

Prime Minister
To note. Agree I write along
lines recommended

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POLICY UNIT
4 May 1984

PRIME MINISTER

SLEIPNER GAS

AT 4/15
No - we will
take about
it first

CC/10

From the late 1960s until the 1980s, the British Gas Corporation refused to pay the going rate to buy gas from the United Kingdom continental shelf. In consequence, all drilling stopped for specific gas targets. When gas was found with oil, companies preferred to reinject the gas where possible during the early life of a well, to avoid the trouble of selling it.

Owing to past follies over gas prices, we are faced with the ridiculous position that a country full of energy resources may well have to rely on imported gas to meet its needs in the early 1990s. The same folly that has left us short of native production of gas has also served to stimulate demand - when prices were too low, many more customers signed up, thereby exacerbating the potential shortage.

The attitude of BGC today has not significantly changed. The Department and BGC see the purchase of Sleipner as a way (p6) of enabling "BGC to continue to purchase new UKCS gas at several p/therm below international prices (probably with favourable escalation formulae which increase the difference with time)".

The removal of BGC's monopoly over purchasing gas and a potential supply gap has led BGC to offer higher prices to UKCS producers. These prices are still some 20% below market prices but they have encouraged a wave of exploration and development activity. More gas would become available if BGC paid international market prices to the UK but it seems to want to penalise domestic gas producers whilst paying a good price to foreigners!

BGC has placed the Government in a silly position, expecting Ministers to decide on future gas prices and supply. BGC have been more concerned with fulfilling their statutory duty to supply than with assessing proper commercial risks and rewards. Their risk averse proposal may turn out to be a very expensive solution for all concerned. The Department of Energy like it because it brings a kind of depletion policy in by the back door.

It was decided in 1982 that the rate of gas depletion in the North Sea is best left to market forces and that there is no case for Government intervention. The decision on whether to conserve UKCS reserves for future use by allowing earlier imports should be decided on commercial criteria.

BGC has in the past sold imported gas at a loss. The Deloitte study showed that this was happening to Frigg gas in 1982/83 when the profit from the early Southern Basin fields was being used to subsidise new sources of supply.

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In order to avoid this situation occurring again, we need to redouble our efforts to create a working market in gas as soon as possible. The only known way of balancing supply and demand with any reliability is to allow the price to take the strain. The best way of ensuring a market price would be to allow exports. Prices paid for new UKCS supplies would then have to rise to international levels which would in turn ensure that gas competed on an economic basis with other fuels. BGC seem incapable of paying the going rate to the UK gas producers without external stimulus. It is precisely this approach which has given such a strong impetus to the oil sector.

The consequences would be:

1. our balance of payments would not be heavily damaged by the need to import energy;
2. we can ensure more activity in the UK, as UK suppliers typically deliver around 70-80% of the hardware required for getting gas out of the North Sea and putting pipelines down;
3. as competitive forces come to bear, the Government would no longer have to take a view on what future gas supply and demand might be.

In the meantime, it is true that there might be a shortfall of gas in the early 1990s because of past errors. It is also true that if world energy demand picks up before the early 1990s, the current security of supply and the price formula which can be agreed now would be preferable to any deal in the early 1990s. In such a condition, it would be no embarrassment to have found a lot more gas in the United Kingdom continental shelf, because we could export it. If Peter Walker is right in second-guessing price movements in the early 1990s, we would then be making a trading profit by buying Sleipner gas at a lower price than we could be selling our own indigenously produced gas for export.

However, Peter Walker may be wrong. This illustrates exactly why Government should not be involved in taking these sorts of decisions. We could get to the position where we have liberalised the gas market sufficiently to bid up the price BGC and others are offering United Kingdom continental shelf producers for new gas. This would undoubtedly stimulate United Kingdom gas production. If at the same time world energy markets moved into greater surplus of supply over demand, prices would then weaken internationally and the Sleipner deal could look like an expensive white elephant.

Conclusion

Perhaps the best way of handling this is to extract a substantial price from both BGC and the Department of Energy for continuing negotiations on Sleipner. This price should be:

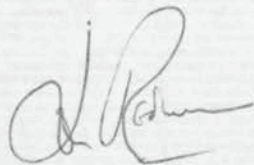
- There is a meeting with PW and NL on Thursday on this AT.*
- i. Pressing ahead with the denationalisation of British Gas itself. This would then mean that the commercial risks and rewards on the contract for buying Sleipner Gas would pass to the private sector rather than resting as an ultimate charge on the consolidated revenues of the UK.
 - ii. Agreement with Peter Walker that in the negotiations there should be an attempt to limit the volumes that are being purchased, whilst keeping the price down, given the uncertainties about the supply/demand balance in the early 1990s and the sloppiness of the market for all types of energy at the moment.
 - iii. Agreement to the more rapid creation of a gas market, including export from the UK. Once market prices dominate the UK, more domestic production would be stimulated whatever British Gas may be doing on price. It would reduce the risk of the UK being left with too much gas through errors by BGC in over-ordering both domestic and foreign gas: it could be exported instead.

Peter Walker is bound to argue, against the background of the current coal strike, that it would be silly to throw away the opportunity of buying other forms of energy at realistic prices. We think you could concede this much, but only against the background of ramming home the message that we are in a mess because we have systematically refused to allow market prices to decide in the past. The price of accepting this negotiation must be that from here on the aim is to remove Government from these difficult and embarrassing dilemmas.

We recommend that you should welcome Peter Walker's intention to hold an early meeting with Nigel Lawson and that you should indicate your interest in the following questions:

- how to establish a true market in gas in the UK
- wouldn't it be worth one more try to improve the terms for buying Dutch?
- could the risk be reduced by a firm contract for a smaller volume without undermining the economics of the scheme?

- can BGC offer better prices to UK producers to stimulate activity further?
- whether Sleipner supplies would be subsidised by existing low price UKCS contracts?



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