CONFIDENTIAL

Qc 02498

To: MR LANKESTER

From: G S DOWNEY

The Future of BNOC

1. The Prime Minister invited CPRS comments on the Secretary of State for Energy's minute on the future of BNOC. In his minute Mr Howell, with the support of the Chancellor, summarises the choice on BNOC's future as being between:

(i) Scheme C - a new independent upstream company with the shareholding split public sector 25-33 per cent, general public 25-33 per cent, and BP 50-34 per cent;

(ii) Scheme E - a revenue interest scheme under which the public are given an opportunity to share in a proportion of BNOC's oil revenue;

(iii) Scheme G - hiving off a part of BNOC's oil field assets into a company in which a 75 per cent interest is subsequently sold to private investors (with perhaps BP taking a share);

and

(iv) retention of the status quo.

2. Scheme C would involve splitting the trading from the upstream operations; Scheme E would retain BNOC's current integrated structure; whilst Scheme G falls in between - part of the upstream operation is split off, leaving a smaller integrated operation than at present.

3. The decision on BNOC's future needs to be taken in the context of three separate strands of Government strategy (i) energy policy, (ii) the requirements of the PSBR, and (iii) a reduction in the size of the public sector.

Energy Policy

4. On energy policy grounds there are strong arguments for retaining the full integrated structure for BNOC. The two principal factors involved are security of supply and flexibility. At present just under a half of the

United Kingdom's crude requirement is represented by 'secure' supplies from the UK Continental Shelf. Schemes C and G would involve relinquishing control of up to 4 million tonnes of this secure oil per annum (around 5 per cent of UK demand) when the public and political expectation is that the United Kingdom should not go short in a sub-crisis. There is also the added risk involved in these Schemes involving separation of the two halves of BNOC, that the Parliamentary discussion might direct attention to the aspects of North Sea arrangements that are vulnerable in terms of Community law.

5. A key element of energy policy in an uncertain environment is flexibility. The full privatisation of the exploration arm of BNOC (Scheme C) would mean the Government giving up an organisation totally committed to finding oil in UK waters. The interests of the Government and UK based private oil companies do not necessarily coincide and it may not always be the case that UK waters will be so attractive for exploration. Moreover, the oil market has been characterised in the recent past by a partial eclipse of the majors and a rapid rise in the proportion of oil traded directly through state-to-state deals. It would seem prudent for the United Kingdom to retain an efficient and effective national oil company to have access to such deals in future. The existence of both trading and exploration arms could only enhance BNOC's international attractiveness as a potential trading partner or customer.

6. From Mr Howell's minute, it is clear that the Chancellor has reservations on the wisdom of splitting BNOC. Besides pointing to the potential problems associated with presenting to the public the relinquishment of secure supplies, the Chancellor considers that it is only as long as BNOC retains an integrated capability that HMG can be sure of using BNOC as an effective lever in negotiations on North Sea Oil policy (including taxation).

<u>Requirements of the PSBR</u>

7. Schemes C and G offer a short-term PSBR reduction, and Scheme E a contribution to its financing. But all would be at the expense of foregoing the longer term cash flow benefits. The sales proceeds will depend critically on the market's assessment of future oil prices. Given the real risk of oil prices out-performing expectations, as Mr Howell's minute points out, it could prove an expensive way of raising money for the Government compared to a

conventional fixed interest gilts issue. Even this picture could be worsened if, as is quite possible, the Opposition threaten renationalisation at something around the issue price.

<u>Reduction in the size of the Public Sector</u>

8. The abolition, last year, of BNOC's statutory role as adviser to the Government and its special privileges vis-a-vis other oil companies has substantially met the main concern about its position expressed by the industry; and has put it essentially on the same basis as private sector companies as far as exploration and development are concerned. BNOC is operating profitably and very successfully in competition with the private oil industry and there are no grounds for believing that the introduction of private capital into BNOC is necessary to provide incentives for greater efficiency; those incentives already exist. The fact that BNOC is within the public sector has in the past been to the benefit of the UK economy in enabling British manufacturers to obtain orders for North Sea development which they would not otherwise have received and in the negotiation of forward oil sales (which are dependent on BNOC having equity oil available). Thus the arguments for (partial) removal of BNOC from the public sector seem to derive more from earlier public statements than identifiable economic benefits.

<u>Conclusion</u>

9. The CPRS view on the very important problem of the future organisation of BNOC is that security of supply and the fact that the international oil scene is changing so fast and unpredictably both point to retaining a unified company. In purely PSBR terms, as Mr Howell's minute makes clear, introducing private capital by any of the Schemes could prove an expensive way of raising money for the Government compared with conventional funding. And since no specific improvements in efficiency resulting from the introduction of private capital have been identified, the CPRS, while recognising the Government's political commitment, takes the view that the balance of the economic argument lies heavily with the retention of the status quo. To justify departing from the line taken in earlier statements, the Government could point to the following changes since it came into office: (i) BNOC's

privileged position has been abolished, thereby making it generally acceptable to the oil industry; (ii) the international oil market has grown markedly more threatening and uncertain in the wake of the Iranian crisis; and (iii) the international oil companies' control over the world market has been eroded by the rapid rise in government-to-government deals.

10. Retention of the status quo would not, of course, aid the short-term problem of the PSBR. The CPRS wonders, however, whether there is scope for encouraging BNOC to pursue further its forward oil sales (as far as market conditions allow) as a possible short-term easement of this problem.

11. Against this background, should it be judged impossible on political grounds to retain the status quo, then the CPRS would recommend that the Government does not proceed further than Scheme E (sale of revenue interest bonds to the public). This would retain the integrated structure of BNOC, which is desirable on energy policy grounds, whilst avoiding the time-consuming renegotiation of BNOC's intricate network of shared licences involved in Schemes C and G.

12. As regards the timing of a possible announcement, unless Mr Howell is under pressure from quarters of which we are unaware, the CPRS sees no advantage in an early statement; the present uncertainties in the international oil market would argue for a cautious approach.

13. I am sending a copy of this minute to Sir Robert Armstrong.

GST

11 July 1980