing in Private Capital

20 The introduction of private capital through the sale of shares in appropriate BNOC interests has clear attractions and if handled right could be popular, reassuring (in terms of keeping 'our oil') and largely irreversible. BNOC's functions as an oil trader, which I propose we keep on the lines of paras 8-12, cannot be treated in this way. But through the establishment of one or more subsidiary or associate companies, incorporated under the Companies Act, assets could be so organised as to make share sales to the British public very attractive. Timing, again, would have to be determined by the market and our broader political strategy.

21 The subsidiary or associate company(ies) would be free to act commercially, and this could reduce our direct influence over their oil. However, I would ensure,,prior to the introduction of private capital, that the Government through the oil trading 'parent' corporation would retain options on at least 51% of the oil eg by means of participation agreements.

Advisory Role

22 Whilst I shall need to consult BNOC and to seek its advice as the need arises particularly where it is acting as an agent of the Government in oil trading, it is not appropriate for its duty to advise to continue to be enshrined in statute. I propose, also, that BNOC should cease to have a place on Operating Committees where it is not an equity partner. Careful discussion with the other companies will be needed to ensure that this change in no way affects BNOC's options to buy oil under participation agreements. I must make clear that removing BNOC from the Operating Committees will make the purpose of the participation agreements more transparent, and so increase the risk of challenge by the EEC Commission. I am investigating what additional arrangements my Department will need to safeguard the Government's position and ensure effective oil policy. Some will certainly be required, and there will be manpower implications.

Further Licensing

23 I intend to accompany my statement on BNOC's future by an announcement of my intentions for future licensing later this year to restore North Sea momentum.

Chairmanship

24 Lord Kearton wishes to go very soon and I am considering possible candidates. Obviously any firm offer must await the Government's decision on proposals in this paper.

Legislation

25 Legislation will be required to:

i) Permit disposal of assets.

ii) Put BNOC's finances on a more conventional basis and to end its access to the National Oil Account.

iii) End its statutory advisory role.

iv) Empower BNOC to establish associate company(ies) with private interests.

Public Expenditure Implications

26 These are set out at Annex 2.

Conclusions

27 I invite my colleagues to endorse the broad strategy identified in this paper. Consequent upon their decision I propose to:-

i) make an early statement to Parliament of our policy decisions;

ii) invite my officials, with such outside help as is needed, to prepare a detailed scheme including provision for early involvement of private capital in BNOC's current upstream assets; and consult my colleagues accordingly.

D.A.R.H.

BNOC REVIEW

BNOC'S ASSETS

BNOC's assets are mainly those deriving from its licence interests. These can be categorised as follows:

a) Fields in production

Field	% Interest	Net present value £m
Viking (Gas)	50	40 - 48
Dunlin	16	115 - 150
Ninian	22.12	360 - 450
Thistle	18.94	145 - 175

The valuations placed on these assets (as for those in subsequent categories) are arrived at by discounting future cash flows. The lower case is based on a constant real oil price and a discount rate of 15%; the higher case an oil price rising at 4% in real terms and a 10% discount rate. It must be emphasised that these are theoretical valuations, and potential buyers can be expected to work on rather more conservative assumptions of all the important parameters (i.e oil prices, production levels, capital costs). Limitation on the timescale for realising these values and the need to give existing partners first refusal could seriously affect the level of proceeds.

b) Fields under development

Field	% Interest	Net present value £m
Beatrice	23	12 - 45
Murchison (UK)	33⅓	75 - 160
Statfjord (UK)	33⅓	40 - 100

c) Fields awaiting development decisions: There are a number of fields in which BNOC has an interest where development decisions may be taken in the next 2 years. Any valuation of these fields is essentially very speculative since the methods and costs of development are still undecided, and production costs and levels are extremely uncertain. Indeed until a development decision is actually taken then it is by no means certain that any such field has any realisable value at all. However, there are 3 such fields in which BNOC has an interest where work on development plans is sufficiently far advanced to make a tentative valuation possible. These are

Field	% Interest	Net present value £m
Hutton	20	0 - 30
Brae	20	0 - 12
30/17b	51	0 - 60

But it should be emphasised that until development decisions are taken, and the details of development plans and expected production profile known, any potential purchaser of these interests is likely to discount the price he is willing to pay substantially below the probable worth of the field, to allow for the uncertainty.

d) Other licence interests:

BNOC has interest through its equity stakes in 62 1st to 4th round licence blocks (including those containing the field interests already listed), in 40 5th round blocks and 13 blocks issued under sole licences. Apart from the developments or potential developments already mentioned, exploration and appraisal work on these interests is either insufficiently far advanced, or has failed to prove the presence of oil reserves in sufficient quantities to justify any realisable value being placed on them. (Although it is possible that some individual companies may be willing to pay 'premiums' for particular unexplored BNOC acreage which they regard as highly prospective). Similar consideration apply to BNOC's expected interests in 36 6th round blocks.

e) Participation interests:

These are not of an equity nature and no realisable value can be attributed to them.

2 Apart from the above licence interests, BNOC other assets consist of its 25% interest in the BP Maintenance and Support Vessel under construction (to which BNOC has contributed £12 m), property and office equipment valued at £10m, and its 50% stake in the recently ordered Marathon rig, where its direct contribution is unlikely to exceed £3m.

Arithmetic of Disposals

3 The main paper suggests outright disposal of BNOC's interests in Viking and Statfjord. The valuations placed on these two interests total together between £80m and £150m, with BNOC suggesting that around £130m might be achieved. The amount we would in practice realise by sale of these assets is very uncertain and will to a large extent depend on the timetable within which we have to work. To get the best possible terms we may have to forego achieving the sale in 1979/80.

4 Additional sums towards the Chancellor's £200m target could be achieved by disposal of some or parts of

a) fields awaiting development decisions (Hutton, Brae, 30/17b)

b) fields under development (Murchison and Beatrice)

c) fields in production (Dunlin, Ninian, Thistle)

The size of interests to be disposed of to meet the target would depend on inter-relationship desired between outright disposals and the introduction of private share capital. As indicated earlier in this note, the valuations placed by potential buyers on category (a) interests are likely to reflect the uncertainty surrounding them until the development decisions are taken. Now would not be a good time to seek buyers. For fields in category (b) this major uncertainty is eliminated, and more satisfactory values are likely to be realised although major capital commitments remain outstanding. The fields in category (c), although likely to command good values, also provide major contributions to BNOC's profitability and to the Government's cash flows. A further important consideration in deciding how additional realisations might be achieved, is that BNOC is operator for Thistle, Beatrice and 30/17b. BNOC's operatorship capability is an important element in the continuing upstream operation that is envisaged for BNOC (and into which private share capital would be introduced).

If BNOC were to retain the operatorships for any of these interests, the partial disposals would have to be fairly limited. Complete disposals together with the operatorships should only be contemplated provided that a smooth transfer to a satisfactory new operator could be foreseen.

ANNEX 2

BNOC REVIEW

Public Expenditure Implications

The effects of the proposed changes on Public Expenditure are difficult to quantify at this stage, but the following mainly qualitative judgements can be made.

(i) BNOC's diminished role in future licensing rounds (para 13(iv)) will result in substantial savings in exploration expenditure, offset largely by the tax allowances of the private companies which will presumably undertake the work instead. On the expectation of a continued 51% stake in future licences BNOC forecast its expenditure on exploring such licences over the next 5 years at about £230m.

(ii) Negotiation out of carried interest (para 13(v)) should be with the objective of not adding to public expenditure. (Thus rather than BNOC undertaking to pay for its share of costs that were to have been carried, it would give up the relevant interest).

(iii) Any disposals (para 16(i)) would cause an immediate reduction in public expenditure, followed by reductions in subsequent years due to capital expenditure not incurred, and increases due to revenues foregone.

Annex 1 shows the range of valuations placed on field interests. In the case of Viking very little capital expenditure is outstanding and net pretax revenues are running at around £10m. Statfjord still faces substantial outlays but over the next five years net revenues are expected to exceed capital expenditures by at least £45m.

(iv) Disengagement from 5th and 6th Round Licences, (para 16(ii)) would result in substantial savings in the same way as would a lessening of BNOC's role in future licensing ((i) above). BNOC's expenditure on exploration of 5th and 6th round interests is presently expected to be around £220m over the next 5 years.

(v) Subsidiary companies would be by definition at least 51% owned by BNOC. If it was evident that BNOC intended to exercise effective control of these subsidiaries any private capital injected would only finance the PSBR not reduce it. If alternatively these subsidiary companies operated as independently as if BNOC had no more than a minority interest in them (ie. effectively as associated companies) the initial injection of private capital could reduce the PSBR. Subsequently, the PSBR would be higher than it would otherwise have been to the extent that profits were distributed to the private shareholders.

(vi) Strengthening the Department's specialist oil industry expertise (para 22) would result in some increase in public expenditure.

Department of Energy
2 July 1979