MR. COLES

SIR ALISTAIR FRAME AND ALLEN SYKES - THE CASE FOR EXPORTING GAS

1. The enclosed paper by Frame and Sykes has been sent to Nigel Lawson. I am sending a copy to you because I think it has important European aspects to it.

2. The present gas regime prohibits exports of gas, even though this would be in both the oil companies and the national interest. This has prevented Britain supplying gas to Europe. And the Europeans in turn have turned to the Soviet Union for supplies.

3. When Mitterand visited No. 10 in September, I saw his Chief Economic Adviser, Monsieur Attoli. It was difficult to talk very frankly at the time since the issue of the North Sea Gas Gathering Pipeline had not been settled. But M. Attoli said that France would be enormously interested in any change in our gas regime. He implied there would be a ready market, not merely in France, but also in Germany. I believe I sent a memo to Mr. Alexander at the time.

4. In my view, it is clearly best to have a completely free regime and allow the oil companies to export gas if they find it to be profitable. I suspect that the free regime would produce very much more gas and very substantial export earnings. It would also be useful to show that Britain was being a good European, and would serve to offset <u>some</u> of the dangers from excess reliance on Russian gas.

AW

10 December 1981

ALAN WALTERS

Mr. Walters

Apologies for delay. I have read this with interest. At first sight I am very sympathetic to the case. I agree with you that the European angle is important. May I send a copy to the F&C.O.? (Who are Frame and Sykes?).

A.J. Coles 22/12.

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MAXIMISING BRITAIN'S BENEFITS FROM OFFSHORE GAS

The case for giving offshore gas the same competitive regime that has been so successful for oil, including the right to export.

By Sir Alistair Frame and Allen Sykes

30 November 1981

CONTENTS

1. <u>The Welcome Government Determination to Introduce Competition</u>

Since mid September, with the cancellation of the government sponsored gas gathering scheme and the 4th November Queen's Speech promise of new legislation to abolish the British Gas Corporation's monopoly buying rights plus allowing oil companies access to the UK industrial gas market via the BGC's pipeline system, the economic environment for offshore gas has certainly improved. All these steps face BGC and political opposition, but the government has accepted the case for introducing competition in the supply and marketing of gas.

The question arises whether these new policies of introducing competition go far enough to achieve the intended results of a much healthier and expanding offshore gas industry. To informed opinion within the oil industry, and outside it, the answer to this question is no. Unless the government takes the vital further step of <u>permitting gas exports,</u> hitherto banned regardless of the higher available prices, then there is little likelihood of a major increase in offshore gas activity which is so much in the nation's interest. In the more bracing competitive economic climate of the last few months, the one major argument left against allowing exports is the fear that Britain's offshore gas reserves are sufficient only for British needs. This concern is not generally shared by the oil industry for the good and sufficient reason that there would be no shortage of proven gas reserves once gas can be exploited as freely as oil. The BGC buying monopoly and the ban on exports combined have given the oil industry no incentive to look for gas in British waters since the late 1960s. To judge the availability of gas reserves after a dozen or more years of having no incentive either to look for or to exploit gas inevitably means taking a misleadingly conservative view of what could be there. If the oil industry could be given the right incentive there should be more than enough gas for Britain's own needs into the foreseeable future as well as providing for major exports to the Continent. Further, and most importantly, the freedom to export gas, particularly if allied to wise and energetic co-operation with Norway, could result in a major increase in offshore gas activity far in excess of that which will be provided by the government's recently introduced policy changes necessary and welcome though they have been.

In connection with the effect of allowing exports on exploration activity and reserves it should be borne in mind that until Australia allowed exports of iron ore in the early 1960s, and Alberta allowed gas exports to Eastern Canada at a similar time both products were locally held to be in scarce supply. They are now huge prosperous industries. The same looks likely to happen to Australian LNG since exports were permitted a few years ago.

2. Background Factors

a) No Incentive for Gas Exploration

Oil companies actively explore for oil but not for gas in UK waters, a situation that has persisted since the late 1960s. The reasons are that oil effectively sells at the world price and some exports, while controlled, are permitted. Gas, in contrast, must be landed in Britain and can effectively be sold only to the BGC. Gas exports are effectively prohibited. Many long term gas contracts were signed between the oil companies and the BGC in the late 1960s to take the output from the Southern Basin gas fields off East Anglia. These were in essence on fixed price terms with minimal escalation clauses such that their prices are now typically only between 15% and 25% of the going free market European gas purchase price. The oil companies have been so discouraged by these early contracts that virtually no further new gas contracts from British waters have been signed with the BGC in the last dozen or so years. The exceptions are such cases as the Brent gas where the gas concerned is a by-product ('associated gas') of oil production. The oil production is usually so valuable that it pays to develop the oil even if the profit on the gas is very low or even negative. But no gas fields - i.e. fields whose revenues derive solely or mainly from gas - have been developed in the British North Sea this past decade. (The Frigg gas field which straddles the boundary line - roughly one third in UK waters - is the partial exception.)

b) No Justification for treating Gas differently from Oil

There is no good reason for making a distinction between the treatment of oil and gas on economic grounds. Oil (hydro-carbons in liquid form) have always been sold at the world free market price and oil exploration and production has flourished, at least until recently when the government has imposed too high a tax burden. By contrast, gas (hydro-carbons in vapour form) has hitherto had only one market outlet, the nationalised BGC, which can and does set its own restrictive price terms. For the past decade the oil industry have not explored for or developed gas fields in British waters and has been reluctant to enter new contracts even for any associated gas, the automatic by-product of most oil production. Yet this distinction of treatment between the two forms of hydro-carbons is a physical not an economic distinction. The oil policy has succeeded in developing our oil: the gas policy has largely failed to develop our gas reserves to their full potential, and in particular gas in gas or gas condensate fields.

3. The Correct Context for Judging Policy Changes

a) The Need for a Wide Perspective

For most of the last decade the gas prices charged to British consumers have been low in comparison with alternative energy sources. The price paid to the oil industry for supplying gas from British waters has been particularly low because of the effective monopoly bargaining position of the BGC. The oil industry have made it clear that they cannot develop new sources of gas at anything like the existing gas supply contract prices but must have realistic and preferably energy-related prices, the basis on which Western Europe mainly buys gas. The government hope that by allowing the oil industry to use the BGC's distribution network that competition between oil companies and the BGC will result in much more gas exploration and development and a better deal for industrial consumers. This is possible, but could take a long time to come to pass. Further, it seems unlikely that simultaneously gas prices to industry can be lowered and the gas prices to the offshore oil industry substantially raised. The likely truth, which should be squarely faced, is that much further British gas over and above existing supplies has a higher value sold to Western Europe than to British industry. This being so the sense or otherwise of changed economic policies cannot be judged solely or mainly in the context of what is best for existing UK industrial customers. Within so narrow a context it is unlikely that the nation's best interests will be apparent.

In addition to the oil industry, the BGC, and industrial consumers, the interests of the rest of UK industry, the balance of payments, and the Treasury tax and royalty take should all be considered. It would be sensible also to consider the interests of both Norway and our EEC partners. In the context of this widened constituency there is no doubt that the best interests of Britain would be served by allowing gas exports.

b) Validly Judging Britain's Gas Reserves

Since the late 1960s there has been a marked reluctance in the oil industry to look for gas in British waters. Such gas that has been found has arisen mainly from the search for oil. Even when found it has not paid the industry to go in for extensive proving, still less for development because there was little likelihood of a profitable sale to the BGC. To judge the total possible UK gas reserves after a dozen or so years of these conditions is to say the least difficult and indeed unreasonable. It will be possible to judge the likely UK gas reserves realistically only when economic conditions have for some years freely encouraged the same unrestrained search for gas as has always existed for oil.[1.] If the government want gas to be the same success as oil has been then the course of action is clear: they must give exactly the same economic conditions which means free exports. Can anyone suppose that we would have had a flourishing offshore oil industry if for the last 15 years a BNOC had been allowed to buy all British produced oil without competition or exports, and entirely on its own price terms? The answer is obvious.

1. Consider the experience of Alberta gas and Australian iron ore mentioned in Section 1.

4. The Case for Unified Development of North Sea Gas Reserves

a) The Wasteful Restrictions of the Boundary Lines

An examination of known gas reserves in the North Sea, and particularly in British and Norwegian waters, reveals that the majority of gas and gas condensate fields, plus oil fields with significant quantities of associated gas, cluster round the boundary line between the British and Norwegian sectors. Every serious observer of the North Sea scene over the last ten years has lamented the effect of this artificial dividing line and the accompanying policies of both governments. These have caused, and continue to cause separate and thus non-optimal development. There can be little doubt that if the two nations could co-operate they would both gain substantial advantages, but this can only happen if <u>both</u> countries have a free economic regime (Norway needs one too) and are determined to act in a way that maximises their joint gains. This means that the North Sea should be developed in a much more unified fashion than existing short sighted policies have allowed. The cheapest way to transport gas for long distances is to use landlines wherever possible as these costs are typically considerably lower than for offshore lines. If the oil industry had a free hand in British and Norwegian waters then it is very likely that there would be joint schemes for bringing British and Norwegian gas to Western Europe, certainly by offshore lines but possibly by at least some landlines.

The recent cancellation of the government supported gas gathering line is currently resulting in the oil companies taking several separate initiatives to bring gas (mainly associated gas) ashore to Britain. If the export ban is lifted then similar initiatives would be very likely to happen with <u>international</u> gas pipeline systems involving not just associated gas, but mainly gas in gas and gas condensate fields. It is wasteful for the Norwegians to have to take their gas and gas liquids by their own offshore pipeline system across the deep Norwegian Trench merely to land liquids in Western Norway to promote industrial development, and then to take the dry gas back again across the same Trench on the route south to Germany and Holland.[1] It is equally wasteful that any Norwegian pipeline should be denied any British gas which can more easily and economically flow into it. Similarly, it is undesirable that Norwegian gas which could more sensibly flow to Britain should be compelled to use the Norwegian system. Patently present restrictions are unnecessarily disadvantageous to both nations. It should also be noted that an international pipeline network would both provide flexibility and permit advantageous 'swap' agreements, thus minimising gas transport costs.

b) The Reasonable Requirements of Norway for Unified Development

Before considering the very considerable advantages to Britain from unified development it is necessary to consider the needs of Norway which must be met as a precondition to such development. Until the Norwegians develop further separate gas pipelines to the Continent (there is only one such at the moment - Ekofisk) they have been compelled either to sell their gas to the BGC or to await other export opportunities. The Norwegian government is, of course, well aware of the economies to be had from marketing its gas in Western Europe via British offshore and land pipelines, but they have been understandably

1. Wherever the gas landed the liquids could be economically sent back to Norway as happens with Ekofisk.

reluctant to agree to such lines because of the control this would give to the BGC (the only possible owner of at least the land part of such lines under present British law) over any future Norwegian gas supplies which should be huge. If Norway's understandable and indeed reasonable reluctance is to be overcome there must be a radically new and more open approach to them. It will be obvious that the only way to get their involvement in a pipeline system in British territory is if they own a substantial part of its, perhaps half, and if it in no way restricts market opportunities for their gas. In these conditions they should welcome lines in British territory <u>because they would greatly enhance their marketing possibilities</u>. Not only would they be given cheaper access to the massive Continental market but, thanks to the government's recent policy changes, they should also have additional possibilities of selling their gas to British industry as well as to the BGC. Thus, with the appropriate safeguards, it should be possible to meet every reasonable Norwegian objection and simultaneously give them greater opportunities for marketing their gas on profitable terms.

c) <u>The Gains to Britain</u>

The gains to Britain from unified development would be equally impressive. But freeing British gas for direct export to the Continent (which would require waiving the requirement of first landing it in Britain) even without further Norwegian co-operation would bring very substantial gains. The first gain is that the oil industry would now have the appropriate incentive to look for gas because the marketing restraints of the last dozen years would be entirely removed. Second, this in its turn would cause a major offshore gas exploration effort. Existing gas indications would be investigated and proved up, and new gas reserves would be actively sought. This would happen throughout British waters and certainly in all promising areas of the British North Sea. It would cause an early and major expansion in offshore activity and thus in the industries supplying goods and services to them. Third, as and when new gas reserves were ready for development a few years hence, there would be major opportunities for platform building (few British yards have significant orders at present), offshore pipelines and, of course, land pipelines, nearly all of which could be done by British firms and presumably supplied by British Steel.

The outcome of all this activity would be greatly enhanced reserves of gas and their optimal development in partnership with Norway with whom our economic and political relationships would be much improved. Apart from the clear and major gains to both countries there would be a major new source of politically secure energy for our EEC partners in Western Europe, a benefit Britain could obviously turn to major political and economic advantage. Had this policy been implemented many years ago perhaps the present Soviet gas line would have been prevented or at least delayed. While it is now being started it is in fact a huge and complicated project which accordingly could well be subject to serious delay, and in the event of political upsets (it has already had to be rerouted around Poland through Czechoslovakia) to cancellation. Whether this happens or not, Western Europe needs as much North Sea gas as can be made available.

5. Conclusions and Recommendations

a) The government's recent and welcome changes in introducing more competition in the supply and sale of offshore gas to industrial consumers is not sufficient to provide the optimal national benefits - that requires lifting the ban on exports.

b) The principal argument against allowing exports is the fear that there may be insufficient gas for British needs, an argument not accepted by those most likely to know, the international oil industry. There has been no incentive to look for gas for a dozen years, or to prove up any gas found. No sound judgment of likely maximum reserves is possible in these conditions. If the oil industry are given the same economic conditions for gas as have always existed for oil then the proving up of known gas reserves and the active exploration for more gas would soon dispel any misgivings, as it has done in similar circumstances in other countries.

c) To maximise the nation's benefit the government should consider its offshore gas policies in the widest context, embracing not just UK consumers, but the whole UK economy, and our economic and political relationships with Norway and the EEC. If this is done the case for allowing exports is very strong. The general gains to industry and employment, the increased tax and royalty earnings of the Treasury, the enhancement of export earnings, and the benefits to our allies should all be very substantial.

d) The major gains from these recommended policies require the most imaginative approach to the Norwegian government, including the unqualified offer of joint ownership in any gas pipeline systems in Britain or British waters which transport Norwegian gas. Such systems must freely permit Norway open acess to West European markets as well as to the BGC and British industrial consumers.

e) Perhaps the Treaty of Rome will compel Britain to allow exports to EEC countries when the oil industry is free to sell direct to UK industrial customers. How much better it would be to take the initiative and freely offer exports, plus the hope of helping to get Norwegian gas more cheaply to the Continent. The economic benefits, and the greater supply of politically secure gas to Western Europe would be widely welcomed.

It is hoped that the government, having gone so far to introduce competition in gas, will take the further step and allow exports thus reaping very major additional benefits. Gas has a contribution to make to Britain second only to that which has hitherto been restricted to oil.

10 DOWNING STREET

Mr Coles.

A.W. is away for a couple of weeks.

I'm sure it OK to copy to FCO, who are AW's natural allies on this subject. The paper has already gone to Nigel Lawson.

Frame is the chief Executive of RTZ.

D Duguid.
22/12.

John
Copy for FCO attached
CS 22/12

Energy

file

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10 DOWNING STREET

From the Private Secretary

22 December 1981

The Case for Exporting Gas

I enclose a paper by Sir Alistair Frame and Mr. Allen Sykes on the above subject which Alan Walters received earlier this month. I understand that the document, which is marked 'strictly private & confidential', has been sent to the Secretary of State for Energy. I think it might also be of interest to the Foreign and Commonwealth Office, in particular because of the European aspect.

If in due course you wish to offer any comments on the paper, I am sure they will be of interest to Alan Walters.

A. J. COLES

Francis Richards, Esq.,
Foreign and Commonwealth Office.

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