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CABINET

MINISTERIAL COMMITTEE ON ECONOMIC STRATEGY

OFFSHORE SUPPLIES INTEREST RELIEF GRANTS SCHEME
MEMORANDUM BY THE SECRETARY OF STATE FOR ENERGY

The attached note discusses the value of this scheme to the UK Offshore Supplies industry in some detail. It also touches on the EEC Commission Decision of 2 May which requires the Government to abolish the Scheme two months from that date as being contrary to the Treaty of Rome and it is with this aspect that I should like to deal here in a little more detail.

So much attention has been given by the media to the Commission's interest in this matter and its employment implication that straight acceptance of the Commission Decision would be politically difficult.

Without interpreting the figures in the paper too literally, it seems probable that the scheme has had some beneficial effects in promoting British industry.

Offering to regard EEC components as eligible provided they do not exceed 50% of the total content would seem an attractive compromise. Going above 50% can be ruled out: it would require legislation; could add more to public expenditure and would be criticised as using tax payers' money primarily to promote foreign competition. However, making some European components eligible would make it slightly more difficult for the Europeans to complain of discrimination.

Although this compromise has already been once rejected by the Commission, and they seem unlikely to change their attitude, it

seems reasonable for a new administration to be seen to be seeking to reopen this particular avenue, and also, if necessary, to look for a longer period for negotiation.

D.A.R.H.

Secretary of State for Energy,

24 May 1979.

OFFSHORE SUPPLIES INTEREST RELIEF GRANTS SCHEME

1. This Note discusses the value of this Scheme to the UK offshore supplies industry; it also touches on the EEC Commission Decision of 2 May which requires the Government to abolish the Scheme two months from that date as being contrary to the Treaty of Rome.

The Scheme

2. The Scheme was introduced by the previous Conservative Government in November 1973 under Section 8 of the Industry Act 1972 to help UK suppliers establish themselves in the UK Continental Shelf (UKCS) market, now worth about £1500 million a year in new orders and which has no tariff or other protection. This was one of the measures taken by the then Government (others were the setting up of the Offshore Supplies Office and moves towards establishing the Full and Fair Opportunity policy) following an independent report commissioned by the Government which estimated that the UK share of the offshore market would reach only 35 - 40% by the late 1970's unless special measures were taken. This was because offshore technology was new to Britain but was already well established in the United States to meet offshore requirements in eg the Gulf of Mexico. It was therefore feared that, left to their own inclinations, the oil multinationals would look to American suppliers for their North Sea requirements with whom they already had close links. The report also highlighted the disadvantages suffered by UK supplies from the availability of preferential export credits for overseas supplies, which was the particular reason why the IRG Scheme was introduced (ECGD facilities could not be used because the UKCS could not be regarded as an export market for ECGD purposes).

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3. The Scheme provides interest relief grants of 3% a year for up to eight years on bank borrowing raised to finance the UK content of contracts for goods and services used in the construction and installation of fixed oil and gas production facilities on the UKCS, subject to a limit of 80% of the contract value which must itself be at least £100,000. Commitments to pay grant in respect of any particular project (eg a field development) in excess of £5m. are subject to H of C Affirmative Resolution procedure. The amount of grant depends upon a number of factors such as the phasing of payments to contractors and the matching of borrowings to those payments. Although the Scheme is open to suppliers as well as buyers, the financing of offshore projects is such that all grants so far made and committed have been to the buyers, ie the offshore operators and their partners in field developments. Since grants are liable to Corporation Tax, the net cost of the Scheme to the Exchequer is dependent upon the tax position of the recipients.

Public Expenditure Considerations

4. About £33m. has been paid in grants so far. There could be another £100m. or so to come over the next 7-8 years even if the Scheme is abolished as the Commission require on 1.7.79. This might, however, save £17m. on the assumed Public Expenditure Survey (PES) figures to 1983-84 for a continuing Scheme. Abolition more than a few months after 1.7.79 (say on 31.12.79) would be unlikely to result in any savings in the PES period. Details are in Annex A.

Value of the Scheme

5. IRG's can reduce the undiscounted pre-tax cost to an oil company of placing a qualifying contract in the UK by up to 14% although the average is probably nearer 8%. Currently, the Scheme reduces UK commercial interest rates for medium term credit to 8½-10%, compared with preferential export credit

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rates in countries outside the EEC of 7½ - 9%. It is, however, extremely difficult to assess the real value of the Scheme. On the one hand, it could be argued that the Scheme has been an important contributory factor in oil company decisions to buy British: the United Kingdom Offshore Operators' Association (UKOOA) have said as much to the Department, and the suppliers' trade associations have also regarded it as of real - if indirect - assistance to them. It is the only form of financial support specifically directed towards the offshore supplies industry, which in general has been and continues to be relatively uncompetitive on price and is also facing some excess capacity problems. There are frequent difficulties with the offshore operators on buying British because of substantial price differentials (and/or lack of confidence by the operators in some British suppliers) which sometimes merit Ministerial intervention. In the context of our general policy, therefore, the Scheme can be a useful bargaining counter in discussions with offshore operators on individual contract awards, and certainly we believe that the Scheme was a significant factor in bringing to the UK those contracts placed over the last two years which are listed in Annex B (Annex C gives some details of the use made of the Scheme by the offshore operators). To the extent that the Scheme has been effective, it has helped to maintain at least some of the 100,000 or so jobs created by UKCS activities, and to prevent the loss of business which would otherwise be a direct cost to the balance of payments and which would not necessarily be recouped by suppliers turning to other products. This applies particularly in the heavy offshore fabrications sector, eg platforms and modules, for which special manufacturing and assembly facilities have been set up in Scotland and the North East of England. Since the Scheme began, our share of the total orders placed for UKCS goods and services has progressively increased from about 25 - 30% in the early 1970's to 66% in 1978. This increase cannot of course be attributed

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5. solely to the IRG Scheme, but it supports the view that the Scheme has had some beneficial effects for the UK.
6. On the other hand, we can never be sure exactly what weight an operator gives to the various factors (eg price, past performance, delivery offered and credit terms) in deciding on a contract award. Moreover, since grants under the Scheme are not discretionary, the offshore operators and their partners can qualify for them if they place eligible contracts in the UK for whatever reason, provided they arrange credit facilities to finance such contracts in ways acceptable under the Scheme and otherwise meet its operating requirements.

7. Thus, although we believe the Scheme is of value in particular cases, we have no means of assessing its effectiveness overall: OSO only intervenes where an operator is proposing to accept an overseas tender, and is not involved in many cases where an operator himself elects to place a contract in the UK (and on which he may subsequently claim grant). We have examined a wide range of possibilities with a view to reducing the cost of the Scheme and ensuring maximum value from it, but we have concluded that, given also the difficulties presented by the EEC Commission's attitude (see below), any such changes would seriously undermine whatever credibility the Scheme may have with the operators and/or would make the Scheme extremely difficult to administer. It really comes down to a political decision whether efforts should be made to prolong the life of the existing Scheme despite the Commission Decision, or to accept that Decision. There would undoubtedly be strong protests following abolition, however, particularly from the hard-pressed areas of Scotland and the NE of England where the offshore supplies industry is mainly located.

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EEC Commission Attitude

8. Following difficult discussions with the EEC Commission over the past three years (Annex D), they issued on 2 May a Decision to the effect that the Scheme is incompatible with the Treaty of Rome, and requiring the UK to stop offering grants under the Scheme for new contracts two months after the date of the Decision.
9. Legal advice is that if we contested the Commission Decision and the case then went to the European Court we would probably lose. An alternative course of action would be to seek some form of compromise. We have however already attempted this and have offered to regard European components as eligible provided they did not exceed 50% of the total contract. This has proved unacceptable to the Commission; and to attempt to go further would cost more, would be against the national interest, and would probably not be successful given the public line now taken by the Commission and the doubts about whether we could do so legally given the form of existing UK legislation. We have to conclude that any other form of compromise is unlikely to be successful.
10. We could perhaps attempt to negotiate for a longer period than 2 months during which we could consider Commission objections to the Scheme. Again however their acquiescence is unlikely given that they have already extended their original time limit from one month to two months presumably as a gesture to the new Government; and they would clearly be unhappy if there were to be further delay during which new cases were approved or commitments extended. On balance therefore it seems prudent to reach a final decision about the Scheme within the two months allowed to us. although, notwithstanding the poor prospects for success, it can be argued that making an attempt to persuade the Commission to extend the notice period (perhaps to six months) could help to avoid presentational difficulties at home of a straight acceptance of the Commission Decision.

Offshore Supplies Office
Department of Energy
7 May 1979

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OSIRG SCHEME EXPENDITURE FORECASTS

£M. (1978 Prices)

	<u>79/80</u>	<u>80/81</u>	<u>81/82</u>	<u>82/83</u>	<u>83/84</u>	<u>Totals</u>
1. FORECAST FOR SCHEME STOPPING wef 1.7.79	20.0	19.5	20.5	19.5	14.0	93.5
2. Further commitments 1.7.79 - 31.12.79	0.5	1.5	4.0	6.0	6.0	18.0
3. FORECAST FOR SCHEME STOPPING wef 31.12.79 (1 + 2)	20.5	21.0	24.5	25.5	20.0	111.5
4. ASSUMED 1979 PES BASE-LINE	19.4	23.9	22.2	22.5	22.6	110.6

NOTES

- Line 1: These figures relate to contracts already placed but also make allowances for contracts which may be placed by the 1.7.79 cut-off date stipulated by the Commission Decision which does not appear to seek to invalidate these commitments.
- Line 2: These figures relate to further contracts which may be placed in an extended period to 31.12.79, assuming a successful outcome to negotiations with the Commission on the notice period and/ or a delay in implementing the Decision pending a European Court action.
- Line 4.: Although the alternative scenarios (Lines 1 and 3) would appear to involve expenditure in particular years above the assumed 1979 Public Expenditure Survey (PES) base line, expenditure could probably be contained within the PES figures as necessary by administrative action. Making allowances for this, the following savings might be possible over the assumed PES base-line figures for a scheme stopping w e f 1/7/79, but it is difficult to foresee any savings in the period if the Scheme continues until 31/12/79.

	<u>79/80</u>	<u>80/81</u>	<u>81/82</u>	<u>82/83</u>	<u>83/84</u>	<u>Totals</u>
	-	3.8	1.7	3.0	8.6	17.1

REPRESENTATIVE SELECTION OF UK CONTRACTS
INFLUENCED BY THE SCHEME

		£M.
1	A substantial number of BSC contracts for steel material (various fields)	55
2	Concrete platform order for Ninian	206
3	A steel jacket for Murchison	42
4	Offshore project South North Sea gas field	59
5	A steel jacket for Tartan	23.4
6	Production facilities for Buchan	15.3
7	Module fabrications for Murchison	9.5
8	Gas Turbines for Murchison	3.7
9	Gas Turbines and Compressors, gas field	8.5
10	Well head jacket for Fulmar	3
11	Deck fabrications for Beatrice	4.6
12	Module fabrications for Tartan	3.4

USE MADE OF THE SCHEME

PROJECT	OPERATOR (MAJOR PARTNERS)	GRANT PAID TO DATE	ESTIMATE OF GRANT TO BE PAID
AUK	Shell (Esso)	£'000s 80	£'000s 43
Beryl	Mobil (Amerada Exploration/ Texas Eastern UK)	507	725
Brent	Shell (Esso)	6,662	6,192
Claymore	Occidental (Getty Oil International/ Allied Chemicals/Thomson North Sea)	1,084	880
Cormorant	Shell (Esso)	2,540	3,450
Dunlin	Shell (Esso)	843	1,750
Forties	BP	5,467	280
Frigg	Total (Aquitaine Oil/Elf Oil)	5,558	2,800
Heather	Union Oil (Getty Oil International/ Tenneco Great Britain)	648	2,860
Indefatigable	AMOCO (British Gas Corpn/ Amerada Exploration Ltd)	159	325
Leman	Shell (Esso/AMOCO/British Gas Corp.)	275	114
Montrose	AMOCO (British Gas Corpn/Amerada)	295	370
Winian	Chevron (BP/BNOC)	8,210	20,099
Piper	Occidental (Getty Oil International/ Allied Chemicals/Thomson North Sea)	258	306
Rough	AMOCO (British Gas Corpn/Amerada Exploration Ltd)	172	174
Whistle	BNOC	549	9,100
West Sole	(Deminex)	103	100
		33,410	49,568

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1. The estimates of grant to be paid are based on contracts already placed although in one or two cases it is

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possible that a few more contracts may be placed by 1 July 1979 cut-off date in the Commission Decision.

2. In addition, there are several fields (Tartan, Murchison, Beatrice, Fulmar, Buchan) for which some contracts have been placed but no grant claims have yet been received. It is not possible to estimate the potential grants on these fields individually, but our best guess is that they could increase grant commitments by up to a further £30m. These are, however, provided for in the figures for a scheme stopping w e f 1.7.79 in Annex A (Line 1).

THE EEC PROBLEM

Although the Commission raised no objection to the Scheme when it was introduced late in 1973, they have shown increasing concern since January 1976 arguing that, by restricting grants to UK supplies, the Scheme is distorting intra-Community trade to an unacceptable degree, contrary to Article 92(1) of the Treaty of Rome. The Commission further objected in October 1977 that the exclusion of EEC components and sub-contracts constitutes a measure having equivalent effect to a quantitative restriction on intra-Community trade, contrary to Article 30.

2. HMG have strongly defended the Scheme, maintaining that it has not caused any distortion and that its effect has been to counter subsidised competition from third countries (eg USA, Norway and Japan). Our defence of the Scheme became more difficult, however, following assurances received by the Commission in mid-1977 from all other Member States that they did not (or, in the case of France, would no longer) provide preferential export credits for UKCS trade.

3. After protracted discussions, HMG offered in August 1978 to make concessions:

- (a) after a suitable transitional period, grants would be offered only where a UK tender was in competition with third country tenders or, subject to prior Commission approval in every case, where there was also other EEC competition but a third country tender was preferred;
- (b) grants would be extended to EEC components and sub-contracts where they represented up to half the value of a UK contract; and
- (c) the operation of the modified Scheme would be reviewed with the Commission two years after its introduction.

4. This conciliatory offer has not found favour with the Commission. They have pressed for all EEC components to be embraced within the Scheme virtually without limit; they have also considered that there should be some link between the award of grants and industrial restructuring objectives. Legal advice has been that to concede the Commission's first point would be contrary to the "national interest" criteria of Section 8 of the Industry Act 1972. In practical terms also it would largely remove any incentive on the operators to buy British. Other objections are that public expenditure would be increased, and that there could be presentational difficulties in the UK. On industrial restructuring, HMG has pointed out that grants are only available to support successful UK companies (ie those securing contracts) and has argued that restructuring is best left to market forces which are already proving effective in this uncertain and high risk field.