CONFIDENTIAL

PRIME MINISTER

This makes it unnecessary to read Mr Walker's paper.
DRN

Gas Industry Privatisation: Gas Imports and Exports
E(A)(85)71

BACKGROUND

1. E(A)(85)17th Meeting on 31 July noted that the Secretary of State for Energy, in consultation with the Chancellor of the Exchequer and the Foreign and Commonwealth Secretary, would put a paper to the Sub-Committee on gas imports and exports before the Second Reading of the Gas Industry Privatisation Bill. The paper before the Sub-Committee responds to this remit, although it does not reflect an agreed approach with the Chancellor and the Foreign Secretary. Second Reading is now scheduled for Tuesday 10 December.

2. The present position is that all gas produced under UKCS Petroleum Production Licences is required to be landed in this country. (The same applies to oil, but wavers of the requirement are readily given in the case of offshore loaded fields.) The landing requirement is justified in terms of the contribution it makes to UK security of supply of a strategic commodity; legal advice has been that it would not be consistent with the Treaty of Rome to seek to impose such a requirement on economic grounds. So far as imports are concerned, there is no specific control; indeed, any overt economic control of gas imports would equally be contrary to the Treaty of Rome.

3. BGC's interest in the 1960s and 1970s lay in increasing its share of the energy market. Following the initial surge of development in the Southern North Sea, BGC contracted to buy the gas from the very large median line Frigg field (60 per cent Norwegian), which now supplies about 30 per cent

of the UK market. The result of this, combined with the operation of landing requirement, was that there was for a considerable period in the later 1970s no market for fresh UKCS gas supplies - BGC did not need them, and they could not be exported. The prospective decline of the first generation fields, and encouragement given by the Oil and Gas Enterprise Act 1982, have led to a substantial resumption of UKCS gas exploration and production activity; and the refusal last year to permit the import of the Norwegian Sleipner gas has ensured the maintenance of the momentum of that activity, although BGC now have more than enough gas to satisfy the UK market in the years immediately ahead.

4. Present declared Government policy of gas exports rests on the statement made by Mr Lawson as Secretary of State for Energy in February 1982, to the effect that the question of gas exports would be considered if new exploration resulted in very substantial additional gas discoveries on the UKCS. Effective control of gas imports has been secured by informal pressures on BGC, buttressed by the need for inter-governmental treaties and submarine pipeline authorisations.

5. Privatisation means that the present defacto controls of imports and exports of gas cannot continue quite as before. BGC will no longer be subject to the same informal pressures as hitherto on the question of imports, and the UKCS licensees will be concerned that privatisation should not lead to the reinstatement of the Sleipner purchase and so the recreation of the 1970s situation in which there was no market for new UKCS supplies. On the other hand, BGC's position, and the prospects for the flotation, could be significantly damaged if the landing requirement were lifted, so providing for unrestricted exports, while the Government managed to maintain a ban on imports; at the least, BGC's negotiating position with the UKCS producers would be substantially weakened. This ground will inevitably require careful treatment in the eventual Prospectus.

MAIN ISSUES

6. The main issues before the Sub-Committee are

(i) what policy to follow on gas imports and exports;

(ii) how to present that policy, in the context of the Second Reading of the Privatisation Bill and in the subsequent Committee Stage Debates.

Demand and Supply

7. Projections of future gas demands and supply are inevitably subject to considerable margins of error. There is an element of unpredictability about the performance of gas fields, even after they have come into production; and the size of the UK market will depend to some extent on future levels of economic activity, as well as on the supply of competing fuels. However, there appears to be little further scope for gas to penetrate the domestic market, while the industrial market will be influenced by the increasing competitiveness of coal and by the fact that economic growth tends to be concentrated in less energy-intensive industries. It is clear that supplies from the UKCS, together with Frigg (which is likely to run out in the early 1990s), will be sufficient to meet total UK demand at least until the mid-1990s, but that some relatively modest new imports are likely to be needed before the year 2000. Thereafter there would be an increasing need for imports unless new discoveries - probably in a new part of the UKCS - transform the situation. The implication is that BGC are likely to need to start negotiating for fresh imports by 1990, if they are to be confident that supplies will be available in time to meet any possible evolution of UK demand.

Government Objectives

8. In determining policy on gas imports and exports, the Government has three basic objectives, which may to some extent point in different directions:

(i) to maintain the momentum of UKCS exploration and production, which contributes substantially to tax revenue, economic activity and technological development;

(ii) to assure UK gas consumers of supplies at competitive prices; and

(iii) to ensure the successful flotation of BGC.

Policy Options

9. The Secretary of State identifies four possible options:

(i) maintain the present effective ban on imports and exports;

(ii) unrestricted exports, but with a continuing ban on imports;

(iii) unrestricted imports and exports; and

(iv) the Government 'holding the ring' keeping open the options of permitting individual imports and exports in the light of the circumstances at the time.

In practice, option (iv) is little more than a repackaging of option (i).

10. The Secretary of State argues against option (ii) on the grounds that it would undermine BGC's assurance of supplies, and tend to push up prices to UK consumers, thus damaging the flotation in the eyes both of investors and of the general public. He argues against option (iii) on the grounds that this would put the UK Government in a uniquely powerless position - as compared with other Western European governments - to influence trade in gas, while at the same time prejudicing future exploration and production on the UKCS because of the threat of the revived Sleipner deal. So he opts for some

repackaging of the present situation, although it is not yet clear how far Ministers could go - consistently with the Treaty of Rome - to establish overtly a selective control of imports and exports.

11. The Treasury position, as we understand it, is that there should be unrestricted exports, with BGC being permitted to import gas provided the Corporation does not discriminate in the prices it offers against UKCS producers. This would be the 'market'solution, and would provide the best assurance of continued successful exploration and production on the UKCS. In practice, however, there could be some problems; it is not clear how 'non-discrimination' would work to prevent the reinstatement of the Sleipner purchase, given that not all the gas which is potentially producible can be absorbed at the same time - would the courts interpret it to require BGC to take small percentages of the output of several fields rather than permit the fields to be developed and produced successively in accordance with the requirements of the market? There is also a possible problem about tax leakage; UKCS licensees selling to the European Continent would have as their customers companies in which they have substantial shares, so that the transactions would not be at arms length, and there would be a risk of prices being set below the 'market' in order to transfer the profits into corporations not subject to UK PRT.

12. All these conflicting considerations have some force, and there is no ideal arrangement which can be guaranteed to meet all the Government's objectives. However, the argument may to some degree be academic. The market for gas has a number of peculiar features, essentially deriving from the nature of the commodity and the means of delivery. It cannot be freely traded like oil, and we cannot run a policy which would provide for all UKCS gas discoveries to be developed and produced as quickly as physically possible. For the foreseeable

future - and with substantial supplies on offer from the USSR and Norway - there is always likely to be a queue of fields awaiting development, and prices will have to be set at the outset for a substantial part of the life-time of each field in order to assure the recovery of the development costs. With other European governments, both producers and consumers, exerting a substantial measure of control over imports and exports of gas, and with the international oil companies participating in different countries in both the production and the distribution of gas, the normal conditions for a free market do not exist. On the other hand, there are some effective constraints on the Government, UKCS licensees, and BGC; if exports were permitted, while imports were restricted, and BGC were unable to secure new UKCS supplies at 'reasonable' prices, the Corporation could negotiate an import from Holland and appeal to the European Court if UK Government sought to prevent it. , On the other hand, if BGC sought on the basis of a revived Sleipner deal to force down the prices paid to UKCS licensees, the Government would be bound to make life as difficult as possible for the Corporation, while an unrestricted export regime would undoubtedly have to be introduced. As matters currently stand, these effective constraints have produced a situation in which BGC is paying for new UKCS supplies prices very similar to those paid by Continental purchasers for new supplies from Norway or the USSR. So although there is not physical free trade in gas, market forces are making themselves felt, albeit in a round-about way.

13. In all the circumstances, the best course may be to say as little as possible about future policy on imports and exports of gas, subject to the need to give some minimum reassurance to UKCS licensees, and to BGC and potential investors, that the scales will not be loaded unfairly in favour of either side. The fact that BGC itself will have substantial interests as

a UKCS licensee as well as a supplier of gas to consumers, with the offshore business probably representing the main scope the Corporation will have for growth, is likely to further inhibit the Corporation from seeking to exploit its position as effective monopsony purchaser to the disadvantage of UKCS producers.

Presentation

14. Because of the perceived interests of UKCS licensees and of potential investors in BGC in future Government policy on gas imports and exports, questions are bound to be asked about this at Second Reading of the Privatisation Bill, and subsequently. Mr Walker sets out at Annex 3 to his paper the possible text of a Government Statement. If Ministers decide that a policy of unrestricted exports should be announced (with the implication that BGC would then have considerable freedom to import gas), of course a rather different statement would need to be prepared. However, if Ministers prefer to try to maintain effect of present arrangements, it is for consideration whether so detailed a statement needs to be made, at any rate as early as Second Reading. We understand that officials are still considering possible forms of words which might be used to describe a policy of selective controls on exports and imports, and it may be that a formula will be found which does not fall foul of EC rules. Meanwhile it may be sufficient on 10 December to point out that, despite the complexity of the forces, arising from both Governments and multinational companies, acting on the gas market, prices paid for new supplies of gas are broadly comparable throughout North West Europe, while UKCS exploration and development is going ahead as fast as the UK market can absorb the gas produced.

HANDLING

15. You will wish to invite the Secretary of State for Energy to introduce his paper. The Chancellor of the Exchequer, the Foreign and Commonwealth Secretary and the Secretary of State

for Industry will all wish to state their positions. The Attorney General may need to comment on some of the legal questions, notably affecting the EC. A number of other Ministers (e.g. the Chancellor of the Duchy of Lancaster) will also wish to take part in the discussion, given the exceptional economic and political interest of the subject matter.

CONCLUSIONS

16. You will wish the Sub-Committee to reach conclusions on

1. The nature of the future UK regime for gas imports and exports (the effective choice seems to be between some version of the present arrangements and relatively unrestricted exports and imports);

2. What should be said at Second Reading of the Privatisation Bill on 10 December.

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6 December, 1985