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CABINET

FIFTH ROUND OF OFFSHORE PETROLEUM PRODUCTION
LICENSING: BRITISH NATIONAL OIL CORPORATION
CONTRIBUTION TO COSTS

Memorandum by the Secretary of State for Energy

1. On 15 April 1976 the Ministerial Committee on Energy (ENM) agreed that there should be a further round of offshore petroleum production licensing. The method and timing of the financing of the British National Oil Corporation's (BNOC) participation in exploration and development arising from the fifth round is however the subject of a difference of opinion between the Chief Secretary, Treasury, and myself.
2. It is my view that BNOC should contribute its share (51 per cent) to the costs of exploration and development under fifth round licences, as the costs are incurred. The Chief Secretary, Treasury, has proposed that BNOC's contributions should be deferred until such time as they can be paid for out of revenues from successful developments.
3. ENM remitted this issue to a group consisting of the Chief Secretary, Treasury, the Chancellor of the Duchy of Lancaster, Lord Kearton and myself, which has not been able to reach an agreed solution.
4. A decision on this issue is urgently needed if the fifth round is not to be delayed.
5. This paper sets out the main arguments. I have reasoned my case at Appendix 1. The Chancellor of the Exchequer's letter to the Prime Minister setting out his main views on the question is at Appendix 2.

PUBLIC EXPENDITURE

6. Figures of Exchequer cash flows under the two alternative courses of action are shown in Appendix 3. In the next five years the additional costs to the Exchequer of BNOC contributing from the outset to exploration

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and development costs are estimated to be £22 million and £13 million respectively. But as can be seen from the appendix early savings are more than offset in the long run by the repayment of deferred contributions with interest.

7, My view, that BNOC must contribute 51 per cent to costs from the outset is based on the following:-

- a. The round must be a success. Deferment of BNOC's contribution to costs diminish the round's attractiveness to potential applicants and introduces a serious risk of failure.
- b. Current participation negotiations have been given impetus by companies' belief that a co-operative stance on participation will ensure favourable treatment in the fifth round allocation. This incentive to negotiate participation is diminished if the round is not seen to be attractive.
- c. It would be difficult to reconcile the British Gas Corporation's and BNOC(Ex)'s ability (established under previous Governments) to contribute from the outset, with a BNOC that was unable to contribute from the outset. BNOC would clearly be at a disadvantage vis-a-vis these corporations and indeed vis-a-vis private sector companies. This disadvantage would be compounded by the fact that BNOC are inhibited from financing development costs from overseas borrowings because this borrowing counts in the Public Sector Borrowing Requirement, while companies such as British Petroleum have no such inhibition.
- d. A decision not to back BNOC with money at least to the extent that its private sector competitors enjoy would be very difficult to justify to the Party at large and to the Trades Union Congress.
- e. We have repeatedly given assurances that when in partnership BNOC will act commercially.
- f. If BNOC is not a fully contributing partner from the outset its ability to influence a range of decisions will be diminished.
- g. BNOC's contribution and hence the burden on the Exchequer could only be deferred till perhaps the mid-1980s and would then have to be paid with interest.

I do not believe it to be worth prejudicing the round for a deferment of a few years in BNOC's contribution.

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8. Treasury Ministers want to defer for as long as possible BNOC's involvement in expenditure under Licences, on the basis that every commercial organisation naturally seeks to defer making payments, if possible until there is revenue to cover them; that the BNOC does not have to buy its way into these licences; and that if it did there would be additional public expenditure in the early years. Treasury Ministers also argue that with interest payable on any deferred contribution the success of the round will not be put at risk; but that if nonetheless it was considered that deferred terms might make the round less attractive, then other terms could be eased to compensate for this. I have looked at this last suggestion and am satisfied that adjustments to the financial terms (eg royalty) would have minimal compensatory effect due to their relative cheapness, and the point that they are expensible for tax purposes.

CONCLUSION

9. In view of the importance that we attach to a successful fifth round, I invite my colleagues to agree that BNOC should pay its share of all exploration and development costs under fifth round licences, as and when those expenses are incurred.

10. If however agreement cannot be reached on this basis, then in the interests of settling the issue as soon as possible, to avoid delaying the round I am prepared to put forward the following as a compromise:-

BNOC will as the standard pattern meet its share of exploration costs as they arise leaving open for decision case by case whether BNOC should pay its share of development costs as they arise, or defer them to be met out of revenue with an appropriate rate of interest.

A W B

Department of Energy

10 May 1976



THE CASE FOR 'PAY AS YOU GO' ROUTE

1. Objectives

In order to achieve success in the round it is my view that BNOC must contribute 51% to costs from the outset. BNOC must begin to build up its existing capability if it is to fulfil its intended role. Full partnership from the beginning will enable it to gain experience and influence decisions.

2. My main arguments are as follows:-

- (a) The attraction of the package is essential to success of the round. We cannot risk a failure. To add the further burden of deferred costs to what is already a tough package will, in the view of our consultants, act as a substantial disincentive to application. Failure of the round would be politically embarrassing, would lose confidence in the UK Shelf and income from future finds. Employment in oil related industries would be jeopardised. For comparison purposes it is worth mentioning that the Irish and Greenland provisions are less onerous than what we propose. This is mainly because neither country has a special oil tax.
- (b) The imminence of the round has added impetus to companies' willingness to negotiate participation. This is because they expect the round to be attractive. If terms are made less attractive by insisting on BNOC being carried through the development stage this lever for getting companies to the negotiating table will become very much less effective.



- (c) Contribution from the start by BNOC would underline the Government's intention that BNOC should be able to behave commercially (a point on which many HMG assurances have been given).
- (d) We are seeking full oil company status for BNOC with access from the start to information and decision taking. Deferred payment could well involve at worst partial surrender of voting rights and diminished status at the best.
- (e) As a full partner BNOC will be better able to influence investment policies to the advantage of the UK oil related industries.
- (f) BNOC would also have more influence over the pace of exploration and thus could aid the achievement of desired depletion policies.
- (g) The burden on the Exchequer of BNOC contributing from the start is recognised, but the costs are relatively modest. BNOC's initial outlay on exploration is estimated to be £50m between 1977 and 1983. If this were carried by private partners the real saving could be smaller as companies are often able to expense such costs for tax purposes.

The additional net burden on the Exchequer by the pay as you go route of development costs might approximate to £100m a year in 1982-1984, £150-200m gross). Deferring contribution would result in the burden on the Exchequer being deferred to 1986-1989, together with any interest that might be agreed on the contribution (£175m at 7%). It is questionable whether it is worth prejudicing the round for a deferment of Exchequer burden starting in nearly 10 years time.

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- (h) BGC & BNOC(Ex) contribute to costs as they arise. BNOC would be seen as a half-hearted participant compared with these corporations if it was not able to contribute. BNOC would also be at a disadvantage in comparison with these corporations and with the private sector.
- (i) If BNOC were to follow the practice of major companies such as EP in borrowing abroad to finance its developments then the Exchequer costs would be eliminated. While I understand that BNOC's foreign borrowing would count as part of the public sector borrowing requirement, this should not be an inhibiting factor if BNOC are to be allowed to compete on level terms with the private sector.

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PRIME MINISTER

Fifth Round North Sea Licenses -
Government Contribution to Capital Costs

I have seen EN(76)9, in which the Secretary of State for Energy reports a disagreement with the Treasury about one aspect of the proposed financial terms for fifth round licenses, and I should like to make my position clear in advance of the EN meeting on Monday 12th April.

2. It may help if I set out my position afresh. We all agree that BNOG should participate in future fifth round licenses. Lord Kearton would like his Corporation to be an active partner from the start, contributing to exploration and development expenditure, having access to information and a part to play in decision making. I see no case for a Government contribution to exploration, although the sums involved are not particularly large. I believe we can secure the access to information and the decision making powers that we need through the ordinary licensing process during the exploration phase, and through participation at the development stage. Participation will also give us half the oil. Provided BNOG has a 'carried interest' option to join in once a field is declared commercial, I think the public interest is safeguarded.

3. The question then is whether it should contribute to development costs as they arise. My suggestion is that there should be no automatic obligation to contribute. Each case should be negotiated individually. There should be a strong presumption that HMG will not put up cash, but that its share of the capital costs should be

/ contributed retrospectively out



contributed retrospectively out of revenue. This means that the companies, in exchange for the right to exploit mineral resources on the Continental Shelf, would be required to finance HMG's share of the investment until any fields it discovered produced sufficient revenue to pay back the public share of the costs out of the public share of revenue. The company would be entitled to interest on the repayment of the capital contribution which it made on behalf of the BNOC. We would have to decide whether, if the field were abandoned before the full development costs were recouped, BNOC would have nevertheless to contribute its share of costs to date.

4. This seems to me the correct commercial approach to the negotiations. It would be wrong for the Government, in conceding a valuable franchise to an oil company, to be required itself to finance its own share of the capital costs of developing any oil fields discovered. If, unexpectedly, any licensee finds himself unable to raise the necessary capital, then BNOC has the power to contribute. But I believe that the whole license package should be constructed on the assumption that, in the normal case, there will be no public capital contribution.

5. It is important to maintain this approach, not only for strictly commercial reasons, but because of the prospective calls on public expenditure and the public sector borrowing requirement if the Government were required to finance 50 per cent of future development costs. It is no answer to say that this would be profitable investment; the difficulty lies in raising the necessary finance during the development stage. Our projections of available real resources and of public expenditure and receipts already allow for a Government take from any new fields which may be discovered, but not for any BNOC capital contribution. As Ministers know, the

/ public expenditure situation



public expenditure situation projected on those assumptions is already difficult enough. To require direct BNOC investment in field development would reduce, pro tanto the amounts available for other public expenditure programmes.

6. I do not see why these terms need necessarily have a disincentive effect. In most cases, the prospective licensees will be borrowing to finance field development, rather than using their own internally-generated cash resources. Some of the borrowing will be (indirectly) on the strength of the BNOC involvement in the field (which has the effect of ensuring that resources will always be available to ensure its development provided it remains viable). So the lenders' security should be improved and the oil companies' problems in raising finance eased. The forecasts of available finance already assume that the oil companies will be able to raise 100 per cent of the capital needed.

7. In any case, if the package as a whole seems unattractive on these terms (which seems unlikely, given the success of the Irish and Norwegian governments in negotiating equally tough arrangements) the solution might be to adjust some other element of the package - the license fee, the rental, resale of some of the BNOC oil, the royalty rate, etc., rather than to compromise on the essential principle of a Government capital contribution. Such concessions would affect future revenues, extending over the life of the field, and would be more acceptable than a Government capital contribution in the early years of the field when the constraints on public expenditure will be tightest.

8. The Secretary of State has argued that, if my terms were included in the license, the whole round might become a flop. I do

/ not believe this



not believe this would happen, for the reasons given above. But if this is considered a real danger, there are two alternatives which we should consider.

9. The first is that we should abandon altogether the idea of a 1976 licensing round. The advice of officials who have studied depletion policy (EN(76)4) is that we should, on balance, go rather slower with new licenses. Admittedly, we have already announced the intention to have a fifth round this year. But we could defend a change of policy by referring to the increasing importance of conservation and of a fairly strict depletion policy.

10. Alternatively, if this course were thought too damaging to the confidence of the offshore supplies industry, I suggest that we simply drop the idea of a 'round' of licenses. Instead, we could indicate in general terms our intention to issue new licenses (without saying how many) and begin separate negotiations with the main potential licensees. We could say that it was open to any company to make a bid for a particular block within the designated area. This course would leave us much freer to negotiate individual terms case by case, and if the number of applicants were smaller than we hoped, we would be able to adjust the terms continuously to maintain the necessary flow of new exploration. But in doing so, we should avoid any risk of a 'flop' with the consequent damage to the offshore industry and to the credibility of the Government's North Sea Policy.

(D. M. H.)
9 April, 1976

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YEAR	NET STATE CASH FLOW (\$M, 1975 PRICES)		
	EXPLORATION	DEVELOPMENT (PAY-AS-YOU-GO)	DEVELOPMENT (CARRIED INTEREST)
1977	-2		
1978	-5		
1979	-5		
1980	-10	-13	
1981	-15	-56	
1982	-10	-117	
1983	-3	-126	+9
1984		-70	+21
1985		+76	+66
1986		+278	+187
1987		+430	+255
1988		+542	+399
1989		+581	+484
1990		+559	+497
1991		+510	+499
1992		+437	+437

- NOTES: 1. Exploration costs based on 50 wells drilled, average cost \$2M/well, 51% met by DNOG.
2. Carried interest at rate 7% for illustrative purposes.

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