Prime Minister.

Since receipt of this brief, we have also received a paper from the Chancellor (Flag A)

JRI [signature] 21/7

CONFIDENTIAL

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PRIME MINISTER

Future of BNOC

(E(79) 20, 21 and 22, also E(DL)(79) 6)

BACKGROUND

There was an inconclusive discussion of this range of subjects in E(DL) under your chairmanship on 5th July. You asked the Secretary of State to produce a further background about the case for retaining BNOC. It has turned out to be three papers, one of which is not self-contained but refers back to his earlier ones. The presentation is confused, and the papers have been circulated late. You would be justified in complaining on both scores. You have since agreed that the strategic issues should be considered in E, followed immediately by discussion in E(DL), again under your chairmanship, of the disposals. In practice, the two discussions will tend to telescope, and the E discussion is in any case likely to run late. At some point you may therefore want to bring in the Financial Secretary who will be waiting around for E(DL). This one brief is intended as a guide for both meetings.

2. There are three important timetable constraints:

(i) Mr. Howell wants to make a statement about the future of BNOC and about the confirmation of awards under the 6th licensing round before the Recess. The case for an early announcement on the future of BNOC is deployed in E(79) 22. The complication arising from the 6th round is explained in paragraphs 6-8 of E(79) 21. Both, if accepted, point to the need to reach decisions at this meeting. (Though you may feel that, at least an announcement on the future role of BNOC could wait till after the Recess).

(ii) The Financial Secretary wants to make a statement on disposals before the Recess. Now that the Government has forgone the option of an early move on the BP shares, this may be less essential, and I think you should question him on the operational necessity. The Treasury has got through the Finance Bill debates without being pressed for a statement of its intentions on disposals, and market rumours have died down.

(iii) There may be a need for legislation to give effect to these decisions. The first part - to allow BNOC to make limited disposals in this financial year - is urgent, but could probably be tacked on to the Industry Bill. The second part, to restructure BNOC and allow for private capital, is not essential to make up the 1979-80 disposals package, and will have to come later. Nevertheless, policy decisions today will allow a lot of drafting to proceed.

3. In his main paper, E(79) 22, the Secretary of State for Energy proposes a holding operation at this stage:

(a) Disposals of £200 million worth of assets now, including Viking and Statfjord, subject to the legislation point above.

(b) A move towards further disposals and/or privatisation, but in a longer timescale.

4. However, colleagues may feel that this does not go far enough. In particular, it would not provide anything like the total Energy contribution to the Chancellor's £1,000 million this year if the BP shares are not sold. The discussion will therefore have to go wider than Mr. Howell's immediate proposals.

5. The decisions which you will need at this meeting are therefore:

(a) On the future role of BNOC: including its upstream activities, its involvement in oil trading and its advisory role.

(b) If BNOC is to be run down, the destination of its assets, and of methods of involving private capital.

(c) If £200 million worth of assets is not good enough this year, then what other options to pursue: BP shares; further short-term disposals of BNOC assets, including perhaps Ninian; or the larger transfer of BNOC upstream interests to BP.

The first of these questions is really one for E; the other two spill over into E(DL).

HANDLING

6. I suggest you concentrate discussion on the three issues, making this clear from the start.

(a) The future role of BNOC.

(i) Upstream activities: The Committee might look first at the 'note by officials' circulated with E(79) 20. The Secretary of State, in his covering note, appears to distance himself a little from this paper. The key figures are in Annex 1. Taking royalty oil in kind gives us 12 per cent of United Kingdom Continental Shelf oil under Government control. BNOC equity oil gives us another 6 per cent, or 18 per cent in all. The smaller United Kingdom companies give us a further 8 per cent but we cannot control this so directly. Shell and BP have another 25 per cent but Mr. Howell in the paper has lumped them with other multinations because they behave in the same way, rather than as "United Kingdom" firms. The present participation arrangements allow BNOC to control roughly an additional 20 per cent of North Sea production at its discretion and give potential control of yet a further 20 per cent if the sale back clauses of participation agreements are operated. Thus at the maximum BNOC/BGC can control up to 55 per cent of North Sea output, of which about two-thirds would be participation oil. Of course the participation oil has far more strings attached to it than has equity or royalty oil. And the equity oil is the most immediately usable. It derives entirely from BNOC's direct involvement in fields. The Annex to E(79) 21 shows that BNOC has equity access to about 125 million tons of recoverable reserves, of which 15 is in Statfjord and 34 in Ninian. Ninian is already on stream, and Statfjord starts next year.

(ii) Trading. The figures in the Annex to E(79) 21 show that BNOC derives control of between 19 and 37 per cent of United Kingdom production from its participation agreements (depending on the use made of sale-back clauses). Mr. Howell recommended (paragraph 12 of E(DL)(79) 6) that the BNOC should retain these participation rights. Since they require BNOC to purchase oil at market price, these rights have, theoretically, no cash value. Obviously the companies would prefer to have unfettered control over this volume of oil, but they do not seem prepared to pay a price to buy these rights back (any more than BNOC paid for the right in the first place). To retain the 'participation rights' does not, therefore, cut across the Chancellor's strategy. The participation agreements were attacked by the Government in Opposition, and might theoretically be challenged in the European Court. But there is likely to be agreement that the Government should hold on to these rights. That in turn means keeping BNOC in existence as a vehicle to exercise them: they could not be handed over to BP, and are not easily exerciseable by Government direct. You might seek to establish quickly whether the Committee agrees with this view. If so it will simplify the rest of the discussion.

(iii) BNOC's Advisory role. Mr. Howell proposes (paragraph 22 of E(DL)(79) 6) to abandon the statutory advisory role of the BNOC while still looking to them for advice as appropriate. But this done the key question is whether the BNOC should retain its present membership of the operating Committees for each field where it has not got an equity interest. The argument for retention is that this gives information about costs, to lesser extent about prices and about reservoir engineering, likely reserves, flaring and so on. Of these, the one with most cash value is information about costs and pricing. Inland Revenue have other means of obtaining this information, although the BNOC material is probably a useful supplement. The other information can, theoretically, be obtained directly by the Department of Energy: though once again BNOC's direct involvement gives it an alternative source. Mr. Howell said last time that he receives conflicting advice on the value of the information and advice he gets from BNOC. But although it is a source of friction with the oil companies, the advisory role will continue informally even under

Mr. Howell's proposal to abolish its statutory basis. The real merit and value of BNOC's membership of operating committees (except where it is an equity partner), is a matter on which the Committee will wish to look to Mr. Howell for technical advice. BNOC could, of course, continue as a trading organisation without such membership.

(b) How can private capital be introduced into BNOC, and to what extent should its assets be run down? At this point this discussion shades off into E(DL) territory and you might bring in the Financial Secretary if you have not already done so. It was at this point that the discussions got into difficulty last time. Mr. Howell is afraid that large scale disposal at this stage will make BNOC a less attractive subject for privatisation. But the form of privatisation which he proposes would still leave BNOC in existence, with control over the oil. (See, particularly, paragraphs 20-21 of E(DL)(79) 6). This is an ingenious package, which would produce cash from the sale of minority interests in the new subsidiary company. It would also, apparently, avoid the 'pre-emption' problem which gives the other partners first refusal over any assets which BNOC sells: (see paragraph 9 of E(79) 21). It will leave BNOC in existence, as a trading organisation, though with progressively less equity oil. If the private interests were, for example, in a newly-established city consortium, control would remain in British hands, but this would not necessarily guarantee that the oil would flow to British use - particularly since the new owners would not have access to their own refinery capacity. The net result would still be some reduction in the Government's direct control over oil. For this reason, Ministers may be reluctant to pursue this option too far - though, since it is envisage as a piecemeal disposal operation, the legislation could be introduced and interests in one or two fields disposed of experimentally.

7. If the decision is to run down BNOC, and to allow the introduction of some private capital, should the assets be retained in British hands, and if so how? The Committee should by now have agreed the participation rights themselves are

unmarketable. In that case, the choice lies between disposing of equity interests directly, or hiving them off into subsidiary companies, and disposing of shares in these subsidiaries. A secondary choice is whether to sell these interests to existing or newly formed British interests, or more widely: and, if the decision is to retain in British ownership, whether to dispose piecemeal, or attempt a block sale to BP. The new paper E(79) 21 deals with these options in detail. But you should ask the Secretary of State to supplement this by reporting orally on his discussion with Sir David Steel, particularly about the idea which the Secretary of State for Trade floated at the last meeting. (This was, briefly, for BP to finance the operation by raising a new loan, with equity rights attached. In order to preserve a 51 per cent interest in BP, Her Majesty's Government would have to be prepared to take up its share of this loan and attached rights, and this would reduce the net benefit of the sale to BP. But since the entire BNOC holding has a net present value estimated in Table 1 of E(79) 21 at between £795 million and £1232 million, the net benefit could still be very large, although it seems most unlikely that it could all be realised in 1979-80.).

/Note: the same table estimates the net revenue of the holdings to 1984 as £1400 million and the liability for extra capital in the same period as £685 million/.

8. The issues here become highly technical. The point to establish early on is whether, as appears to be the case, there is little prospect of pressing ahead with a block disposal to BP in 1979-80. If that is so (and it will disappoint the advocates of such a scheme, including the Financial Secretary) then the choice does come down once again to the sale of the BP shares this year versus a shortfall on the Chancellor's £1000 million target, or finding some other means of balancing the books. Looking further ahead if it is accepted that a block sale is impracticable this year but remains a long term option, there is no need to reach final decisions on this particular issue at this meeting: the issues can be remitted to another meeting of E(DL) under the Chancellor, before or even after the Recess. If, unexpectedly, it emerges that a block sale to BP could be completed in the current year, despite E(79) 21, then again you might seek to record agreement in principle, and once more remit the details to the Chancellor.

The Committee should however note that all of the options - hiving off, block sale and probably the limited disposal (say Statfjord and Ninian only) - would require legislation.

CONCLUSIONS

9. I think you might try to set out conclusions on the pattern as suggested above; there would be four. The first three might be recorded as conclusions of E, and the last as a conclusion of E(DL).

10. Subject to the course of discussion, these might be:

(i) That the Committee sees a continuing role for BNOC, as a trading organisation, retaining its participation rights, but disposing of some /or all/ of its equity interests, and /probably/ deprived of its statutory advisory role.

(ii) That legislation should be prepared to provide for the introduction of private capital into BNOC (any remaining points of detail to be decided by E or (E(DL) after the Recess).

(iii) That the disposals of assets, whether to other oil companies or for the sale of equity in subsidiaries of BNOC, should be pursued only to the extent that it does not involve any significant loss of control over oil. /The Committee will need to decide whether sale to BP involves "loss of control" in this sense/.

(iv) Either that disposals in 1979-80 should be confined to the £200 million offered by the Secretary of State for Energy, and that he should pursue the details with the Financial Secretary urgently; or that he should aim to dispose of more in 1979-80 /including Ninian?/ and (in either case) that he should seek to attach additional clauses to the Industry Bill to facilitate these disposals; or alternatively that he should proceed urgently, in consultation with the Financial Secretary/Chancellor of the Exchequer, and with the Chairman of BP, to make arrangements for an immediate sale of most or all of BNOC's upstream assets to BP, to be financed by a loan issue and noting that Her Majesty's Government would take up its share of rights and retain control over BP. (If this is not the decision, you will also need an additional conclusion: that the Committee should return to the question of selling BP shares after the Recess, on the basis of the original proposals put forward by the Financial Secretary in E(DL)(79) 5).

11. You might also note that there is another meeting of the Sub-Committee on Thursday under the Chancellor to take a paper on longer-term disposals; on disposal of land; on British Aerospace; and - if necessary - on British Airways [on which the Secretary of State for Trade hopes to make a statement on Friday].

for (John Hunt)

16th July, 1979

10 DOWNING STREET

Prime Minister

Yes mt.

The E discussion on BNOC will obviously merge <u>into E(DL)</u>. It would be a good idea if <u>Mr Lawson joined E</u> for the <u>BNOC</u> item. Agree? (He is the only E(DL) member who is not a member of E).

TL.

16/7