Energy

(2)

Ramsbotham. MLS

PRIME MINISTER

You asked about the objectives for BNOC after the privatisation of Britoil. see Nigel Lawson's letter (attached)

The paragraph you questioned said that BNOC's most important role will be "in setting term prices for UKCS crude at levels which maximise overall public sector revenues from our North Sea oil production, even though that might sometimes result in a trading loss". I understand that BNOC's term price, i.e. their price for a three month contract and not for a one-off cargo is both a market price, and also a tax reference price. That is to say that the Treasury's tax revenues from the oil of North Sea oil production are based on this BNOC price. Sometimes the Secretary of State for Energy and the Chancellor will put discreet pressure on BNOC to squeeze this price up somewhat, in the interests of increasing North Sea revenue. In doing so they may make BNOC's price on the high side so far as maximising its own profits are concerned, since these are largely based on the ~~term~~ turn ('mark-up') it makes when it buys oil from its suppliers and sells it to refiners and distributors.

I am told that the theory is that BNOC is wholly independent and that its term prices should be totally determined by the market. But the practice is as I have described above. Much is at stake, since an increase in BNOC's term price of 50 cents a barrel brings in £125m. to the Treasury.

MLS

20 July 1982

CONFIDENTIAL

cc JV Energy

Prime Minister (2)

MLS 23/7

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

23 July 1982

The Rt. Hon. Nigel Lawson, MP
Secretary of State for Energy

Dear Nigel

BNOC TRADING AFTER THE SEPARATION OF BRITOIL

Thank you for your letter of 13 July.

It is disappointing that you have not been able, with the Corporation, to define and set limits on the risks to which the Corporation may be exposed at any one time. I attach considerable importance to this. Now that the pressures on the traders of preparing for the privatisation of Britoil have reduced, I believe that a further effort should be made to fix limits, expressed in financial terms, to come into effect as soon as possible.

Until these limits are set, it will be difficult to assess the case for as high a level of retained profits as £30 million. We should be careful not to set too high a level, firstly because it might encourage the traders to take unnecessary risks and secondly because the opening lvel of reserves will add, either directly or indirectly through the diminution of proceeds from the Britoil sale, to public expenditure. I recognise that you have arrived at the figure you propose after negotiation with the Corporation, but before agreeing to a figure as high as £30 million I really do think we need to be sure of a satisfactory limitation of the Corporation's exposure.

The Corporation's surplus funds should of course be invested in public sector securities in accordance with the existing general guidelines.

As to the Corporation's temporary borrowing, I am content that it should be subject to an overall limit of £50 million, and that your Department may, with Treasury approval, guarantee

/facilities

CONFIDENTIAL

9/E JV

Prime Minister (4)

HUS 22/7

CABINET OFFICE
Central Policy Review Staff
70 Whitehall, London SW1A 2AS Telephone 01-233 7765

From: John Sparrow
CONFIDENTIAL

Qa 05991

22 July 1982

The Rt Hon Nigel Lawson MP
Secretary of State for Energy
THAMES HOUSE SOUTH
S W 1

Dear Nigel,

BNOC Trading after the Separation of Britoil

Your letter of 13 July - JPM proposes a regime for the public sector trading operations of BNOC.

I agree with you about the importance of setting limits to the extent of BNOC's trading activities, outside its main duty of trading in participation oil. It is not entirely clear to me why BNOC will need to carry on any trading in non-participation oil, after a transitional period when Britoil may depend on BNOC expertise in selling its own non-participation products. Beyond that, there may be some need to spread risks at the margin, and to offer enough challenge to attract and retain skilled trading staff. But the risks of allowing the Corporation to go in for speculative commodity trading without clear limits are of course very great, as your letter recognises.

You suggest setting these limits from year to year, in the context of the annual business plan. I understand why it is difficult to set firm limits now. But I think it would help to make it quite clear from the outset that you intend to keep the scope of the business firmly under control, by adding to the third 'general objective' something like the words underlined:

"(iii) To trade profitably in all non-participation petroleum and petroleum products, within limits which may be set by the Secretary of State."

It will then clearly be desirable to get actual limits set as soon as possible.

I am sending copies of this letter to those who received copies of yours.

Yours sincerely,

John Sparrow

22 JUL 1982

DCJ Energy

SECRETARY OF STATE FOR SCOTLAND

SCOTTISH OFFICE
WHITEHALL, LONDON SW1A 2AU

CONFIDENTIAL

The Rt Hon Nigel Lawson MP
Secretary of State for Energy
Department of Energy
Thames House South
Millbank
LONDON
SW1P 4QJ

NBPM

MLS 27/7

26 July 1982

Dear Nigel,

BNOC TRADING AFTER THE SEPARATION OF BRITOIL

I am grateful to you for copying to me your letter of 13 July to Geoffrey Howe on this subject.

The guidelines you propose for the British National Oil Corporation's operations after the "privatisation" of Britoil seem entirely reasonable. I have, therefore, no comments to offer at this time but I would appreciate being kept in touch with any future developments.

I am copying this letter to the recipients of yours.

Yours ever,

George.

27 JUL 1982

CE JV

Prime Minister (2)

MS 16/7

01 211 6402

The Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
H M Treasury
Parliament Street
London
SW1

13th July 1982

BNOC TRADING AFTER THE SEPARATION OF BRITOIL

With the enactment of the Oil and Gas (Enterprise) Bill, we are proceeding with the steps necessary to privatise BNOC's upstream interests. We need at the same time to formulate clear guidance to those who will be in charge of the continuing public sector trading operation. My officials have therefore prepared the attached note which covers the Corporation's general objectives, certain specific duties, financial structure and financial targets, and reporting and control. The note has been prepared in a form in which it could be published if necessary.

It may be helpful if I explain the thinking behind the note.

(i) Objectives

Apart from contributing to security of supply, the Corporation's most important role will be in setting term prices for UKCS crude at levels which maximise overall public sector revenues from our North Sea oil production, even though that might sometimes result in a trading loss. BNOC are in no doubt about this. However, too bald a statement to this effect could prejudice the Corporation's independent standing and the status of its prices as market, rather than Government determined prices.

(ii) Initial capital

It could be argued that, since the Corporation will not be doing any investing, and will be expected at least to cover its costs from its gross trading profits, it will have no need for any financial reserves. I am persuaded, however, that it would be unreasonable to give BNOC nothing but a guaranteed overdraft to accommodate swings in its trading position. This is because - particularly in the short run - trading in participation oil is subject to considerable market fluctuations; if it had no reserves the Corporation would have to seek fresh grants from Government whenever it went through a period of trading difficulty.

The result would be an exceptional degree of dependence in the short run on Government support, and the Corporation would clearly be seen as having no standing in the market independent of the Government. Leaving aside any other difficulties, I do not believe we could secure and retain competent people to run the trading operation if we insisted on a regime of this kind. How large the reserves should be is a matter of judgment in which ordinary commercial precedents are of little value; I believe that £30 million would give the Corporation a reasonable prospect of avoiding the need to ask Parliament for fresh grant money for several years.

(iii) Financial target

We shall be lucky if the trading operation as such does much better than break even, taking one year with another. As emerged clearly from officials' recent work on oil production and pricing in weak market conditions, BNOC - whether before or after the separation - cannot earn significant profits on trading in participation oil, since it is obliged to buy the oil from the Companies at the full market price, but it remains exposed to the risk of significant losses. Assuming, however, that BNOC's earnings cover the administrative costs of participation trading, the Corporation should be able to show an overall profit through the investment of its reserves. The financial target is designed in effect to require the Corporation to break even on its trading activities; I would envisage using the powers in the OG(E) Act periodically to extract from BNOC the cash generated through the investment of its reserves. If, against our present expectations, the trading results were markedly better than break even, then of course we should require the Corporation to pay over larger amounts.

(iv) Limits on trading activities

Paragraph 4(i) of the guidance note records that BNOC's business plan will cover the general sales strategy and the extent of the risks to which the Corporation might be exposed. I attach great importance to ensuring that BNOC does not get deeply involved in risky trading activities: indeed it is highly desirable that the Corporation should actively seek ways of reducing the risks inherent in its present operations. I should by now have preferred our officials, with BNOC, to have defined and set limits to the risks to which the Corporation may be exposed at any one time. However, those responsible in the Corporation have had to give their main attention in recent weeks to aspects of privatisation - the participation arrangements with Britoil and the preparation of the scheme. I consider that BNOC Trading's activities not connected with participation should be restricted to their present levels for the remainder of this calendar year. BNOC and my officials will meanwhile re-examine the Corporation's trading strategy, with the objective of devising new and more relevant limits to take effect in 1983. In particular, I shall be considering - although I am by no means certain we can achieve this - whether the limits might be set by reference to the financial exposure on transactions, rather than, as hitherto, limits to the physical volume of business over a period without any regard to risk.

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Now that the Prime Minister and other colleagues have accepted my proposals for the Chairman and Chief Executive of BNOC after the flotation of Britoil: and the Chairman's appointment has been announced, I should like to convey the guidance formally to Lord Croham and Ian Goskirk as soon as possible. I am anxious to ensure that there is no loss of confidence or reduction in commitment on the part of the trading team on account of doubts or uncertainties about what the Government expect from them in future. I hope, therefore, that you and others will be able to agree to my proposals within the next few days.

I am copying this letter to the Prime Minister, other members of E(NI) and to Sir Robert Armstrong.

NIGEL LAWSON

JUL 1982

Energy BNOC file Pt 5 with PYCS

Pl attach

CF

To all recipients of letter.

Secretary of State for Energy

14/7/82.

We copied you a letter from us to Geoffrey Howe MP about BNOC Trading after the separation of Britoil on 13th July.

Attached is the Enclosure that should be with the letter. If you could please attach this I would be most grateful

DeTopper.

APS/SOS for Energy
Nigel Lawson's office
Thames House South.

BNOC AFTER THE SEPARATION OF BRITOIL

1 General objectives for BNOC

(i) Through participation, to secure and dispose of UK and UKCS petroleum in a way which contributes to our national security of supply.

(ii) Through effective trading and marketing, to ensure that the UK economy receives the maximum benefits from BNOC's access, through participation rights, to UK and UKCS petroleum. A simple guide may be to seek to maximise sales revenue for participation oil.

(iii) To trade profitably in all non-participation petroleum and petroleum products. 'Trading' may include the arrangement of shipping and of processing, although the Corporation would be expected not to seek to invest in ships or in refining and processing.

2 Specific duties not covered by the general objectives

(i) To act as the Government's agent in the sale of oil taken as royalty in kind (RIK). (Although some small fields are being excluded from RIK, oil will continue to be available in future from this source on roughly the present scale.)

(ii) To discharge the requirements of the agency agreement covering the Government pipeline system.

3 Financial structure and financial target

(i) After disposing of its upstream assets BNOC will be provided with £30 million of retained profits.

(ii) The Department of Energy with Treasury consent will arrange to guarantee short-term borrowing facilities of up to £50 million on terms similar to those enjoyed by other nationalised industries.

/ (iii)

(iii) BNOC and the Department are agreed that a financial target set in terms either of annual percentage return on assets or a percentage on turnover would not be appropriate. BNOC will instead be asked to earn a net surplus pre tax of £10-15 million* over its first four year period, after meeting all its administrative and other costs.

(iv) The Oil and Gas (Enterprise) Act contains powers for the Government to make grants to BNOC, to support the participation agreements. While the Government would not expect to be called on to provide grants of this kind frequently, BNOC would not, in the event of it making a loss too large to be covered by its own resources, be expected to rely for more than a short period on additional short-term borrowing.

(v) The Oil and Gas (Enterprise) Act provides powers for the Corporation's profits to be recouped by the Exchequer. It is expected that these powers would be used either if BNOC generated continuing surpluses or if circumstances allowed a single large profit to be made.

4 Reporting and control

(i) BNOC will submit to the Department of Energy not later than April each year a business plan covering the following four calendar years. Following discussion at official level, this will be submitted, subject to any necessary modifications, for the approval of Ministers not later than June. The business plan will cover the general sales strategy, and the extent of the risks to which BNOC might be exposed, as well as figures on forecast physical availabilities and projected financial results.

* The exact figure will be determined in the light of a re-evaluation currently being made of BNOC (Trading)'s financial prospects by the company's accounting advisers. / (ii)

(ii) An updated version of the business plan covering the immediately following calendar year only will be prepared each October. Unless it is invalidated by unforeseen changes in market circumstances, this will provide a yardstick for assessing the Corporation's trading performance.

(iii) Six-monthly consultations will be held with the Department as hitherto.

(iv) Each quarter in January, April, July and October, the Department of Energy will review formally the trading results for the most recently completed quarter together with the prospects for the next two quarters ahead.

(v) The Chief Executive will report every month to the Corporation on trading results, plans and opportunities.

(vi) Each month the Corporation will provide a funds flow statement to the Department of Energy.

7 July 1982