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CRAIO

PRIME MINISTER

SLEIPNER

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For the past six months or so, following the remit I was given by ES on 20 June, Alick Buchanan-Smith and I have been negotiating with the Norwegians about aspects of the proposed Sleipner gas deal which we regarded as unsatisfactory. There have, however, been a number of important developments which have fundamentally altered the case for proceeding with the proposed purchase. The attached memorandum sets out my current assessment, in the light of the re-negotiation, and concludes that we should now turn down the present Sleipner deal whilst instructing the British Gas Corporation to pursue options for an alternative smaller gas import.

I hope that we can agree these conclusions in correspondence. The Norwegians are, of course, pressing for an early decision and I have promised to let them have our answer with the minimum delay.

I am copying this minute to the Secretary of State for Foreign and Commonwealth Affairs, the Chancellor of the Exchequer, the Secretary of State for Trade and Industry and to Sir Robert Armstrong.

SECRETARY OF STATE FOR ENERGY

31 January 1985

PROPOSAL TO PURCHASE SLEIPNER GAS: A REASSESSMENT

INTRODUCTION

1. ES(84) 2nd Meeting considered proposals for the possible purchase by BGC of gas from the Norwegian Sleipner field on the basis of the memorandum I circulated with my letter of 2 May 1984 to the Chancellor of the Exchequer. The main feature of BGC's proposals was that they should enter into a contract with the Norwegians to import Sleipner gas from 1991 until at least 2010 at a plateau rate of up to 550 bcf/year (representing 30% of total UK gas requirements) and at a balance of payments cost of between £1.4 billion and £2.4 billion/annum (1983 prices).

2. One of the main problems with the draft contract drawn up between the BGC and the Sleipner Group was this high maximum rate of delivery which could have had the effect of delaying developments on the UKCS. ES therefore invited me to open negotiations with the Norwegians with a view to reaching agreement on a lower rate of delivery (430 bcf/year) which would not be exceeded without HMG approval. In so far as there was opportunity to do so without prejudicing this principal objective, an attempt was also to be made to:-

- (i) secure agreement to Sleipner liquids being landed in Britain on acceptable terms;
- (ii) obtain a commitment from the Norwegians to give genuine full and fair opportunity on the Sleipner project for the UK offshore supplies industry;
- (iii) secure agreement that the Sleipner Treaty should grant control over the 25% spare capacity in the Sleipner gas pipeline to the UK Government and control over the use of the 75% capacity dedicated to Sleipner gas to the UK and Norwegian Governments jointly.

3. ES also agreed that when the Sleipner proposal was brought back to the Committee for final decision, proposals for introducing a controlled gas export regime should be considered at the same time.

NEGOTIATIONS WITH THE NORWEGIANS

4. Negotiations with the Norwegian Government have proved difficult. Initially they refused to negotiate on any of the changes sought by the UK on the grounds that the two Governments should not interfere in an essentially commercial matter. However after six months of discussion we have finally won most of the concessions we sought. In particular it has been agreed that gas deliveries should be limited to 430 bcf per year unless HMG approves a higher figure. On other matters:-

- (i) Sleipner liquids would be landed in the UK but the Norwegians insist on using a Norwegian-owned pipeline to Teesside rather than a UK-owned pipeline to Flotta; the Norwegians are offering compensation to HMG of £150 million (which might be capable of improvement in further negotiation) for loss of tax revenue that would have been due on tariffs on the UK-owned route. But we would still prefer the Flotta option since it would help extend the economic life of the Piper oil 'gathering' system and would result in up to £100 million additional orders, compared to the Teesside route, for the UK process plant and offshore supplies industries;
- (ii) the Norwegian Government have offered UK industry full and fair opportunity but on a basis which in our view lacks 'teeth' and could result in Norwegian industry winning the lion's share of the orders. Such an arrangement would be difficult to defend politically, particularly given the expectation expressed by the Energy Select Committee that the Government would rigorously examine the terms of the deal to ensure that UK firms were allowed fair opportunities. It would quickly become apparent that the arrangements were deficient and that they would not enable us to verify that UK companies had been given an opportunity to compete or provide means of appeal if there was discrimination against them (as there almost certainly would be);

- (iii) draft Treaty clauses have been negotiated which secure UK Government control over the use of the 25% spare capacity and joint UK-Norwegian control over the remainder.

A more detailed account of the outcome of the discussions with the Norwegian Government is at Annex A. The outcome is satisfactory except in the case of full and fair opportunity.

5. When I met Mr Kristiansen, the Norwegian Minister of Petroleum and Energy, in December, he made it clear that the Norwegians saw little scope for further concessions. He asked for an early decision whether or not we wish to proceed with the Sleipner purchase on the terms at present on offer.

6. There have however been three developments since May 1984 which in sum bear more importantly on the Sleipner decision than the detailed points covered in negotiation. First there have been new discoveries on the UKCS, leading my Department and BGC (in common with all the major oil companies) to revise upwards their estimates of UK gas supply in the 1990s to a greater extent than we previously envisaged. Secondly, the dollar has strengthened, pushing up sterling prices for gas and oil. Thirdly, the Law Officers have reviewed the likelihood of our being able successfully to defend challenge under the Treaty of Rome to a controlled export regime.

UK GAS SUPPLY AND DEMAND

7. BGC's decision a few years ago to increase their offer prices for UKCS gas, coupled with the incentives in the 1983 Budget, has led to an upsurge in exploration and appraisal drilling, which accelerated during 1984 and has in turn led to a significant increase in known reserves. In the April 1984 "Brown Book" my Department estimated remaining gas reserves in the proven plus probable categories at 41 trillion cubic feet (tcf). This estimate has now been raised to 47 tcf or about 26 years supply at the present rate of UK consumption.

8. Partly as a result of the increased reserve estimates and partly due to further appraisal work on previously existing finds, my Department have made substantial upward revisions to their forecasts of gas supply potential of the UK continental shelf. These have been offset to some degree by increases in forecast demand. Studies by my own Department and Sussex Univeristy confirm the BGC's view that they will be able to expand gas sales to industry during the 1990s as well as retaining interruptible sales beyond 2000. Earlier BGC had expected their interruptible sales to be reduced by over half by the year 2000, because of price competition from coal.

UK GAS SUPPLY AND DEMAND
(Bcf/year - May Estimates bracketed)

	1996*	2001
<u>Supply</u>		
Fields in production or under under development	790 (630)	350 (350)
New UKCS developments:		
- existing finds	1070 (980)	1500 (810)
- future finds	120** (100)	200** (240)
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Total UKCS supply	1980 (1710)	2050 (1400)
) 230 shortfall) 460 shortfall.
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UK Demand	1960 (1940)	1990 (1860)

14 shortfalls of 230 bcf in 1996 and 460 bcf in 2001 have now disappeared on the central estimates

* The previous forecasts for 1996 shown here differ from those quoted to ES last year because we have put the earlier estimates and the present ones onto a common forecasting basis so that valid comparisons can be made.

** Our estimate of recoverable reserves in future finds has been raised significantly but we now expect most of this gas to be produced after 2001.

9. Details of the supply and demand forecasts are set out in more detail in Annex B. In effect, there is now a smaller risk of deficit in UK gas supplies in the 1990s. However, since the supply and demand forecasts each fall within a range, there are still risks of a supply shortfall in the 1990s. For example Figure 3 in Annex B shows a highly plausible downside-risk case in which UK gas consumers would depend from as early as 1992 on a substantial and growing contribution of gas supplies coming from uncertain sources: gas fields which have not yet been discovered and gas condensate fields with many development problems yet to be solved.

INTERNATIONAL GAS SUPPLIES

10. There are no reliable indices of trends in natural gas prices. Unlike oil, there is no single price for internationally traded gas. Major deals are few and far between and details of terms are normally kept confidential both for commercial and political reasons (particularly where important side deals, not directly reflected in the price of the gas, are struck as part of the package). Even so, it is widely reported that prices for new gas imports into Europe have fallen from a high of \$4.70 - \$5.50/MMBTU 3 years ago to between \$3.80 - \$4.20/MMBTU at present. This is in part due to falling oil prices (affecting old as well as new contract prices), slack demand and the readiness of the Soviets to undercut prices to expand market share (important new deals with the FRG and Italy are priced at \$3.80/MMBTU).

11. Competition between suppliers to the European market has also increased. In addition to the Soviets, Norwegians and Algerians, the Dutch have, after 10 years, re-entered the export market with major new supplies firmly on offer. With demand from their existing customers not particularly strong, the Dutch appear keen to widen their market to include the UK. An opening offer in March was estimated to be priced 20% above Sleipner, due mainly to the construction of the price escalator. Understandably, having provisionally agreed to buy Sleipner from the Norwegians, BGC were not in a position to pursue alternative offers, but contacts with my officials suggest that the Dutch would be keen to negotiate on the basis of a revised offer, competitive with Sleipner.

THE DOLLAR-STERLING EXCHANGE RATE

12. The dollar price of oil remains a dominant influence on the development of gas prices, through its impact on producer expectations and escalation clauses incorporated in contracts and on competition between gas and other fuels in final markets. Weakening oil prices have depressed dollar prices for all fuels internationally. A weaker pound - which may or may not recur in the 1990s and after 2000 - has enhanced the value of indigenous resources and a greater degree of reliance on them.

13. The sterling cost of Sleipner gas, which is priced in dollars, has risen sharply in recent months due to the rise in the value of the dollar. This rise has been offset to some extent by falls in the dollar price of oil in the Sleipner escalator. But the overall effect has been an increase in the price of Sleipner gas from 28.9 pence per therm in the last quarter of 1983 to 34.7 pence per therm at the end of 1984, or 33.1 pence after allowing for the lagged effects of oil price changes to work through. This represents an increase in the sterling price of Sleipner of some 15 per cent. This increase should not however be viewed in isolation. The prices which the BGC is paying for new gas supplies from the UKCS have risen to a similar extent over the same period because they too are linked through escalators to oil prices. Should the pound recover against the dollar, the trend would be reversed. For example an exchange rate of \$1.60 to the £, similar to that at the beginning of 1983, would reduce the present sterling price of Sleipner gas by 25% to 26 pence per therm, on the basis of present oil prices.

CASE FOR SLEIPNER

14. The case for HMG agreeing to the Sleipner purchase as currently proposed has weakened over the past few months. In the light of recent exploration and appraisal work it now appears more likely that UKCS gas supplies, supplemented until the early 1990s by imports already under contract, could meet Britain's gas requirements until the end of the century. It follows that if Sleipner

imports were to start in 1991, there would be a distinct risk that the development of some UKCS gas fields would be delayed by several years, with consequent delays in employment opportunities and tax revenues.

15. The price of Sleipner gas looks less attractive now following the downward movements of international gas prices and recent weakening of sterling. But I would not want to make too much of these factors. Both would be liable to further change before any actual payments were made for the gas in the 1990s and the Sleipner price, as negotiated, would be expected in any event to maintain broadly its present relationship to the price of oil.

CASE FOR LIMITED NEW IMPORTS

16. The main reason for the weakening of the case for buying Sleipner is the improvement in our prospective supply position relative to demand. There is always much uncertainty in forecasting supply availability so far ahead and in the case of our present forecasts there is considerable downside risk associated with two areas in particular:-

- (i) the extent of reserves in the Frigg area. The BGC believe that recoverable gas in the main Frigg reservoir could prove to be as much as 1.3 tcf below the operator's (upper) estimate and could come off plateau as early as 1988, some 2 to 3 years earlier than the operator's least pessimistic forecast. The Department's reservoir engineers take a middle view.
- (ii) The increasing proportion of forecast UKCS gas output in the 1990s (about 25% by the end of the decade) derived from condensate fields in the central North Sea (ie fields containing very light oils and gas). Experience in developing such fields is very limited and there are considerable technical and economic uncertainties, which cannot be resolved until a late stage of appraisal, about the timing and size of the gas contribution.

The risk that supply will not be sufficient to meet demand is still significant and provides a sound case for taking a limited tranche of new imports in the 1990s. The political importance of ensuring that the gas industry meets its obligation to supply the need of its 16m domestic and smaller customers as well as the requirements of large industrial and commercial companies makes it essential to ensure supplies are available.

17. A policy of, effectively, restricting BGC to UKCS gas purchase would also be liable to overcorrect for the problems we inherited in 1979, going further than is necessary to maintain incentives for UKCS gas exploration and development and shifting the balance of negotiating strength too far in the oil companies' favour. A captive customer facing a sellers' market and possibly a producers' cartel in UK gas might generate additional tax revenues for the Exchequer but the consequences for gas prices and perhaps gas availability to more than 16 million consumers would be very damaging politically. It would also be contrary to our philosophy on competition.

18. Taking a modest level of import during the 1990s would guard against these risks. It would also provide a strategic hedge against an otherwise rapid prospective rate of decline in UKCS production in the early years of the next century.

OPTIONS FOR LIMITED IMPORTS

19. If the Sleipner deal is not pursued in its present form there are a number of possibilities for alternative imported supplies on a smaller scale, ie equivalent to some 10% of consumption in the 1990s:-

- (i) the Sleipner field comprises two main reservoirs. The smaller of these, Gamma, could possibly be developed on its own, supplying about 200 bcf of gas per year at plateau;
- (ii) the Sleipner field could be developed as proposed but the gas shared between BGC and, say, Ruhrgas and/or Gaz de France. The UK would, in effect, provide a land bridge for conveying gas from Norwegian

waters, via a cross-Channel link, to the Continent. This would be constructed as an entrepot deal rather than export (paras 25-28 below) from the UK;

- (iii) the whole Sleipner field might be capable of development at a still further reduced rate of delivery;
- (iv) Dutch gas;
- (v) Soviet gas.

20. It would not be possible to pursue these options in detail until Sleipner has been formally turned down. There are important strategic and wider international advantages in continuing to look to Norway and working to bring about the real contribution which the Norwegians are able to make, from their enormous gas reserves, to containing Western European dependence on Soviet gas. The US Government has recently again underlined the importance of the strategic considerations. An initial purchase of, say, Sleipner gas could well lead on to further developments harnessing other, more northerly Norwegian reserves and the general approach should command strong US backing. We do not know how quickly the Norwegians will be prepared to resume negotiations nor have we yet explored the extent of interest in France and Germany, though the French have made some informal overtures. Both countries are, in principle, adequately supplied into the 1990s but both have a strong strategic interest in broadening their base of supply and France may have some incentive to rein back on its high cost purchases from Algeria.

21. The Dutch option also has potential advantages. The gas could be supplied with more seasonable variation than Sleipner gas, possibly saving expenditure on new sources of peak supply. It could also be supplied on a shorter lead time than Sleipner and could be available by 1989 to offset any shortage from an early decline in Frigg supplies (Sleipner would not start production until two years later). But it might be subject to interruption if there were a serious supply shortage in Europe.

22. It is inconceivable that we would contract with the Soviet Union to cover, say, 10% of UK supplies in the 1990s. But I would not want, at this stage, to rule out exploring the terms the Soviets - as European price leader - have on offer, as part of the negotiating process with others.

CONTROLLED EXPORT REGIME

23. Without Sleipner, the question of a controlled export regime is not immediately at issue. I have, however, considered in consultation with interested Departments possible objective criteria on which to base a controlled gas export regime and have received further advice from the Law Officers on the legal standing of such a regime. The purpose of such a regime would be to safeguard the security of our gas supplies whilst avoiding unnecessary delays to gas field developments.

24. The main difficulty identified is that a controlled regime would not be compatible with the Treaty of Rome. The very concept of a control on exports is contrary to the Treaty. However, a total ban, where all are at least treated equally, is easier to maintain than a selective ban, with the discriminations inherent in allowing some to export and others not. Two possible defences to a challenge of a controlled regime have been identified. The first would involve a long term commitment to inflexible gas depletion objectives which are no part of our present policy and which would be difficult to demonstrate in practice. The second, the need to protect security of supply to British gas consumers, would have been undermined by the very fact of contracting a major secure source of imports (and could not be used with any guarantee of success to defend individual refusals to export which would, by definition, have only a marginal impact on future security of supplies).

25. The original objections to the remaining option of an uncontrolled export regime still stand. We would be powerless to determine the rate of exports, to prevent non-arms length deals (on a corporate or national basis) or to ensure that export developments were undertaken fully in the national interest. These arguments are spelled out in greater detail in Annex C. Above all, however, the

prospect of exports will no longer be required as a stimulus to UKCS developments, at least for the time being, given the closer correlation we now see between potential supply and demand in the 1990s. We can return to this question in a few years time if circumstances change, although clearly there would be serious risks in introducing a controlled export regime and fundamental objections to the introduction of an uncontrolled one.

26. Many of our oil and gas policies are vulnerable under the Treaty but have avoided serious challenge so far because they have been in place and undisturbed for many years. To attempt to introduce a gas export regime could well attract unwelcome and unnecessary attention to our policies, crucially affecting the development of the UKCS as a whole.

CONCLUSIONS AND RECOMMENDATIONS

27. In the light of all the changes in circumstances since the contract was first negotiated, I cannot recommend that we now agree to BGC proceeding with the Sleipner purchase. I am concerned, however, that alternative arrangements should be made as quickly as possible for the UK to import a smaller quantity of gas during the 1990s, to guard against supply shortfall and to avoid putting undue pressure on what remains, on latest estimates, a limited gas resource in the UKCS.

28. I, therefore, invite my colleagues to agree that I should:

- (i) inform BGC and the Norwegians that HMG is not prepared to endorse the present Sleipner contract;
 - (ii) instruct BGC to open immediate negotiations with potential suppliers of gas (paragraphs 21-24) with a view to securing a smaller import on the best competitive terms available, up to about 200 bcf a year (or 10% of likely demand in the 1990s);
- Why immediate?*

(iii) make an early public announcement to this effect.

I shall report back on the outcome in due course.

Secretary of State for Energy

31 January 1985

OUTCOME OF NEGOTIATIONS WITH THE NORWEGIAN GOVERNMENT

Rate of Delivery of Gas

1. The BGC and the Sleipner Group have agreed to revisions in their draft agreement which allow for annual contract quantities to be held down to 430 bcf per year unless HMG approves a higher figure. This was achieved without increase in the price despite the lower rate of delivery.
2. UK and Norwegian officials have also negotiated a draft Treaty article which specifies that when HMG grants authorisation for a Sleipner pipeline it will limit the throughput of Sleipner gas to 430 bcf per year.

Sleipner Liquids

3. The Norwegian Government is adamant that the Sleipner liquids should be landed at Teesside though a Norwegian-owned pipeline. The Sleipner Group would prefer that route for commercial reasons and tax revenue on the pipeline tariffs would go to Oslo.
4. The UK would gain substantial benefits if the Sleipner liquids were sent to shore by a UK-owned pipeline to Flotta in the Orkneys. The Exchequer would receive up to £180 million in tax revenue on tariffs (1984 net present value). The Flotta route would also be likely to result in up to £100 million more orders for the UK process-plant and offshore-supplies industries than the Teesside option. And the project would help extend the life of the Piper oil pipeline system, aiding eventual "gathering" of oil from a number of small fields in that area of the North Sea. The total economic advantage to the UK of the Flotta route is estimated at £250-300 million (1984 net present value).
5. The Norwegian Government has offered the UK compensation of £150 million if the Sleipner liquids go to Teesside. We believe that scope remains for negotiating this figure upwards to some extent.

Full and Fair Opportunity

6. The Norwegian Government has offered arrangements to help ensure that UK companies have the opportunity to bid for work on the £5000 million Sleipner project. Full details are attached. But the offer falls far short of the negotiating objectives of the Offshore Supplies Office (OSO) of the Department of Energy. In particular OSO would not have access to bid-assessment documentation and there would be no arrangements for appeal against contract awards which appeared to be discriminatory. Past experience suggests that under these circumstances there is a danger that UK industry might get a low percentage of Sleipner orders and Norwegian industry a high percentage, even in areas where UK firms have a strong competitive advantage. As an alternative the possibility of the Norwegians giving an informal undertaking that, say, 60% of the orders would come to British companies was considered, but the Norwegians saw insuperable difficulties with such an approach.

Draft Treaty Clauses

7. Norwegian and UK officials have negotiated draft Treaty Articles for inclusion in a written agreement between the two Governments which would have to be concluded before approval was given to the Sleipner deal. The Treaty articles cover gas transmission, taxes and charges, pipeline construction and operation, gas measurement, inspection of facilities, safety, and civil and criminal proceedings.

8. Among the many topics included in the draft Articles are provisions that:-

- (i) Sleipner gas deliveries shall be limited to 450 bcf per year;
- (ii) transmission of gas through the 25% spare capacity in the Sleipner pipeline shall be subject to HMTG approval;
- (iii) regulation of the construction and operation of the pipeline, and of measurement and safety matters shall rest with the UK on the UKCS and Norway on the Norwegian shelf (but inspectors of both countries shall have access to all parts of the pipeline system as necessary for safety and technical reasons);

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- (iv) civil and criminal proceedings with respect of the Sleipner pipeline shall be determined in accordance with UK laws on the UKCS and Norwegian laws on the Norwegian shelf.

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FULL AND FAIR OPPORTUNITY IN RESPECT OF THE SLEIPNER DEVELOPMENT

I. The following items have been suggested by MPE to be included in a memo of understanding between our governments.

1. It is the declared intention of both Governments that UK companies have a full and fair opportunity to compete for goods and services required for the development of the Sleipner field.
2. Accordingly, the Norwegian Government expects that UK companies will be invited to tender based on technical and commercial considerations by the operator.
3. It is in the interest of both Governments to continue and strengthen the regular contacts and consultations between OSO and MPE on questions concerning North Sea related procurement matters such as time schedule for major contract enquiries, relevant technical information, contract strategy etc.
4. MPE will ensure that OSO regularly receives information on UK-companies invited to bid.

MPE will, based on submitted bids, inform OSO of the competitive status of UK-suppliers. Such information will be given as documentation in regular meetings between MPE and OSO.

II. In a meeting between OSO and Statoil on 7 November, Statoil presented their plans to ensure UK companies full and fair opportunities to compete for goods and services required for the development of the Sleipner-field. The main items are;

1. Statoil is willing to arrange seminars for UK industry in the same way as for Norwegian industry in order to review the project and allow the companies to be prepared to tender.
2. UK companies will be included on all bidders lists (possibly with the cooperation of OSO).
3. Evaluation of bids on an exclusively technical and commercial basis.
4. UK companies submitting unsuccessful bids may in the same way as Norwegian companies ask for a briefing on their competitive status.

III. Statoil has earlier expressed their willingness to send BGC a letter with the following content:

"In connection with our discussions concerning the manufacture and supply of the Sleipner Pipeline, we write to confirm that we will ensure that British Steel Corporation is given a full and fair opportunity to tender for and manufacture and supply the Sleipner Pipeline.

We also confirm that we, considering the time schedule for the Sleipner Project, will ensure the periods to be allowed for tendering and delivery will be such as will give interested suppliers, including those who have not previously manufactured pipe of the specification and size required for the Sleipner Pipeline, a fair opportunity for competitive bidding."

UK GAS SUPPLY AND DEMAND

1. The Department of Energy has recently prepared an updated central forecast of UK gas supplies to 2005. The latest estimates are substantially higher than those prepared early in 1984 prior to the last ES discussion of the Sleipner question. Total UK gas supplies are now expected to be 240 billion cubic feet (bcf) per year higher on average in the 1990s than had been predicted previously. Comparisons between the new and old forecasts are shown in Table 1 below and, as graphs, in Figure 1 at the end of this Annex. Figure 2, following Figure 1, shows the make-up of the new forecast over time, as gas from existing developments is successively replaced by new supplies, initially from known fields and latterly, to an increasing extent, from less certain sources.

TABLE 1 - UK GAS SUPPLY

(bcf per year - previous forecast in brackets*)

	<u>1986</u>	<u>1991</u>	<u>1996</u>	<u>2001</u>
<u>UKCS fields</u>				
(i) In production or under development	1440 (1290)	1090 (1120)	790 (630)	350 (350)
(ii) Discovered but not yet under development	10 (140)	600 (760)	1070 (980)	1500 (810)
(iii) Future finds	0 (0)	0 (0)	120 (100)	200 (240)
<u>Imports</u>				
(i) Existing contracts	480 (500)	360 (180)	0 (0)	0 (0)
<u>Total supplies from UKCS and already-contracted imports</u>	1930 (1930)	2050 (2060)	1980 (1710)	2050 (1400)

* The 1996 figures shown here for the previous forecast differ from those quoted to ES last year because we have put the earlier estimates and the present ones onto a common forecasting basis so that valid comparisons can be made.

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2. The main changes between the two forecasts can be summarised as follows:

(i) UKCS fields in production or under development

Expected output in the period 1985-2005 has increased in total by 1.7 trillion cubic feet (tcf) due to a number of fields (Esmond, Forbes, Gordon and Victor) having moved to the development stage during recent months.

(ii) Existing import contracts

Supplies from the Frigg area in the years 1985-1995 are now expected to be 0.8 tcf higher because additional satellite fields are being tied in to the system (East and South East Frigg and Odin);

(iii) UKCS finds not yet under development

Record levels of exploration and appraisal activity in the southern and central North Sea (combined with sustained success rates) have contributed through new discoveries and further proving-up of old finds a further 4.2 tcf of expected gas output between 1990 and 2005;

(iv) Future finds

Reassessment of the prospects for future discoveries has confirmed earlier assumptions that an additional 7.0 tcf of recoverable reserves may be found in the Southern Basin of the North Sea by the year 2000. Much of this gas, assuming that it is found, will take many years to appraise and develop. The new forecast assumes that gas from new finds will be rather more delayed in contributing to UK supplies than had previously been assumed. No allowance is made for gas supplies from future finds in the central and northern North Sea or elsewhere on the UKCS.

3. The new supply forecasts are of course subject to uncertainty and are most unlikely to prove to be correct, even though they are based

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on the best information available to the Department of Energy. The most serious risks arise if they are in reality over-estimates and if policy decisions taken on the basis of them result in the 1990s in gas shortages or enforced rationing.

4. The BGC have also revised upwards their forecasts of UK gas supplies since early 1984, in their case by about 250 bcf per year on average in the 1990s. However the BGC started with a lower supply forecast than the Department and their central case remains on average 170 bcf per year below the Department's forecast in the 1990s. The principal reason for this difference is a 1.2 tcf gas find in the central North Sea which has not been announced publicly; the Department has information on this field but BGC do not. The other main source of difference arises on the Frigg field. This reservoir has natural water-drive and output from the main development will decline from plateau to zero over 18 months or so in 4 or 5 years time. The operator, Elf Norway, and BGC have not yet established the extent of remaining recoverable reserves, nor the timing of the final plunge in output. The Department of Energy has adopted a middle position between the operator's and BGC's estimates in the new forecast. BGC forecast that Frigg output could start to decline in 1988, a year earlier than the Department has assumed, and will finally contribute 0.4 tcf less gas than in the Department's forecast. Elf Norway are carrying out further appraisal of the reservoir to clarify the position but the results will not be available until the end of the year.

Demand

5. The Department has also updated its assessment of UK demand for gas up to 2005, and the new estimates are higher than the early 1984 demand forecast, although not to such a marked degree as on the supply side. Overall UK demand is now expected to be over 100 bcf per year higher by the end of the 1990s than had previously been forecast.

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The new and old forecasts are compared in Table 2 below:-

TABLE 2 - UK GAS DEMAND

(bcf per year - previous forecast in brackets)

	<u>1991</u>	<u>1996</u>	<u>2001</u>
Domestic	1030 (1030)	1050 (1050)	1050 (1050)
Commercial	310 (310)	310 (310)	310 (310)
Industrial:			
Regional Firm	220 (240)	230 (240)	240 (240)
Regional Interruptible	230 (210)	270 (180)	200 (100)
HQ Sales	160 (170)	20 (100)	20 (100)
∟ Total Industrial	610 (620)	520 (520)	560 (440)∟
Own Use and Losses	90 (70)	80 (60)	70 (60)
Total Demand	2040 (2030)	1960 (1940)	1990 (1860)

6. The main change between the two forecasts is that the Department now takes the view that the BGC will be able to increase interruptible sales to industry during the 1990s. (In the May 1984 paper the Department mentioned that it was possible that BGC could retain interruptible sales in the 1990s but in the demand forecast itself it was assumed that price competition from coal would squeeze the BGC out of this part of the industrial market by 2000). The Department's latest views on interruptible gas demand are based on the results of research by the Science Policy Research Unit at Sussex University carried out on behalf of the Department.

7. The Department's demand projection (Table 2) is based on an assessment of the BGC's latest forecast. It falls near the centre of a range of approximately 150 bcf in 2001 on the assumption that current BGC pricing policy is continued. In nearly all respects there

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is close similarity of view on demand but the BGC are more optimistic than the Department about the outlook for gas sales to petrochemical and fertiliser manufacturers in the 1990s. ICI are currently supplied with cheap gas under a contract which will expire in 1989. There are doubts about whether BGC would retain this business in the 1990s at Sleipner-level prices; continued sales could be dependent on cross-subsidisation to lower the feedstock price. The Department's forecast assumes that BGC's petrochemical sales would be reduced by about 130 bcf/year between 1990 and 1995 whereas the BGC assume a drop of only 40 bcf/year.

SUPPLY-DEMAND BALANCE

8. The increase in the level of UK gas supplies which the Department is forecasting for the 1990s is expected to be only partly offset by increased demand. As a result there now seems to be a fair chance that the widening gap which had previously been predicted to open up between supply and demand in the absence of new imports in the early 1990s will not start until rather later. Table 3 below and Figure 1 at the end of this Annex compare the balance between forecast UK gas supply and demand on the new basis with our expectations in early 1984.

TABLE 3 - UK GAS SUPPLY AND DEMAND

(bcf per year - previous forecast in brackets)

	<u>1991</u>	<u>1996</u>	<u>2001</u>
<u>Total supplies from UKCS and already-contracted imports</u>	2050 (2060)	1980 (1710)	2050 (1400)
<u>Total UK demand</u>	2040 (2030)	1960 (1940)	1990 (1860)

9. But Table 3 makes no allowance for downside risk. Table 4 below and Figure 3 at the end of this Annex show what could happen to the Department's forecast of demand/supply balance if output from the

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Frigg area proved to be lower than is assumed in the Department's central case and if demand from the petrochemical industry was higher than assumed:-

TABLE 4 - UK GAS SUPPLY AND DEMAND COMPARISON
BETWEEN RISK MODIFIED AND CENTRAL CASE

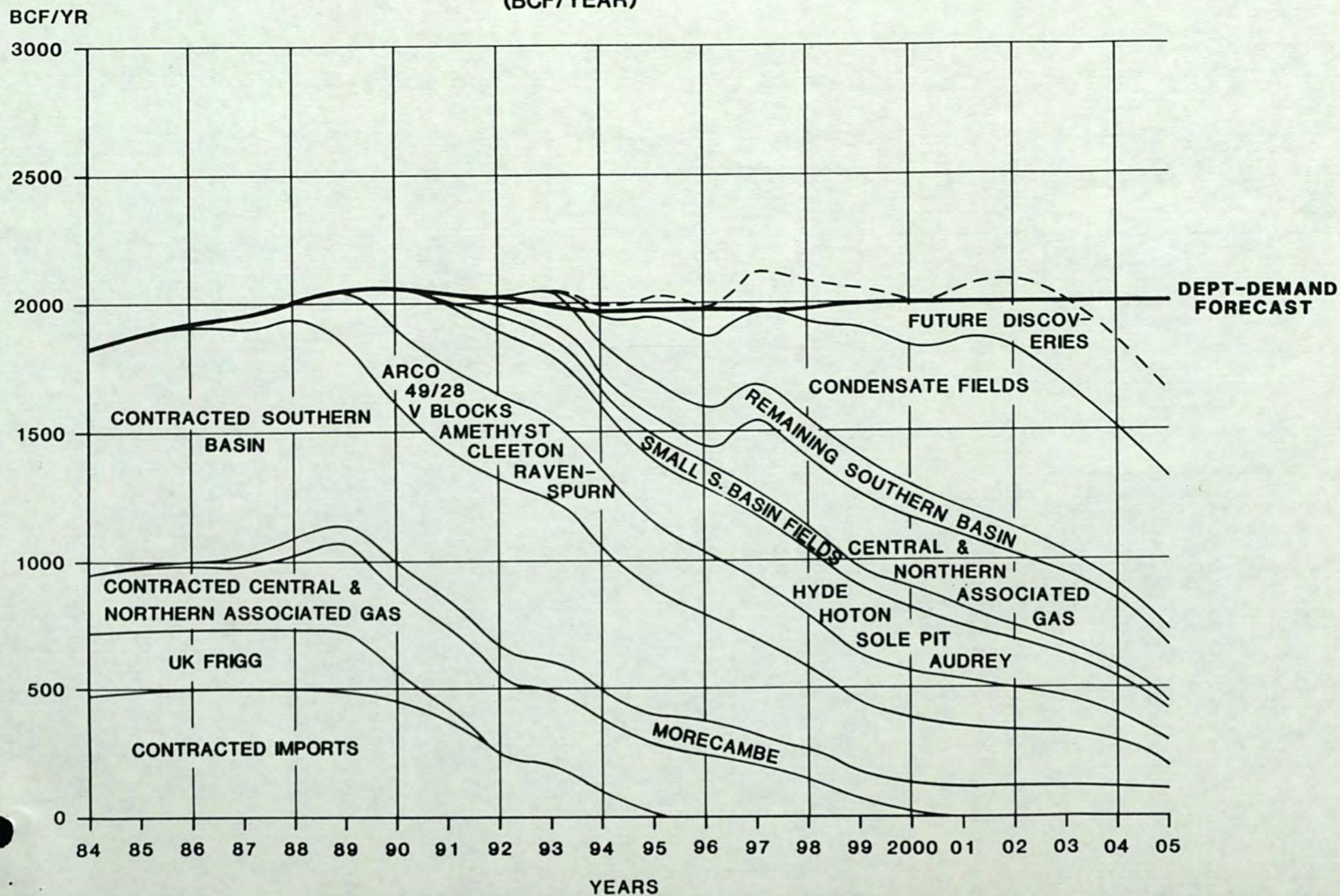
(bcf per year - central case in brackets)

	<u>1986</u>	<u>1991</u>	<u>1996</u>	<u>2001</u>
<u>UKCS Fields:</u>				
(i) In production or under development	1430 (1440)	1060 (1090)	720 (720)	270 (350)
(ii) Discovered but not yet under development	10 (10)	790 (600)	1030 (1070)	1420 (1500)
(iii) Future finds	0 (0)	10 (0)	220 (120)	320 (200)
<u>Imports</u>				
(i) Existing contracts	490 (480)	190 (360)	0 (0)	0 (0)
<u>Total supplies from UKCS and already-contracted imports</u>	1930 (1930)	2050 (2050)	1970 (1980)	2010 (2050)
<u>Total Demand</u>	1930 (1930)	2060 (2040)	2040 (1960)	2040 (1990)

10. Table 4 and Figure 3 show that a real risk remains that gas consumers could go short of gas if the UK relies on indigenous supplies alone from the mid-1990s. And dependence both on gas not yet found and on condensate fields could start as early as 1991. Some degree of insurance against these risks would clearly be prudent and Figure 4 shows the effect of introducing a limited supply of new gas imports from 1991 onwards, reaching plateau at 180 bcf per year in 1993 (about 40% of the Sleipner plateau or 10% of UK demand). As Figure 4 indicates this strategy would leave ample scope for development of new UKCS gas fields but would reduce considerably the risk of shortfall in supplies to UK consumers.

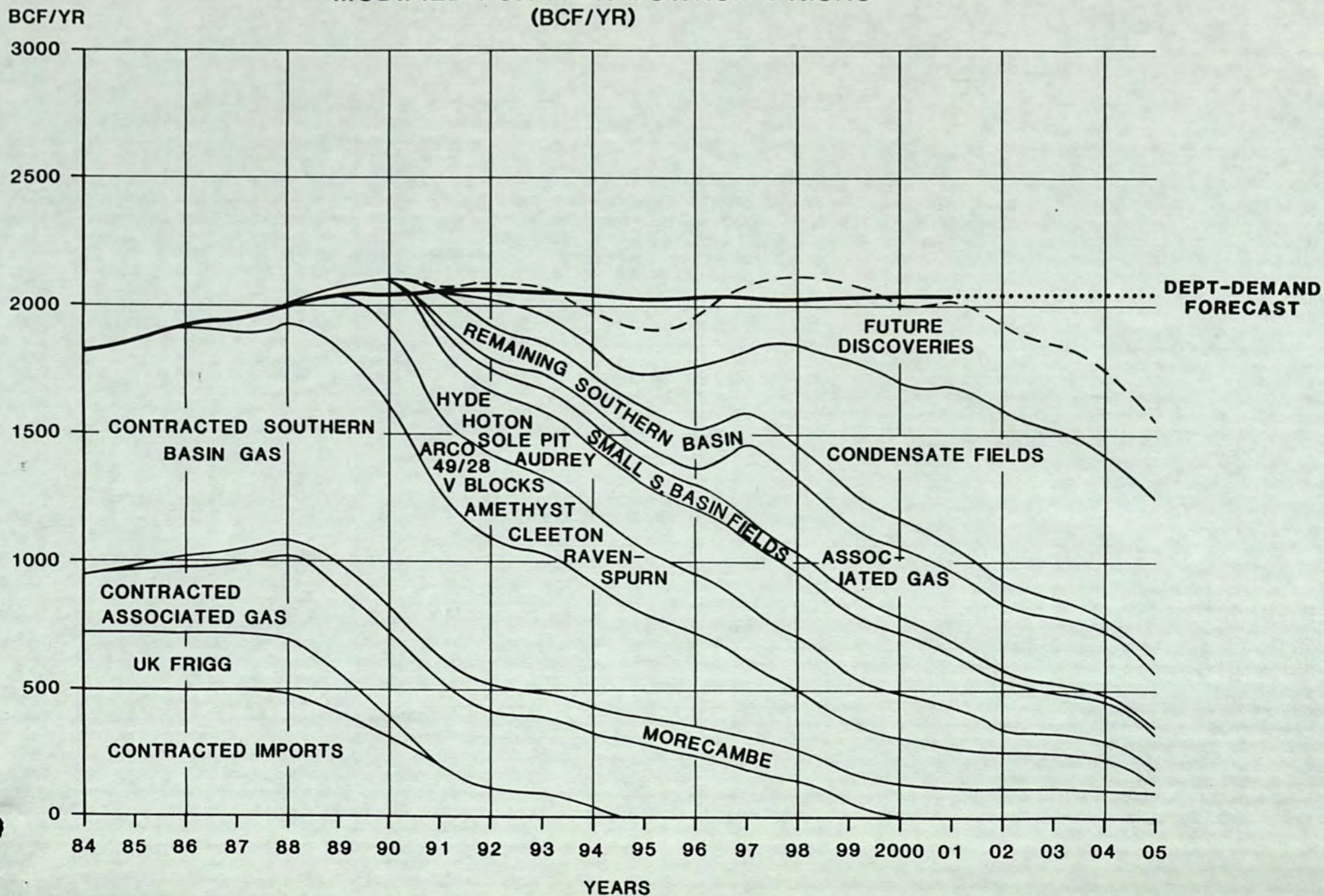
DEPARTMENT OF ENERGY GAS SUPPLY FORECAST
1.1.85.
(BCF/YEAR)

FIGURE 2



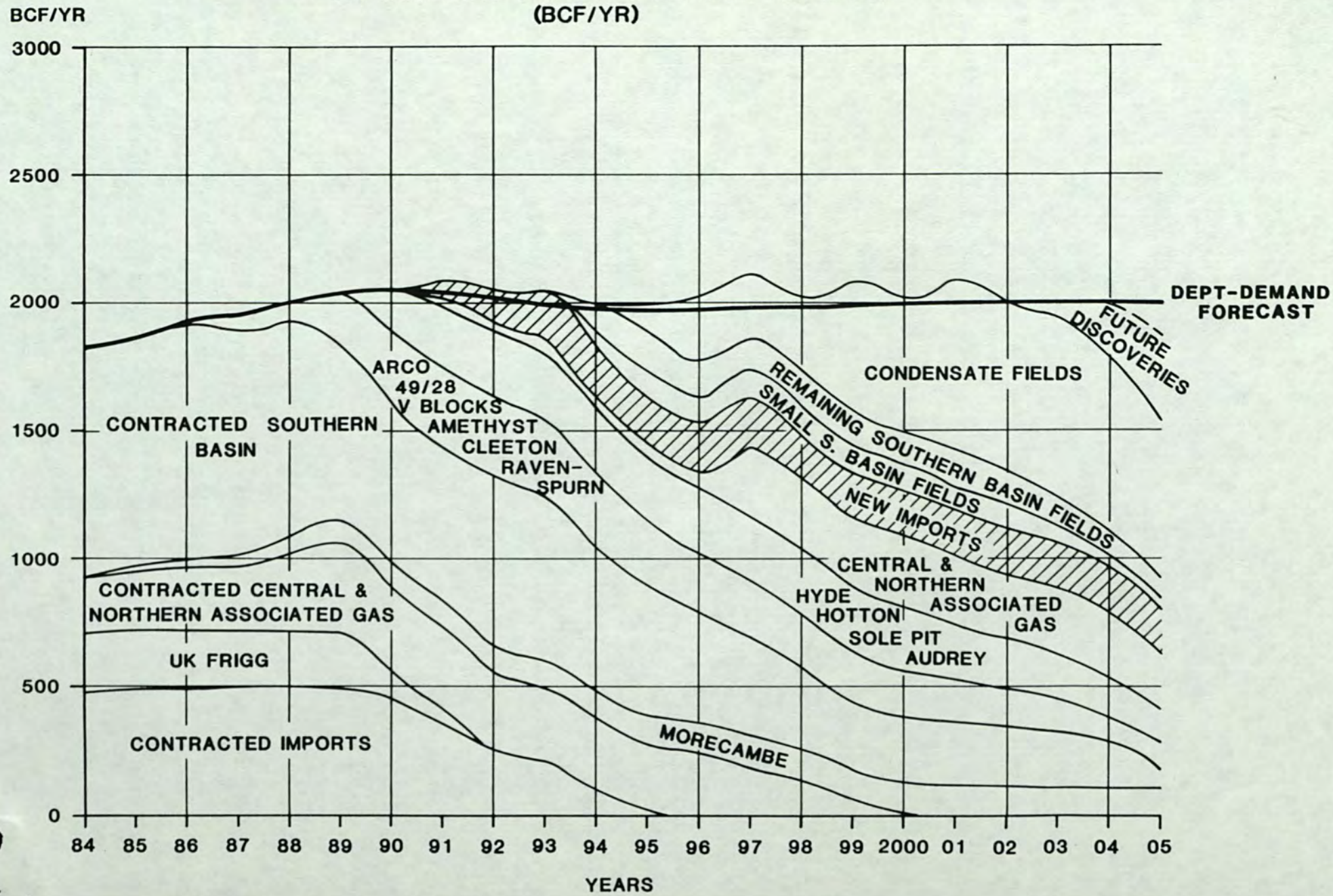
DEPARTMENT OF ENERGY GAS SUPPLY FORECAST
 MODIFIED FOR MAIN DOWNSIDE RISKS
 (BCF/YR)

FIGURE 3



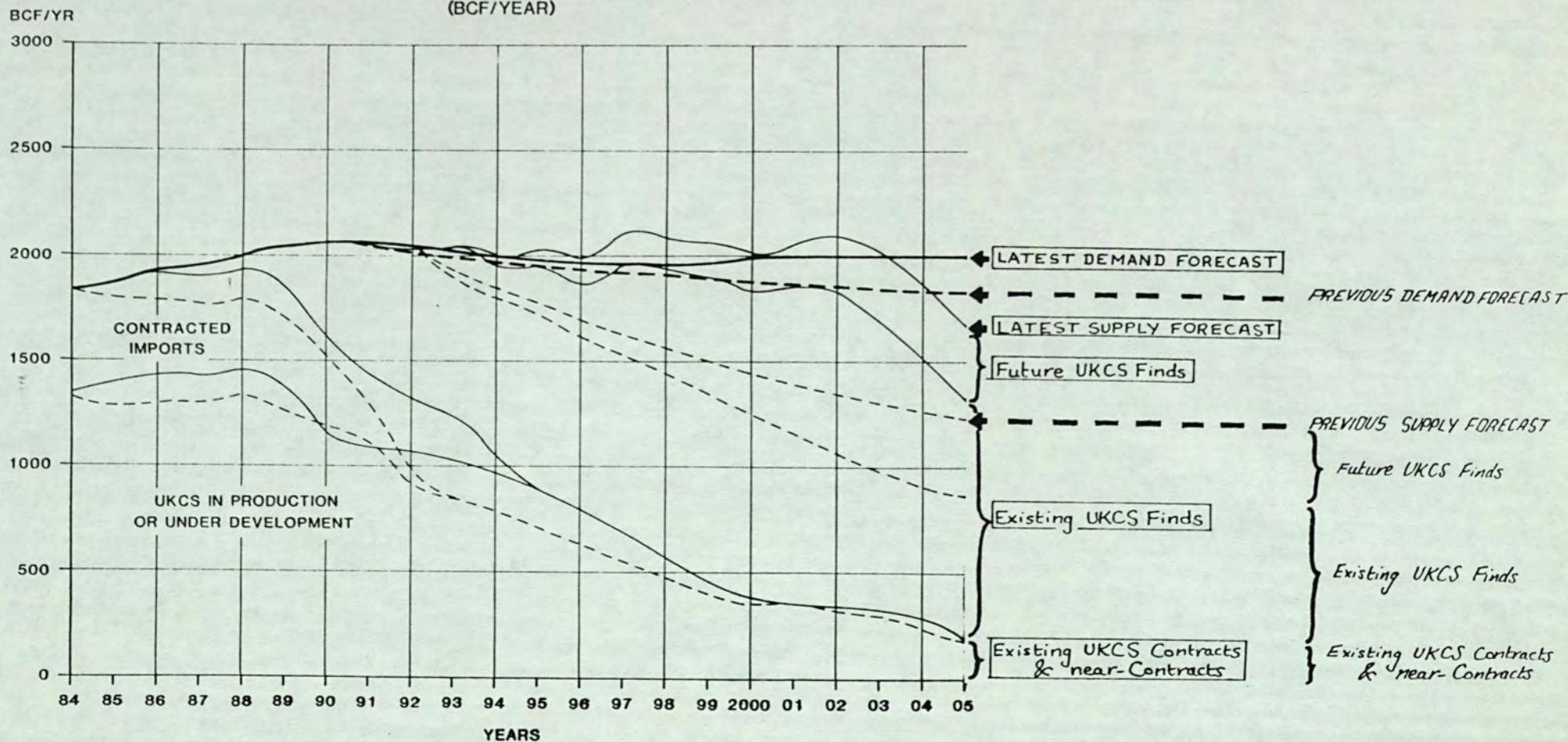
DEPARTMENT OF ENERGY GAS SUPPLY FORECAST MODIFIED
TO INCLUDE 180 BCF/YR NEW IMPORTS
(BCF/YR)

FIGURE 4



DEPARTMENT OF ENERGY FORECASTS OF GAS SUPPLY
& DEMAND TO 2005
(BCF/YEAR)

FIGURE 1



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A GAS EXPORT REGIME

ANNEX C

1 ES(84)2nd meeting agreed that in parallel with pursuing the Sleipner negotiations, proposals should be considered for introducing a controlled gas export regime based on objective criteria.

2 A wide range of criteria were subsequently identified (some 20 in all) for possible inclusions in a regime. These were considered against the prime objectives of avoiding delays to UKCS developments as a result of the prospect of surplus gas arising from the Sleipner purchase and the maintenance of security of supply to British gas consumers. Out of the full list of possible criteria, four were regarded as best suited to these objectives.

- a) the rate of return available to developers (if the BGC offer price was inadequate to justify development);
- b) whether firm supplies were available over a future period (eg. 5 to 10 years ahead) and the extent to which these assured security of supply.
- c) whether a development would have to be delayed for a long period if the export were not allowed;
- d) the gains or losses to the offshore gas gathering infrastructure.

3 Fundamental to any controlled regime is its defensibility against challenge under the Treaty of Rome. The implications of this for the criteria as a whole as well as for a regime based on the preferred short list were therefore considered in consultation with interested Departments before obtaining the Law Officer's advice. Earlier advice had suggested that

there were reasonable prospects of defending a controlled regime based on ensuring continued security of gas supplies (criteria (b) above). However at that stage the Law Officers had not been asked to consider the effect on the defensibility of a regime that the Sleipner purchase itself might have, nor the defensibility of other criteria such as (a) and (c) above more directly based on economic and fiscal discrimination in favour of the UK. The earlier advice was also subject to the outcome of the Whitegate Refinery case then before the European Court.

Issues put to the Law Officers

4 In the light of these developments, the Law Officers were asked to consider the degree to which a regime, now more closely defined and directly linked to the purchase of Sleipner, could be defended under the Treaty.

5 The argument centres on Article 34 which states that "Quantitative restrictions on exports, and all measures having equivalent effect, shall be prohibited between Member States" and how far an exemption in Article 36, "The provisions of Article 34 shall not preclude prohibitions or restrictions on ... exports ... justified on grounds of public morality, public policy or public security ...", can be applied to gas exports. The specific issues put to the Law Officers were:

- i) the strength of the argument that gas supplies are essential to the public security of the State and hence the degree to which security of supply can be maintained through controls on exports under Article 36;
- ii) the extent to which each of the 20 or so criteria identified in the full list for possible inclusion in a regime were defensible;
- iii) whether a mixture of defensible and indefensible criteria would weaken or negate the overall acceptability

of a regime. A two tier mechanism was suggested, with decisions justified in public against defensible criteria while in private additional (indefensible) criteria were taken into account;

- iv) the degree to which it was possible or desirable to publish the details of a regime and the terms in which any announcement should be made.

Advice was also sought on the impact on a controlled gas export regime of the recent Whitegate Refinery Judgment by the European Court.

Advice on Defensibility of a Regime

6 The Law Officers have obtained Counsel's opinion on the defensibility of a regime the outcome of which as endorsed and qualified by the Law Officers, is summarised as follows:

a) Risk of challenge. There is a significant risk that any form of controlled regime will be held to infringe the Treaty. The very notion of an authorisation to export is, on the face of it, contrary to the Treaty. It can of course be argued that the current complete ban on exports is harder to defend and that a partial ban might be easier to justify. However, this advantage could be offset by the greater risk of challenge to a partial ban. It would create the general expectation that exports were allowed, so that a particular refusal to export might be more likely to challenge than if there had never been any prospect of exports.

In addition to disrupting the status quo for the gas landing requirement, there is the risk of a challenge to the landing requirement for oil as a consequence of liberalising the gas regime.

b) A general defence of the regime. A distinction is drawn between the defence of the regime as a whole and that of individual decisions taken under it. Counsel's Opinion

introduces the argument that a State is entitled to formulate a depletion policy for its own natural resources and if, purely as a consequence of this policy, one result is to limit the resources available for export then the Treaty could be held not to apply. To be successful it would be necessary to:

- i) identify a viable depletion policy which had nothing to do with limiting exports;
- ii) demonstrate clearly that the refusal of a particular export was designed to meet depletion policy objectives and was not simply a disguised restriction on exports;
- iii) show that reserving a substantial share of UKCS production to the home market was justified on security of supply grounds and did not involve arbitrary discrimination between producers, Member States or in favour of the UK on price or economic grounds.

The Law Officers have endorsed this argument as the main overall defence of a regime, having expressed doubts about the strength of the original security of supply argument, brought about by the prospect of purchasing Sleipner.

c) Security of Supply. The Law Officers regard the very fact of purchasing Sleipner, with the major increase in firm supplies available to Britain, as weakening the security of supply defence. The more comfortable the supply position, the greater the difficulty in demonstrating that genuine hardship would result from exports. The argument is nonetheless thought capable of use in two ways; as a secondary defence of the regime as a whole, and as a partial justification of individual refusals to export. But its use in individual cases is further weakened by the difficulty of justifying any particular security threshold adopted and the ability to dispute the estimates on which it was based.

d) Publication. Any regime should be presented as a depletion policy based on certain principles (rather than carefully defined criteria which would encourage disputes about their validity and application), emphasising the need for flexibility. The Law Officers also strongly advise against attempting to operate a two tier mechanism: "it would be particularly unwise to publish criteria or guidelines governing the decision-making process and then employ other criteria or guidelines in fact". They also point to the possibility of claims for damages (which in the case of gas exports could be considerable) being made if a refusal were successfully challenged.

d) Disclosure. The Law Officers warn that a refusal to export, if challenged, could lead to disclosure of the documents relating to the decision-making process. Demands for disclosure might be limited to those documents relating to the individual decision, although further disclosure of documents relating to the whole policy (if the need for justice was held to outweigh public interest immunity) could not be ruled out.

7 Lastly, on a point of domestic law, the Law Officers advise of the need not to fetter the exercise of Ministerial discretion. Objective criteria could not therefore be framed so as to apply automatically; there must always be flexibility to take account of the particular circumstances of each case.

Conclusions on the Law Officers' Advice

8 The advice casts considerable doubt on the ability to operate successfully a controlled export regime defensible under the Treaty. It gives rise to three main difficulties.

9 First, while in strictly legal terms the risk of challenge may not be significantly greater between a total and a partial ban, in practice the risk is considerably increased. Under a total ban all producers are treated equally. But discrimination is inherent in a controlled regime; some would be allowed

to export, others not. Those refused permission would inevitably regard the decision as arbitrary and hence unreasonable. While producers with a future on the UKCS may hesitate before challenging HMG, potential continental customers for the gas would not be under the same constraint.

10 Moreover, many of our UKCS policies are questionable under the Treaty (indeed, four of the published criteria for the 9th Round of Licensing are currently the subject of correspondence with the Commission). But these have escaped serious challenge so far mainly because the policies have been in place and undisturbed for many years. The major disruption to the status quo resulting from the introduction of a controlled regime could trigger an investigation into our UKCS policies which went beyond gas.

11 Secondly, the requirements of the depletion policy argument, now regarded as the primary defence, have serious drawbacks both on policy and practical grounds. For the argument to work it would involve a high degree of commitment to a restrictive depletion policy openly designed to constrain the pace of gas developments in the longer term. This is not part of the Government's economic philosophy and is contrary to the greater reliance now being placed on the UKCS to meet future demand. It would also be unwelcome in the practical sense. To be convincing it would, for example, necessitate refusing at least one development needed to satisfy home demand simply to illustrate that the depletion policy applied equally to developments destined for the home and overseas markets (and hence was distinct from a control on exports).

12 Thirdly, the reservations now expressed about the security of supply argument reinforce earlier doubts about the strength of this defence. These particularly concern the ability to show that a shortage of gas would have the same dire consequences for the country as a shortage of oil; whether a sudden shortage, which would not permit alternative supply measures to be taken, could in fact arise as a result of a particular export; and

whether it could be argued that it was reasonable to seek to protect a high level of supply (eg. 100% or 75% of current demand) 5 or 10 years into the future. This last point would be particularly difficult to demonstrate in the case of individual refusals to export. The size of future gas developments is likely to be small and by definition each would have only a marginal impact on the level of total available supplies.

13 There is thus not a single criterion or group of criteria which could provide a reasonable defence under the Treaty and meet the objectives of a controlled regime. The best available option would be to attempt to present exports as part of a far reaching depletion policy based on broad principles without reference to objective criteria. Even if acceptable on policy grounds, there would be considerable difficulty in formulating a depletion regime which successfully disguised the true intent of controlling exports. The Law Officers have advised against operating a two tier regime with decisions defended against certain public guidelines while different and indefensible criteria were applied in private. They also warn of the risks of disclosure and compensation. The original defence, security of supply, is now held to be of secondary importance in justifying a regime and an incomplete defence of individual decisions taken under it. There is therefore little certainty that a challenge could be defended successfully and the risk of provoking a challenge would be greatly increased by the introduction of a controlled regime as opposed to maintaining the present status quo.

Uncontrolled Gas Exports

14 The only remaining alternative to the status quo would be to remove completely all controls over the export of gas. Although ES has decided against this, it is worth summarising the main objections to this option:

- a) the door to gas exports could be jammed open. Once an uncontrolled regime was introduced there would be

no prospect of re-imposing either a partial or total ban;

b) the introduction of an uncontrolled regime would be a more significant disruption to our offshore policies as a whole than that represented by a controlled regime. The sharp distinction between a free regime for gas and the controls retained over oil would be bound to provoke a Commission investigation into our remaining UKCS policies.

c) the UK would be powerless to determine the rate of exports, irrespective of the security of supply position in the home market.

d) the European gas market is itself far from free. Contract negotiations are subject to open political direction. European gas purchasers are either nationalised or heavily influenced by government and a European consortium operates as a buyers' cartel. Similarly, many UKCS gas producers have substantial interests in Continental gas industries and some are state controlled.

e) in the absence of a free market, UKCS gas could be exported at below its true value and it would be impossible effectively to police deals involving UKCS producers with vested Continental interests. (A deal between Elf/Total and Gaz de France for example could deny tax or price value to the UK to the advantage of the French economy).

f) demand for new gas supplies in the UK and Continental markets are unlikely to match. A bout of purchasing for export one year (when UK prospects might be slack) could leave the UK market short or forced to purchase at a premium the next.

g) a measure of control over the development of UKCS gas fields would be lost. Producers would submit

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development applications only after export negotiations were complete and in accordance with the export contract. The development of the UK gas gathering infrastructure would also be impaired.

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Cons & Elec. Pricing; NAT ind. RHO