D/EN letter is Commercial in Confidence

CF - Yours?

JCE SR

c D/N D. Pascall

10 DOWNING STREET

THE PRIME MINISTER

22 February, 1984

Dear Sir Alistair,

Thank you for your letter of 1 February, enclosing a copy of the paper you have written in collaboration with Allen Sykes on maximising Britain's benefits from offshore gas. I have read this with interest.

The main conclusion of your paper is that as a first priority we should consider in collaboration with Norway the development of a strategic gas supply capacity, available to Continental Europe in the event of a disruption to imported gas or oil supplies. The security of gas supplies to Europe has been the subject of detailed study both in the European Community and in the International Energy Agency. Two reports, the most recent in May last year, concluded that major European gas importing countries could in general cope with a loss of up to 30% of imports over 6 months including a winter period. This confirmed the ability of Europe to withstand even quite severe gas supply interruptions.

The position on imported gas supplies is being kept under close review in the European Community and in the IEA. Further studies on the adequacy of gas transportation and storage facilities within the Community and on the level of future imports are expected shortly. Discussion of these will provide the opportunity for international consideration of further security measures such as those proposed in your paper. The willingness of gas importing countries to pay

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the security 'insurance premium' and the attitude of the Norwegians are important in assessing those proposals. I should mention that the Norwegians have so far shown no interest in those more limited suggestions for co-operative measures to which you also refer, for example for the UK to act as a 'landbridge' for the delivery of Norwegian gas to the Continent.

Your second conclusion is for the Government to pursue increased competition in the supply of gas to the British market by relaxing the landing requirement for gas. We have, as you may know, made clear that the Government is willing to reconsider the question of gas exports if large new volumes of gas should be discovered on the UKCS. The issue rightly identified in your paper is whether current policies are providing sufficient incentive to the oil companies to explore for and develop our offshore reserves. Here, I feel you have under-estimated the impact which our policies are already having. In the late 1970's offshore exploration activity indeed fell appreciably. Over the last two years (which have seen the passage of the Oil and Gas (Enterprise) Act and the Eighth Round of Licensing) some 65 wells have been drilled in the Southern Basin gas province alone and ten new gas developments are either under way or in prospect. This upsurge in activity is resulting in a much better understanding of available gas reserves, which will be reflected in this year's Brown Book, due out in April.

Lastly, the landing requirement, which incidentally applies equally to oil and gas, does afford Britain significant security of supply benefits over our petroleum resources. While these benefits may not be as far reaching as those you suggest on a European scale, they could nevertheless be of great importance to the nation in times of emergency.

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As your paper ranges over a large number of interesting issues relating to gas policy you may like to send a copy to Peter Walker, who would I am sure be glad to discuss it with you.

Yours sincerely

Margaret Thatcher

Sir Alistair Frame

6, St. James's Square
London, SW1Y 4LD
Telephone: 01-930 2399

NBPM AT
27/2

24th February, 1984

Dear Prime Minister,

In Sir Alistair Frame's absence overseas, may I acknowledge and thank you for your letter to him of the 22nd February. This will be placed before him when he returns to London on the 5th March.

Yours sincerely,

Elisabeth Hughes

Elisabeth Hughes (Miss)
Secretary to Sir Alistair Frame

The Right Hon. Margaret Thatcher, M.P.,
10 Downing Street,
London, S.W.1.

Nat Ind: Gas + Elec pt. 9.

SECRETARY OF STATE FOR ENERGY
THAMES HOUSE SOUTH
MILLBANK LONDON SW1P 4QJ
01 211 6402

GR
For PM's sig pr.
D
20/2

David Barclay Esq
Private Secretary to the Prime Minister
10 Downing Street
London SW1

17 February 1984

Dear David

will come Monday

Thank you for your letter of 2 February requesting a draft reply to Sir Alistair Frame's letter of 1 February and attached paper on 'Maximising Britain's Benefit From Offshore Gas' (returned as requested). Sir Alistair takes a regular interest in gas industry affairs, including a recent unsuccessful bid by RTZ for BGC's share of Wytch Farm and proposals for acquiring directly the assets now vested in Enterprise Oil.

The paper argues that, as a first priority, the UK should consider joint action with the Norwegians for the strategic development of standby gas fields. These, with gas links to the Continent, would provide an insurance policy for NATO against Soviet interruption to gas supplies or OPEC interruption to oil supplies. (Sir Alistair assumes that in such circumstances gas would substitute for oil; he does not recommend that standby oilfields should be similarly prepared for use in a supply emergency). The paper also puts the case for UK gas exports. It argues that the requirement for gas to be landed in the UK, together with BGC's position in the market, have depressed the level of offshore gas activity and consequently estimates of gas reserves, as well as prices to producers (such as RTZ) and consumers. The full potential of UKCS gas resources has not therefore been realised.

The level of European dependence on Soviet gas supplies (notably to France, FRG and Italy) has been studied at length in the International Energy Agency (IEA), following the Siberian gas pipeline dispute with the US, and by the European Community. Both studies, which were carried out in consultation with member States (including the UK), concluded that security of gas supplies would not be jeopardised by dependence on a single source of imports, such as the USSR, at levels below about 30% of supplies. With imports up to this level, countries could cope with even a prolonged interruption to supplies. This conclusion was endorsed by IEA Ministers prior to the Williamsburg summit. In these circumstances, It is unlikely that European countries importing Soviet gas would be prepared to consider paying a considerable 'insurance premium' for developing significant North Sea gas reserves for use only as an emergency standby. It should also be noted that the Norwegians have been actively hostile to ideas for co-operative measures for bringing Norwegian gas through Britain to the Continent, as suggested by Sir Alistair.

You will be aware from my Secretary of State's letter of 9 February to the Chancellor that a decision is called for on the British Gas Corporation's proposal to purchase Norwegian Sleipner gas, once details of the outcome to the commercial negotiations have been established with the Corporation. The relationship between gas imports, levels of UKCS gas production and any future gas exports is relevant to the Sleipner purchase and one of the issues which Ministers will wish to consider carefully. The question of gas exports is further complicated by the legal issues concerning whether a controlled export regime can be established which is defensible against possible challenge under the Treaty of Rome. This aspect is before the Law Officers, whose advice is expected in the very near future. Again, Minister's will wish to consider this advice in the Sleipner context.

In arguing its case, the paper makes a number of exaggerated claims and there are some statements which could reasonably be questioned. These points have not been addressed in the draft reply to Sir Alistair, although a detailed commentary on the paper can be provided if this is thought necessary.

Yours ever

John

J S NEILSON
Private Secretary

DRAFT LETTER FOR THE PRIME MINISTER'S SIGNATURE

Sir Alistair Frame
6 St James's Square
London SW1Y 4LD

Thank you for your letter of 1 February, enclosing a copy of the paper you have written in collaboration with Allen Sykes on maximising Britain's benefits from offshore gas. I have read this with interest.

The main conclusion of your paper is that as a first priority we should consider in collaboration with Norway the development of a strategic gas supply capacity, available to Continental Europe in the event of a disruption to imported gas or oil supplies. The security of gas supplies to Europe has been the subject of detailed study both in the European Community and in the International Energy Agency. Two reports, the most recent in May last year, concluded that major European gas importing countries could in general cope with a loss of up to 30% of imports over 6 months including a winter period. This confirmed the ability of Europe to withstand even quite severe gas supply interruptions.

The position on imported gas supplies is being kept under close review in the European Community and in the IEA. Further studies on the adequacy of gas transportation and storage facilities within the Community and on the level of future imports are expected shortly. Discussion of these will provide the opportunity for international consideration of further security measures such as those proposed in your paper. The willingness of gas importing countries to pay the security 'insurance premium' and the attitude of the Norwegians are important in assessing those proposals. I should mention that the Norwegians have so far shown no interest in those more limited suggestions for co-operative measures to which you also refer, for example for the UK to act as a 'landbridge' for the delivery of Norwegian gas to the Continent.

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Lastly, the landing requirement, which incidentally applies equally to oil and gas, does afford Britain significant security of supply benefits over our petroleum resources. While these benefits may not be as far reaching as those you suggest on a European scale, they could nevertheless be of great importance to the nation in times of emergency.

As your paper ranges over a large number of interesting issues relating to gas policy you may like to send a copy to ~~might wish to discuss it with~~ Peter Walker, ~~to whom I have sent a copy.~~ ~~who~~ who would I am sure be glad to discuss it with you.

Sir Alastair FRAME

10 DOWNING STREET

Energy draft reply to "Frame", requested by AB on 2/2, will come tomorrow (deadline was today)

CST 16/2.

GR.

PP. Ring D/Energy - they've returned Sir Alastair Frame's papers but NO DRAFT REPLY.

Coming 20/2

Sir Alistair FRAME

FILE

16/2 Rev

Ack 2/2

10 DOWNING STREET

From the Private Secretary

2 February, 1984

I enclose a copy of a letter and enclosure the Prime Minister has received from Sir Alistair Frame.

I should be grateful if you could let me have a draft reply for the Prime Minister's signature by Thursday, 16 February. Could you also return the enclosure with your draft reply.

(David Barclay)

J. Neilson, Esq.,
Department of Energy

6. St. James's Square
London, SW1Y 4LD
Telephone: 01-930 2399

1st February, 1984

Dear Prime Minister,

Some two years ago, an ex-colleague of mine on the RTZ Board and I wrote a paper on maximising Britain's potential benefits from offshore gas. This was shortly after the RTZ led study into a multi-user gas pipeline in the North Sea had collapsed.

We have recently updated the document, and I thought you might be interested to see a copy.

Yours sincerely
Alistair Frame.

The Right Hon. Margaret Thatcher, M.P.,
10 Downing Street,
London, S.W.1.

Enclosure: Two Copies of 'Maximising Britain's Benefits from Offshore Gas'

STRICTLY PRIVATE & CONFIDENTIAL

MAXIMISING BRITAIN'S BENEFITS FROM OFFSHORE GAS

The case for strategic co-operation with the EEC and NATO, and for giving offshore gas the same competitive regime that has been so successful for oil, including the right to export.

By Sir Alistair Frame and Allen Sykes

January 1984

CONTENTS

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

Since the 1982 Oil Enterprise Act which restricted the British Gas Corporation's monopoly buying rights, and allowed oil companies access to the UK industrial gas market via the BGC's pipeline system, and since the very much higher prices being paid for British gas, the economic environment for UK offshore gas has certainly improved considerably. All these steps faced both BGC and political opposition, but the government commendably accepted the case for introducing some competition in the supply and marketing of gas.

The question arises whether these new policies of introducing competition go far enough to achieve the intended results of a much healthier and expanding offshore gas industry. To informed opinion within the oil industry, and outside it, the answer to this question is no. Unless the government takes the vital further step of permitting gas exports, hitherto banned regardless of the generally higher available export prices, then there is little likelihood of a major increase in offshore gas activity which is so much in the nation's interest. In the more bracing competitive economic climate of the last two years, the one major argument left against allowing exports is the fear that Britain's offshore gas reserves are sufficient only for British needs. This concern is not generally shared by the oil industry for the good and sufficient reason that there would be no shortage of proven gas reserves once gas could be exploited as freely as oil. The combined BGC buying monopoly and the ban on exports gave the oil industry no incentive to look for gas in British waters between the late 1960s and the early 1980s. Now the much higher gas prices on offer from the BGC are changing the position To judge the availability of gas reserves after a dozen or more years of having no incentive either to look for or to exploit gas inevitably means taking a misleadingly conservative view of what could be there. If the oil industry could be given all the right incentives there should be more than enough gas for Britain's own needs into the foreseeable future as well as providing for the possibility of major exports to the Continent. Further, and most importantly, the freedom to export gas, particularly if allied to wise and energetic co-operation with Norway, the EEC, and NATO, could result in a major increase in offshore gas activity far in excess of that which has resulted from the BGC's more realistic pricing policies and the government's policy changes necessary, welcome though they have been.

In connection with the effect of allowing exports on exploration activity and reserves it should be borne in mind that until Australia allowed exports of iron ore in the early 1960s, and Alberta allowed gas exports to Eastern Canada at a similar time both products were locally held to be in scarce supply. They are now huge prosperous industries with reserves dwarfing initial expectations.

2. Background Factors

a) Too Limited an Incentive for Gas Exploration

Oil companies actively explore for oil but far less so for gas in UK waters. The reasons are that oil effectively sells at the world price and some exports, while controlled, are permitted. Gas, in contrast, must be landed in Britain and can effectively be sold only to the BGC. (The right to sell direct to industrial consumers is more theoretical than real.) Gas exports are effectively prohibited. Many long term gas contracts were signed between the oil companies and the BGC in the late 1960s to take the output from the Southern Basin gas fields off East Anglia. These were in essence on fixed price terms with minimal escalation clauses such that their prices only two years ago were typically only between 15% and 25% of the going free market European gas purchase price. This permitted the Soviet Union to pre-empt much of the large European market with its own huge gas line. The oil companies have been so discouraged by these early contracts that virtually no further new gas contracts from <u>British</u> waters have been signed with the BGC in the last dozen or so years. The exceptions are such cases as the Brent gas where the gas concerned is a <u>by-product</u> (called 'associated gas') of oil production. The oil production is usually so valuable that it pays to develop it even if the profit on the gas is very low or even negative. But no <u>gas</u> fields - i.e. fields whose revenues derive solely or mainly from gas - have been developed in the British North Sea this past decade. (The Frigg gas field which straddles the boundary line - roughly one third in UK waters - is the partial exception.) Now, thanks to very much higher BGC prices under combined political and oil industry pressure some smaller UK gas fields are being developed.

b) <u>No Justification for treating Gas differently from Oil</u>

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

3. The Correct Context for Judging Policy Changes

a) The Need for a Wide Perspective

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

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

b) <u>Validly Judging Britain's Gas Reserves</u>

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

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

a) The Wasteful Restrictions of the Boundary Lines

An examination of known gas reserves in the North Sea, and particularly in British and Norwegian waters, reveals that the majority of gas and gas condensate fields, plus oil fields with significant quantities of associates gas, cluster around the boundary line between the British and Norwegian sectors. Every serious observer of the North Sea scene over the last ten years has lamented the effect of this artificial dividing line and the accompanying policies of both governments. These have caused, and continue to cause separate and thus non-optimal development. There can be little doubt that if the two nations could co-operate they would both gain substantial advantages, but this can only happen if both countries have a free economic regime (Norway needs one too) and are determined to act in a way that maximises their joint gains. This means that the North Sea

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

should be developed in a much more unified fashion than existing short sighted policies have allowed. The cheapest way to transport gas for long distances is to use landlines wherever possible as these costs are typically considerably lower than for offshore lines. If the oil industry is given a free hand in British and Norwegian waters then it is very likely that there would be joint schemes for bringing British and Norwegian gas to Western Europe, certainly by offshore lines but possibly by at least some landlines.

The September 1981 cancellation of the government supported gas gathering line has predictably resulted in the oil companies taking several separate initiatives to bring gas (mainly associated gas) ashore to Britain. If the export ban is lifted then similar initiatives would be very likely to happen with <u>international</u> gas pipeline systems involving not just associated gas, but mainly gas in gas and gas condensate fields. It is wasteful for the Norwegians that they have had to transport their gas and gas liquids by their own offshore pipeline system now being built across the deep Norwegian Trench merely to land liquids in Western Norway to promote industrial development, and then to take the dry gas back again across the same Trench on the route south to Germany and Holland. It is equally wasteful that any Norwegian pipeline should be denied any British gas which can more easily and economically flow into it. Similarly, it is undesirable that Norwegian gas which could more sensibly flow to Britain should be compelled to use the Norwegian system. Patently present restrictions are unnecessarily disadvantageous to both nations. It should also be noted that an international pipeline network would both provide flexibility and permit advantageous 'swap' agreements, thus minimising gas transport costs.

b) The Reasonable Requirements of Norway for Unified Development

Before considering the very considerable advantages to Britain from unified development it is necessary to consider the needs of Norway which must be met as a precondition to such development. Until the Norwegians had to commit to developing a further separate gas pipeline to the Continent (there is only one such at the moment - Ekofisk) they have been compelled either to sell their gas to the BGC or to await other export opportunities. The Norwegian government was, of course, well aware of the economies to be had from marketing its gas in Western Europe via British offshore and land pipelines. But they were understandably reluctant to agree to such lines because of the control this would give to the BGC (the only possible owner of at least the land part of such lines under present British law) over any future Norwegian gas supplies which should be huge. If Norway's understandable and indeed reasonable reluctance is to be overcome there must be a radically new and more open approach to them. It will be obvious that the only way to get their involvement in a pipeline system in British territory is if they own a substantial part of it, perhaps half, and if it in no way restricts market opportunities for their gas. In these conditions they should welcome lines in British territory because they would greatly enhance their marketing possibilities. Not only would they be given cheaper access to the massive Continental market but, thanks to the government's recent policy changes, they should also have additional possibilities of selling their gas to British industry as well as to the BGC. Thus, with the appropriate safeguards, it should be possible to meet every reasonable Norwegian objection and simultaneously give them greater opportunities for marketing their gas on profitable terms.

c) The Gains to Britain

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

d) The Greatest Gain of All - Enhanced Western Security

The most important casualty of British and Norwegian economic policies for gas over the last decade or so, however, are not lost economic opportunities, important as they are, but the avoidable weakening of EEC/NATO security. The two countries' economic policies had the unintended result of permitting the Soviet Gas line project which has made Western Europe too dependent on the Soviet Union in times of political strain or a major OPEC inspired energy crisis. And who can safely predict these events will not happen? Due to the short sighted pursuit of export orders in a recession, Western Europe is now going to pay a heavy economic, political and security price for supporting the Soviet gas pipeline and signing long term contracts with high floor prices. (See in particular the attached article from 13 December 1983 issue of the Wall Street Journal.) It is too late to stop the Soviet project, but it is not too late to take steps to mitigate the Soviet Union's ability to put pressure on Western Europe in time of crisis. What is needed is the development of both British and Norwegian gas reserves on a standby basis, plus putting in place an interlinked pipeline system to Europe. For a start this could include tying in a new offshore British pipeline to the Norwegian Statpipe line presently under construction. Later, perhaps an additional pipeline or two should be constructed sufficient to ensure that Western Europe could get enough gas in an energy crisis not to be beholden to the Soviet Union in any significant way.

Such a project, at least initially, would be a pure insurance policy to improve NATO security, although it might soon be the channel for commercial exports as gas demand expands in Europe, particularly the demand for politically secure energy (Europe is overdependent on both OPEC oil and Soviet gas). Because it is initially an insurance project all, or certainly most of the costs of gas field development and new pipelines should be borne by the governments of the EEC and the Continental members of NATO (largely the same countries). The oil companies involved could be required to pay for the gas fields and pipeline facilities as and when they come to use them for commercial exports. The details of such a financing and repayment scheme need not concern us here, but are easily demonstratable when required.

Such a scheme should do much to cement EEC relationships, and NATO solidarity, and would also be well received in the United States for obvious reasons. It would give Britain, and Norway, a chance to demonstrate far sighted political statesmanship. Further, it would be a major and much needed boost to the British economy, and especially the under-utilised North Sea supply industry. It merits the most serious consideration.

e) <u>The Need for Norwegian Co-operation</u>

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

f) Being Wise in the Face of Necessity

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

g) The Need for Government Resolution

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

5. Conclusions and Recommendations

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

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

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

d) Above all else immediate consideration should be given to the strategic development of standby gas fields in British and Norwegian North Sea waters, plus pipeline links to the Continent to neutralise potential Soviet and OPEC pressure on Western Europe. The benefits to Britain, Norway, the EEC and NATO are very considerable strategically and economically. Its achievement calls for the highest and most imaginative order of British statesmanship.

THE WALL STREET JOURNAL, TUESDAY, DECEMBER 13, 1983

Europe Pays for Its Pipe Dream

By Gordon Crovitz

The Soviet natural-gas pipeline to Europe will be switched on next month. President Reagan's sanctions of last year forced the Soviets to substitute pumping equipment from their domestic gas lines, increasing the project's cost to the Russians. But the more important effect of the sanctions was to force the West to look more closely at the project. Europeans should now consider the economic effects, which are devastating.

In retrospect, it's clear that even when European governments agreed to the project in 1981 the deal was on questionable economic ground. Subsidized loans, credit guarantees and pricing concessions were offered out of a detente-era desire to engage in East-West trade—even when the "trade" involved no mutually beneficial exchange.

Recent evidence shows that the relative negotiating positions made it extremely unlikely that the Europeans could benefit even if they had pushed harder for a good deal. Soviet negotiators successfully took advantage of their position as a single negotiator faced with several competing traders.

Three Delegations

The Soviet Union was a monopsonist, the sole "buyer" of pipe and equipment from Europe, and the sole supplier of gas to several competing buyers. All the information was held by the Soviets, who—at least in theory—should have been able to hold out for the best deal from each of the European countries.

This is precisely what they did. The Soviets appointed an expert committee to handle each part of the negotiations. Three standing delegations were created to deal with Western exporters of pipe and equipment, the Western banks that are to finance the project in cooperation with European governments, and the state-controlled European gas importers.

The Soviets played off the European bidders against each other on each aspect of the project by announcing the best offers, then inviting more competition. Axel Lebahn, until recently the Moscow representative of Deutsche Bank AG, which led the German consortium that provided the largest share of the pipeline's financing, recently reported that Western exporters of equipment were forced to cut their prices by as much as 60% because of their weak position as independent bargainers against the U.S.S.R.

In addition, the Soviets were able to take advantage of their monopsonist position when it came to arranging for below-market credits. The French offered the cheapest credit for the pipeline deal. At a time when the interest rate in France was 16%, the French offered the Soviets 7.8%. This generosity is not surprising coming from the French, who historically have had difficulty grasping the concept of non-subsidized export-credit terms.

Other European governments, especially West Germany's, view subsidized credit to the Soviets with more skepticism. But since the French offered a basement rate, everyone else felt compelled to do so. For example, Hermes, the German government's insurance agency, guaranteed $3.66 billion in loans at real rates far below what the government would have to pay to borrow the funds in the money markets. European investment in Europe has been crowded out by huge borrowing on behalf of the Soviets.

The economics of the pipeline project can be understood only as neo-Keynesianism. The goal, which fit in nicely with detente's encouragement of East-West trade, was to create government spending—regardless of the fact that the money could have been better spent in creating real growth in European economies rather than in the Soviet economy. European governments reasoned that spending in a recession would reduce unemployment, and billions of dollars invested in the pipeline would appear to help halt the growth in joblessness. In fact, the pipeline had little to do with producing natural gas. Alternative sources of gas from Norway and the Netherlands, the North Sea and Africa were available at lower economic and political costs.

But of course government spending often impedes growth. In cases like the pipeline, the "jobs" created in steel and other industries are not real jobs, in that they would not exist in a competitive market. The jobs are make-work rather than productive, restraining economic growth through the inefficient use of resources.

Changes in world energy prices have been the worst news so far for Europeans. Under the supply contracts, they accepted the risks of the fall in the world inflation rate and the chance that the Organization of Petroleum Exporting Countries cartel might begin to lose its hold on the oil market.

The contract price for the gas starts at $4.70 to $5 per million British thermal units, depending on the transportation costs to the purchasing country. The Soviets also insisted on a clause that European negotiators most likely doubted would ever be applied. What if oil prices and inflation fell from their 1981 levels? The contracts include a "floor price" clause, which states that the price Europeans will pay will increase at a minimum rate. The Soviets are therefore, for example, guaranteed a floor price of $5.70 per million BTUs from the West Germans by the end of the decade, regardless of what has happened by then to either the inflation rate or the ability of OPEC to control oil prices.

In addition to the floor-price clause, there is a term of the contract that determines the minimum amount of gas the Europeans must buy regardless of the future cost of alternatives. This "take-or-pay" clause means European buyers must take or pay for 80% of the contracted volume of gas.

Western entities mustn't compete with each other to the degree that all risks fall on the West, not the Soviets.

Consider the combined effect of the floor-price and the take-or-pay clauses on, say, the French. The French supply contract provides for a floor price beginning at $5.50 per million BTUs. This is equivalent to about $34 per barrel of oil—perhaps a reasonable price in 1981, but not now, when the price of oil is $29 a barrel. Even worse news for France, like many countries in Western Europe, is that its government has squandered one source of economic recovery—the capital saved through energy conservation—by its too-rosy prediction of economic growth. France's economic growth was 0.3% in 1981, 2% in 1982 and around zero this year, and energy consumption has fallen nearly 10% since 1979. But, largely due to the Siberian gas contracts, France has signed up for the equivalent of 29 million tons of petroleum in natural gas by the end of the decade. The nation's planning ministry now estimates usage will be no more than 22 million tons' worth.

The European press has reported that the West Germans and French hope to renegotiate the pricing clauses of their contracts with the Soviets. It's easy to see why they would want to, but it's not at all clear what incentive the Soviets would have to accept lower prices or waive the take-or-pay clause.

For that matter, say European countries do offer the Soviets some sort of quid pro quo that includes a price reduction and/or a volume reduction. While European gas consumers would benefit, the same people, as taxpayers, would lose: The result of such a renegotiation would be a reduction in the earnings of the pipeline, which in turn would mean that the Soviets could not pay back the loans at the expected rate. European taxpayers would then be forced to bail out the bankers who made the subsidized loans. If the price is reduced, it seems likely that the hard-currency-starved Soviets would insist on an increase in the volume to be purchased. But the loan repayments would still have to be stretched out.

In any case, if some agreement is made between the European governments and the Soviets to reduce the price or volume of gas, one must ask what sort of deal this might be. It is hard to imagine any purely economic incentive the Europeans could offer. The Soviets are in no position to make any purchases of Western goods, even at a discount. And Europe simply has no demand for other goods the Soviets might offer to sell.

Some Lessons

Politics is the most likely basis of a renegotiation. It's possible to imagine all sorts of deals that the Soviets might make once European leaders scale the slippery slope of political deals for economic redemption. Delay further deployment of U.S. missiles? Extend more credits at even more favorable rates?

There are some better-late-than-never lessons from the pipeline disaster. The West must take a more clearheaded approach if it ever again pursues a project of this magnitude with the Soviets. In particular, Western companies and governments must not compete against one another to the degree that in the end all the risks fall on the West, not the Soviets.

Western governments must agree to leave East-West trade to the traders. European governments intervened in the pipeline contracts at every step, most significantly when it came to financing the project. Without the bad detente politics that led to bad economics, the pipeline never would have been built, and Europeans would have been better off.

Mr. Crovitz is editorial page editor of The Wall Street Journal/Europe. His "Europe's Siberian Gas Pipeline" was just published by the Institute for European Defense and Strategic Studies, London.