cf. AD
JV.

Gray

PRIME MINISTER

OIL DEPLETION POLICY: PRODUCTION CUTS

This minute concerns the question of cutting production from UKCS oil fields this year and next. The purpose would be to defer some oil production to the 1990s, when we must expect to become net importers again.

2. My predecessor circulated on 12 May 1981 a report on this subject by the Interdepartmental Working Group on Depletion Policy (WGDP). We then deferred a decision (as announced by Hamish Gray on 2 June 1981). Relevant unfettered powers to impose production cuts became available to me on 1 January 1982 with the ending of the main period covered by the so-called Varley assurances of December 1974. A statement of intent is now required since continuing uncertainty could be very damaging.

3. The Working Group report has been updated and is attached. It concentrates on action which might be taken in the second half of this year and 1983 but looks ahead to the year 2000.

4. For the four years 1982-1985, there is expected to be a cumulative surplus of UK production over consumption ranging between 70 to 180 million tonnes, depending on production and demand. Some 17 to 28 million tonnes of this will accrue this year and 24 to 37 million tonnes in 1983. The probable scope for cuts - 5 million tonnes in the second half of this year and 13 million tonnes in 1983 - would leave production significantly above UK demand. By the mid 1990s, if not earlier, we are likely to move into net deficit.

5. There are well known arguments for imposing production cuts:

i) this is the only means of significantly reducing the hump of production in the 1980s in the interests of longer term security of supply;

ii) now is the most propitious time to cut production, given the expectation of continuing slackness in the world oil market;

iii) conservation of "associated gas" would be likely to be enhanced.

6. I am less impressed by the argument that, on balance, the real sterling value of oil left in the ground can be expected to rise faster than 5% p.a (the public sector discount rate). This turns on assumptions about the future of oil prices and the exchange rate which inevitably are little more than guesses. Moreover, production cuts would have clear-cut adverse consequences, notably:

i) cuts of 5 million tonnes in 1982 and 10 million tonnes in 1983 would increase the PSBR by about £600 million in 1982-83 and about £1.7 billion in 1983-84, endangering our wider economic objectives;

ii) receipts from the privatisation of BNOC's and BGC's oil production assets could be depressed;

iii) adequate continuing further investment by the oil industry in the North Sea could be discouraged.

I attach particular weight to this last point - more than the authors of the report - particularly given that Geoffrey Howe and I are agreed that we cannot go as far as the industry would like in meeting their very real concerns about the North Sea fiscal regime.

7. Despite the energy arguments for enhanced security of supply, I am bound to conclude that we should decide against imposing production cuts.

8. I would propose to announce this decision in terms of the positive features of our existing oil depletion policy, which lays stress on the need to create conditions which will encourage a sustained high level of production from the UK Continental Shelf; and to say it will hold good at least for the lifetime of this Parliament.

9. I should be glad of your agreement that, in the absence of dissent from colleagues, I should proceed as set out above.

10. I am copying this minute to the Foreign Secretary, the Chancellor of the Exchequer, the Secretaries of State for Industry and Scotland, the Attorney General and to Sir Robert Armstrong.

NL.

Secretary of State for Energy
20 January 1982

JH 180

Energy
cc Mr Walters

WR 22/5

PRIME MINISTER

OIL DEPLETION POLICY - PRODUCTION CUTS

I agree that David Howell should inform Parliament that we have decided not to impose production cuts at the beginning of 1982. We can, as he proposes, reconsider the options in the autumn, weighing the industrial position and prospects on the one hand against the hazards, costs and inflationary risks of seeking to ease down the exchange rate further on the other.

2 I am copying this to the other recipients of David Howell's minute.

KJ

K J

22 May 1981

Department of Industry

Energy Policy
TL 20/5

Copies to Mr Ingham
Mr Pattison

3.

Prime Minister.
MAP 22V

SECRETARY OF STATE FOR ENERGY
THAMES HOUSE SOUTH
MILLBANK LONDON SW1P 4QJ
TELEPHONE: 01-211 3000

01 211 6402

John Wiggins Esq
Private Secretary to the
Chancellor of the Exchequer
Treasury Chambers
Parliament Street
London SW1

MO

21 May 1981

Dear John,

Following the Prime Minister's and the Chancellor's own agreement with the proposal in my Secretary of State's minute of 12 May that we should defer a decision on production cuts until the autumn and make an early announcement to that effect, I now enclose the draft of a Parliamentary Question and Answer.

As you will see, the Answer merely refers to a review in the autumn and ends with a promise to give the industry proper notice of our intentions. The formulation which my Secretary of State suggested in the penultimate paragraph of his minute to the Prime Minister was, of course, rather more positive in affirming that we would not impose production cuts at the beginning of 1982. But Mr Howell now recognises that this would have given rise to presentational problems.

We are, I think, bound to get questions about the present draft. We would propose to deal with them by pointing to our promise to give the industry proper notice of any decision to impose cuts and to the practical considerations (eg the need for companies to unwind supply commitments), which make it unlikely that we could in any event start the process at the beginning of 1982.

I am copying this minute to the offices of the Prime Minister, the Foreign Secretary, the Secretaries of State for Industry and Scotland, the Attorney-General and Sir Robert Armstrong.

Yours ever,

John

J D WEST
Private Secretary

DRAFT PARLIAMENTARY ANSWER ON OIL PRODUCTION CUTS

To ask the Secretary of State for Energy whether the Government has decided to introduce oil production cuts.

No decisions have been made whether to impose oil production cuts. I shall review the position in the Autumn and I shall give the industry proper notice of my intentions.

File

ds

10 DOWNING STREET

From the Private Secretary

MR. IBBS
CPRS

Oil Depletion Policy

The Prime Minister was grateful for your minute of 15 May in which you argued that there was nothing to be gained by deferring discussion of this issue. However, in view of the strong views expressed by the Chancellor in his minute of 15 May, she has decided to go along with Mr. Howell's proposal.

I am sending a copy of this minute to David Wright (Cabinet Office).

T. P. LANKESTER

20 May 1981

ac.

CONFIDENTIAL

ds

10 DOWNING STREET

From the Private Secretary 20 May 1981

Oil Depletion Policy

The Prime Minister has now considered your Secretary of State's minute of 12 May, and also the Chancellor of the Exchequer's of 15 May. She accepts his proposal that he should make an early announcement to Parliament that the Government has decided not to impose production cuts from the beginning of 1982, but will be reconsidering the position in the autumn.

I am sending copies of this letter to Francis Richards (Foreign and Commonwealth Office), Richard Tolkien (HM Treasury), Ian Ellison (Department of Industry), Godfrey Robson (Scottish Office), Jim Nursaw (Law Officer's Department), David Wright (Cabinet Office) and also to David Heyhoe (Chancellor of the Duchy of Lancaster's Office).

J. P. LANKESTER

Julian West, Esq.,
Department of Energy.

CONFIDENTIAL

CONFIDENTIAL Flag D

19 May 1981

ALAN WALTERS

PRIME MINISTER

OIL DEPLETION POLICY

I support the Chancellor's view that there should be no deliberate cutback in oil production over the next two years. The CPRS argument for production cuts hinges on:

a. the proposition that longer self-sufficiency will insulate us from either high prices or boycotts; and

b. the real value of oil is likely to rise so that it is best to leave it in the ground now to enjoy the benefit later.

The second proposition is a common assumption but, in my view, it is based on an inadequate assessment of both demand and supply responses to price. Over a 15-20 year horizon, I would expect that the real price of oil is as likely to go down as to increase. The supply response to the change in the real price of oil that occurred in the mid and late 70s has still a long long way to run. The lead times for exploration and exploitation are many years, probably an average of ten is correct. On the demand side every commentator has under-estimated and continues to under-estimate the cutbacks in demand in response to the higher real price of oil. And there is considerable room for adjustment of demand yet awhile, especially in the United States which has yet to reflect world prices at US domestic pumps.

The first argument, about security of supply against an oil crisis, probably could be better handled by retaining suitable stocks. In any case it is likely that the dispersion of supply we have seen over the past four or five years will continue at an even more rapid rate as new fields become productive. So the possibility of an oil boycott being effective becomes less likely as the decade progresses. In the 1990s it is likely to be small indeed.

/The economic

CONFIDENTIAL

The economic advantages stressed by the Chancellor of continuing with the planned production schedule are, of course, very considerable. The Government needs all the help it can get in order to bring the public sector accounts into balance during the next few years. My rough calculations confirm those of the Chancellor: the cutback would be equivalent to about a penny on income tax.

Politically there are good reasons for continuing the production programme. The argument that the Government is "frittering away" the proceeds of North Sea Oil by subsidising uneconomic industries, will not be rebutted by changing the production schedule. And there is the plausible case that the Government needs all the help it can get in putting right the manifest wrongs of these many past administrations.

Conclusion

No urgent production cuts are needed and the discussion of a depletion policy, as the Chancellor and the Secretary of State for Energy agree, could well be deferred until the autumn. In my judgment, the balance of both political and economic argument is to continue at the scheduled production rate.

I am copying this minute to Geoffrey Howe and David Howell.

AW

ALAN WALTERS

CONFIDENTIAL

Mr Lankester

19 May 1981

ALAN WALTERS

PRIME MINISTER

OIL DEPLETION POLICY

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CONFIDENTIAL

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I am copying this minute to Geoffrey Howe and David Howell.

AW

ALAN WALTERS

1

Prime Minister

Are you content with Mr Howell's proposal summarised at x below? The Chancellor (Flag B) and Alan Walters (Flag D) strongly support it; the CPRS (Flag C) argue for a discussion now.

Yes pro

TL 19/5

COMMERCIAL - IN CONFIDENCE

Ref. A04927

MR. LANKESTER

Oil Depletion Policy - Production Cuts

Flag A

X The Secretary of State for Energy, in his minute of 12th May, proposes making an early announcement to Parliament that the Government has decided not to impose production cuts from the beginning of 1982, but will be considering the position in the autumn.

2. The main purpose of such an announcement would be to clear the air before the proposed BP rights issue. The Attorney General has advised that the Government should avoid taking and announcing decisions on depletion policy which could affect the share price either immediately before or for some time after the issue has been floated.

Flag B

3. The Chancellor of the Exchequer, in his minute of 15th May, finds the proposal to defer decisions on production cuts welcome on revenue grounds. I understand that the Foreign and Commonwealth Secretary is expected to go along with the Secretary of State for Energy's proposals.

Flag C

4. In his minute of 15th May, Mr. Ibbs has drawn attention to the long-term arguments in favour of slower depletion. These clearly have considerable force, and, if the Prime Minister is content to defer decisions for the time being, she will want to make sure that Ministers come back to them in the autumn.

RTA

ROBERT ARMSTRONG

18th May, 1981

cc Ad Walters

2 ppo

CONFIDENTIAL

Qa 05368

To: MR LANKESTER

From: J R IBBS

15 May 1981

with T2?

Oil Depletion Policy - Production Cuts

Flag A

1. The Secretary of State for Energy in his minute to the Prime Minister dated 12 May recommends deferring until the Autumn a Ministerial discussion on whether to implement oil production cuts. This in turn delays the earliest date that oil production cuts could be implemented until mid-1982. It is, however, open to the Government to impose such cuts from January 1982.

2. Indigenous oil production currently exceeds oil demand in the United Kingdom. The Department of Energy's latest central projections for UKCS oil production and UK demand suggest that the net exportable surplus of oil in 1982 will be 23 million tonnes. Over the period 1981/93 as a whole the projected surplus will be equivalent to three years' total UK demand. Production cuts offer the only significant opportunity to reduce this surplus; but on the basis of the central estimates the surplus could not now be eliminated entirely. Given this limited scope for reducing the production surplus, it is at least arguable that the opportunity to cut production during the first six months of 1982 should not be so readily foregone.

3. When Ministers discussed the timing of the Clyde Oil Field Development last December (E(80)44th Meeting), the Prime Minister, summing up the discussion, said that development should be deferred by two years rather than five. This was on the understanding that, if necessary, production cuts would have to be implemented elsewhere to keep production in line with the Government's North Sea oil depletion policy and to avoid surpluses.

4. There are two strong arguments in favour of a firm depletion policy. First, it would prolong the period for which the UK was self-sufficient in oil; thereby extending the timespan in which the UK would

have a large measure of security of supply against the possibility of a tight oil market or oil crisis. Second, oil left in the ground is likely to increase in value as oil prices rise in real terms.

5. The principal argument against production cuts is the short-term loss of income to the Exchequer in that oil not produced reduces the tax taken from the North Sea. A reduction in output of 10 million tonnes in 1982 would increase the PSBR by about £1 bn. in 1982/83.

6. The decision on production cuts is not an easy one. The CPRS recognises that if oil production is restricted it will be difficult to find alternative Government income to replace the revenue foregone. However, the long-term arguments in favour of slower depletion seem so strong that the CPRS believes this difficulty should be faced.

7. The CPRS does not believe that there is anything to be gained by deferring discussion by Ministers. Mr Howell argues that the economic outlook and oil consumption levels may be clearer by the Autumn thereby making decision-making easier. On the other hand, experience suggests that one uncertainty removed is only replaced by another. Moreover, deferring a decision will exclude the opportunity to cut production during the first half of 1982.

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

15 MAY 1981

cc Asb[illegible]

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

PRIME MINISTER

OIL DEPLETION POLICY - PRODUCTION CUTBACKS

I have seen a copy of David Howell's minute of 12 May about the timetable for consideration of oil production cuts.

2. I do not dissent from David's proposal to delay decisions on production cuts until the autumn. But it is only fair to point out now that I see no scope for production cuts in the life of this Parliament. Cuts in Government take as a result of production cuts would require offsetting increases in tax or reductions in public expenditure in order to keep to the figures for the PSBR in the MTFS. As the report of the Interdepartmental Working Party indicates, cuts of between 510m tonnes in 1982 and of similar amounts in later years would have increased the PSBR by about £500m-£1,000m in 1982-83 and by about twice as much in 1983-84. Indeed, revenue losses in 1982 could be roughly equivalent to the increases in Government take from the North Sea brought about by the Budget tax changes. Certainly production cuts would defer production into the late 80s and into the 90s, but the natural process of slippage of production is already having that effect without Government action as the report makes clear. Furthermore, I will wish to argue that we should accept BP's application to revise upwards its agreed profil of production at Forties. Refusal would add some £200m to the PSBR in 1982-83.

/3.

3. But I am content that we decide all this in the autumn.

4. I agree with David that there should be an early announcement to Parliament of our intention to delay decisions until the autumn.

5. I am sending a copy of this minute to the Foreign Secretary, the Secretaries of State for Industry and Scotland, the Attorney General and Sir Robert Armstrong.

(G.H.)

15 May 1981

15 MAY 1981

cc Aatters

CONFIDENTIAL

Prime Minister

OIL DEPLETION POLICY - PRODUCTION CUTS

When I announced the Government's oil depletion policy on 23 July 1980 I made it clear that the Government had not taken any decision on production cuts which, under the assurances given by the previous Administration and confirmed by us, cannot be made before 1 January 1982.

The Interdepartmental Working Party on Depletion Policy under my Department's Chairmanship has been considering the issues involved in implementing production cuts in 1982. I attach a copy of their report.

There is certainly an argument for the Government to implement depletion policy by introducing some production cuts in 1982 and later years. The measures already announced will roll forward only a small proportion of the hump of net exportable surplus in the mid-1980s equivalent to some 2-3 years current consumption into the 1990s. If we do not implement production cuts we shall probably find ourselves net exporters on a significant scale from the second half of 1982 onwards - thanks to the far lower levels of domestic demand for oil than was previously foreseen. Indeed the central estimate for the net exportable surplus in 1982 as a whole is now some 20m tonnes, the equivalent of 25% of domestic consumption. There could be public concern at the export of a scarce natural resource on such a scale thus putting at risk our longer term security of supply - we expect to become net importers again in the early 1990s, albeit on a smaller scale than previously envisaged.

This is a particularly difficult time to reach in view of where the balance of national interest lies. There are wide differences of view about the economic prospects in the next 12 to 18 months. I know that the Chancellor will be particularly concerned about containing the size of the PSBR and the possible effects of any depletion policy on it. There are also vast uncertainties about our forecasts for both oil production and consumption in 1982 - the net exportable surplus could be as small as some 5m tonnes a year or as large as 34m tonnes.

CONFIDENTIAL

There is a chance that the uncertainties - particularly about the economic outlook and therefore oil consumption - will be less in the autumn. I would therefore recommend that we defer a decision until then. I recognise that, given the need for proper consultation with the oil companies, this delay means that we shall have to forego the opportunity to implement cuts in the first half of 1982. But as the net exportable surplus is likely to be more significant in the second half of 1982 I believe it is right given all the uncertainties to accept this delay.

When we come to discuss production cuts we shall also need to consider BP's proposal to revise upwards its agreed profile of production at Forties. I must make it clear now that I do not believe we could maintain any credibility for our depletion policy if we agreed to significant increases in approved levels of production at a time when we had become significant net exporters of oil.

The oil industry and other interested parties know that it is open to us to impose production cuts on certain fields from 1 January 1982. This is also known to the Select Committee on Energy which is currently studying oil depletion policy. I would therefore like to inform Parliament at an early date that the Government had decided not to impose production cuts at the beginning of 1982, but will be reconsidering the position in the autumn. If you and other colleagues agree I will circulate a draft announcement.

I am sending copies of this minute to the Foreign Secretary, the Chancellor of the Exchequer, the Secretaries of State for Industry and Scotland, the Attorney-General and Sir Robert Armstrong.

JG

SECRETARY OF STATE FOR ENERGY

12 May 1981

DEPARTMENT OF ENERGY

WORKING GROUP ON DEPLETION POLICY

REVISED 1981 REPORT ON OIL
PRODUCTION CUTS

31 December 1981

DEPARTMENT OF ENERGY

WORKING GROUP ON DEPLETION POLICY

REVISED 1981 REPORT ON OIL PRODUCTION CUTS

SUMMARY

(a) The Varley assurances which constrain the Government's freedom to cut oil production on the United Kingdom Continental Shelf (UKCS) begin to expire on 1 January 1982. This report seeks a decision in principle on production cuts in the second half of 1982 and throughout 1983. If the decision is in favour of cuts detailed discussions on its implementation will be necessary with the oil companies concerned. (paras. 1-4).

(b) The Ministerial Committee on Economic Strategy agreed on 11 March 1980 (E(80)9th Meeting, Item 1) that it was in the national interest to prolong high levels of UKCS production to 2000. It agreed that this objective should be sought through a case by case approach to development delay, gas flaring and upward profile variation. It noted the need for future decisions on production cuts. The Government's decisions were announced by the Secretary of State for Energy on 23 July 1980 (paras. 5-7).

(c) Relevant developments since the July 1980 statement include:

(i) a delay of two years in the development of the Clyde field;

(ii) an increase of 2 1/2 m. tonnes in approved production from the Forties field has been agreed for 1981: but British Petroleum (BP) subsequently reduced production in response to market conditions,

(iii) the decision on the gas gathering pipeline;

(iv) the decision to privatise the oil production assets of the British National Oil Corporation (BNOC) and the British Gas Corporation (BGC),

(v) a continued slackening of the world oil market;

(vi) reductions in forecast (UKCS) production and UK demand;

(vii) the introduction of supplementary petroleum duty and changes in petroleum revenue tax leading to strong oil industry representations against the UKCS fiscal regime (para. 8).

(d) The world oil market is slack, and barring accidents may well continue so until the mid 1980s. Pressures on the market are likely to increase in the second half of the 1980s and intensify in the 1990's with the possibility of a doubling of the real price of oil between 1980 and the end of the century (paras 9-12).

(e) UKCS production is likely to exceed UK consumption by 17-28 million tonnes in 1982 and by 24-37 m. tonnes in 1983. Production should continue to be substantially above demand throughout most of this decade. The outlook beyond 1990 is uncertain. Much will depend on the extent of new discoveries and how quickly they can be brought into production. On pessimistic assumptions we could become net importers by the middle of the decade. If things go well the UK could remain net self sufficient in oil until towards the end of the century. But it is prudent to assume that even allowing for new discoveries the UK could well move into a position of significant annual net deficit by the end of the century (paras. 12-16).

(f) The practical scope for production cuts is up to 5 million tonnes in the second half of 1982 and up to 13 million tonnes in 1983. This is less than half the net surplus expected in the second half of 1982 and about half the minimum net surplus expected in 1983. To impose cuts would effectively mean refusing any renewed BP application to increase Forties production by up to 2 1/2 million tonnes a year. A decision against cuts would not necessarily imply that such a request would be granted. (paras. 17-20).

(g) The primary considerations involved in the decision on production cuts are security of supply, macro-economic factors, micro-economic factors and the effect on the oil industry's willingness to invest in the UKCS (para. 21).

(h) Prolonging net self-sufficiency would improve UK security of supply both in tight market conditions not severe enough to trigger the allocation scheme of the International Energy Agency (IEA) and if the IEA scheme were implemented. It would also enhance although not guarantee security of supply in a severe crisis in which the IEA scheme was triggered or if that scheme broke down. (paras. 22-25).

(i) Macro-economic factors argue against production cuts in 1982 and 1983. The decisive factor is the worsening fiscal prospect since Ministers considered depletion policy in March 1980. A reduction in output of 5 million tonnes in 1982 and of 10 million tonnes in 1983 would increase the PSBR by about £0.6 billion in 1982-83 and by £1.7 billion in 1983-84. The effects of reduced production on the exchange rate and the longer term macro-economic effects are unclear. (paras. 26-31).

(j) The assessment of micro-economic factors depends on highly uncertain assumptions about movements until 2000 in the world price of oil and the real £/$ exchange rate and on the discount rate used (currently 5%). If as is perhaps most likely the oil market remains slack for some years but thereafter the real price of oil increases sharply so as to double between 1980 and the end of the century deferment of production could yield significant resource gains. On the other hand, if the real price of oil increases smoothly or by less than an average of 4% a year, deferment of production could mean resource losses (paras. 32-35).

(k) The oil industry is opposed to production cuts. The levels of cuts suggested in this report would not of themselves unduly damage company cash-flows. But if they came at about the same time as adverse decisions on the oil industry's representations on the UKCS fiscal regime future investment could be affected. Clear guidance that depletion measures would not continue beyond the end of the 1980s could help to maintain confidence (paras. 36-38).

(l) Secondary considerations in the decision on production cuts include gas conservation, effects on final oil recovery from reservoirs; effects on the offshore supplies industry; the possible international reaction; and the effects on BNOC/BGC privatisation measures. The most important is the effect on the conservation of gas. This factor points towards production cuts. The other factors are not decisive provided a decision in principle to cut production is carefully implemented on a field by field basis in consultation with the oil companies and with our partners in the IEA and the European Community (paras. 39-48).

(m) The scope for production cuts after 1983 is uncertain but it should be possible to reduce production in the mid-1980s by some 15 million tonnes a year. This would still leave surpluses of UKCS production over UK demand (paras 49-51).

(n) If the decision is in favour of cuts, it would be desirable to make clear in an early public announcement that cuts are likely to continue - although not necessarily at the same level - for most of the 1980s and that the deferred production will be recoverable in the early 1990s (para. 52).

(o) If Ministers decide against production cuts it would be desirable to make it clear that the decision will hold for the remainder of this Parliament unless there is a major change in circumstances (eg a sharp fall in the price of oil) (para. 53).

(p) A decision in favour of production cuts should be announced as soon as possible in a Parliamentary statement. The licensees and our EC and IEA partners should be informed immediately before the statement. There are also strong arguments for an early announcement of a decision against production cuts. But Ministers may wish to consider delaying the announcement of a negative decision until decisions on the UKCS tax regime are announced. This will probably be in the next Budget speech. (para 55-56).

(q) Ministers are invited:

(a) to decide in principle if they wish to implement production cuts in the second half of 1982 and throughout 1983.

<u>If the answer to (a) is "yes" -</u>

(b) to agree that discussions should be opened immediately with the licensees concerned and that detailed decisions should be taken field-by-field in the light of those discussions;

(c) to agree that an upward profile variation in the Forties Field should not be allowed in 1982 and 1983;

(d) to agree that there should be an early Parliamentary announcement of the decision and that this announcement should say that cuts are likely to continue - not necessarily at the same level - for the remainder of the 1980s with the deferred production being recoverable in the early 1990s;

If the answer to (a) is "no" -

(e) to agree that the decision will hold for the remainder of this Parliament unless there is a major change in circumstances;

(f) to decide whether an announcement should be made quickly or at the same time as an announcement of decisions on the UKCS fiscal regime;

(g) to agree that a decision on upward profile variation in the Forties field should be deferred until BP re-apply and gas utilisation studies have been completed;

In either case -

(h) to agree that the licensees and our EC and IEA partners should be informed of the decision immediately before it is announced in Parliament (para.57).

DEPARTMENT OF ENERGY
31 DECEMBER 1981

CONFIDENTIAL

DEPARTMENT OF ENERGY

WORKING GROUP ON DEPLETION POLICY

REVISED 1981 REPORT ON OIL PRODUCTION CUTS

INDEX

CONFIDENTIAL

I INTRODUCTION

1 In its 1979 Review of Depletion Policy (WGDP(80)1) the Working Group* recommended that the possibility of cutting oil production be reviewed in the first half of 1981 so that, if Ministers so decided, cuts could be implemented from January 1982 when the "Varley assurances" start to lapse. The Ministerial Committee on Economic Strategy generally endorsed the 1979 Review's conclusions on 11 March 1980 (E(80)9th Meeting Item 1).

2 In May 1981, the Working Group produced a report seeking a decision in principle from Ministers on whether they wished to implement production cuts in 1982. Ministers decided to defer a decision on production cuts until the autumn because of uncertainties about general economic prospects and future oil consumption and production (minute of 12 May 1981 from the Secretary of State for Energy to the Prime Minister and the Prime Minister's reply of 20 May 1981). This decision was announced by the Minister of State for Energy in a written Parliamentary Answer on 2 June 1981.

3 Production cuts are central to any strategy of deferring significant oil production from the 1980s. Oil production from the United Kingdom Continental Shelf (UKCS) will exceed demand in 1981 and the surplus is expected to rise steadily for the next five years or so before tailing off. Exploration policy cannot affect the pattern of production before the 1990s and development delays can make little or no difference to the mid-1980s. However, restraining production could have serious consequences for tax revenue and the Public Sector Borrowing Requirement (PSBR) in the next few years and thus for the achievement of the Medium Term Financial Strategy (MTFS). There could also be difficulties for particular companies and projects.

4 This revised report analyses the conflicting factors relevant to a decision on production cuts in the second half of 1982 and the whole of 1983. If Ministers decide in principle in favour of production cuts, urgent discussions with licensees will be necessary. Detailed decisions would be sought from Ministers in the light of those discussions.

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*The Working Group on Depletion Policy is chaired by the Department of Energy and includes representatives of the Treasury, Foreign and Commonwealth Office, Department of Industry, Scottish Office, Inland Revenue and Central Policy Review Staff.

II THE 1979 REVIEW AND SUBSEQUENT DEVELOPMENTS

(a) The 1979 Review

5 The 1979 Review estimated that, if no action were taken, there would be a "hump" in UKCS oil production in the mid-1980s yielding a total net exportable surplus of oil of 200-250 million tonnes (equivalent to 2 - 2 1/2 years' consumption) between 1981 and 1990. It recommended early action to defer production to later years when the UK is likely again to be a net importer. It considered the various instruments of depletion policy available to Ministers (production cuts, refusing upward profile variations, gas flaring controls and development delays), and identified production cuts as by far the most important.

6 The Ministerial Committee on Economic Strategy endorsed the recommendations on development delay, gas flaring controls, and upward profile variations, noted the need for future decisions on production cuts, and agreed that the Secretary of State for Energy should make a statement on depletion policy, after consultation with the oil industry and our European Community (EC) and International Energy Agency (IEA) partners.

(b) The Secretary of State for Energy's Statement

7. The main points of the Secretary of State's statement made on 23 July 1980 were:

- forecasts suggested significant surpluses of production over UK demand in the 1980s, turning into deficits from about 1990;
- on strategic and security of supply grounds it was in the national interest to prolong high levels of UKCS production to 2000,
- action was needed both to increase exploration and to defer some oil production from the 1980s;
- such action was fully consonant with our international commitments,
- close supervision of reservoir performance and of new development applications would continue;
- policy needed to be flexible to take account of future uncertainties,
- the Varley assurances would be respected,
- the Government would consider delaying the development of fields not covered by the Varley assurances;
- gas flaring controls would be tightened.

The Statement left open the question of production cuts when the Varley assurances expired. It also omitted reference to upward profile variation as British Petroleum (BP)'s application in respect of Forties was pending. (The full text of the statement is at Annex A).

(c) Developments since the 1979 Review

8 The main developments since the 1979 Review have been:

- development delay: The Ministerial Committee on Economic Strategy agreed on 16 December 1980 (E(80)44th Meeting, Item 2) to delay the development of the Clyde Field by two years. First production is now scheduled for 1987, and the bulk of Clyde's oil will not now come ashore until the 1990s.

- upward profile variations (upv): BP applied in May 1981 for permission to increase production from the Forties Field by 2½ m tonnes in 1981 and the three subsequent years. This request was granted for 1981 in the interests of increased revenue. In the event BP reduced production because of the weak market. Their application to increase production over the next three years is in abeyance, but may well be renewed if market conditions stabilise in 1982. No significant requests for changes in expected production levels for other fields are foreseen.

- Gas Gathering Pipeline: The Government's decision to look to private sector schemes to bring associated gas ashore will have no significant effect on oil production, although the Minister of State for Energy has said publicly that flaring controls will be tightened to encourage such schemes. New fields will not be approved for development unless licensees make satisfactory proposals for conservation of associated gas.

- Privatisation of Oil Production Interests of British National Oil Corporation (BNOC) and British Gas Corporation (BGC): The Secretary of State for Energy announced on 19 October 1981 the Government's plans to transfer BNOC's and BGC's oil producing assets to the private sector.

- Change in oil market: The world oil market is slack and may well remain so throughout the early 1980s.

- Slower growth of UKCS production: The growth of UKCS production has been slower than anticipated in the 1979 Review but this has been more than offset by reductions in forecasts of UK oil demand. On central projections, production will reach a maximum of 116 million tonnes in 1985. Demand is expected to be stable throughout the 1980s.

- <u>Changes in the tax regime</u>: Supplementary Petroleum Duty (SPD) and changes in tax allowances were introduced in the 1981 Budget. The oil companies allege that the UKCS is no longer attractive for new investment. Treasury and Energy Ministers are considering representations recently made by the United Kingdom Offshore Operators Association (UKOOA) and the Association of British Independent Oil Exploration Companies (BRINDEX).

III SUPPLY AND DEMAND FOR OIL

(a) The world oil outlook

9 The world oil market is slack and as the following table shows may well remain so throughout the early 1980s.

Free World Oil Supply and Demand
million barrels per day (mbpd)

	1979	1980	1981	1982	1983	1984
(a) Potential OPEC supply	31.6	28	27	27	28	29
(b) Demand for OPEC oil	30.0	26.4	23.2	(24	24	24
				(25	26	27
Balance of a-b	1.6	2.4	3.8	(3	4	5
				(2	2	2

10 This assessment assumes that Saudi Arabia will maintain relatively high production and that Iran and Iraq resume higher oil production in 1983/4. Little growth in oil demand is expected because of the likely weakness of the world economy and the effect of past price rises.

11. The longer term prospects for oil supply, demand and prices were examined by the Interdepartmental Group on Prospects for Oil Prices to the year 2000 (POP) which reported in the summer of 1980.* POP examined a number of scenarios. These were based on high and low economic growth rates and alternative possibilities for energy supply. They initally assumed that real oil prices rose by 2 per cent per annum from 1980 to 2000. The scenarios generated the following balances for the supply and demand for oil.

Free World: Excess of Oil Production over Oil Demand (mbpd)

1985	1990	2000
+1.8 to -5.1	+2.5 to -5.7	-3.8 to -27.3

Emphasising the great uncertainty involved in such long term projections, the POP Report concluded that in order to close the imbalances in the world market by 2000, the real price of oil would need to rise by more than the initial assumption. The extent of the overall rate of rise required varied from projection to projection but the Report recommended that policies should be tested against a range of outcomes with an average annual growth rate of 4% p.a. as the central case.

* NOTE

The report was circulated to the Ministerial Committee on Economic Strategy by the Chancellor of the Exchequer in August 1980.

12 Since the POP Report was prepared the real price of oil has risen more than 4% a year as a result of rises in crude oil prices and in the value of the US dollar. POP have recently reviewed their report in the light of the current weakness of the market. Further work is being done. However, POP's preliminary conclusion was that there was as yet no reason to change the range of price projections for the year 2000 although there were growing signs that some of the highest price projections could now be discounted. There is now less likelihood of a significant price increase before 1985. If the market remains slack the real price of oil could well drift between now and then to below the 4% path.

(b) UK Supply and Demand

(i) General

13 Forecasts of UK production and demand are subject to uncertainties which increase the further ahead one looks. Uncertainties about total UKCS production grow as fields now producing decline and as judgements have to be made about the timing, and amount of future production from discoveries which are not yet fully appraised and for which no approved development plans exist. By 1995 some 35% of estimated production is expected to come from fields in this category. It is also a particularly difficult time to assess future demand. Major changes may have occurred in the pattern of consumption. In 1980 oil demand in the UK fell by 15%, but heavy fuel oil consumption fell by 30%. UK oil demand has continued to fall during 1981 and in the year as a whole may be around 8% lower than in 1980. It is not yet clear to what extent this fall reflects a long run trend and to what extent demand will pic up with economic recivery. It is therefore advisable to consider ranges of likely outcomes rather than central estimates.

(ii) The Short-Term Outlook

14 Production for 1981 is expected to be 88 million tonnes compared with demand of 75 million tonnes. Thus the UK is already a significant net exporter. Production in 1982 is expected to be in the range of 89 to 105 million tonnes and consumption in the range 72-77 million tonnes, yielding a surplus of between 17 and 28 million tonnes. In 1983 a net surplus between 24 and 37 million tonnes is expected.

(iii) The Medium and Long-Term Outlook

15 The following table shows the difference between UK production and demand on the basis of a range of estimates for production and low, central and high demand forecasts. (The year-by-year production and demand forecasts on which the table is based are at Annex B). The figures shown make no allowance for production from future discoveries.* Some production could be expected from such discoveries before 1995. They could provide a significant contribution in the last five years of the decade.

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*NOTE The May 1981 Report allowed for production of up to 65 million tonnes from future discoveries between 1991 and 1995 and up to 165 million tonnes between 1996 and 2000. However further work on the methodology underlying these estimates suggests that they are so uncertain that it is better not to include a figure. But there will almost certainly be some production from new discoveries in the 1990's.

SURPLUS OF PRODUCTION OVER DEMAND
[DEFICIT] million tonnes

	Low Demand	Central Demand	High Demand
1982-1985	102-181	86-165	72-151
1986-1990	68-204	32-168	[1]-135
1991-1995	[62]-90	[113]-39	[165]-[13]
1996-2000	[177]-[11]	[247]-[81]	[315]-[149]

N.B. No allowance is made for production from future discoveries.

16 The main conclusions to be drawn from this table are:

(a) UK production should on all scenarios be substantially above demand until 1985. The expected surplus for the four years 1982-1985 ranges from a total of 72 million tonnes to 181 million tonnes.

(b) A significant net surplus should continue until 1990. The forecasts range from net balance to a surplus of 200 million tonnes.

(c) The outlook for the first half of the 1990s is unclear with scenarios ranging from a net deficit of 165 million tonnes to a surplus of 90 million tonnes. By 1995 production has fallen below demand on both the high and central demand scenarios.

(d) The scenarios for the second half of the 1990s show a net deficit ranging from 10 to over 300 million tonnes. But this is the period when production could be expected from future discoveries. Any such production will reduce the net deficit. Under some scenarios the UK could remain in a position of net balance until close to the end of the century. But it is prudent to assume even allowing for new discoveries that by the end of the century the country will have moved into a position of significant annual net deficit.

IV THE SCOPE FOR PRODUCTION CUTS

17 The Government's powers to control oil and gas production rates are contained mainly in the model clauses set out in Schedule 2 of the Petroleum and Submarine Pipe-lines Act 1975. They subject all production programmes to Ministerial approval and permit the Secretary of State for Energy to reduce previously agreed approvals subject to due consideration of licensees' financial or technical representations. The so-called "Varley assurances" (full text at Annex C) given by the then Secretary of State for Energy on 6 December 1974 and reaffirmed by the present Government contain the following voluntary constraints on the use of Government powers to control production:

- <u>on development delay:</u> None would be imposed on pre-1976 discoveries. There would be full consultation with companies to avoid premature investment in other cases.

- <u>on production cuts:</u> There would be none on pre-1976 discoveries until 1982 or four years after the start of production, whichever were later. No cuts would be imposed on post-1975 discoveries under first to fourth round licences until 150% of capital expenditure had been recovered. Full regard would be had to the technical and commercial aspects of the fields in question, implying generally cuts of 20% at most.

18 While 1 January 1982 is the first date at which fields become eligible for production cuts it is assumed that no cuts could now be arranged before 1 July 1982. By that date nine fields will be eligible for cuts; during the remainder of 1982 and in the course of 1983 a further four fields will become eligible. The following table gives estimates of the maximum scope for cuts in these thirteen fields assuming adherence to the 20% ceiling in the Varley assurances and negotiation with the licensees on the basis of realistic production forecasts.

	Potentially Deferrable Oil (1) (m tonnes)	
	1982 (July-December only)	1983
<u>Fields eligible for cuts by July 1982</u>		
Argyll	0.04	0.06
Auk	0.05	0.06
Beryl A	0.5	1.0
Brent	1.6	4.0
Claymore	0.4	0.8
Forties	1.9 (2)	3.6 (2)
Montrose	0.1	0.2
Piper	0.9	1.3
Thistle	0.6	1.0

Additional Fields Losing Protection by end-1983	1982	1983
Dunlin (August 1982)	0.3	0.8
Heather (October 1982)	0.04	0.2
Ninian (December 1982)	0.2	2.2
UK Statfjord (November 1983)		0.03
Totals	6.63	15.25

(1) Crude oil only, although small quantities of associated gas would also be deferred.

(2) Based on presently approved profile ie without upv.

19 On present knowledge Argyll, Auk, Montrose and Heather are too small or economically marginal to be worth cutting. Concessions would no doubt have to be made to licensees in negotiations about other fields. 5 million tonnes is probably the practicable maximum for the second half of 1982. This is less than half the minimum surplus projected for the year as a whole. The maximum for 1983 probably lies between 10 and 13 million tonnes, compared with the estimated minimum surplus of 17 million tonnes (The position in later years is discussed in paras 50-52).

20 Special considerations apply to Forties, the largest UKCS field. As explained in paragraph 8 Ministers agreed that output from Forties could be increased by 2½ million tonnes in 1981. A decision in favour of production cuts in the second half of 1982 and 1983 including Forties would imply that this concession would not be continued. On the other hand if Ministers decide against applying production cuts in 1982 and 1983 a separate decision will be needed if BP renew their request for an upward profile variation in the Forties field. This would need to take account of the results of gas utilisation studies that are in hand.

V FACTORS AND CONSIDERATIONS RELEVANT TO A DECISION

21 Four major considerations are crucial to the decision on production cuts - security of supply, macro economic factors, micro-economic factors and the effects on the oil industry's willingness to invest in the UKCS. This section examines these first. It then covers a number of other considerations which are relevant but, provided they are carefully handled, not crucial.

(a) Security of Supply

22 Security of supply considerations could become important in two sets of circumstances - first if oil is scarce but not to an extent which would trigger the allocation scheme of the IEA, and second in a crisis when that scheme is triggered.

23 About half of UK oil consumption is at present met by imported crudes. This allows a corresponding amount of high quality UKCS crude as well as any net surplus to be exported at premium prices. Since 1979 voluntary arrangements have been made with most UK marketing companies with access to UKCS crude to protect supplies to the UK in a tight market not triggering IEA sharing. Without these arrangements UKCS production would not necessarily contribute to UK security of supply because in periods of scarcity the international companies which supply 90% of the UK market often apply an "equality of misery" policy, sharing their total worldwide supplies among all affiliates or even giving a preference to the home markets of their parent organisations. If UKCS production can be maintained at a high level over a longer period security of supply in a tight market would b enhanced.

24 If the IEA allocation scheme were operating UKCS production would form part of the pool of oil available to member countries. However, the scheme's provisions give some advantage to oil-producing members. This advantage is at its maximum when domestic production is just below demand. So the longer we can stay close to net self-sufficiency the longer the UK will obtain maximum benefit from these provisions.

25 It is possible that in a severe oil supply crisis the IEA arrangements for sharing the available oil would break down and each Western country would seek to safeguard its own interests. While the UK is net self-sufficient in oil, it is relatively better placed than other Western countries (except Norway) to handle such a situation. From that point of view too the longer we remain net self-sufficient the better. But unless the Government of the day were prepared to stop all exports even net self-sufficiency would not give us complete security of supply.

(b) Macro-economic Factors

26 The 1979 Review concluded that macro-economic considerations pointed (albeit not clearly) to slower depletion. There have been two relevant developments since then. The real exchange rate rose considerably then fell back though to a level higher than it was in early 1979. But the relationship between depletion policy and the exchange rate is unclear. Secondly, the fiscal prospect has worsened considerably since 1979. The effect of production cuts on the fiscal prospect is clear and adverse.

27 The causes of the rise in the real exchange rate in 1979 and 1980 are not well understood, but oil-related improvements in the oil current account are not thought to have been among the most important factors. This suggests that depletion policy would not provide a useful or reliable means of influencing the exchange rate. Any downward pressure on the rate from reduced net oil exports would be at least partly offset by the higher interest rates or tightening in fiscal stance required to compensate for the corresponding loss

of Government revenues. Even if the direction of the effect could be predicted, the scale of production cuts envisaged in 1982 and 1983 suggest that any net change in the exchange rate would be very modest indeed.

28. Production cuts in 1982 and 1983 on the scale proposed would have a clear and damaging effect on the Government's budgetary position. Cuts of around 5m tonnes in the second half of 1982 and 10m tonnes in 1983 would increase the PSBR by about £600 million in 1982-83 and by about £1.7 billion in 1983-84, if nothing was done to make good the loss of revenue. The refusal to allow Forties upward profile variation would mean foregoing a reduction of £400m in the PSBR.

29. The fiscal prospect over the next two years is already very difficult. In the event of production cuts, with a resulting deferral of Government revenues, the achievement of the monetary targets set out in the Medium Term Financial Strategy without an increase in interest rates would require cuts in public expenditure plans now agreed or increases in the burden of non-oil taxation. The former would be difficult to achieve and the latter would add to the already sharply rising tax burden, with effect on incentives and on the Government's overall objectives for a reduction in tax. If the loss in North Sea revenues could not be made good, interest rates would have to rise above what is already a damaging level. Like increases in the burden of non-oil taxation, higher interest rates would, by inhibiting private sector investment and the efforts of industry to improve its competitiveness, worsen the prospects for recovery of the economy.

30. The calculations in Annex D assume that any cut back in oil production in the period 1982-87 would be recouped by increased oil production in the late 1980s and the 1990s. This deferred oil production may ease the macro-economic problems which could face the nation at a time when oil production is expected to be falling. However, the rate at which production will fall during the so-called "re-entry' period is rather uncertain and the macro-economic situation which will then face the country cannot be known. Also, in so far as production cuts in the early 1980s hindered economic recovery, the effects of this might still, at least in part, linger on into the 1990s. Finally, the decline in the value of oil production could be at least partly offset by rising earnings from investments financed by oil revenues.

31 The effect on the immediate fiscal prospect is the most important of the macro-economic considerations.

(c) <u>Micro-economic Factors</u>

32 Deferring oil production will result in resource gains to the UK if the net real sterling value of the deferred oil (its gross value less the incremental costs of producing it) increase faster than the discount rate used for assessing public investment - currently 5% a year.

33 The POP Report recommended that as a central case an average increase of 4% a year in the real (dollar) price of oil between 1980 and the end of the century be assumed. Future movements in real sterling exchange rates are also uncertain. A 3/4% a year decline from the mid-1980s is taken as a central assumption. Current forecasts, however indicate a stagnant real sterling price upto the mid-1980's. Together these assumptions mean a rise in the real sterling price pf UKCS oil averaging about 5% a year from the mid-1980's to the end of the century. This would result in neither losses nor gains if the price path was smooth (see Annex D Case 1).

34. In practice, prices are unlikely to rise by a smooth 4% a year to 2000. The micro-economic arguments thus turn on the judgement made on when price jumps occur and their size. If, as the current situation suggests, the oil market remains slack for some years but thereafter the real price of oil increases sharply so as to double between 1980 and the end of the century - not the highest possible outcome - deferment of production to the 1990s could yield significant resource gains. On the other hand, if the dollar price of oil increases smoothly or by less than an average of 4% a year deferment of production could mean resource losses.

(d) Attitude of the oil industry

35. The industry's long-standing opposition to production cuts have been confirmed in the companies' evidence to the Select Committee on Energy, who are now studying depletion policy. In their 15 October 1981 submission to the Chancellor of the Exchequer on the UKCS fiscal regime, UKOOA took the view that if the Government required further revenue in the period 1981-85 it should be obtained by maximising production in those years and proposed a changed fiscal structure which (on the industry's figures) would reduce Government revenue by £800-900m a year from the middle of 1982-83 and lesser amounts thereafter. The conclusions of an inter-departmental working party on these proposals are being reported to Treasury and Department of Energy Ministers.

36. The effect on less profitable fields was a constraint on this year's tax increases, production cuts applied to these fields would worsen this position further. Broadly revenue-neutral variants of UKOOA's proposals would reduce cash flows of PRT paying fields (eg Forties and Piper) by about 10% on average but by almost 25% in 1983 for these two fields. Production cuts in the short to medium term reduce cash flows by 20% for these fields (and up to 50% for others) though the cash flow effect of production cuts plus broadly revenue-neutral variants of the UKOOA tax proposals would be significant. However these fields have IRR's approaching 30% in constant prices, with annual cash flows of £320-380m up to 1985 for Forties and £75-175m for Piper.

37. The UKCS remains a secure and generally profitable investment area. Production cuts have long been foreshadowed. They could be applied selectively to those fields most able to bear them and, at the levels suggested in the report, would not in themselves self-evidently ruin company cash flows. The effects of cuts on confidence in future investment would depend to some extent on Ministers' decisions on taxation. But these effects might be less if clear guidance could be given that depletion measures would not continue beyond the end of the 1980's.

(e) Other considerations

(i) Gas conservation

38 Where there are reasonable prospects for a technically and economically feasible outlet for associated gas, a tight flaring regime will continue to be applied. In the application of any production cuts to individual fields the effect on future gas supplies will be one of the important aspects that will need to be considered in setting the level of reduction. For example, in the short-term, if the commissioning of the FLAGS pipeline is likely to be further delayed, cutting Brent's oil could yield additional gas and NGL savings. Equally, the application of production cuts to Forties would materially increase the likelihood that an economic method of recovering the associated gas could be identified for the future.

(ii) Technical Considerations

39. The future behaviour of reservoirs is always subject to uncertainty especially in the North Sea. The costs and physical difficulties of working in the harsh environment mean that pre-production appraisal drilling is less extensive than it would be onshore. Reservoir knowledge is therefore sketchier. Either too rapid or too slow depletion of a reservoir can reduce final oil recovery. So production cuts would need to be considered and monitored carefully field by field to ensure that ultimate recovery was not impaired. There is a present a serious shortage of the technical staff required for this task in the Department of Energy. It would be technically prudent to recover deferred production as early as possible and it would anyway be economically unattractive to extend field lives beyond those planned by operators. These lives could in some cases be constrained by the limited physical endurance of production installations.

40 Full development of an oil field extends over a number of years. Production cuts could therefore reduce fields' short-term production capacity by causing the deferral of development expenditure. New wells needed to sustain production, for example, are unlikely to be drilled any earlier than necessary. Operators would expect the Government to be as clear as practicable about its future intentions on cuts and particularly on the retrieval of deferred oil. Reasonable clarity for future production planning will be in the Government's own interest. Clearly production cuts could be reversed fairly quickly if this was needed within a few months of their implemntation. However, if cuts are operated for a longer period new constraints arise. The speed with which production could be increased would then depend on:-

(i) the extent of notice that can be given to operators to enable them to put the necessary work in hand;

(ii) the particular situation of individual fields and operators at the time a request to increase was made;

(iii) how attractive oil prices were at the time.

Depending on circumstances it could take from a few months to a year to restore full production.

(iii) Legal and Practical Considerations

41. The model clauses contained in Schedule 2 of the Petroleum and Submarine Pipe-lines Act 1975 give licensees affected by proposals for production cuts the right to make technical and financial representation to the Secretary of State. This means that:-

(i) the Government cannot necessarily impose a common formula on all licensees, even though UKOOA have in the past asked for this;

(ii) the achievment of a particular level of cuts cannot be guaranteed in advance.

42. No formal understanding has been reached with licensees on the precise modalities of cuts on the early fields. The baseline from which the Varley 20% maximum might be deducted could be contentious because most fields are at present producing under 3 or 6 months "consents" and far below levels initially contemplated for the early 1980s. It was, however, made clear to licensees

early on that production slippage would not be permitted to nullify the Government's depletion powers. Calculations in paragraph 19 of the potential for cuts assume that they would be deducted from a realistic assessment of what fields could actually produce in the second half of 1982 and in 1983.

43. Licensees' rights to make representations (paragraph 41) could lead to protracted negotiations in difficult cases. How protracted it is difficult to specify in advance. This would be the Government's first use of its powers in this area, and the technical resources at its disposal in the Department of Energy are limited. Barring mishaps, it should be possible in the time available to July 1982 to satisfy most licensees that their representations had been properly considered and that cuts had been implemented in a reasonable manner.

44. In some instances the Varley assurances have been formally incorporated into agreements between the Government and the banks on field financing and supplemented by assurances that the Government will not reduce production below the level in the approved development programme without consultation with the banks with a view to ensuring that repayment of their loan would not be prejudiced. Oil price rises since the agreements were concluded have made most loans more secure than they were when they were granted. In the case of possible candidates for production cuts in 1982 and 1985, the assurances given are unlikely to inhibit the Government's ability to make cuts but consultations with the banks as well as the oil companies, on the commercial aspects would be required for Ninian, Claymore and Heather.

(iv) <u>Offshore Supplies Industry</u>

45. Production cuts would not have such a serious impact on the offshore supplies industry as other measures of depletion policy, particularly development delay. But they could have some impact on the overall work programme of the industry.

(v) <u>International Considerations</u>

46. The Secretary of State for Energy's statement of 23 July 1980 aroused little interest either among our partners in the IEA and EC, or among the oil producing countries. Adverse reactions to a decision to cut production are not likely to be strong during the present slack oil market. Indeed, such a decision would fit with the consensus of opinion in the IEA and EC that the present relaxed state of the oil market is no occasion for complacency and that action is needed now to reduce future dependence on imported oil. From the international viewpoint, there is hardly likely to be a more propitious moment for introducing production cuts.

(vi) Privatisation of North Sea oil Assets

47. The imposition of production cuts affecting BGC's equity interests in Beryl and BNOC's interests in Thistle, Dunlin, Beatrice, Murchison and Statfjord seem likely to reduce the worth of the assets to private investors. The extent of such reduction will depend upon the market's view of oil prices, its choice of discount rate and its expectations of profitability in the light of uncertainties surrounding such factors as production costs and the level of taxation.

(viii) Effect on BNOC

48. Production cuts of 15 million tonnes overall from mid-1982 to end 1983 would not in practice adversely effect BNOC's already limited capacity to divert crude in support of national objectives, even though privatisation of BNOC's oil producing business in 1982 will result in its trading aim losing control of some 3-4m tonnes a year. This is because, although in theory cuts at this level could reduce the availability of BNOC's participation oil by 7½m tonnes, they are likely to affect fields where much of this oil is sold back to the producers. BNOC's equity oil (assuming cuts of around 10% in the fields in question) would be reduced by about 0.5m tonnes.

VI PRODUCTION CUTS AFTER 1983

49. The scope for production cuts will grow slightly after 1983, up to 15 million tonne a year during the middle-1980s. It will later be reduced by the natural decline in the production capacity of the earliest fields. Cuts of 15 million tonnes a year in the mid 1980s would still leave sustantial surpluses after meeting the UK commitments to the IEA and EC to achieve net exports of 5 million tonnes in 1985.

50. A decision to impose cuts over the 18 months to end-1983 would create a strong presumption that cuts would be continued over all the surplus years of the 1980s. There could, however, be scope for relying on development delays, which are economically preferable to cuts, from 1988 onwards. Deferred production could be recovered in the 1990s. An early statement that this is intended would be desirable to maintain confidence in new developments for production starting in 1990 onwards and to ensure that the necessary work would be done to recover deferred oil then. The statement should also indicate why production cuts were necessary, stress that the established level of cuts to end-1983 was the minimum level necessary to achieve the Government's objectives, and avoid implying that later cuts would necessarily be at the same level. It might be possible to give more specific guidance on the Government's intentions when decisions on particular fields were taken following detailed discussions with licensees.

51. A decision against cuts in 1982 and 1983 need not in theory commit the Government for later years or even prevent a reversal of policy in 1982/3. In practice there would be advantages in making it clear that the decision would hold for the lifetime of the present Parliament barring a major change in circumstances (eg a sharp fall in the price of oil). This would help maintain the confidence of the oil industry particularly if their representations on the fiscal regime are rejected.

VII TIMING OF ANNOUNCEMENT

52. The Minister of State for Energy's statement of 2 June 1981 said that the position on production cuts would be reviewed in the autumn. Questions are already being asked about the outcome of the review. A positive decision would need to be followed by a six month period of field-by-field negotiations with licensees, deferring the start of cuts to the second half of 1982. In that case an early announcement of the Government's general decision would be essential.

53. If Ministers decide against production cuts they will wish to consider whether to announce their decision immediately or to delay it until the announcement of the Chancellor of the Exchequer's decision on the oil industry's representations on the UKCS fiscal regime. This would probably mean deferring an annoncement until the Budget. The latter course has presentational advantages. But delay will prolong uncertainty and lay the Government open to continued questions about its intentions.

54. The licensees and our IEA and EC partners should be told of the Government's decision immediately before the Parliamentary announcement.

VIII QUESTIONS FOR DECISION

55. The analysis in Parts III to VI shows that it should be possible by production cuts to reduce UKCS production below what it would otherwise have been by up to 5 million tonnes in the second half of 1982 and up to 13 million tonnes in 1983. Deferring significant production from the 1980's would require at least the partial implementation of cuts. It is difficult to foresee an oil market more favourable for reducing production than that likely on present prospects in 1982 and 1983. EC and IEA criticism is unlikely. Reductions of 5 million tonnes in 1982 and 13 million tonnes in 1983 could be absorbed without pushing production below the level of UK demand. Security of supply considerations point towards early action to reduce production. Micro-economic considerations probably point in the same direction: but the analysis is subject to major uncertainty.

56. On the other hand, production cuts in 1982 and 1983 would worsen still further the fiscal prospect. A reduction in production of 15 million tonnes in the 18 months to end 1983 would increase the PSRB by about £0.6 billion in 1982/3 and £1.7 billion in 1983/4. There would be difficult implications for the North Sea tax proposals made by the industry, which would regard cuts and a decision against tax concessions as a double blow. Cuts would also somewhat depress the receipts from the privatisation of BNOC's & BGC's oil production assets.

57. Ministers are therefore invited:

(a) to decide in principle if they wish to implement production cuts in the second half of 1982 and throughout 1983.

<u>If the answer to (a) is "yes"</u> -

(b) to agree that discussions should be opened immediately with the licensees concerned and that detailed decisions should be taken field-by-field in the light of those discussions (para 4);

(c) to agree that an upward profile variation in the Forties Field should not be allowed in 1982 and 1983 (para 20);

(d) to agree that there should be an early Parliamentary announcement of the decision and that this announcement should say that cuts are likely to continue - not necessarily at the same level - for the remainder of the 1980s with the deferred production being recoverable in the early 1990s (para 52);

<u>If the answer to (a) is "no"</u> -

(e) to agree that the decision will hold for the remainder of this Parliament unless there is a major change in circumstances (para 51);

(f) to decide whether an announcement should be made quickly or at the same time as an announcement of decisions on the UKCS fiscal regime (para 53),

(g) to agree that a decision on upward profile variation in the Forties field should be deferred until BP re-apply and gas utilisation studies have been completed (para 20);

In either case

(h) to agree that the licensees and our EC and IEA partners should be informed of the decision immediately before it is announced in Parliament (para 54).

Department of Energy
31 December 1981

THE SECRETARY OF STATE FOR ENERGY (MR DAVID HOWELL)'S STATEMENT OF OIL DEPLETION POLICY 23 JULY 1980

The following statement was made by the Secretary of State for Energy on 23 July 1980:

"We expect that from later this year UK oil production will regularly reach a level equal to UK consumption. Thereafter on present forecasts production would rise to a peak in the mid-1980s giving a significant suplus over UK consumption in the 1980s as a whole. We are likely to become net importers of oil again about 1990.

"Recent events underline the fragilities of the world energy scene. The Government believes that on strategic and security of supply grounds it is in the national interest to prolong high levels of UKCS production to the end of the century. This requires action to increase exploration, which we have already taken, and to defer some oil production from the 1980s. Such action accords fully with the recommendations to maximise indigenous hydrocarbon production on a long term basis and with our other international commitments including net exports of 5 million tonnes in 1985 as agreed in the Community and the International Energy Agency.

"There are of course, major uncertainties about future levels of North Sea production and UK consumption. There can therefore be no rigid plan. We shall continue close supervision over reservoir performance at existing fields and scrutinise new applications for field developments to ensure good oil field practice consistent with optimum oil and gas recovery in the national interest. We shall also continue to take decisions on a case-by-case basis, but giving greater emphasis to the need to limit the sharpness of the peak in production. We shall, of course, honour the assurances given by the Rt Hon Member for Chesterfield (*) on 6 December 1974 on the basis of which heavy investment has been undertaken by the oil companies.

"In particular the Government will consider delaying the development of fields discovered after the end of 1975, which are not covered by the assurances given by the Rt Hon Member for Chesterfield. The Government will also continue to tighten control on gas flaring.

"The Government has taken no decisions on whether to have production cutbacks which, under the assurances given by the previous Administration, cannot be made before 1982.

"I believe that this flexible approach is the right one and takes account of both the needs of those involved in the difficult business of oil production and, more important, the long term national interest."

(*)Rt Hon Eric Varley MP

ANNEX B

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UK OIL PRODUCTION AND DEMAND FORECAST

(Million tonnes)

	PRODUCTION			DEMAND		
	Lower Limit	Upper Limit	Central Expected	Central Projection	Lower Range	Higher Range
1981	79	96	88	75	74	76
1982	89	105	100	75	72	77
1983	95	115	106	75	71	78
1984	100	122	113	75	71	79
1985	102	123	116	75	70	80
1986	98	120	112	76	70	81
1987	89	115	105	76	70	82
1988	82	110	96	76	69	83
1989	75	105	89	77	69	84
1990	70	100	83	77	68	85
1991	65	95	77	77	68	86
1992	60	90	72	77	68	87
1993	55	85	67	78	67	88
1994	50	81	63	78	67	89
1995	45	76	58	78	67	90
1996	40	72	54	79	66	91
1997	35	67	49	79	66	92
1998	30	63	46	79	65	93
1999	25	59	40	80	65	94
2000	20	55	34	80	65	95

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ANNEX D

ANNEX C

THE SECRETARY OF STATE FOR ENERGY (MR ERIC VARLEY)'S STATEMENT OF NORTH SEA OIL DEPLETION POLICY 6 DECEMBER 1974

"In my Statement to Parliament on 11 July on U.K. offshore policy, I said that the Government proposed to take powers to control the rate of depletion of oil. I already have power to decide on the timing, nature and extent of future licensing rounds, and in the forthcoming petroleum legislation I shall be proposing powers to control the rate of production.

"How or when such powers may be used in the 1980's and 1990's will depend on the extent of the total finds, on the world oil market and on the demand for energy: on all these points great uncertainty prevails. Policy will also be influenced by our general economic situation and, in particular, the outlook for our balance of payments. The Goverment cannot therefore be expected to define, before any oil has come ashore and when large parts of the sea remain unexplored, a long-term production pattern.

"On the other hand, these powers may be needed in the future to safeguard national interests. However much oil we find, it is limited and can be used only once. This and future Governments must therefore ensure that this vital national resource will be used at a rate which secures the greatest long-term benefit to the nation's economy and, in particular, to Scotland, Wales and other parts of the U.K. in need of development.

"We propose therefore to take powers of control for use in the future, but it remains the Government's aim to ensure that oil production from the U.K. Continental Shelf builds up as quickly as possible over the next few years to the level set out in paragraph 4 of the White Paper (Cmnd. 5696). This will help our balance of payments, contribute to Government revenues, stimulate our industries and make our energy supplies more secure. It will also be an important British contribution to the development of the indigenous energy resources of the industrial world.

"I wish therefore to assure the oil companies and the banks to which they will look for finance, that our depletion policy and its implementation will not undermine the basis on which they have made plans and entered into commitments. Our future policy will be based on he following guidelines:

(a) No delays will be imposed on the development of finds already made or on any new finds made up to the end of 1975 under existing Licences, if it should prove necessary to delay the developmen of finds made in 1976 or later, there will be full consulation with the companies so that premature investment is avoided.

(b) No cuts will be made in production from finds already made, or from new finds made before the end of 1975 under existing licences, until 1982 at the earliest, or until four years after the start of production, whichever is the later.

(c) No cuts will be made in production from any field found after 1975 under an existing licence until 150 per cent of the capital investment in the field has been recovered.

(d) If we later need to use these powers we will have full regard to the technical and commercial aspects of the fields in question; and this would generally limit cuts to 20 per cent at most. We shall be consulting the industry on the period of notice to be given before any reduction in production comes into effect.

(e) In deciding on action to postpone development or limit production, the Government will also take into account the needs of the offshore supply industry in Scotland, Wales and other parts of the U.K. for a continuing and stable market.

"Longer term conservation strategy is being and will be formulated as progressively more information becomes available. At this stage, the regime for depletion of any finds made in the Celtic Sea should not be regarded as settled. The British National Oil Corporation, to be established by Petroleum Bill next year, could have an important role to play in exploring areas yet to be licensed, and in establishing potential fields whose reserves could be husbanded or developed quickly in accordance with the widest national interest. This for the future, and does not affect present licences: but I think it right to state our more immediate intentions now."

Illustrative Assumptions for Oil Prices up to 2000 and Resultant Resource Gains and Losses from Imposing cuts of 20% in Production from 1982-87 (with deferred oil produced thereafter).

		Approximate Net Gains (+) or losses (-) per tonne of Oil Deferred. (£1980) Present Value, applying a 5% Discount Rate	Undiscounted value
1	Central Price Assumption (world (marker crude) oil price of $65/barrel in 2000; sterling declines at 1% p.a. after 1985.	0	+50 to +90
2	Low Price Assumption (world 2000 price of $55/barrel).	-5 to -15	+35 to +65
3	High Price Assumption ($87.50/barrel in 2000)	+5 to +10	+55 to +120
4	Central Price in 2000 reached by a 45% increase in early 1980's (1983); 2% per annum increase other years.	-10 to -15	+30 to +70
5	Central Price in 2000 reached by 55% increase in late 1980's (1988) 2% per annum increase other years.	+20 to +30	+80 to +130
6	High price in 2000 reached by an increase of 33% in the early 1980's and a 50% increase in the early 1990's, 2% per annum other years.	+10	+50 to +140
7	Low price in 2000 reached by a jump of 30% in the early 1990's; 2% per annum increase in other years.	+5	+40 to +100
8	Central price in 2000; sterling declines more sharply as production falls in the late 1980's/early 1990's.	+10	+50 to +110