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PRIME MINISTER

Energy Issues

The free world uses about 7,000 million tonnes of coal equivalent of energy a year. About 50 per cent of this is oil, about 20 per cent coal, about 20 per cent natural gas, about 7 per cent hydroelectric power and about 3 per cent nuclear. Most of the non-oil energy is consumed near the point of production. Oil is the balancing fuel. About 45 per cent of the free world's oil is produced in the Middle East and 90 per cent of this enters international trade.

2. With the exception of the United Kingdom, Norway and Canada, the industrialised Western countries are all heavily dependent on imported oil to maintain their economies. The USA imports 40 per cent of its supplies and takes nearly 20 per cent of the oil moving in international trade - mostly from the Middle East. The EEC countries import something over half of their combined energy requirements, again mostly oil and mostly from the Middle East. Japan imports 90 per cent of her energy - once again mostly as oil and mostly from the Middle East.

3. The United Kingdom has an especially favoured position among Western nations in terms of energy supply. By next year we should be producing as much energy as we consume - though because our oil is mostly valuable high-quality crude, and two-thirds of our requirements can be met adequately by cheaper low-quality crude, we will remain substantial international traders in energy.

4. The heavy dependence of the Western industrialised countries on Middle East has become a point of danger. The price-fixing activities of the OPEC cartel have imposed very heavy burdens on the Western economies and have threatened the stability of the world financial system. The vulnerability of the West to interruptions in oil supply has been underlined by recent events in Iran. But Iran provided only about 10 per cent of the world's oil consumption. Saudi Arabia produces nearly twice as much.

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5. Against this background energy issues loom large on any Government's agenda. Internationally we are joined, through our membership of the International Energy Agency, in a joint effort with the industrialised West to cut oil consumption. Nationally we are seeking to save energy and need to devote a substantial effort to the production of our own energy supplies.

6. As three (coal, gas and electricity) of our energy industries are in national ownership and the fourth (oil) has a considerable public stake (BNOC plus the Government's share in BP and the necessary Government involvement in the regulation, licensing, taxation and control of the North Sea) a good many energy issues inevitably come to the Government for decision. The Department of Energy is of course in the lead in these matters but other Departments, notably, but not exclusively, the Treasury, the Foreign and Commonwealth Office and the Scottish Office have a locus, and a high proportion of the necessary decisions require to be taken by Ministers collectively. The following paragraphs describe briefly the main issues which you and your colleagues may face on energy matters over the coming months.

Issues

7. Oil consumption: In order to achieve the target 5 per cent reduction in oil consumption to which we have committed ourselves in the IEA and to accommodate to a rather similar EEC decision, we have now embarked upon the policy of increasing the burning of coal in power stations through the summer months. But our ability to continue the effort next winter is in doubt, partly because the hard winter has run down our coal stocks and partly because of uncertainties about coal production - and transport capacity - next winter. You will want to satisfy yourself that continued increased coal burn can be accommodated at a reasonable cost and without reducing coal stocks to a dangerous level (and thus affecting the Government's bargaining position with the miners). Among other matters this raises the difficult question of coal imports. An early situation report is needed from the Department of Energy.

We must
try to keep
coal stocks at
a high level.
For 1979-80 that
is more important
than cutting
oil consumption
this.

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8. Coal: Linked with this is the dreadful financial position of the National Coal Board (NCB), with a prospective loss of around £300 million in 1979-80. To keep within the cash limits will probably require either cutting back heavily on investment or closing uneconomic pits, together with a substantial further increase in coal prices in the autumn (perhaps to levels which affect the NCB's ability to keep its market share). In simple economic terms the choice is clear, but pit closures will not be easy. Imported coal is substantially cheaper than that of our marginal pits and you will wish to consider what place imports should have in our economy. A particularly important case is fuel for the steel industry as further imports of coking coal have recently been the subject of licensing controls. These fundamental questions will arise naturally over the next few months when the Government come to consider the long-term coal policy review on which officials are now working.

9. Nuclear energy: We are at present committed to building two new advanced gas-cooled reactors (AGRs) and to proceeding with design and development work on a pressurised water reactor (PWR). The organisation of the nuclear construction industry is in disarray. There is a general wish to change the structure of the National Nuclear Corporation, ownership of which is currently vested partly in the public and partly in the private sectors and in which GEC have the management contract. GEC were strong protagonists for the PWR and since the decision was taken to go ahead with additional AGRs, they have indicated their wish to pull out of the business. The uncertain future of the industry has led to the loss of key staff and continuing low morale. You will need therefore to consider quite quickly what needs to be done to prevent the industry drifting further and to remove uncertainties about its future. Decisions are also needed fairly soon on our policy towards Fast Breeder Reactors (FBRs). In particular a decision is needed on whether we should go ahead with a first commercial FBR and, if so, whether it should be built on the basis of international collaboration. This is likely to be a difficult decision not least because of the great

→ We are committed
to an enquiry into
the work started
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uncertainties of what will necessarily be a very expensive project. There are those who would advocate not proceeding with an FBR at all, relying on thermal reactors (AGRs or PWRs) until such time in the 21st century when fusion may provide virtually unlimited low-cost energy. But either route involves a highly risky gamble. Department of Energy are in the lead and you will want early proposals from them over the whole nuclear field.

10. Interest relief grants: Interest relief grants under the Industry Act have been used for some years as a means of stimulating the United Kingdom offshore supplies industry. They are currently under attack from the EEC as a distortion of competition and there are growing doubts in Whitehall whether they still represent value for money. There is a strong possibility that the EEC Commission will initiate legal proceedings against us over these grants and a very early review of their effectiveness will be needed.

11. Taxation of North Sea Oil: Your Party is now committed to making the changes in Petroleum Revenue tax proposed by the previous Government. As world oil prices rise the possibility of extracting yet further Government revenue from the North Sea will present itself. This is a matter for the Chancellor of the Exchequer in the first instance, but you will want to keep the possibility in the back of your mind.

12. British Gas Corporation profits: The British Gas Corporation is highly profitable, partly because it enjoys some very favourable supply contracts from the earlier North Sea fields and partly because its prices to the industrial consumer are related to the price of oil and rise with it. As a result the Corporation is actively and massively repaying its debts to the Government. You will want to consider whether there is a case for clawing back some of this profit in a more direct way. This, too, is primarily a matter for the Chancellor but again you will want to bear the possibility in mind.

13. North Sea Oil and Gas Depletion policy: So far the exploitation of oil and gas from the North Sea has been on the basis of maximum exploitation for maximum short-term benefit to the economy. The time may however be approaching when we need to assess anew the balance between short-term gains and the possible longer-term advantages of spinning out our reserves. No

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immediate decisions are needed because the sixth licensing round has just been completed and there is a legacy of past promises to those holding earlier licences. Nevertheless future decisions on licensing and to an extent production from existing finds require to be based on a view of the most nationally advantageous profile of future production. The Department of Energy keep these matters under regular review and you might care to ask for a paper to come forward later in the year.

14. Electricity: Decisions in the nergy sector are characterised by long lead times, none more so in electricity generation where power stations have to be ordered 7-10 years ahead of forecast need. Past decisions mean that we have a good deal of apparently spare capacity in hand or on order. Current demand on the power plant industry is therefore low and it is desperately short of work. It is difficult to believe that the two turbine manufacturers - GEC and NEI(Parsons) - can both stay in the business and early rationalisation may be inevitable. There are substantial regional employment implications and you may wish to commission an early review from the Departments of Industry and Energy as a basis for later decisions.

15. The Role of the BNOC: BNOC is at present a producer and trader in oil, adviser to the Government on oil matters and an important instrument in carrying out the previous Government's participation policies. You will want an early review here so that the future course of the BNOC can be charted in ways acceptable to you. Linked with this is the future of the existing "participation" agreements with the private oil companies. Views about their real importance vary and there is some doubt about their legal validity. The Department of Energy should be asked for advice.

16. BP: The Government is the major shareholder in BP and its relations with that company are of prime importance. You will want to consider whether the Government prefers to reduce its shareholding (remembering that 17 per cent of the Company's shares are held by the Bank of England as a result of the Burmah rescue operation and their ownership is currently a matter of legal dispute).

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17. Disposal of North Sea Oil: The previous Government erected three non-statutory guidelines for the disposal of oil from the North Sea. These guidelines covered the proportion of North Sea oil which it was felt desirable to refine in the United Kingdom; the maximum length of contracts for the sale of North Sea oil; and the restriction of North Sea oil imports to member countries of the EEC and the IEA. The issues are complex and link with foreign policy, not only through the IEA and the EEC but also through the recurring questions of the possible supply of oil to Israel and South Africa.

You will want an opportunity to confirm, alter or abandon the guidelines.

18. Energy Conservation: The Iranian situation showed clearly how vulnerable was the world in general and the West in particular to even a marginal and temporary interruption in oil supplies and it jolted the IEA countries to make further immediate efforts towards energy savings. By international standards our present policies are reasonably good, but there is no doubt that more can be done. A number of proposals are in preparation by officials. As some involve extra Government spending you will want to take decisions in time for them to be reflected in the public expenditure review.

19. Energy Prices: Soundly-based energy prices are the key to energy conservation, to the financial health of the energy industries and to the Government's tax take or expenditures on energy supply. Oil prices are set externally by the world market and you presumably would not wish to seek to hold down our domestic oil prices artificially. The price of coal and natural gas follow oil prices (not always very closely) and there is no national economic advantage to be gained by seeking to interfere in this process. Electricity prices follow from the costs of the primary fuels used and the very heavy capital costs incurred in providing new generating capacity. Given the strength of the OPEC cartel it is likely that energy prices will in any case tend to rise in the long run faster than prices in general. More immediately a substantial increase in coal prices seems inevitable in the autumn which will have a consequential effect on electricity prices. In the normal course of business both of these decisions would come to Ministers for endorsement.

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There are however two underlying energy price issues which you may also care to have examined. The first relates to gas prices where those for domestic supplies, unlike industrial sales, are currently below the oil-related price. Should they be increased in the interests of conservation? Both the coal and electricity industries will argue that they currently suffer unfair competition in their domestic sales from gas. ^{They will claim more than 50% efficiency} The other issue relates to current cost accounting. The BGC's accounting practices already come close to full CCA depreciation. But the depreciation practices of both the NCB and the Electricity Supply authorities fall well short of this. The effects of full CCA depreciation could be particularly dramatic for electricity. You may think that Ministers should be presented with the arithmetic so that they can take a conscious decision on the issue.

Conclusions

20. The energy sector will present your Administration with a series of challenging and complex problems of great national significance. It would be well worth while asking the new Secretary of State for Energy, in consultation with interested colleagues, to let you have quickly a full list of the main issues that need to be tackled together with a considered timetable for bringing them forward for collective consideration.

I will visit
the department before
we rise for the
news
mt.

John

John Hunt

There must be great
potential for increased
efficiency and competition
in the electricity industry. Also
imposed research on the
efficiency concerns of Jeds
& Commission costs.
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