

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
Treasury Chambers
Parliament Street
LONDON SW1P 3AG

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SLEIPNER

I enclose a paper on the proposed purchase of Sleipner gas. You will see that within this paper I have dealt with all the points you raised in your letter to me of 14 February.

I am afraid I am also having to circulate a detailed appendix, as this is a most complicated subject.

You will see from my paper that I have taken a great deal of trouble to look at all of the options. Indeed, I intervened personally to obtain a realistic assessment of what is available from the Dutch.

The Norwegians have been very understanding in recognising the importance of our examining this proposal thoroughly. They do however have a genuine Parliamentary problem. If the proposal in my paper to seek some amendments to their proposals is agreed, I will need to negotiate these very speedily in order to enable them to obtain the appropriate approvals in the Norwegian Parliament. I would therefore appreciate a meeting being held on this as quickly as possible. I would also be only too pleased to provide at such a meeting a visual presentation of the factual background to the analysis we have carried out.

I am copying this letter to the Prime Minister, Geoffrey Howe, George Younger, Norman Tebbit and to Sir Robert Armstrong.

Peter Walker

PETER WALKER

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BGC'S PROPOSED PURCHASE OF SLEIPNER GAS

(Memorandum by the Secretary of State for Energy)

THE PROBLEM

1. The gas industry is faced with making major new investments in gas supplies in order to maintain its important role in meeting a high proportion of premium energy requirements of British industrial and other consumers in the 1990s and beyond.
2. The purchase of gas from the Norwegian Sleipner field, for which BGC is seeking HMG approval, arises in this context. The background to this, together with an analysis of the effects of allowing or not allowing the purchase to proceed, is set out in detail in the paper at Appendix I. The position may be summarised as follows (where references appear at the end of the following sub-paragraphs they refer to paragraphs in Appendix I where more information may be found):-
 - (a) Between 35% and 45% of new requirements for gas in the mid-1990s can be satisfied by contracting to buy Sleipner gas. The Corporation has made a provisional deal with the Norwegians which is good in terms of the international market and they have advanced strong arguments for accepting it. The deal is less clearly advantageous in national terms because it will cause us to rely on imports to a greater extent than may really be necessary in the 1990s, thereby delaying developments on the UKCS unless gas exports are permitted. The Dutch have also offered gas (and being a smaller volume this drawback would be avoided) but the terms offered are substantially inferior to those agreed for Sleipner. (Paragraphs 1, 2.4, 3 and 8).
 - (b) Sleipner reserves are of the same order of magnitude as those in the Frigg field (60% Norwegian, 40% UK) which has been supplying us with gas since 1977. The balance of payments cost of buying Sleipner would be £1.4 to £1.8 billion/annum (1983 prices) in the mid-1990s rising with increasing oil prices to perhaps £1.9 to £2.4 billion/annum by 2000. This compares with the current balance of payments cost of Norwegian gas of about £1.2 billion/annum. There is however a high probability that, if Sleipner were not purchased, imports would still be needed in the 1990s and much more would certainly be needed later; so the cost of gas imports to the balance of payments would not be eliminated even in the 1990s. (Paragraphs 2.1 and 10).
 - (c) Sleipner gas would come on stream in 1990 (just as Frigg runs out), reach plateau in 1996 and remain there for up to 10 years. Plateau offtake (430 to 550 bcf/year, meeting 25% to 30% of our total demand) compares with 180 bcf/year (10% of demand) offered by the Dutch. On the basis of their present offer,

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Dutch gas would be 20% more expensive than Sleipner by 1995; and this assessment ignores the fact that Sleipner terms include delivery to Britain, whereas Dutch gas would have to be transported from Holland at BGC's expense. The Sleipner deal would also make available to BGC spare capacity in the pipeline for transporting non-Sleipner gas without payment other than a contribution to operating costs. This could be of considerable value in allowing UKCS gas which at present has no means of delivery to shore, to be gathered. (Paragraphs 2.2 to 2.6).

(d) (i) Forecasts of gas demand 10-15 years ahead are inevitably uncertain. BGC's forecast for the mid-1990s (1840 bcf/year) is 10% below the peak expected in the next five years, and assumes that by 1995 prices to consumers will have risen by 15% or so in real terms (with a further 25% rise predicted by 2000).

(ii) These increases assume a continuation of current pricing policies, but reflect a declining base of cheaper gas under old contracts available to be averaged in with newer more expensive gas. My Department's forecast based on these same selling prices is actually 100 bcf/year more than BGC's. Against this, however, prices could be higher still, and demand in the 1990s lower, if prices are moved up to full long run marginal cost levels, depending on how such marginal cost prices are defined, and when they are achieved.

(iii) I would be loath to rest too much faith on any lrmc calculation, or to assume, in considering gas demand forecasts, that gas selling prices will necessarily follow a path dictated by such lrmc estimates.

(iv) On BGC's latest lrmc estimates, their current selling prices are virtually at full marginal cost levels already, and their proposed prices in the 1990s fall only slightly behind full lrmc levels based on the forecast cost of Sleipner then. BGC's lrmc estimates are at the top end of the plausible range for marginal costs in the 1990s, when demand will be falling, and even assuming selling prices were increased to such full marginal cost levels then, the impact on the Department's forecast of gas demand would merely be to bring it back to the same level which BGC anyway project. I am therefore confident that BGC's demand forecast for the 1990s is realistic in terms of the pricing policies we are likely to want to be pursued, and that it is consequently an appropriate basis for judging the need for Sleipner. I am also satisfied that BGC will be able to on-sell Sleipner gas profitably, in the sense that their finances will be better if they buy replacement gas at these prices than if they do not do so. (Paragraphs 4.1.1 to 4.1.18).

(e) BGC believe that, in view of the favourable Sleipner price, they could in addition retain profitable sales of 230 bcf/year in the interruptible and petrochemical feedstock markets which they were previously planning to shed. This seems over-optimistic

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particularly with regard to retention of sales in the petrochemical feedstock market where it is known that ICI have recently turned down a private sector deal for future supplies of gas at a price less than BGC will be able to supply to them profitably in the 1990s. For this and other reasons which are explained in Annex C, my Department thinks it would be more reasonable to assume retention of 100 to 150 bcf/year of additional sales in these markets if sufficient gas were available. Without such sales, there would be additional opportunities for competing fuels, which in this context would be mainly coal, although not necessarily British coal. (100 bcf/year of gas is approximately equivalent in terms of thermal value to 4 million tonnes/year of coal). (Paragraphs 4.1.19 and 4.1.20).

(f) Although the recent upsurge of activity on the UKCS has increased our confidence, my Department's forecasts of supply availability from the UKCS still cover a wide range (from 1200 to 1900 bcf/year). Our central forecast of 1500 bcf/year in the mid-1990s assumes some 25 or so new North Sea gas developments could be brought on stream by then if Sleipner-type prices were offered for new UKCS gas within the next year or two. This figure might be increased by gas from at present undiscovered fields (by perhaps 50-200 bcf/year). (Paragraph 4.2)

(g) Comparison of the demand and supply forecasts in (d) and (f) suggests that, in a central case, supplies would fall short of demand by 340 bcf/year if we attempted to rely solely on present UKCS discoveries, whilst supply would exceed demand by 210 bcf/year if we bought Sleipner and it achieved the top end of its supply range (see para 4.3.1 of Appendix I). Only on optimistic estimates of gas from both existing and future UKCS discoveries could demand in the mid-1990s be met. In contrast if UKCS supplies are at the low end of our forecast range, they could still fall short of requirements, even if Sleipner is bought. This assessment is based on 1996, when the chance of a surplus is at its greatest (as shown in Figure 3 to Annex A); on average in the 1990s the need for Sleipner is some 50 bcf/year greater than in 1996 taken alone, and beyond 2000 (when Sleipner will still be at plateau) there would on central estimates be no surplus resulting from buying Sleipner, even at maximum output. (Paragraph 4.3).

(h) Various measures might be taken in the event of a prospective shortfall in supplies. Increasing prices offered for UKCS gas by some 10-15% above the Sleipner level could perhaps bring forward another 150 bcf/year of UKCS gas, but such higher prices could not be limited to this extra gas, the marginal cost of which to BGC and to gas consumers would therefore be high. The availability of imports other than from the Soviet Union is uncertain. The alternative course would be to reduce demand by increasing prices or restricting supplies; the latter would mainly hit industrial customers (e.g. by the accelerated withdrawal from the interruptible market). Gas

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demand is not particularly responsive to price increases; to eliminate 150 bcf/year of demand, BGC would have to increase their proposed selling prices by a further 10% in the mid-1990s, (in addition to the 15% real increase already projected), and withdraw completely from the interruptible market. (Paragraph 5).

(i) Clearly, we would not want to contract for a possibly excessive quantity of Sleipner gas now if we were confident that sufficient imports would be available in future at no greater price. Such confidence is not sustainable.

(j) There are at present four major gas suppliers to Europe. If we turn down Sleipner, Norway seems likely to accelerate oil developments and defer both Sleipner and its successor, the giant Troll gasfield, until competition for the gas is stronger (probably the late 1990s or beyond 2000).

(k) The Netherlands has limited new reserves to contract for export now (in total, about two-thirds of Sleipner) but could commit all of this simply by extending existing export contracts, which run out in 1995, by five years. These contracts are due to be renegotiated by October of this year; after that it seems likely that the Netherlands will again close the door to new exports.

(l) Algeria has in the past been a price hawk and an unreliable supplier. Judged on these three sources of supply alone, prices in the European market (relative to crude oil) would appear to have reached a low point which would not recur.

(m) Two factors which complicate the picture are Soviet gas and LNG. The USSR has massive gas reserves and spare capacity in the pipelines to Western Europe presently under construction. Soviet gas (or gas displaced by Soviet gas) would therefore probably be available if we need it in the 1990s, but there are obvious political drawbacks. There is no reason why the price of Soviet gas should be less than just sufficient to under-cut the marginal supply of gas to Europe, which by then will probably be LNG from the Middle East or West Africa.

(n) At present major LNG schemes from these sources are ruled out by their high cost; and though many projects could in theory become viable, as real gas prices rise (e.g. because oil prices rise), it is not clear that the exporting countries (such as Nigeria, Cameroon, Qatar and Trinidad) will radically revise their expectations of net-back prices in relation to crude oil. Given this, and the major act of faith by both investors and customers that promotion of an LNG scheme requires, I do not believe it likely that we could turn Sleipner down now and buy either Soviet gas or LNG later at a similar price in the event of a shortfall.

(o) The effect of a prospective surplus of supplies might be initially to accelerate the appraisal and offering of new UKCS

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fields as licensees made efforts to get the gas contracted by BGC before their needs were met. Later, however, licensees would start delaying exploration and appraisal for gas. Some developments would be delayed (on central estimates, about a quarter of the new gas projects otherwise expected by the mid-1990s) but would come forward some years later, which would have advantages as well as disadvantages. (Paragraphs 6.1 to 6.3).

(p) In the absence of competition, BGC would be enabled to continue to offer, as at present, prices several pence per therm below international levels, with consequent loss of offshore tax revenues. This could be remedied by introducing an export regime. Another possibility to reduce tax loss would be to require BGC to pay prices which took more account of international deals; this could be done directly or via the tax system. (Paragraph 6.4 to 6.7).

(q) A decision to buy Sleipner or other imports would enable some UKCS reserves to be conserved for later use. On current estimates, reliance solely on UKCS gas throughout the 1990s would, if it were possible, result in only some 7-14 years reserves remaining by 2000. From being self-sufficient in 2000, we would have to become 50% dependent on imports by 2010, and would therefore be in a weak bargaining position when negotiating such new contracts. In contrast maintaining imports at current levels throughout the 1990s would result in a more gradual descent into heavier import dependence (from 30% in 2000 to 50% only after 2015) giving us much more scope to contract new imports only when the terms were right. (Paragraph 7).

(r) The choice to be made is not simply between Sleipner or an equivalent volume of UKCS gas. The key question is rather whether some combination of more UKCS gas, limited imports and reduced demand might not be better than importing such a large tranche as Sleipner. My Department has addressed this issue extensively, comparing the risks and consequences, in resource cost terms, of either buying Sleipner, buying the volume now offered by the Dutch, or seeking to rely on UKCS gas unless and until imports become unavoidable. This analysis has shown that although the resource costs of production (net of taxes and profits retained in the UK) of UKCS gas will probably be significantly lower than the cost of Sleipner gas in the 1990s, this saving will be wholly or partly offset by the cost of increased import dependence 10 or 15 years later, by the costs of cutting back gas demand and by any premium paid on other imports. The analysis has addressed a 'worst case' focussing on 1996 (the year of largest potential surplus) and assuming that Sleipner output would then be at the top of its range (550 bcf/year). Even so it appears to be worth turning down Sleipner only if Dutch gas or other imports can be bought at virtually the Sleipner price, or if we expected that any exports of surplus UKCS gas (in the event of buying Sleipner) would be at a significant loss. As the earlier discussion of the European gas market suggests, I would consider neither such eventuality likely. (Paragraph 9).

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(s) The effect of buying Sleipner on the PSBR has also been considered although the conclusions are not clear-cut. The initial impact would be to moderate the surge of new UKCS gas developments otherwise required, on which tax-relievable capital expenditure would have taken place in the late 1980s and early 1990s. Later in the 1990s the effect would reverse as taxes on any such extra UKCS fields would then have become payable. Finally having some extra UKCS gas to offset imports beyond 2000 would benefit the PSBR then. Allowing UKCS gas exports would reduce or eliminate the PSBR impact of the Sleipner purchase. (Paragraph 11).

(t) The Sleipner deal is significant from the UK's viewpoint as buyer. It has far greater importance for Norway as the seller both because of its size relative to the Norwegian economy and its place in determining their future oil and gas development strategy. Vetoing of the deal by HMG would inevitably sour Anglo/Norwegian relations, though this should certainly not deter us if the case against Sleipner were clear-cut. We should also recognise the longer-term implications on commercial dealings with Norway if we turned Sleipner down. First, we might lose out in terms of British oil company licence interests on the Norwegian Continental Shelf and British suppliers missing Norwegian orders. Secondly, the Norwegians are likely to be exporting gas long after our supplies run dry - and we will be back negotiating with them for such longer term imports, within a decade, even if we buy Sleipner, and sooner if we do not.

(u) The Sleipner purchase is also of wider international significance. Looking beyond our bilateral relations with the Norwegians, the security of European gas supplies is important to East/West relations, particularly following the Siberian gas pipeline dispute with the US. There is clear evidence that US interest in, and concern over, European gas security has not abated. Major studies undertaken by both the International Energy Agency and the European Community as a result of the dispute, the conclusions of which have been endorsed by UK Ministers, have stressed the importance of fully developing indigenous Western European resources to limit the level of dependence on Soviet gas supplies. The early development of the massive but complex Norwegian Troll field has been singled out, particularly by the US, as a necessary alternative to still higher dependence on Soviet imports from the mid-1990s onwards. US concern on this point was emphasised to me during my recent visit to Washington. Two further studies this year by the IEA and EEC also urge the opening of immediate negotiations over the delivery of Troll gas. A deferral of the Sleipner development now would postpone the development of Troll perhaps into the next century. Such a delay would increase international concern over European gas security and leave the Government open to criticism that it has stifled an important European gas development to the long term advantage of the Soviets.

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OPTIONS

3. (a) On the basis of our analysis, the main options for HMG appear to be:-

- (i) to refuse the Sleipner offer and request BGC not to negotiate any further imports until it is clear to us that UKCS gas will be inadequate;
- (ii) to accept a Dutch offer;
- (iii) to authorise BGC to sign a contract for Sleipner on the terms offered;
- (iv) to seek changes in the proposed Sleipner deal.

(b) Under option (i), the denial for the time being of further imports to BGC would force them to pay much higher prices to UKCS producers. The paucity of new UKCS supplies in relation to forecast demand would probably result in their having to raise their offer prices to Sleipner levels within a short period. Although this would generate higher tax receipts and avoid short-term loss to the balance of payments it is likely that, within a few years, it would become apparent that UKCS supplies alone could not meet requirements in the 1990s. We would then be faced with the alternatives of even higher prices for UKCS gas with consequent sharp increases in prices to consumers or with having to authorise an alternative import. Although we would by then have a better idea of the volume required, such an import would probably not be available on terms as attractive as Sleipner is on offer now and might not be available at all other than from the USSR.

(c) On (ii), the first question is whether it is possible to negotiate the Dutch offer down to, or near to, the Sleipner price. The second question is whether the 180 bcf/year on offer from the Dutch would be sufficient for our needs. On the former, further negotiations with the Dutch would of course take time (the Sleipner negotiations took nearly 18 months to complete). The Dutch can probably sell all the gas they want to their existing customers in the late 1990s without going down to the Sleipner price (adjusted for pipeline costs). If further negotiations were pursued, we would expect pressure from the Norwegians in the meantime to make up our minds on their offer. Although our bargaining position might seem strong, the Norwegians could well decide to withdraw their offer on Sleipner and switch their attention to oil development as the means of securing construction activity in their yards in the late 1980s and in the expectation of a better market for their gas after an interval of several years. On the second question, the Dutch will not be prepared to increase the volume of gas made available to us. It represents half the total volume they have decided, after much deliberation, to release for new export contracts generally; the remaining half is not much to spread between existing customers, with whom they will wish to retain a relationship. The Dutch appear to realise that the Norwegians are offering a favourable deal. In fact, the Dutch Ambassador told me recently that the

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Dutch could not believe that the Norwegians had quoted such a low price and if he were us he would certainly take advantage of the Norwegians' "crazy" offer.

(d) One of the main problems with Sleipner is its size and the consequential risk that UKCS developments which would otherwise come on stream in the early to middle 1990s would be deferred and prices to producers depressed in the meantime, with consequential effects on tax take. Under the proposed contract terms, the actual rate of delivery in the range 430 to 550 bcf/year is to be determined at the seller's option. At the lower level, the risk of significant deferral of UKCS developments would be greatly reduced. I therefore propose that if we buy Sleipner gas we should seek inclusion in the contract of a provision that any increases above 430 bcf/year should be subject to the approval of HMG. The objective would be to ensure that any decision in favour of such an increase took full account of the consequences for developments on the UKCS. Our analysis has shown that the cost of this concession to the Norwegian licensees is probably not great although it would not be surprising if they asked for a compensating price increase. If they did so, we should have to consider the position further.

(e) I propose that we should also inform the Norwegian Government that we would like the Sleipner liquids to come to Britain on substantially the terms (including tariffs) included in the Heads of Agreement currently under discussion between the Occidental Group and the Sleipner Group for conveying the liquids to Flotta or on comparable terms if the liquids are taken to Cruden Bay. (See paragraph 2.6 of Appendix I).

(f) The spare capacity in the Sleipner pipeline which BGC have negotiated for their own use in transporting additional quantities of gas (without payment other than an operating cost contribution) represents about 25% of the total capacity in the line. BGC's present intention is to use it solely for transporting gas from UKCS fields in the vicinity of the pipeline. However, I would wish to safeguard our position in case, at some future date, it is proposed that this spare capacity should be used to convey additional quantities of Norwegian gas. We might of course be quite prepared for this to happen but not, I imagine, if UKCS gas was thereby to be excluded. I will therefore wish to propose that in the Treaty between HMG and the Norwegian Government governing the operation of the pipeline, use of the spare capacity referred to above will be subject to British Government (but not Norwegian Government) approval. I will also wish to propose that the use of any additional space which is available or which develops in the remaining 75% capacity in the line shall be subject, under the Treaty, to joint British and Norwegian Government approval.

(g) I propose to seek a commitment from the Norwegians to give British suppliers genuine full and fair opportunity to bid for the equipment to be used in the Sleipner development.

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(h) If we authorise the purchase of Sleipner, we would still have to be prepared to take measures to mitigate the consequences of deferred development and lower prices to producers. To allow exports would be one course but we should bear in mind that something like 16 new UKCS gas developments will be required on stream to supply the British market as soon as Frigg runs out in 1991. Though some of these will be phased in over the next few years BGC will not be able to absorb them all quite as soon as the companies offer them. To allow exports immediately without any form of control would therefore be risky, as licensees could well choose to export such fields to gain a more immediate return, leaving us short of supplies in early 1990s.

(i) An attempt to control the rate of export would need careful handling because of the risks of infringing the Treaty of Rome. The Law Officers have now advised that there would be reasonable prospects of successfully defending a partial restriction on gas exports on the grounds of public policy, security and safety. However, the outcome of the Whitegate case now before the European Court of Justice, which is not expected until later in the year, could change this view (see Appendix D).

(j) We could agree now to be ready to allow a controlled export regime, if the judgement in the Whitegate case does not erode confidence in our ability to fend off any challenge to such a regime. If the Whitegate outcome undermines that confidence we could still consider whether the benefits of an uncontrolled regime outweigh any disadvantages; and we could also consider possible alternative measures as outlined in paragraph 6.7 of Appendix I.

CONCLUSIONS AND RECOMMENDATIONS

4. This decision is of great importance, both for the future of the gas industry and for the national economy. It has to be seen against the background of our plans for the future of the industry and of our views on the proper division of responsibilities between Government and the industry's management.

5. BGC have the statutory function of buying gas to meet the needs of their consumers. When considering whether to accept or reject a supply contract firmly offered to them, they are unwilling to rely on necessarily highly uncertain estimates of future gas availability from other fields for which no firm plans exist, and still more unwilling to rely on gas which has not yet even been discovered.

6. If we were to turn down the deal, we should be assuming a major degree of responsibility for the adequacy of future supplies to consumers, on the basis of faith in the more optimistic estimates of future UKCS supplies and faith in the future availability of reasonably priced alternative imports if needed. I should particularly regret the fact that rejecting a Sleipner purchase on favourable terms now may

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foreclose the opportunity to retain natural gas as a major source of bulk heat to industry in the 1990s, an opportunity of great value to industry itself and potentially to the environmental policies we may adopt in future.

7. I recommend that we should proceed on the basis of option (iv) in paragraph 3(a) and that we should approach the Norwegians with the prime objective of seeking their agreement that any increase in supply above 430 bcf/year should be subject to HMG approval (paragraph 3(d)). We should at the same time, in so far as we see opportunity to do so without prejudicing this principal objective,

- (i) endeavour to secure their agreement to the Sleipner liquids coming to Britain on acceptable terms (paragraph 3(e));
- (ii) seek their agreement that suitable provisions should be included in the Treaty governing the operation of the pipeline, on the use of spare capacity (see paragraph 3(f));
- (iii) seek a commitment from them that British suppliers will be given genuine full and fair opportunity to bid for orders on the Sleipner project (paragraph 3(g)).

Secretary of State for Energy

1 May 1984

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APPENDIX I

AND

ANNEXES

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G. Gray

18/7/2013

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