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Qa 05647

To: MR LANKESTER

From: J R IBBS

Prime Minister
The Chancellor and
Mr Howe will attend
this meeting accompanied
by officials.

31 July 1981

Gas Gathering Pipeline

1. In your minute of 20 July the CPRS was asked to clarify the factors causing the apparent current impasse on the gas gathering pipeline. In the short time available the CPRS has discussed the issues involved with the Secretary of State for Energy and his officials, Treasury officials, Sir Denis Rooke as Chairman of the Organising Group and representatives of BGC, BP and Mobil as members of the Organising Group. We have also had brief discussions with officials in the Scottish Office and Department of Industry.

2. The number of issues involved in a project of the magnitude and complexity of the Gas Gathering Pipeline (GGP) are such that exhaustive coverage would run to many tens of pages. In what follows we have tried to restrict the analysis to the minimum necessary to answer two simple questions -

- (i) why is there an impasse?
- (ii) what options are available to break the log-jam and what are their respective advantages and disadvantages?

The situation is extremely complex and in this short note consideration has been concentrated on the central issues.

3. To understand why there is an impasse it is necessary first to explain a little of the background.

Background

4. The concept agreed at E Committee last summer was that an Organising Group should develop proposals for constructing an integrated gas gathering line as a private utility transmission company. The project would be in the private sector, BGC would have 30 per cent of the equity but this would have only a small effect on the PSBR because equity was not seen as a major source of finance.

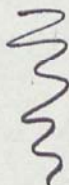
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5. The Organising Group (BP, Mobil and BGC under the Chairmanship of Sir Denis Rooke) was given confidential guidelines embodying features of E Committee's decisions. Key points in the guidelines are:

(i) that the pipeline should be built by a company not a joint venture (a main point here was to prevent North Sea producers setting off investment in the pipeline against tax liabilities arising from field incomes);

(ii) that the tariff charged for use of the pipeline should be calculated on a cost of service basis (so that the natural monopoly position of the pipeline would not be abused to yield excessive profits and deter new field developments);

 (iii) that investment in the pipeline should not carry with it rights to use the pipeline (to prevent investors either pre-empting spare pipeline capacity or sub-leasing at exorbitant rates when other producers might wish to make use of it).

6. The Organising Group has pushed ahead with the technical work on the project, and this has gone well; detailed design is nearly complete, the project is on schedule for completion in 1985 and to keep to that deadline major contracts involving commitments of hundreds of millions of pounds must be placed this year starting in September. However, the Organising Group will not undertake these commitments without financial backing and, in spite of extensive discussions, its efforts to develop proposals on financing have come to nothing. (A recent attempt by the Bank of Scotland to raise £700m. of interim finance failed because a guarantee of completion was needed which the potential participants in the scheme were not willing to provide.) To understand why the oil companies, who provide the key to the financing, are unwilling to participate on current terms, it is necessary to appreciate the economics of the gas gathering line.

Economics

7. In national terms there is an overwhelming case for development of the gas in the northern basin of the North Sea; the discounted value of the reserves (possibly a conservative one at that) is some £25 billion

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against pipeline costs of £1½ billion (1981 money). This calculation is, of course, in terms of total costs and benefits not in terms of profit and loss as a private company would see it; because of the distorting effects of high taxation in the North Sea the outstanding return in national terms does not necessarily imply that private capital will be available to finance a project.

Integrated Pipeline compared with Multiple Developments

8. However, the key question is not so much whether the gas will be developed but what is the most economic way of doing so. The alternative to the integrated gas gathering line is to allow multiple developments of the gas fields through the two existing gas pipelines (FLAGS and Frigg) with as many new separate pipelines as may be necessary. In other words follow the same development procedure for gas as has happened on oil. The integrated Gas Gathering Pipeline costs more than its multiple alternative (for both onshore and offshore construction £1.5 billion against a broad brush estimate of £1.2 billion for the best multiple scheme that Department of Energy officials have devised). Nonetheless it has numerous advantages which led to its endorsement at E Committee, amongst these are:

Whether the gas will be developed

- (i) it shows a higher economic return in national terms than the multiple scheme and is robust to variations in the main assumptions (nevertheless the multiple scheme still offers a very good return);
- (ii) it has been carefully sited and sized with an eye to future exploration and development and should be able to service whatever the reserves may ultimately turn out to be;
- (iii) it will provide competition for the existing gas pipelines (FLAGS and Frigg) thus reducing the amount of money from gas development going to the existing pipeline owners who could otherwise exploit their monopoly positions;
- (iv) it guarantees early collection of all gas liquids and their bulking for potential petrochemical use;
- (v) it offers a better opportunity of attracting gas from the Norwegian sector;

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(vi) it offers UK companies the best chance of receiving the bulk of the development contracts.

Disadvantages of Integrated Pipeline

9. However, it also has some disadvantages against the multiple alternative:

(i) it is a major project and therefore arguably more liable to cost over-runs than individual developments;

(ii) more important, it entails a greater risk than multiple developments because it effectively involves committing capital ahead of time and investing for the future. The whole length of the integrated line must be built to take advantage of the 'associated' gas shortly available from oil fields. However, the economics of the line depend only to a minor extent on associated gas, the principal return will come from development of unassociated gas fields along the route of the line. In the alternative of having multiple pipelines these are built only when gas fields are to be developed; in the integrated approach the pipeline is built first in anticipation of individual field developments.

Why the Impasse?

10. It is the above two disadvantages that have been at the heart of the oil companies reluctance to participate. It is a risky project and the cost of service approach means that if the risk pays off the benefits accrue not to the shareholders but to users of the pipeline in the form of lower tariffs. Oil companies do not traditionally invest in projects with utility returns and the present guidelines give them no incentive to participate. It is a perfectly rational policy for any potential user of the pipeline to stand back and let another party use up financial resources and stand the risk.

11. The particular risk that the oil companies are most concerned about is that not enough gas will be forthcoming in the early years of the pipeline to provide a satisfactory return (the early years are the most important in calculating financial returns). Moreover, this could

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initiate a vicious circle; if the gas were not forthcoming, the cost of service approach would mean higher tariffs which in turn would inhibit gas development. The oil companies point to the fact that the rate of production of gas is not subject to pure market forces and involves risks that they cannot reasonably assess. First of all the Secretary of State for Energy can determine the rate of development through his powers of approval for individual fields (the Department of Energy say this problem can be overcome and they can provide a guarantee to the oil companies that they will not intervene in gas production through exercising depletion controls); more important, BGC through its current monopsony powers sets gas prices and through these determines the rate of development, thereby operating an implicit depletion policy. (At present BGC are blocking exploitation of relatively low cost gas in the Southern Basin by not bidding.) It is the price of gas that is the major stumbling block to progress on the project; it not only determines an oil company's direct return on the gas it develops but the price offered to other producers will determine the volume put through the pipeline and therefore the financial return.

The Way Ahead

12. It is common ground that the project cannot move ahead in its current form and on the current terms. In essence there are four options:

- (i) abandoning the GGP and adopting the multiple approach;
- (ii) constructing an integrated line at a later date;
- (iii) going far enough towards meeting the oil companies' demands for participation to convince a sufficient number of interested parties before the end of September that the project is viable enough for them to undertake the immediate commitments;
- (iv) going ahead with the integrated pipeline, at least initially, in the public sector.

The Multiple Approach

13. The advantages of the integrated line over the multiple approach were described previously (paragraph 8). In short the integrated pipe-

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line seems to serve the national interest better but the multiple scheme involves a later commitment of capital and therefore offers more flexibility to meet changing circumstances.

Constructing an Integrated Line at a later date

14. It is arguable that delay in constructing the integrated pipeline would lead in practice to the multiple approach. This is the third time that the prospects for an integrated gas gathering pipeline have been evaluated and failure again to launch a scheme would only serve to increase scepticism that the project would ever succeed because of its inherent complexities and the different interests involved; at the very least it would be more difficult next time around to persuade companies to dedicate people and resources to an examination.

15. In addition, delay carries with it further disadvantages:

- the likelihood is that gas would be lost to the prospective line, UK Statfjord, North Alwyn and possibly Beryl;
- the prospects for petrochemical use of NGLs brought ashore by the line would recede;
- UK companies hoping for major orders would be disappointed;
- once the prospect of an integrated line receded the Norwegian pipeline would become an attractive outlet for UK gas producers.

Meeting some of the Oil Companies' Demands

16. There seems little doubt that part of the oil companies' present reluctance to participate in the financing is a negotiating ploy; they know that their support is needed and that the Government is keen to see the line go ahead quickly, while they themselves can in many cases afford to delay, negotiating for the best possible deal on gas price, taxation and a system adopted to suit best their own individual interests. Their shopping list is long, including

- gas pricing as the primary concern
- the tariffs to be charged on the pipeline
- the financial return on the pipeline

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- access to capacity in the pipeline
- tax offsets
- depletion policy
- scope of the project.

17. It has emerged from our enquiries that an improved gas price would not itself ensure that oil companies would participate in the pipeline; they would need some direct incentive to invest in a line that offers only a utility type return. One possibility would be to offer investors in the pipeline first refusal on capacity. What other concessions might be necessary could only be found through detailed negotiation.

18. However, the critical factor without which there can be no progress is price. Behind the wide gap in what BGC is currently willing to offer for gas (around 16p/therm) and what the oil companies are currently demanding (26-29p/therm) lies a qualitative difference in pricing mechanisms. The oil companies want a posted price for gas in the same way as there is a common price for North Sea oil thus allowing a wide variety of returns; BGC currently price gas on a cost plus basis in effect giving the companies a fixed return and capturing as much as possible of the available economic rent (gas production costs for fields supplying the pipeline can vary from 2p/therm for associated gas to 30p/therm for a small dry gas field). Although BGC are currently urgently reviewing their pricing policy, our interview with Sir Denis Rooke did not give any grounds for optimism that a compromise satisfactory to the oil companies would be possible without Government intervention. It is possible that a compromise might be achievable on the basis of a different posted price for each of the different categories of

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gas - associated, dry, condensate - with a distinction between that already discovered and that to be explored for.

19. In addition, and as an aid to successful completion of these negotiations, two possibilities exist for making the integrated scheme more attractive to the oil companies:

(i) initially utilising existing onshore facilities at Mossmorran thus reducing the overall cost of the scheme;

(ii) there may be advantage in splitting the project into two, onshore and offshore, to encourage the chemical companies, who would benefit from the onshore facilities, to participate thereby increasing the number of economically interested parties that might invest.

20. However, the key constraint to this approach is time. Could negotiations be completed in time for letting contracts in September? A possible mechanism for the negotiations would be for discussion to take place with a small representative group of the producers; if, after negotiation, they believed the basis for a viable project had been established, it would be up to them in turn to convince the other producers. Needless to say the negotiations would require a very skilled Government intermediary capable of puncturing negotiating stances.

21. The recent signing of a contract between BGC and Mobil for Beryl Gas at 16p/therm has been put forward as likely to encourage other companies to complete negotiations. However, this is rather a special case involving associated gas and it is whether prices will be sufficient for the higher cost unassociated gas field development that is the primary concern of the oil companies.

Going Ahead in the Public Sector

22. The Department of Energy argue that such negotiations would make no progress and that a necessary pre-requisite to bringing negotiations with the oil companies to a successful conclusion is to announce in advance that the project is definitely going ahead in the public sector. The basis for this view is that, they believe, the companies do not think that the Government will put a project of this magnitude in the public sector. Therefore as time goes on the oil companies believe that the Government will become increasingly desperate to involve the private sector and that their negotiating hand grows stronger. Alternatively, if the project is abandoned the multiple scheme offers the companies advantages in terms of greater tax offset. In the view of the Department of Energy a prior announcement that the project would proceed in the public sector would break the current deadlock because the companies would not wish to see BGC in sole control of the pipeline. Thereafter there would of course be further negotiations in settling the terms on which private companies came in, with gas prices as one of the factors.

23. The key question is whether Ministers would be willing to see the whole of the capital cost of the Gas Gathering Line fall on the PSBR initially, even though it would come off the PSBR again when the pipeline was subsequently privatised. In comparison, the capital cost of the multiple alternative would be tax deductible and hence it would also increase the PSBR; but its timing would be later than that of

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the GGP and the total effect smaller. The table below illustrates the level of expenditure involved in the GGP and the multiple alternative.

| | <u>1981</u> | <u>1982</u> | <u>1983</u> | <u>1984</u> | <u>1985</u> | <u>1986</u> |
|-----------------------------|-------------|-------------|-------------|-------------|-------------|-------------|
| <u>GGP</u> | | | | | | |
| Pipeline | 60 | 230 | 470 | 450 | 180 | NIL |
| <u>Multiple Alternative</u> | | | | | | |
| Pipeline | | | | 300 | 350 | NIL |

- Note 1: the above table excludes the associated Field Expenditure which is tax deductible and would vary between the schemes.
- Note 2: the timing of pipeline expenditure on the multiple alternative is particularly uncertain and the figures shown for 1984 and 1985 could be brought forward into 1982 and 1983.
- Note 3: the multiple alternative assumes some gas fields are deferred, which would reduce the level of gas supplies. Whether other fields would be brought forward to maintain the same energy production profile is a separate depletion issue, which could involve extra PSBR costs.

Thus during the initial period, which will in any case be one of heavy pressure on the PSBR, the GGP would make greater claims on Exchequer finance unless it were successfully privatised at a very early stage in which case it would constitute only a very small temporary burden.

24. The Department of Energy view that the oil companies would not like to see BGC in control of the GGP is certainly true. However, the CPRS is not convinced that public financing of the line will in itself other investors necessarily cause to come in, if there are doubts about the basic economics of the line.

Removal of BGC's Monopsony

25. Overhanging all these issues is the question of the possible removal of BGC's monopsony. If BGC's monopsony was removed, it would in theory give the companies the necessary reassurance on price that they need. However, it is not as simple as this. The removal of BGC's monopsony powers would not in itself be enough to encourage the oil companies to participate. If BGC's monopsony were removed and exports not permitted, there is a good chance that the ensuing rapid

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development of the cheaper cost Southern Basin gas would serve to depress prices in the UK. This would discourage development of the higher cost Northern Basin fields feeding into GGP on which its economics depend. To ensure the economics of the GGP the oil companies would therefore require reassurance that depletion controls would limit production from the Southern Basin, if BGC's monopsony were removed.

26. We understand the Secretary of State for Energy intends publishing a White Paper on the possible removal of BGC's monopsony. It is difficult to foresee what the effect of this uncertainty would be on the GGP. On the one hand it is arguable that oil companies would be reluctant to agree any prices with BGC until they knew definitively about the monopsony and depletion policy; on the other hand BGC might not be interested in negotiating prices whilst the White Paper was under discussion since it would be unclear where prices would eventually settle. Sir Denis Rooke was adamant when we saw him that if BGC's monopsony were to be relaxed BGC would not accept the total financing risks of the pipeline. (This is in effect the same argument as the oil companies are using. BGC will accept all the risks if they have control over prices; the oil companies will not accept any of the risks unless they have some reassurance on prices).

27. Logically both depletion policy and the question of BGC's monopsony should precede decisions on the GGP. Depletion Policy, the prime decision, determines the rate at which UK gas resources are developed; the question of BGC's monopsony relates to the most economically efficient way of bringing the gas to the market; the GGP concerns the physical way in which gas is transported to the market and is therefore a secondary decision. If the GGP is to be held to the present timetable of operation in 1985, Ministers have to take a decision on it before the questions of monopsony and depletion policy are settled.

CONCLUSIONS

28. It seems to the CPRS that an integrated pipeline would best serve the national interest - it would ensure maximum recovery of gas, it provides the best basis for underpinning the UK chemical industry with low cost feedstock and, it would maximise the construction orders

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let to UK industry. However, if the GGP is not built, most of the gas in the Northern Basin will not be lost, it will be developed less efficiently through multiple pipeline developments.

29. It is clear that with the present guidelines and BGC's posture on price there is currently no scope for the project to progress as a private sector venture on a normal commercial footing. Moreover it is also clear that substantive negotiations involving movement by all parties that might enable it to go ahead are not taking place. Some initiative is necessary.

30. One possible way forward, the one favoured by the Department of Energy, would be to decide that because the GGP is in the national interest, the project should be launched initially in the public sector, with an intention of bringing in private sector participants later. However quite a lot of easement, especially on price, would be necessary to begin to make the project attractive to such participants; this would take time. We are not convinced that if the pipeline was going ahead in any event, participants would want subsequently to come in unless the return was very attractive.

31. If Ministers are not willing to take the risk that the GGP might remain on the PSBR for a considerable time then the CPRS would suggest that an alternative route is the converse approach. This would consist of telling the potential participants that, in the national interest, the Government was prepared to make one last effort to launch the pipeline as a private sector venture, but that, if this failed then the GGP would be abandoned for the foreseeable future. It would be made plain that the Government was willing to make concessions on the guidelines and, through BGC, on gas price in an effort to bring about the project; this easement would provide a positive incentive for movement from present negotiating positions. If nothing came of it, the potential concessions including those on price would be withdrawn. It would be made clear to the companies that failure to respond to this initiative would be frowned on. The Government would arrange for an independent "honest broker" (possibly a consultant with oil knowledge) to see, within a fixed period, whether a reasonable compromise would be struck between the potential private sector participants and BGC.

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It is not clear how much movement on gas prices and the guidelines would be needed to secure sufficient participation by the oil companies. The concessions required could be considerable.

32. I am sending a copy of this minute to the Chancellor of the Exchequer, the Secretary of State for Energy and to Sir Robert Armstrong.

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