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P.01310

PRIME MINISTER

Sleipner Gas

BACKGROUND

The latest projections by the British Gas Corporation (BGC) and Department of Energy of GB demand for gas against supplies already contracted to BGC indicate that a gap will open up in the 1990s, its size depending on price developments for gas and other fuels, economic growth etc. That gap must be filled by imports of gas; from the development of known, but not yet contracted, reserves; and from undiscovered reserves in the United Kingdom Continental Shelf (UKCS).

2. Negotiations have been under way for some time to import gas from the Norwegian Sleipner field. A draft contract was signed in February for gas to be supplied over a 12-15 year period from the early 1990s. The amount has still to be settled; but the Department of Energy aim to meet about half the above projected gap from Sleipner. The remainder will be met by production from the UKCS. But production may by the 1990s well exceed the amount required to fill the remaining gap, if Sleipner gas is bought, leaving a surplus available for export. At present, however, gas exports from the UKCS are not permitted: all gas from the UKCS must be landed in the UK, and re-exporting gas landed here is not economic.

Proposals

3. In his minute to you of 8 June, the Secretary of State for Energy proposes that the Government should announce its intention to proceed with the Sleipner purchase, and should negotiate further with the Norwegian Government on the precise volume. At the same time the Government should announce that if the purchase appeared to

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be inhibiting exploration or development of the UKCS, the landing requirement might be waived (thus permitting gas exports) either generally or for a particular development, providing security of supply to the UK was not undermined. BGC would be required not to damage development through its policies.

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4. In his minute to you of 12 June, the Chancellor of the Exchequer, drawing a parallel with the Frigg gas field in the mid-1970s, expresses concern about the impact of the Sleipner purchase on the development of the UKCS. He argues that the addition of Sleipner to BGS contracts (existing and expected) will lead to an excess of supply over demand. This will discourage the exploitation of the UKCS with detrimental effects on UK employment, profits, tax revenue and the balance of payments. He argues that to encourage more UKCS activity the Sleipner purchase should only go ahead if restrictions on gas exports are removed. He favours an unrestricted export regime. But in recognition of the concern about security of supply, he is also prepared to agree to Sleipner with a restricted export regime providing it allows immediate exports and is based on clear and objective criteria.

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5. The Secretary of State for Trade and Industry in a letter of 15 May, had broadly endorsed the Chancellor's approach with the proviso that reserve powers to prevent export contracts should be taken. The Foreign and Commonwealth Secretary in a minute of 8 May to the Secretary of State for Energy supports the purchase of Sleipner gas.

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MAIN ISSUES

6. There is no dispute that the Sleipner gas is available on relatively favourable price terms. Though there are other options (eg Dutch gas), the purchase of Sleipner should not be an issue: the Chancellor's minute makes it clear he will agree to the purchase providing satisfactory conditions for derestricting gas exports can be agreed. Nor does Mr Walker dispute, at least in principle, that



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gas exports should be allowed, if that is necessary to maintain exploitation activity on the UKCS. The main issue therefore is:

- 3 - what kind of export regime should be applied to gas exports assuming that the Sleipner gas purchase will go ahead?

7. In essence the difference between the two alternative proposed export regimes is as follows:

- that proposed by the Secretary of State for Energy is discretionary, with the implication that exports will be the exception rather than the norm and with the burden of proof resting on those who wish to export;
- that proposed by the Chancellor is based on objective criteria (albeit not yet finally settled), with an assumption that exports will normally be allowed and with the burden of proof resting on those who wish to restrict exports.

The Committee will need to consider/^{the}respective impacts of these two approaches on: gas prices; exploration and development of the UKCS; security of supply; and they will then wish to assess the overall balance of advantage in the light of these factors.

Gas prices

8. The first effect of the strategy proposed by Mr Walker is to strengthen BGC's negotiating position against other suppliers. BGC would have access to a large and secure supply from Sleipner while retaining to a high degree its monopsony over UKCS supplies. Both theory and experience suggest that the BGC would use this position to depress the price of new supplies from the UKCS. No doubt part of the gains to BGC would be passed on to gas consumers through lower prices. It is however likely that there would be higher profits for the BGC reflecting its monopsony powers rather than economic efficiency. This might be defensible if the BGC was to stay in the public sector (though it would still be less satisfactory than securing the revenue for the benefit of the taxpayer). It would be much harder to defend if the BGC is privatised.

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9. The Chancellor's approach would mean BGC losing its monopoly powers, having to compete for supplies and having to pay something closer or equal to the international market price. That would be reflected in higher purchase prices for new gas supplies. But the impact of that on consumer prices would be fairly small: only the price of the last tranche of gas supplies in the 1990s would be affected. The Chancellor suggests prices to consumers might be about 4 per cent higher in the 1990s under his proposals.

Pace of exploration and development

10. Mr Walker's proposals on the exploitation of the UKCS would leave the responsibility for keeping up the momentum of exploration and development largely on BGC and Government rather than the market. But the discretionary approach proposed would mean the companies could not be sure whether their gas would go to the UK or be exported; the price, and hence the return on their investment, would be uncertain. Nor could the effectiveness or fairness of BGC in stimulating activity be relied upon. Both factors would tend to dampen the level of exploration and development activity.

11. It seems more likely that the kind of free export regime proposed by the Chancellor would stimulate greater exploitation of the UKCS. Under a market regime, companies would expect higher prices with more certainty of, and a larger volume of, sales.

Security of supply

12. There is likely to be agreement that the UK should have adequate security of supply. Mr Walker will argue that his proposed export regime gives better assurance in that respect because it leaves the Government in the position effectively to ensure that the UK has first call on gas supplies from the UKCS. The Chancellor suggests that the problem can be dealt with by allowing exports only as long as the level of proven reserves not already contracted to export remains above a prescribed benchmark, or by allowing exports for a limited period. There is a genuine problem because gas purchases are so much more inflexible than oil purchases.



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When gas has been contracted for many years ahead to a foreign purchaser and the appropriate pipelines and facilities constructed, the position is irrevocable. On the other hand, the three main companies involved - BP, Esso and Shell - are unlikely to discriminate in favour of export markets, providing BGC are prepared to pay the going rate. The existence of pipelines to the UK in the southern basin and the geographical proximity to the UK in the north make the UK the obvious market. Moreover, security of supply is in the last resort dependent on exploration and development.

Overall assessment

13. Under Mr Walker's proposals gas prices to the consumer would be a little lower than under the Chancellor's, but the pace of exploration and development activity would be slower. Hence tax revenue, profits, employment and export earnings would be lower, perhaps substantially less, than under the Chancellor's proposals. Mr Walker's strategy would favour gas consumers in general and certain energy intensive industries in particular; it would also probably increase BGC's profits and the return to BGC's shareholders in the event of privatisation. Mr Lawson's proposals would lead to lower taxes (and a higher exchange rate), spreading the benefits more widely through the economy. Mr Walker's export regime might give more reassurance about security of supply, but much will depend on exactly what objective criteria are provided under the Chancellor's approach. Moreover the lower benefits to the economy as a whole may be too high a premium to pay for this added insurance.

Detailed export regime

14. If the Committee concludes that the balance of economic advantage lies with the Chancellor's more export-biased approach, it will be necessary for officials to do more work on the details of the export regime. The Chancellor has left open the precise nature

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of the objective criteria to be applied. It may be sufficient for the Committee to agree that objective criteria should be drawn up to ensure that if serious concern were to arise over security of supply exports could be restricted. The details might be worked out by officials and cleared in correspondence. Similarly, if Mr Walker's proposals are favoured, it would probably be useful for officials to do further work on the details.


HANDLING

15. You will wish to invite the Secretary of State for Energy to put forward his proposals on the Sleipner purchase and associated export regime and the Chancellor of the Exchequer to reply. The Secretary of State for Trade and Industry will wish to comment on the industrial aspects and the Foreign and Commonwealth Secretary on the international aspects. The Secretary of State for Employment may have views on the employment implications of the proposals.

CONCLUSIONS

16. You will wish the Committee to reach conclusions on the following:

- i. whether to proceed with negotiations for the purchase of an appropriate volume of gas from the Sleipner field;
- ii. whether the export regime for gas from the UKCS should be on the basis proposed by the Secretary of State for Energy or that proposed by the Chancellor of the Exchequer;
- iii. what, if any, guidance should be given to officials about the details of the preferred export regime.


P L GREGSON

13 June 1984