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

22 November 1982

NBPM

MCS 23/11

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 15 November.

The arrangements for limiting the Corporation's exposure are a considerable improvement on earlier suggestions and I am content for them to be formally communicated to the Corporation. I am sure that you are right in proposing that the whole issue of limiting risks should be reviewed once the Corporation, under the direction of its new Board, has had a clear period of six months' experience of operating under the guidelines. No doubt my officials will be involved in that review. It will be important then to check that the guidelines are having the practical effect of limiting exposure, and that the Corporation are operating within both their letter and spirit.

Finally, now that we have agreed the guidelines, I agree that the Corporation should have a starting capital of £30m.

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

GEOFFREY HOWE

Energy

BNOC

SECRETARY OF STATE FOR ENERGY
THAMES HOUSE SOUTH
MILLBANK LONDON SW1P 4QJ
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Prime Minister
MCS 15/11

The Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
Treasury Chambers
Parliament Street
London SW1P 3AG

15 November 1982

Dear Chancellor,

BNOC TRADING AFTER THE SEPARATION OF BRITOIL

Thank you for your letter of 5 August. My officials, in conjunction with yours and with traders from BNOC have examined the question of exposure to risk in some detail. As a result I enclose a revised version of the note I circulated with my letter of 13 July, which now has an annex setting controls and limits on BNOC's trading activities within which the Corporation will be content to work.

In the annex the risk of financial exposure is covered on two fronts:-

(i) the trading of participation and quasi participation oil;

(ii) BNOC's other trading activities.

Under the heading of participation trading the Corporation is required to continue the present practice of letting me know in advance of any change in their prices for UKCS crude oil. It further limits to £5m any risk to which the Corporation may expose itself without first obtaining my consent.

All the Corporation's other activities are designed to provide a basis for making sufficient money to cover the Corporation's business costs and to give the traders sufficiently interesting opportunities that they will remain with the Corporation. The motive for the Corporation undertaking these opportunities is thus one of profit. Against that there are bound to be risks. I believe that at any one time their exposure to possible losses should be limited to 20 per cent of their reserves.

With an initial starting capital of £30 million that limits exposure under this heading to £6 million; but of course if they are successful and are permitted to retain some part of the increase in reserves, so the opportunity to take risk will increase - albeit modestly. The attached annex assesses the risks associated with current trading activities and demonstrates that the limit I propose, while protecting the public purse, is not so low as to constrain unduly the Corporation's activities.

If you agree, I propose that the note be sent to the Corporation and that we confirm a starting capital of £30 million. In giving these guidelines it would be made clear, in a covering letter, that if the Corporation were to incur within a financial year losses under the general trading heading in excess of the exposure limit, there would have to be a review of the permissible extent of their future exposure to risk of financial loss. The letter would also make clear that the guideline note will need to be supplemented by limitations on non-participation trading (provided for in 1(iii) of the note). The question of spot trading in crude oil will be considered when these limitations are set. The guideline note makes clear that the BNOC-Britoil purchase agreement will not count towards the limits on 3rd party crude oil trading; these arrangements are short-term and it would be inappropriate for them to constrain BNOC's activities in the longer term.

I am satisfied that the Corporation under Douglas Croham's leadership will operate in a way fully consistent with the guidelines. However, I shall ensure that the whole issue of limiting risk in this way is reviewed once the Corporation, under the direction of its new Board, has had a clear period of six months experience of operating under those guidelines. In the meantime I propose to ask the civil servant member of the Board to press for appropriate delegation of financial responsibilities, including arrangements for monitoring exposure to risk within the Corporation.

I am sending copies of this letter to the Prime Minister, other Members of E(NI) and to Sir Robert Armstrong and John Sparrow.

sincerely

J. P. Clark

pp NIGEL LAWSON

(Approved by the Secretary of State and signed in his absence)

ANNEX

EXAMPLES OF CURRENT TRADING EXPOSURES

1 LPG trading Whilst the LPG market is by its nature volatile and often difficult to predict, BNOC's acquisition and disposal structure has been developed on a "risk-avoidance" basis. There have been occasions, though not many, when traders and even the oil majors have reported losses as high as $100/ton but this tends to be on spot or speculative trade, neither of which activities BNOC engages in. BNOC acquires and disposes of its LPG on term contracts to a very high percentage, and its trade is essentially of a back-to-back nature; as a result of its bulking up and freighting activity, BNOC would normally expect to earn a profit of several dollars/ton. The level of trade is currently around 160,000 tons per quarter; there can be a trading exposure but it is unlikely that the maximum could exceed $25/ton and thus a quarter's loss on the whole business is most unlikely to exceed $4 million (£2.3 million) with the probability that at least a part would be covered by back-to-back arrangements.

2 Product trading The arrangements BNOC currently has are essentially back-to-back both on volume and price and there is currently no exposure other than where unforeseen ambiguities or errors are found in contracts.

3 Freighting The Corporation are able to pass their total costs onto customers and normally make a modest profit. There is little prospect of loss in this area unless a crude oil contract is broken leaving BNOC with unwanted freight. However, that could normally be relet albeit at a small loss. In future, BNOC aims to tie freighting more tightly to the crude oil contracts so that such risks no longer exist.

4 Non-participation crude oil trading Total volumes purchased under long term contracts at present amount to some 40,000 barrels a day, or 3 per cent of BNOC's total available crude. The nature of BNOC's trading business prevents losses being attributed directly to specific volumes of oil. Losses should be regarded as distributed pro-rata between different classes of oil. On this

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basis, the largest loss made by BNOC to date averaged some eight cents per barrel for one quarter. The share to be allocated to non-participation would be £190,000. If BNOC finds it must sell oil on the spot market which has been purchased at term prices, the worst scenario would be a loss of $5/barrel for one month (thereafter there could in principle be a realignment of term prices). It is unlikely that BNOC would have more than 150,000 b/d of such oil and it would be split pro-rata between participation and royalty and non-participation; on this basis the loss attributable to non-participation crude would correspond to that on 5,000 b/d, i.e. about £400,000 for a 30 day period. But at the same time there would be a loss of £13 million on participation and royalty; thus in practice the position would be covered by the overriding provision for participation oil.

5 Spot trading If there were to be pure spot trading at the margins (hitherto BNOC have not engaged in this) a reasonable upper bound would be some 100,000 b/d. Any open position could be closed within one day with no more than 50 cents/b loss even in rapidly falling markets. Typically, oil is sold in individual cargoes of some 500,000 b/d; assuming at most two cargoes left outstanding, this would imply a risk of loss of £600,000. BNOC recognise that they are not to initiate trading of this kind without prior consultation with the Department.

6 Total exposure On the basis set out in this Annex, non-participation trading - even taking pessimistic assumptions on all aspects simultaneously - should not lead to an exposure to potential losses of more than £3 million.

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, within limits which may be set by the Secretary of State (annex 1). '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) The Corporation's surplus funds are to be invested in public sector securities in accordance with existing general guidelines.

(iv) 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 million over the first four year period, after meeting all its administrative and other costs.

(v) Section 6(i) of the Oil and Gas (Enterprise) Act provides powers for the Government to make grants to BNOC, in support of the participation agreements. While the Government would expect to be called on to provide grants of this kind only in exceptional circumstances, BNOC would not, in the event of it making a loss too large to be covered by its own resources, be expected to reply for more than a short period on additional short-term borrowing.

(vi) Section 5(i) of 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.

(vii) The Corporation will not expose itself to risks in excess of limits set by the Secretary of State. These are set out at Annex 1 but may be reviewed from time to time.

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.

(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.

11 November 1982

ANNEX 1

LIMITS TO FINANCIAL EXPOSURE

1. Crude Oil Trading

1.1 It is recognised that the major element of crude oil passing through BNOC's books is the aggregate of participation oil and royalty in kind. In addition, the Corporation is committed to buy some 40,000 b/d of oil on long term contracts from small producers. These latter arrangements were put in place in lieu of participation arrangements even though they cover 100 per cent rather than 51 per cent of production (net of royalty). For the purposes of defining financial risk, these existing contracts will be considered as quasi participation oil and subject to the same trading limits.

1.2 However, new contracts of this kind will not automatically be regarded in this light. The Corporation may enter into unlimited contracts where the seller agrees to accept from BNOC the same price as that at which BNOC disposes of the oil providing a sales fee is charged which covers adequately the administrative costs of managing both the buying and selling operations. Where the Corporation wishes to enter into contracts where the buying price is specified in the same way as for participation purchases, a handling fee should be sought sufficient to cover costs and provide cover against trading losses. Moreover, new contracts of this kind should not in total commit the Corporation to purchases in excess of 25,000 barrels per day at any time.

1.3 As far as participation and quasi participation oil is concerned, the Secretary of State expects the Corporation to follow past practice and inform him in advance of the event when market pressures require a change in BNOC's prices. In addition, the Corporation should consult the Secretary of State immediately if it finds itself exposed to a risk of loss of £5 million or more within a quarter on crude oil trading.

1.4 Where the Corporation is forced to buy or sell individual cargoes in order to balance volumes under long term selling contracts coupled with the acquisition of participation and quasi participation crude, this is to be regarded as falling under the rules for participation trading.

2. Other Trading Activities

2.1 This heading includes, but is not limited to:

(i) all trading in LPGs;

(ii) trading in petroleum products;

(iii) freighting arrangements;

(iv) true spot market trading in crude oil, including that which might stem from a deliberate policy to sell short (ie to enter into term supply commitments in excess of those to purchase participation oil or quasi participation oil).

2.2 In entering into contracts under these headings, the Corporation should not at any time allow itself to be exposed to a loss in excess of 20 per cent of its reserves. At the point of severance from the National Oil Account, this means a limit of £6 million. In calculating its exposure, the Corporation should take account both of the risks on fully open positions and those associated with buying contracts where prices are fixed quarterly without provision on associated selling contracts for price variations within the quarter to be passed through on a back-to-back basis.

Energy, BNOC, Pt 5

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Energy

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Britoil Flotation

It is hoped that members will find this note useful in connection with the sale of shares in Britoil.

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Enquiries on this brief to:

The attached graph charts the course of oil share prices from 19 October 1981, when the Government first announced the privatisation of Britoil, to last week's close (5 November). Over the period as a whole, the index rose by a little over 17 per cent.