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Energy 2

Prime Minister

To glance

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The Rt Hon Sir G Howe MP QC
The Chancellor of the Exchequer
HM Treasury
Parliament Street
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TL 3/7

3 July 1980

Dear Geoffrey

DEPLETION POLICY

Thank you for your letter of 27 May.

I enclose a paper agreed by Department of Energy, Treasury, FCO and CPRS officials, which concentrates on the revenue implications of implementing in full the three depletion measures which we endorsed in E on 11 March.

The strategic case for implementing a depletion policy has not changed since E's discussion. As set out in your letter our production forecasts have fallen since then reflecting our assessment of the latest forecasts which we have received from the companies. But our demand forecasts have also fallen largely on account of the gloomier economic prospects in the period immediately ahead. As the table below demonstrates we are therefore still left with a very substantial net exportable surplus of UKCS oil in the mid-1980s with a potential peak of some 35m tonnes in 1984 and in total equivalent to some two or three years UK demand for oil.

Potential Net Exportable Surplus
m tonnes

	1980	1981	1982	1983	1984	1985
Current Estimate	-(1/4)	7/10	16/21	23/30	30/35	25/30
1979 WEDP Review	-(3/6)	10/13	17/22	20/27	25/35	20/35

On both strategic and economic grounds it is essential to try to roll forward some of the large net exportable surplus into the late 1980s and 1990s to reduce our dependence on OPEC oil which is likely to be even less secure then than now. Leaving aside production cutbacks which we shall need to consider very carefully next year, one of the points brought out by the paper agreed by our officials is that the three depletion measures we have already agreed upon, even if implemented in full, will at most only roll forward a limited proportion of the net exportable surplus.

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I fully understand that you and your colleagues in the Treasury are concerned about the revenue implications of the depletion measures which we have already endorsed. However, the paper agreed by our officials brings out that these measures are only likely to involve a reduction in revenue of an average of £150m a year over the period up to 1985, compared with the forecast average loss of some £250m p.a. in those years when we collectively endorsed the three depletion measures. The sums involved are limited and well within the margin of error for calculating both North Sea tax take and the PSBR. The only way of reducing the annual average figure of £150m significantly would be to allow substantially more gas to be flared than can be justified on gas conservation and energy policy grounds. We could not possibly justify such a profligate policy with our finite natural resources either to Parliament or to the electorate. You will also note that the other major depletion measure agreed at E, namely development delays, would not lead to a reduction in tax take nor an increase in the PSBR in the period up to 1985 but would rather lead to an increase in tax take and a reduction in the PSBR in this period.

One point that I would however wish to draw to your attention is that in earlier discussions with BP they indicated that a request for an upward profile variation was now less likely and the assumption underlying current production forecasts in the enclosed note is that no request will be made. Since the enclosed paper was agreed my officials have had a preliminary discussion with BP on depletion, at which the Treasury was represented. BP stated that they had not completed their review of the Forties field and were consequently not in a position yet to say whether or not they would be applying for an upward profile variation. It is therefore possible that BP will put in such an application, if only for tactical reasons. Even then it is not at all clear whether they would seek as large an upward profile variation as we earlier thought might be the case (ie some 3 million tonnes a year). Even if they do so we may have to reject it on grounds of good oil field practice, ie that such a change will reduce the recoverable resources of the field. Were a serious application to be made I would, of course, review it with you in the light of all the circumstances at that time.

I hope you will agree that, having studied the paper and the considerations set out above, it would be wrong to reopen the collective decisions taken by E on depletion. I should add that if we do not take action on some of the development delay and gas flaring cases this year we shall have foreclosed our options permanently.

My officials will, of course, continue to keep in touch with your officials about the implementation of the policy, where significant volumes of oil or gas are involved.

I am sending copies of this letter and the report by officials to the Prime Minister, the Foreign and Commonwealth Secretary, Sir Robert Armstrong and Mr Ibbs.

Yours ever
David

D A R Howell

REVENUE IMPLICATIONS OF DEPLETION MEASURES ENDORSED BY E COMMITTEE

This review by officials from the Department of Energy, the Treasury, FCO and the CPRS has been undertaken following the Chancellor's letter of 27 May to the Secretary of State for Energy.

Total UKCS Tax Receipts

2. The Medium Term Financial Strategy (MTFS) forecast revenue receipts from UKCS Sea Oil in the financial years 1980/81 to 1983/84 on the basis of the oil production forecasts given in the 1979 Review of Depletion Policy and the other assumptions on income growth, exchange rate and oil prices underlying the MTFS were:

£ billion, 78/79 prices

	80/81	81/82	82/83	83/84
MTFS	$2\frac{3}{4}$	$3\frac{1}{4}$	$4\frac{3}{4}$	$4\frac{3}{4}$

3 The latest estimates shown in the table below together with the MTFS forecast was prepared by the Inland Revenue as part of the recent National Income forecasting exercise (NIF) on the basis of current assumptions including a lower oil production forecast, a higher path for the real world price of oil and higher UK domestic inflation.

£ billion, 78/79 prices

	80/81	81/82	82/83	83/84
NIF	2.7	2.9	4.4	4.3
MTFS	$2\frac{3}{4}$	$3\frac{1}{4}$	$4\frac{3}{4}$	$4\frac{3}{4}$

4 UKCS tax revenues at 1978/79 prices in the latest forecast (NIF) are lower in every year than in the MTFS. In 1983/4, for example, they are some £0.4 billion down and this is mainly due to the net effect of three factors; lower oil production forecast -£0.5 billion; higher real dollar oil prices +£0.6 billion and a higher UK domestic inflation assumption -£0.4 billion.

Depletion Measures

5 The scope for deferring production from the peak is estimated as follows:

Measure	Decisions from	Maximum Reduction in 1984/85 (m. tonnes)
Gas Flaring Restrictions	1980	2
Refusal of Upward Profile Variations	1980	1
Development Delay	1980	4
Production Cutback	1981	15-16
		22-23

6 This is a little different from the 27 m. tonnes potential identified in the 1979 Review of Depletion Policy; the reduction being mainly accounted for by a loss of 3 m. tonnes potential under the head of refusal of upward profile variations at BP's Forties field (this potential production having been taken out of the base production forecast already on the assumption that BP will not now seek an upward profile variation in view of the expected reservoir performance of this field) and some 2 m. tonnes slippage in production under the development delay head in part accounted for by a delayed production start up at Mobil's Beryl B field.

7 The tax revenue implications in the years to 1985 and the net benefits to the economy over time of implementing the first three depletion control measures endorsed by E Committee are discussed in turn below. The net benefit to the economy is determined by assessing the change in net present value in

1979 prices (defined as Government revenue plus UK company take) with and without depletion controls at a test discount rate of 5%. Decisions on production cutback which cannot be implemented before 1982 at the earliest will be the subject of a further report by officials to E Committee in about a year's time. The potential effect on revenue of this measure are therefore not dealt with here.

Summary of the Revenue Effects in the Years to 1985 from Depletion Control

8 The tax revenue effects of implementing the first three depletion control measures in full for the years to 1985 are estimated to be:

£ million, 78/79 prices

	1980	1981	1982	1983	1984	1985
Gas Flaring Restrictions	-40	-80	-220	-150	-170	-150
Refusal of Upward Profile Variations	-30	-30	-30	-20	-5	-5
Development Delay	0	+5	+10	+10	+40	+130
Total	-70	-105	-240	-160	-135	-25

9 The maximum potential impact would occur in the financial year 1982/3 with the average loss of revenue over the period 1982 to 1985 running at under £150 m a year. This compares with an average loss of £250 m a year between 1982 and 1986 given in the 1979 Review endorsed by Ministers. The difference between the two estimates is mainly accounted for by the removal of the option to refuse an upward profile variation at BP's Forties field - a decision which Ministers are not now expected to have to take.

10 The effect of these measures on the PSBR would however be somewhat less than shown above as delaying the development of BNOC's Clyde field (30/17b) - which is included under the development delay head - would defer 100% of BNOC's investment not just the Corporation Tax element. This additional benefit would amount to some £5 m in 1983, £25 m in 1983 and 84 and £10 m in 1985.

Gas Flaring

11 The UK has already since 1975 flared gas equivalent to some 13 m. tonnes of oil worth at current prices some £1.5 billion with flaring over the past three years running at the equivalent of some 7-8% of total oil production. Energy Ministers in agreement with Treasury Ministers began to introduce

tougher flaring controls at the Shell/Esso Brent field in November 1979 and Ministers collectively have endorsed a progressive tightening of flaring restrictions on economic and gas conservation grounds. On both gas conservation and economic grounds there is a strong justification for further action on Brent during the course of 1980 and 1981. We currently pay a premium in terms of gas flared of around $10 per barrel of oil produced at the Brent field. The potential net benefit to the economy from imposing tougher flaring restrictions at Brent over the next two years which would defer some 1.5 m. tonnes of oil is estimated at £60 m. in 1979 prices.

12 In the years 1982 to 85 the revenue implication of taking up the estimated potential under the gas flaring head has been illustrated using BP's Forties field. This field was identified in the 1979 Review as a prospective candidate for tougher flaring restrictions and this has been reinforced by possible gas gathering pipeline developments. As Forties is in the full tax paying position and also has a low gas/oil ratio, it can be considered as a "worst case" example for illustrating action under the gas flaring head. Even so, the net benefit to the economy of deferring some 2 m. tonnes of oil a year at peak is estimated at around £15 m. in 1979 prices.

Refusal of Upward Profile Variations

13 Assuming that BP do not seek an upward profile variation at their Forties field the main prospect under this head at the present time is Mobil's Beryl A field. If an upward profile variation was refused it would incur a small net loss to the economy in the order of £5 m. in 1979 prices. A decision to refuse an upward profile variation would therefore rest on deferring oil from the years of peak production when we have a large potential export surplus.

Development Delay

14 It is possible that five major fields will come forward for development before 1985. These are the three protected fields Hutton, Alwyn and Andrew and two unprotected fields Clyde (30/17b) and T-Block. Assuming a one year delay for protected fields and a five year delay for unprotected fields the net benefit to the economy of action here is estimated at around £160 m. in 1979 prices. The effect of development delay on revenue, unlike the other measures considered, is to increase substantially the Government's tax take over the period to 1985. This revenue gain arises because delaying the development of fields reduces companies' ability to offset Corporation Tax liabilities on existing fields against development expenditure on new fields.

Summary of the Net Benefit to the Economy from Depletion Control

15. The total net benefit to the economy over time from implementing the first three depletion control measures endorsed by E Committee is estimated at around £230 m. The bulk of this, some £160 m, is accounted for by development delay; with a further tightening of gas flaring restrictions contributing some £75 m. There is estimated to be a small net loss from the refusal of upward profile variations of around £5 m.

Conclusions

1. The net effect of a lower forecast for oil production, higher real dollar oil prices and a higher UK domestic inflation assumption since the MTFS means that the real UKCS tax revenues are lower throughout the period to 1983/84 than in the MTFS. In 1983/4, for example, they are some £0.4 billion down and this is mainly due to the net effect of three factors; lower oil production forecast - £0.5 billion; higher real dollar oil prices + £0.6 billion and a higher UK domestic inflation assumption - £0.4 billion.

2. Excluding the option to refuse an upward profile variation at BP's Forties field, a decision which Ministers are now unlikely to have to take, the measures available and potential to defer production are essentially unchanged from those endorsed by E Committee.

3. The loss of revenue in the early-mid 1980s is estimated at a little under £150 m a year with the maximum potential impact being in 1982/83. The estimated loss of revenue given in the 1979 Review of Depletion Policy was some £250 m a year. The difference being accounted for mainly by Forties production on which Ministers are now unlikely to have to take decisions.

4. The net benefit to the economy of the use of the three measures endorsed by E Committee on which decisions have yet to be taken is of the order of £230 m in 1979 prices.

Department of Energy
25 June 1980

3 JUL 1980