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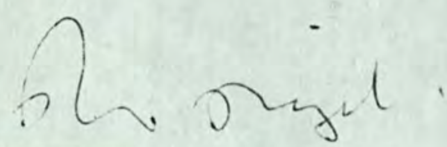


BNOC REVIEW

I attach a report prepared by officials from the Treasury, the Revenue, the Foreign and Commonwealth Office, and my Department, which reviews the case for and against retaining BNOC.

I endorse its conclusion that BNOC should be retained for the time being with its current objectives and on much the same scale as at present. I also agree that the question should be looked at again in 2 - 3 years time.

The review concludes that there is a case for retaining BNOC both on grounds of its potential contribution to the security of our oil supplies in a supply crisis and of helping to ensure that the UK economy receives the maximum economic benefits from UKCS production.

In an oil shortage BNOC could make a limited, but useful contribution to our security of supply, unless the IEA emergency sharing scheme is activated. The fact that the UK Administration now seems reluctant to see that scheme activated, except as a last resort, enhances the potential role of BNOC.

The report also draws attention to BNOC's role in providing reliable market intelligence in a crisis. The oil companies followed courses of action in 1973 and in 1979, which were detrimental to our national interest. In any further crisis they would undoubtedly again be under pressure to do so both from their parent companies and from other Governments. It is vital that we have reliable information in a crisis so that we can protect our interests and in particular ensure that the British public does not go short unnecessarily. I am confident that BNOC under Douglas Croham and Ian Goskirk would be willing and able to provide valuable information and thus help to achieve our policy objectives.

There is also an important political dimension to the security of supply argument. The public, Parliament and the Press all tend to believe that BNOC can make a considerably greater contribution to our security of supply in a crisis than is likely to be the case. This belief is likely to persist. Indeed I understand that when the 1982 Oil and Gas (Enterprise) Bill was being considered in the House, Energy Ministers at the time laid stress on BNOC's potential contribution to our security of supply. I believe it would be particularly damaging to start dismantling BNOC at a time when we are living with the continuing threat of the closure of Straits of Hormuz. We would be criticised universally for undermining BNOC at a time when everybody believed it had a great deal to contribute. Unravelling the participation agreements with all the companies with oil on the UKCS would be very complicated and ensure the process was long drawn-out.

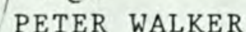
I agree with the report's conclusion that over the last year and a half or so BNOC, working closely with the Government, has played an important role in helping stabilise the world oil market. It has thus helped to avoid large price gyrations with all their disruptive effects and maintained our oil revenues at a higher level than would otherwise have been the case. OPEC would certainly see abolition of BNOC as a de-stabilising factor in the market, and if it were abolished would still look for ways of putting pressure on us to restrict production, so as to reduce the burden on them of restraining production in order to prevent a fall in prices.

The report lays particular stress on the BNOC's contribution to the economy through helping to ensure that enough arms-length transactions in the various grades of UKCS oil take place at transparent prices which can then be used by the Oil Taxation Office in valuing inter-affiliate transfers of oil. As long as things remain as they are in the oil market, this consideration alone would seem to justify retention of BNOC. Furthermore BNOC is not expensive to run. Indeed it makes a net contribution to the Exchequer, as its annual operating costs of about £5 m are more than offset by the £25 m - £30 m benefit of taking royalty oil in kind, for which BNOC acts as the Government's selling agent.

I also accept the report's conclusion that retaining BNOC but at a lower volume of activity would achieve the worst of both worlds.

I should be glad to hear if you and other colleagues agree with the report's conclusions. If so, our officials will need to meet to consider the terms of an early announcement as well as to undertake the proposed further study of the guidelines within which BNOC engages in commercial trading.

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



PETER WALKER

REVIEW OF BNOC

Note by Officials

INTRODUCTION AND CONCLUSIONS

A. During the period of serious difficulty in the world oil market in the spring of 1983, questions were raised about the impact of BNOC's operations and institutional arrangements. The Select Committee on Energy in the last Parliament took evidence about BNOC and the oil market during March to May last year. The then Secretary of State was examined orally (on the basis of a factual written memorandum); Shell, BP, Esso, Brindex and Thomson N Sea submitted other significant memoranda. The Select Committee did not complete any report before the election; but Mr Lawson instructed officials to review the position of BNOC in the light both of the evidence submitted and of experience gained in the world oil market. While in his evidence to the Select Committee he mentioned the need to review BNOC's operations and institutional arrangements, he asked officials to study the implications of abolishing the Corporation. His main concerns were that the existence of BNOC might involve Government unnecessarily in the market with an attendant risk of financial loss in participation trading, and that the BNOC price acted as a focus for political pressure from OPEC countries in a weak market and importing countries in a shortage.

B. We have examined BNOC's effectiveness in meeting its objectives as listed in para 10. The review is in four sections:

i) background information (paras 1-10);

ii) BNOC's economic role (paras 11-28);

iii) BNOC's contribution to UK security of supply (paras 29-39);

iv) policy options (paras 40-45).

C. We conclude that

(i) the advantage lies with retaining the present system of taxing arm's length sales on the prices actually realised and valuing non arm's length transfers on the price the oil would have fetched if sold at arm's length. While these rules would probably be workable without BNOC, at present BNOC does provide valuation evidence of a significant volume of UK crude sold at arm's length at transparent prices. Without this evidence, the Inland Revenue would be in a weaker negotiating position in certain circumstances with a consequential revenue risk. However the evidential value of BNOC's prices has declined in the last year or two and other evidence of market prices is growing (paras 4-7, 12-17);

(ii) the UK is not a large enough oil producer for BNOC to be able to contribute decisively to stability in the international oil market. But it did contribute in March and December 1983 and the balance of probability is that it helped achieve higher world, and thus UKCS, prices than would otherwise have been the case. Per contra, there is little doubt that it could have destabilised the market in the spring of 1983 had that been the Government's policy. The act of abolishing BNOC now would be interpreted by OPEC as a signal that HMG was no longer interested in stability and would also create a new uncertainty in a fragile market with a consequent risk to stability (paras 18-20);

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(iii) given a structure of world oil prices established through OPEC discipline, there is no clear evidence for or against BNOC as an instrument for securing relatively high prices for UKCS crude

within that overall structure. Undoubtedly in 1979/80 it facilitated the policy of holding down UKCS prices during the shortage, which may have cost the Exchequer several £ hundred millions: but that policy was also applied to individual licensees in the UKCS and the only complete remedy is to resist the temptation (and pressures from consuming countries) to adopt such a policy in future emergencies (paras 21-26);

(iv) abolishing BNOC would save the £5 million per year administrative and running costs. But the net cost of running BNOC is lower, and is more than offset by the £25-30 million per year benefit of taking Royalty in kind rather than in cash (paras 27-28);

(v) in an emergency, BNOC may make a limited but useful contribution to physical security of supply, by diverting some additional crude into the UK in certain circumstances, by acting as a source of pressure on the refining companies and by providing Government with a greater insight into the workings of the market place (para 39).

D. We also conclude that if BNOC is retained, any significant reduction in the quantity of crude oil it traded would threaten its most valuable contribution to the UK - that at C(i) above, although that does not imply that in all circumstances BNOC's business volume has to be maximised particularly in hydrocarbons other than crude oil. While some non-participation trading is essential if BNOC is to stand a reasonable chance of making a profit, that needs to be kept within strict bounds both to avoid abuse of market position and to limit exposure to loss. It may be appropriate to arrange for an independent check on the form and level of management control on BNOC's traders (para 42).

OVERALL CONCLUSION

E. The balance of argument at each of C(i) to C(v) is either neutral, or in favour of retention. We conclude that if BNOC did not exist, we would not recommend its creation but that, given its presence, the balance of the arguments points clearly, though not strongly, to retention. However, the judgements in C depend on current circumstances; that at C(i) depends particularly on the present lack of transparent arm's length UKCS sales other than BNOC's. Circumstances may well change and we therefore recommend that the assessment is again reviewed in 2-3 years' time.

I BACKGROUND

World Market

1. The significant net exporters of oil fall into two groups

(i) those countries, the Soviet bloc, the UK and Norway, Egypt and one or two minor OPEC countries who do not constrain production and allow the market to set the price;

(ii) the main OPEC producers and perhaps Mexico who attempt to set prices and allow the market to set production levels or seek to agree a production programme to allocate their aggregate sales.

Although the US is not a net exporter, its free market in which imported crudes compete with those produced domestically has a very substantial effect on overall world market prices.

2. Maximum sustainable production capacity in the OPEC countries is some 34 mb/d against a demand for their oil of only about 18 mb/d. Production costs are only a fraction of prices - operating costs lower still. Accordingly unless there is an emergency, or OPEC countries agree to effective constraints on the amount of oil they will produce, strong downward pressure on oil prices is likely to emerge. Moreover because the demand for OPEC oil is not very sensitive to price changes in the short term, once oil prices begin to fall they could fall a long way. In the medium to long term both demand for oil and non-OPEC oil production are much more price sensitive and will limit the period over which any given price fall could be sustained. Ultimately, given the amount which OPEC are willing and able to produce, a new equilibrium price would be established. We cannot be confident what that equilibrium price is,

but our own calculations suggest that if the price declined from the current level of $29-30/b to $20/b, a shortage would threaten to occur before the end of the decade.

3. In the Sixties a small group of international oil companies, integrated both horizontally and vertically, set prices and allocated oil administratively between their various sources and to their various markets. In the Seventies, OPEC countries effectively wrested from them the power to set prices but they retained control over the allocation of oil through their remaining equity interests and long term contacts with the producing Governments. From 1979 on oil has been increasingly allocated by the market, firstly through "annual evergreen" contracts under which, while producer and consumer retained bonds of loyalty, prices were renegotiated quarterly or more frequently, and then through the development of a substantial level of spot of spot related sales, especially of North Sea crudes.

The UKCS Tax Regime

4. The OPEC countries set in advance Government Selling Prices (GSPs) which generally act both as the prices at which their national oil companies sell oil (though discounting in one form or another frequently occurs) and as tax reference prices for any companies which still have equity interests there (although the tax reference price is in some cases set higher). These prices are applied to all oil of the same grade. Norway also applies a simple tax reference price for each grade, though that price is determined administratively in the light of market prices from time to time and applied retrospectively to sales during the relevant period. The general rule in western developed countries (including the US and Canada as well as the UK) is however based on the arm's length principle. This means that for oil from the UKCS sold at arm's length, whether under term contract or spot, profits are assessed for tax on the price received. For oil transferred other than at

arm's length it is necessary to establish a market value - ie the price it would have fetched if sold at arm's length. If oil were valued at above its market value, the industry would be overtaxed compared with the intended balance in the Budget and marginal fields would suffer disproportionately. Moreover, the arm's length principle of transfer pricing is written into the UK's network of tax treaties; departure from it could lead to challenges by foreign tax administrations either by way of loss of creditability for UK taxes or by way of different transfer prices being fixed by the foreign fisc. Either response would lead to double taxation of investors in the UK. This is a particularly sensitive issue at a time when the UK is defending the arm's length principle against the use by US States of the unitary system of taxation.

5. There is no single arm's length price for valuing non-arm's length transactions. When the market is in flux prices for the same grade can vary by $2 a barrel or more (6%) depending on the precise date of the transaction, the type of transaction (spot or term), and the bargaining strength of the parties. Traditionally a term transaction has been regarded as the appropriate analogue for valuation. Following the spring 1983 price crisis, however, the Inland Revenue accepted that in certain circumstances regard would also be paid to prices in the spot market.

6. Taxes on production of UKCS oil are much higher than those on the downstream operations of the oil companies in any consuming country (often tax liability downstream is nil because of losses or tax allowances). The level of upstream tax means that usually about three-quarters of any change in proceeds caused by a price change will accrue to or be borne by the Exchequer. As a consequence, when oil is plentiful and spot prices below term prices integrated companies with both production in the UKCS and downstream interests have a strong incentive to switch disposal from inter-affiliate transactions

to arms length spot sales. (This is called "oil spinning" by Esso.) While at first sight this practice appears to reduce Exchequer take, without it as a safety-valve term prices might have to be lower, and since tax valuations have generally been based mainly on term prices, overall tax take might be lower. Though some OPEC countries have claimed that increased volumes placed on the spot market could, at the margin, add to instability of the market in times of weakness, we would regard the effect as mainly psychological and limited since the practice increases both supply and demand on the spot market equally.

7. Ministers have from time to time considered whether to change the valuation rules to a norm-type or other administrative system. They rejected such a proposal in autumn 1982 on grounds of general taxation principles, because of the danger that such a system would endanger our tax agreements with other countries, especially the USA on double taxation and because of doubts whether the system would be workable in the absence of any mechanism for the objective determination of market value. With the current market-based system, however, there is a case for strengthened information powers, and relevant measures have been included in this year's Finance Bill.

BNOC's Operations

8. Current UKCS oil production is about 2.5 million barrels a day (mbd). About 52 per cent of this (1.3 mbd) passes through BNOC's hands either as participation oil or as "Royalty in Kind" (ie oil directly taken by the Government in lieu of money royalties, equivalent to 12½% per cent of output). Nearly half of the oil accruing to BNOC is sold back to its producers who refine and market in the UK; the remainder is sold at arm's length by BNOC, traditionally on a term basis. Despite the operation of sale-back, BNOC is the dominant supplier of UKCS oil to the world market.

9. BNOC has to give at least 6 months notice of an election to take participation oil from any licensee: it is then obliged to take the oil throughout the election period which runs for a year (or sometimes longer). For each quarter, or if there has been a substantial change in the market, it will propose a single price for each grade of oil. That should represent the world market term price. If BNOC's suppliers are not satisfied with it, they can have it referred to an expert, but neither they nor BNOC can unilaterally reduce the proportion of output taken by BNOC. BNOC strives to sell all its oil (other than saleback) on normal annual evergreen contracts at the same price as that offered to BNOC's suppliers. The customers do not have the right to appeal to an expert but, if they disagree with the price, can at 15 days notice progressively reduce the volumes they take. BNOC has no control over the rates of production and HMG has foresworn use of its own powers of control until the end of 1984. It lacks the financial strength to store oil, though it may be able to juggle with the timing of particular cargoes and thus achieve the effect of storing some of its avails for up to a month. Accordingly BNOC is at risk of losing term outlets while being unable to reduce its purchases.

BNOC's Objectives

10. Any review of BNOC must start from the Corporation's objectives, and consider whether those objectives could better be achieved if changes were made. BNOC's objectives, set out in the Financial Guidelines given by the Government to the Corporation, are in essence:

(a) to assist in ensuring that the maximum benefit is secured for the UK economy from the exploitation of UKCS oil resources; and

(b) to contribute to the security of UK supplies of crude oil and oil products.

II ECONOMIC ROLE

11. In explaining the retention of BNOC as a public sector trading operation when the Corporation's upstream interests were privatised as Britoil, Ministers emphasised security of supply - too clear an explanation of the economic role of BNOC could have provoked Commission questioning of the compatibility of the participation system and other aspects of our licensing regime with the Treaty of Rome. In the view of officials, however, the economic role is probably the more important. The latter objective can be discussed under 3 heads:

(i) establishing transparent arm's length prices to aid tax valuation;

(ii) promoting stability in the world oil market.

(iii) maximising the value of UKCS crude within a given world price band;

BNOC's role in tax valuation

12. To value non-arm's-length disposals of UKCS crude, the Oil Taxation Office (OTO) of the Inland Revenue requires evidence of transparent arm's length prices for all the North Sea grades. The prices obtained by BNOC for non-saleback participation and royalty oil are accepted by willing buyers and also by the licensee sellers. BNOC therefore performs two functions:-

(i) It ensures that a significant volume of UK crude is sold in arm's length deals.

(ii) It provides a relatively transparent price which the OTO believe can be quoted in evidence in appeals.

The latter has been the more important.

13. In the absence of BNOC's sales of participation and royalty in kind, the bare minimum that would be sold on the open market would be about 14% of UKCS production - the volume produced by companies without downstream interests. In normal circumstances the proportion is likely to be substantially higher though there would remain the risk that arm's length sales would be minimised if companies believed this would reduce their tax bill.

14. In the absence of sales by BNOC of participation and royalty-in-kind, evidence for valuation would present a more difficult problem. The OTO would have to rely on one or a mixture of the following:

(i) Arm's length prices for UKCS crudes. Significant volumes are currently sold by licensees at arm's length, and this evidence would continue to be available to the OTO, and to provide an important source of data in forming the Revenue judgement in valuation. The data is however commercially confidential, and, unlike the relatively transparent BNOC Price, cannot be used without consent as evidence in another company's appeal. In appeal proceedings it would doubtless be necessary to support the OTO's views - as indeed we would do in current circumstances - by putting in evidence from consultants based on their own general experience and published material. Another possible weakness is that for some grades there are no arm's length sales apart from those made by BNOC.

(ii) Spot and futures prices. Over a period of years the Exchequer would not necessarily be worse off if all inter-affiliate sales were valued at spot rather than term prices. But the spot market is not at present transparent - reports are selective - and the market may sometimes be thin enough for it (or the reports) to be manipulated by large companies. Prices in the futures markets which have been established in the USA for about a year and have just started in London, are true market clearing prices but volume at present is very small and it is not clear that futures prices have any relevance to current transactions.

(iii) OPEC Government selling prices. These are not market determined and may not represent the true price. Hidden discounts or premia often exist; non-standard credit-periods may be used; often there is an element of barter or other non-price inducements. None of the OPEC grades is exactly comparable with North Sea grades and the appropriate differentials to take account of quality and geographical differences are difficult to determine and vary over time.

(iv) International arms-length market selling prices. The Soviet Union and Egypt price their crudes competitively and their prices usually become public. But they differ significantly in quality from UKCS grades. Some US grades, eg West Texas Intermediate (WTI), are similarly sold at transparent market prices and are not dissimilar in quality to UKCS grades; indeed BNOC prices have historically closely tracked WTI. But UKCS crudes are sold both in US and European markets which may well differ in the values attributable to different crudes. For the

future, Statoil's sales are expected to rise to around 300,000 barrels a day (equivalent to 12% of UK production) during the mid-1980s thus providing a substantial and we would hope transparent source of evidence of North Sea prices. But we would still need to make the appropriate allowance for the differences in quality of other North Sea crudes.

(v) Netback values from product sales. BP has proposed such an approach. It would, of course, base valuation on true market prices, though for products rather than crude. It would also have the advantage to BP of eliminating downstream losses on UKCS production. But it could lead to endless argument about the proper method of deriving the crude valuation from the ultimate product realisation; when losses are made downstream, it would tend to depress the value of UKCS crudes below other crudes; it would remove much of the incentive companies now have to maximise product realisations; if product realisations outside the UK were to be used there would be different tax valuations for the same grades of oil; and if we confined sale of such crude to the UK, we would be in breach of the Treaty of Rome.

15. The position may change. Large non-integrated UK licensees such as Britoil and Enterprise may, like Statoil, propose uniform transparent selling prices. Some large integrated companies have occasionally entertained the possibility of introducing into Europe the US system of transparent purchase prices posted by refiners. Spot markets may develop, perhaps influenced by the futures market, into truly transparent commodity markets. However if BNOC were abolished, and there was insufficient transparency or there were problems of evidence on appeal, it would be necessary to consider controversial

legislation which either required disclosure of commercially confidential transactions by one company to another involved in an appeal, or to deny companies the effective right to appeal against valuations (for example by setting up a special board to determine tax reference prices on the lines of the Norwegian norm price board).

16. In recent years moreover, the value of BNOC's prices has been partially undermined as BNOC has had to resort to discounts and spot sales and as the companies have refused to follow BNOC's prices, believing them not to be market prices, and have resorted to the spot market. Under pressure from the industry, the Inland Revenue made a public statement last year accepting that in some circumstances it would be appropriate to take spot prices into account in tax valuations. Were such circumstances to recur on a large scale, the evidential value of BNOC's price would be substantially eroded. Apparent Government intervention in BNOC's pricing policy would also reduce its evidential value.

17. For the time being we conclude that the present system with BNOC is superior to the present system without BNOC. Though the latter would be workable, somehow or other, satisfactory evidence from arm's length transactions could be in short supply; even BNOC's spot sales could have important evidential value, although such sales could if large enough undermine the value of the term price as evidence. In the absence of BNOC, the difficulties of establishing the appropriate valuation for non-arm's length transactions could cause the Revenue to lose amounts which, though small in terms of price per barrel, could be large overall. Abolition of BNOC could subject a substantial amount of revenue to some uncertainty.

Stability in the world oil market

18. Early last year Venezuela claimed that as well as leading term prices down in a weak market due to its participation trading arrangements, BNOC acted as a price leader in world markets without the powers (ie to hold oil off the market) to make such leadership effective.

19. Undoubtedly in early 1983, Nigeria was comparing its prices with BNOC's then published prices; any move in those prices risked attracting a competitive move in Nigerian prices and ultimately in OPEC prices as a whole. More generally, the existence of a semi-official price for UKCS crude may be used as grounds for trading and diplomatic pressures against the UK from OPEC countries. But Nigeria was determined in any event for budgetary reasons to sell a certain quantity of oil, and was convinced that its competitor was the UKCS. It is difficult to believe that it would not have cut prices to promote sales even if there had been no BNOC price. With hindsight, it does seem likely that the slide in spot oil prices from December 1982 through the first quarter of 1983 would have occurred whether or not BNOC existed and that BNOC's actual performance under that pressure helped crucially in halting that slide. Wherever the balance of argument lies on these points, it is undoubtedly true now that OPEC countries believe that the actions of HMG and BNOC in postdating price changes and minimising them to fit into an OPEC pattern of prices were intended to and did help stabilise the market. To abolish BNOC now would be interpreted by them as a signal that HMG no longer had an interest in stabilising prices. It would also create a new uncertainty in a fragile market which had grown accustomed to the presence of BNOC. That would tend to be destabilising.

20. Nor - leaving aside these important issues of sentiment - is there any general reason to expect that the absence of BNOC would contribute to the stability of the world oil market. If abolition of BNOC led to channelling more UKCS oil through inter-affiliate deals rather than through the spot market, the amount and visibility of spot transactions would be reduced (but it is not clear that the volume of spot transactions would decline - the result could well be the opposite). Whatever the outcome, it would do nothing to affect the underlying weakness, which springs from excess world supply: spot buyers would be removed from the market to exactly the same extent as spot sellers. The real OPEC complaint against the UK is not that BNOC prices are too low but that the UK refuses to assume part of the burden of price support by restricting its current output.

<u>BNOC as Maximiser of UKCS Prices</u>

21. The criticism of BNOC's role under this head have been two-fold:

(i) BNOC has to dispose of all its avails at the same price. It must therefore price all its disposals at the low clearing price. That price also has a predominant influence on inter-affiliate transfers (because of the tax regime) and de facto rules for arms-length contracts covering sales by licensees. In the absence of so monopolistic a seller, individual licensees could cream higher prices off buyers when North Sea crude was more valuable than the BNOC clearing price. Moreover, for a quiet life and to avoid losses, BNOC tends to come down in favour of the customers, who are at the same time the more powerful producers.

(ii) The existence of a semi-official selling price proposed by a public sector body provides a target for pressure from consumer countries on HMG to restrain price rises in conditions of shortage. During the 1979/80 emergency, HMG kept the rise in BNOC's prices behind the rise in spot prices, though this did not, in fact, moderate the increase in world prices. On average the differential between the spot and the BNOC term prices was $10. Tax valuation at the BNOC price was thereby lower than it would otherwise have been had the BNOC price been allowed to rise in response to market forces (though the spot price, in a very thin market might not have risen so high if larger volumes had been traded on it) and substantial amounts which could have run into £ hundreds of millions of tax were foregone. However at that time, the Government also put heavy pressure on licensees to restrain prices and much of that loss cannot be held to BNOC's account.

22. The counter-arguments to (i) are:

(a) the non-integrated companies producing in the North Sea are in the main small and no match in negotiating strength for the large integrated companies who would be their customers. BNOC effectively acts as a cartel for them obtaining higher prices;

(b) in particular BNOC holds UKCS prices high by offering term contracts that are expected to be honoured in all circumstances. BNOC's customers believe that BNOC oil is secure from political interference or shortages, and are prepared to pay some premium for this. (This aspect of course may conflict with BNOC's security of supply role.)

(c) on occasion when the market has been exceptionally weak, BNOC has - rather than lower term prices across the whole range of its sales - sold the marginal barrel at a lower price, by means of spot sales or discounts, than the bulk of its sales. This course may well be more beneficial to the UK than the alternative of an across the board term price reduction despite the losses to BNOC of buying participation oil term and selling it spot. Because of the very high marginal tax rate on oil production, the Exchequer receives on average 75 per cent of the benefit from prices being higher than they would otherwise have been; on this basis it would be worth BNOC selling, say, 250,000 barrels a day spot at a discount of $1 a barrel, in order to keep average prices over the remaining 2mbd of UKCS production 17 cents a barrel higher than they would otherwise have been. This practice served to stabilise prices last spring (see para 25 below), but can only work against short-term weakness; over an extended period, the credibility of BNOC's prices as market prices would be weakened.

23. The circumstances of (c) above arose in early 1982, and again in early 1983, when spot sales exceeded 50% of BNOC's total arm's length sales. The approach is costly to BNOC: a reduction in term prices can be passed on to its suppliers; the loss from selling spot cannot so be passed on. (Fortunately in the summer of 1983 spot prices rose above term and BNOC managed to recoup much of its loss by spot sales of the oil for which it had lost term custom and showed a small overall profit for 1983 as a whole.) Moreover the theoretical advantages to the nation would decline the more extensively or frequently BNOC had to sell spot in weak markets; the Corporation would tend to lose its term customers, and the validity of its term prices as an indicator of arm's length prices for tax purposes would diminish over time -

indeed as already noted in paragraph 16 that validity has already to some extent diminished because last spring's crisis obliged OTO to consider evidence from spot as well as term transactions. In particular if BNOC's losses exhausted its capital and borrowing limits so that grants had to be made under Section 6 of the Oil and Gas (Enterprise) Act 1982, it is unlikely that BNOC's term price could any longer be regarded as significant market evidence.

24. On (i) we do not find the arguments that BNOC prevents some sales at above market clearance levels and favours customers conclusive. More certain is the very much more limited point that BNOC has succeeded in improving the prices paid for some particular grades of crude from fields in which one or more weak licensees have been dominated by one or two powerful integrated companies (eg Buchan, Fulmar) and that some licensees have welcomed BNOC's presence in field, pipeline and terminal committees as a protection against unfair transportation or offlift terms.

25. In the absence of BNOC, each licensee would be responsible for selling all his oil in whatever combination of term and spot transactions best suited him. One result would be a large increase in the proportion of UKCS oil where the licensees could choose, depending on circumstances, between spot sales and disposal through inter affiliate transactions. To the extent that term contracts continued to be made, one would expect term customers to be lost more rapidly in crumbling markets than under current arrangements: there would be so many alternative supplies of crude that customers would have a much reduced incentive to preserve a term relationship with any one particular supplier. Moreover there would be even less opportunity to manage disposals on the spot market so as to minimise their impact on prices.

26. We find it hard to assess the effectiveness of BNOC as a maximiser of UKCS prices within a given level of world oil prices. For the present we consider that there is a risk that prices for UKCS oil could tend to be lower in the absence of BNOC. However, this is an area which needs to be looked at year by year in the light of market developments. There is little doubt that BNOC's prices acted as a focal point for pressure from consuming countries in 1979/80. and HMG's decision to hold them down may have cost the Exchequer substantial revenues; but the main safeguard against such a possibility in the future is a determination by Government to resist such pressure rather than abolition of BNOC (which might merely direct the focal point to the main non-integrated licensees such as Britoil and Enterprise Oil).

27. Royalty in Kind and BNOC operating costs At present the Government takes royalty in kind, rather than in cash, from most producing oilfields. This policy was confirmed by Ministers in 1982, following consultations with the Treasury. Because royalty in kind is taken as the oil is produced, and proceeds of sale realized shortly afterwards, there is a cash flow benefit to the Government through taking royalty in kind as compared to royalty in cash (which is not payable until two months after the end of each half year). The net value of this cash flow advantage to the Government is expected to be £25-30 million per year over the next few years.

28. The Government has no facilities for handling royalty in kind: the use of an agent is essential. BNOC does the job for an agency fee of some £1.5 million per year, within its total operating costs of about £5 million per year. If BNOC did not exist. we would have to consider asking a major oil company or a broker to act as our agent. Such an agent would enjoy a considerable, and possibly undesirable, degree of market power through handling such a large quantity (some 12-13 million tonnes a year, worth £1.8 billion) of HMG's oil, and could not be relied on in all circumstances to maximise HMG's

receipts. Furthermore, the agent's fee would still have to be paid, with the cost to the Government likely substantially to exceed the just over 2 cents/barrel hitherto paid to BNOC.

III SECURITY OF SUPPLY

The UK Objective

29. The Government's policy in the event of a significant interruption of part of the world's oil supply has been the subject of a separate paper circulated to Ministers. Essentially UK objectives would be to ensure that UK demand is met and at prices as close to current levels as possible. The policy to be pursued during any period of world supply difficulty will depend on whether or not a decision has been taken by the IEA to implement its programme of demand restraint, stock drawdown and oil allocation - and this cannot happen until a world supply shortfall of at least 7 per cent has been confirmed. As the recent paper to Ministers showed, once the IEA allocation scheme is in force, appropriate action to mobilise stocks should be sufficient to ensure full product supplies to UK consumers during a disruption lasting up to a year without any infringement of our Treaty obligations to other IEA members. (A situation in which the IEA scheme has been triggered is referred to as a "full crisis"). But particular attention has been given to action to improve the position of UK oil product consumers in a situation falling short of a full crisis (which we refer to as a "sub-crisis") or where there is a full crisis but the IEA scheme is not activated.

Government policy in a sub-crisis

30. In accordance with the UK's position as a member of the European Community and as an open market economy, successive Governments have refrained from imposing controls on the use of UKCS oil or on exports and imports of crude oil and oil products. UK refiners have been permitted to process whichever grades were most economic, depending on the structure of the UK product market and the refinery facilities available. Some 60 per cent of UKCS crude output is exported, while more than 40 per cent of the throughput of UK refineries is imported crude (or refinery feedstock).

Against this background the Government has sought to improve security of supply in a sub-crisis through the negotiation of a series of informal assurances

i) with UKCS producers who are also refiner/marketers in the UK, that they will either maintain normal deliveries to UK customers (where their UKCS crude supplies are sufficient to meet the requirements of their market), or will ring fence such UKCS crude as they have available and only apply "equal misery" restrictions to supplies in proportion to the fraction of their UK product market not covered by UKCS oil;

ii) with producers who have no UK downstream activity, that they will, on being given 45 days notice by the Secretary of State, offer their UKCS Oil at the going price to UK refiners.

(These assurances cease to have effect when the IEA allocation scheme is brought into force.)

31. Participation and royalty oil is sold back by BNOC to most producers covered by (i) essentially in return for the supply assurance. Many companies covered by (ii) have been content to give this assurance in order to maintain good relations with the Government in relation to future licensing and development; participation and royalty oil is not automatically sold back to them by BNOC. All these assurances depend for their validity and effectiveness on their remaining informal although this is unlikely to detract seriously from their usefulness in a sub crisis; any attempt by the Government to enforce them would require overt use of emergency powers and might well fail on the ground that it was inconsistent with Article 34 of the Treaty of Rome. Indeed the assurances may themselves contravene that Article but the Commission has not yet challenged them.

The role of BNOC

32. In the event of a sub-crisis, the following steps would be open to the Government (apart from pressing producer/refiners to honour their assurances):

i) require non-refiners (at 45 days notice) to repatriate some or all of their UKCS equity production;

ii) ask BNOC to steer back into the UK market some of the participation and royalty oil previously exported under term contracts or on a spot basis; and

iii) invite BNOC to discuss with certain major international companies whether UKCS oil in excess of the requirements of their UK downstream markets, and sold to them on a term basis for use outside the UK, could be diverted in whole or in part into the UK market.

Under present arrangements BNOC might act as the Government's agent in offering "repatriated" oil to UK refiners who were short of crude or marketers who could enter into process deals. The Corporation could reinforce this by selling its spot availabilities into the UK and, in principle, by not renewing "annual evergreen" term contracts with overseas purchasers as they fall due; they estimate that they could by this means (possibly supplemented by some action under (iii)) in 3-6 months make available an extra 100,000 barrels a day (7% of UK demand) to UK refiners. There would, however, be commercial costs to BNOC, (and consequential tax losses on non arm's length disposals) since failure to renew evergreen contracts would make them appear less reliable as term suppliers; once the market had returned to "normal" and the underlying position of over-supply had reasserted itself, they would then find it more difficult to recover term customers. Nevertheless these arrangements

should in principle be sufficient to offset any imaginable sub-crisis supply shortfall in this country; provided the major producer/refiners honour their assurances, these additional supplies would more than cover any shortfall of deliveries by refiners with inadequate UKCS crude supplies or independent distributors previously reliant on imports.

Full crisis with IEA triggered

33. If the situation moved into a full crisis and the IEA allocation scheme were triggered BNOC like other oil suppliers would become subject to it. It would not then be open to the Corporation to redirect contracted supplies, however informally, to the UK as long as IEA member Governments and other oil companies were generally observing the rules: BNOC would then make no direct contribution to. security.

Full crisis without IEA triggered

34. However both the USA and Germany appear hesitant about the desirability of activating the IEA allocation scheme even if Iran succeeds in closing the Straits of Hormuz - an action more than sufficient to trigger the scheme. Moreover the allocation scheme has not been tested in real life, and could be difficult to implement. In a full crisis in which the IEA scheme had not been implemented (or even had broken down), we would initially rely on the steps described in para 32 above. We would however be pushing the assurances to the limits. Our ability to instruct BNOC not to sell back RIK could be an additional means of holding companies to their assurances; but the provisions of the Treaty of Rome might make the employment difficult and risky. If the world shortage of oil exceeded that covered by the possibilities in para 32, then, if it wished to avoid shortages in the UK, the Government would have to direct supplies under the Energy Act and there would be no independent role for BNOC (though the Corporation might be useful as the Government's agent in some transactions).

35. The contribution BNOC can make by repatriating oil or putting pressure on refiners cannot be relied on without qualification. Repatriating crude can help only if we can be sure that supplies of imported oil are not reduced (or product exports increased) in line with the increase in UKCS supplies reaching the UK market. That requires the co-operation of the oil companies. While we possess through BNOC some pressures to achieve that co-operation, the companies are also in a strong position since so long as we do not activate the Energy Act powers they can deny product to the UK consumer. The pressures we can bring on refiners through BNOC are very unlikely to persuade them to go beyond their assurances; though the pressures might be needed to keep the refiners to the mark and perhaps to resolve any ambiguities in the assurances in the UK's favour. The powers HMG has to award licences and make life easy or difficult for licensees are much more significant. BNOC's role in diverting crude oil back to the UK is limited, although still useful when the shortfall is also limited.

36. BNOC has two further roles, whether in a subcrisis or in a full crisis, which are potentially important. First, in periods of market difficulty the prices of different crude grades could well diverge by margins greater than would be warrented by differences between the values of the products refined from them. It may be open to licensees to export UKCS oil at a relatively low price to their affiliates overseas leaving UK consumers to pay prices based on the term price or even spot price of other crudes. So long as there was sufficient evidence of higher arm's length prices, the Inland Revenue could over-ride low inter-affiliate prices for tax purposes but, as discussed above, such evidence could be limited. The role of BNOC would be to ensure that UK term prices kept pace with term prices elsewhere in the world, and thereby remove (or at least greatly limit) the scope for UKCS producers to transfer profit margins to other parts of the world where taxes were lower. In essence we are back to the subject matter of the first part of this paper; no satisfactory mechanism has been identified to replace BNOC's present role.

37. Second, BNOC could help the Government through the provision of information about what is really happening in the oil market at a time of crisis - information that Ministers are likely to attach considerable importance to having readily available at such a time. Information from oil companies might be coloured; and the views and experience of BNOC could provide a useful independent check on it. Through its continuing operations (and its continuing discussion with its suppliers and customers), the Corporation has access to a great deal of information about physical supply arrangements and market prices for UKCS oil. By virtue of this BNOC would be in a position to advise the Department on the difficulties and constraints which oil companies might face; the Government would thus better be able to assess whether the performance of some of the companies fell short of their reasonable expectations - as was the case in 1979.

38. BNOC could not however assure supplies of oil to the UK at prices lower than those faced by other industrial countries. As a member of the EC, the UK could not insulate its domestic oil market from domestic markets elsewhere in the Community, meanwhile forcing UKCS producers to supply the UK market at preferential prices. It must, however, be doubtful whether such a policy could ever make economic sense if pursued for an extended period; the example of the US and Canada in the 1970s confirms that this policy can both discourage the development of new production and delay the adjustment consumers have to make in response to major changes in relative prices. UK experience in 1979 provides an example of the practical difficulties involved in seeking to keep domestic prices below those ruling at any time in international trade; the UK, although not yet self-sufficient in oil, was the only substantial oil producer in the EC, but was still alone among EC members in suffering shortages at the petrol pumps. As soon as price controls were lifted however, the supply position righted itself. Following this experience, the sub-crisis supply assurances are generally drafted so that they cease to be applicable if the UK imposes price controls; the implication of this is that the UK consumer can

expect, in a sub-crisis or a full crisis, to be subject to a less stringent regime of administered demand restraint (or none) than his counterparts in other countries without domestic oil production, but he will have to pay the world market price for his supplies. Prices should be broadly the same from one country to another, with the world level reflecting on the one hand the extent of the original reduction in supply and on the other hand the effectiveness in the aggregate of the demand restraint and destocking measures taken by the consuming countries collectively.

The value of BNOC's contribution to security of supply

39. The present position of the UK is that in a sub-crisis the main element (other than facilitating the use of stocks and not constraining price increases) in the Government's policy to assure the security of UK oil product supplies is the network of voluntary assurances given by UKCS producers who are also major refiners and marketers in the UK, with repatriation of UKCS equity oil by non-refiners in response to a requirement by the Secretary of State as the next element. In a full crisis, it could be argued that the supply position would essentially be determined by the IEA (and EC) oil allocation arrangements. This note suggests that in the absence of such arrangement BNOC might be able to divert some supplies of crude normally exported into the domestic market. More important, whether or not the IEA arrangements have been triggered, BNOC as an actual player in the market, can give the Government greater insight into the position in the market place, together with some limited capacity to intervene in response to actions by UKCS oil producers damaging to UK interests or to breaches of the allocation scheme by other participants. But the role of the Corporation in protecting Government revenue from the effects of insufficient evidence of arm's length prices in a crisis or sub-crisis is likely to be the more important one.

IV OPTIONS FOR POLICY TOWARDS BNOC

40. The Government has three broad policy options to consider in any review of the future of BNOC:

(i) abolish the Corporation, as an unnecessary interference in the operation of a free market;

(ii) confirm the Corporation in its present role, while maintaining proper discipline over its costs and suitable incentives for it to undertake a limited amount of profitable, but not risk-free trading; and

(iii) retain the Corporation, but with a narrower remit so as to reduce public sector exposure to the risk of losses.

The advantages and disadvantages of these courses, reflecting the considerations set out in this paper, are as follows.

Abolition

41. For: (a) removal of Government involvement from the market and avoidance of financial risk;

(b) removal of a focus for pressure from OPEC countries on prices in a weak market and from importing countries on supplies and prices in a crisis.

(c) avoidance of BNOC's administrative costs of £5 million a year.

(d) reduction in the taxation penalties arising from integrated companies' ability to choose to pay tax at term prices when (in tight markets) they are below spot, and through 'oil spinning' at spot prices when (in slack markets) they are below term.

Against:

(a) risk of erosion of tax revenue through insufficient evidence of arm's length prices being available in certain circumstances;

(b) loss of information for purposes both of revenue and security of supply;

(c) loss of some limited practical support for Government policy on security of supply;

(d) OPEC criticism of UKCS production relates fundamentally not to BNOC's operations but to the Government's refusal to impose restrictions on field output: OPEC would probably now regard abolition of BNOC as an unhelpful act;

(e) the benefits of taking Royalty in Kind (£25-30 million per year) considerably outweigh BNOC's administrative costs of £5m per year (less any profits made for the public sector by BNOC's non-participation trading);

and

(f) political embarrassment arising from inconsistency with previous Government statements (eg in the context of Britoil privatisation) when BNOC's contribution to security of supply was emphasised.

Confirmation in present role

42. Essentially the arguments are the obverse of those for and against abolition. If BNOC is to continue to function effectively as a commercial organisation playing a full part in the market, maintaining an effective information-gathering and intervention capability, and generating the revenues needed to meet its administrative costs, the Corporation will need to continue to develop a limited volume of trading activity, including spot purchases and sales of crude oil and oil products as well as LPG trading, which is not related directly to participation. The financial guidelines under which BNOC are operating already provide for this, up to a limit which the Corporation's Board intend to keep well within. That limit is needed both to keep exposure to financial loss within bounds and to avoid the danger that the corporation might be regarded as abusing a dominant position, contrary to Article 86 of the Treaty of Rome. It may also be appropriate to arrange for an independent check on the form and level of management control on BNOC's traders.

Retention, but with a narrower remit

43. The idea would be just to keep BNOC in existence so that the full apparatus of participation could be re-established (although the notice periods are such that the exercise could take up to 18 months to complete). While the arguments over BNOC's exposure to the risk of loss on participation trading would be substantially reduced, the Corporation would have little or no freedom to engage in other trading activities. The difficulties are that it would be impossible to retain a staff of the quality needed to take a successful part in any oil trading activity with such a drastically reduced remit; that the information and advice available to the Government would be

reduced; that the overhead costs in relation to the volume of business would be increased; and that the risk of loss would not be reduced pro tanto with the volume of business - the problems are likely to arise with the marginal barrels as the market moves out of balance, and the reduction in BNOC's activity could not be relied on to reduce either that balance, or the Corporation's difficulty in disposing of its marginal barrels. Moreover any significant reduction in its activities would threaten BNOC's function of providing clear market evidence for the purposes of taxation. To do this:

i. BNOC must have enough crude net of saleback to construct a number of term deals. This certainly requires several hundred thousand barrels of oil a day.

ii. It is helpful to the OTO if worthwhile volumes are sold from as many fields as possible - from small fields this points to retaining at least half, again net of saleback, where we can. Reducing participation proportions in large fields while retaining full participation in small fields stands to attract accusations of discrimination.

44. If BNOC is to be retained, therefore, the advantage lies with continuing its business on much the same scale as at present. That does not imply maximising its access to all forms of petroleum and particularly not to forms other than crude oil.

45. The judgments in this review point clearly, though not strongly, to the retention of the Corporation. But they depend on circumstances, which could well change over time. For instance, greater evidence of arm's length North Sea prices (perhaps through developments in the spot market or transparent pricing of Norwegian crude) could reduce BNOC's contribution to tax valuation.

Similarly, if BNOC's prices are seen frequently to be politically determined, rather than representing the 'true' market price, then BNOC's effectiveness both in stabilising the market and providing tax valuation evidence may be prejudiced. Accordingly, we recommend that if BNOC is retained, we should look again at it in say 2-3 years time in the light of changing circumstances and experience gained.