

CONFIDENTIAL

THIS DOCUMENT IS THE PROPERTY OF HER BRITANNIC MAJESTY'S GOVERNMENT

B(80)32
31 March 1980

COPY NO 55

CABINET
MINISTERIAL COMMITTEE ON ECONOMIC STRATEGY

SEVENTH ROUND OF OFFSHORE LICENSING: ALTERNATIVE METHOD
OF LICENSING

Memorandum by the Secretary of State for Energy

INTRODUCTION

Irrespective of how the principle of licence auctions may be viewed, I consider that Seventh Round licences should be awarded on the present system as agreed with colleagues in October, 1979. To introduce auctioning would:

- a. hurt the smaller British companies who do not have large financial resources;
- b. undermine the efforts we have made to ensure a significant British presence in licence awards;
- c. cause further delay in launching the Round.

2. This paper considers the advantages and disadvantages of the present licensing system and of the system of awarding licences by closed tender (referred to in this paper as "auctioning"). It concludes that the present system should be retained for this Round with higher initial payments being applied to some blocks.

ADVANTAGES AND DISADVANTAGES OF THE TWO SYSTEMS

1. A brief description of the advantages and disadvantages of the two systems is given below: a fuller exposition is at Annex 'A'.

1. The advantage of the present system is that it is the most effective means of supporting our offshore policies. Companies recognise that good performance on full and fair opportunity for UK suppliers of offshore equipment, and on security of oil supply, will count when applications are being compared, and that poor performance will adversely affect their chances of getting further awards. This

33

34

35

36

37

CONFIDENTIAL

CONFIDENTIAL

CONFIDENTIAL

average secures support for our policies. The disadvantages of the system as presently designed is the small amount of money it produces when licences are granted. But this can be remedied.

The main advantage of auctions is that they face applicants with substantial sums of money being bid for some blocks, The main disadvantages are that they would prevent use of the licensing system to achieve objectives on the British share in licences, on the British content of offshore supplies orders, and on security of oil supply.

WOULD WE SAFEGUARD OUR OBJECTIVES WITH A HYBRID AUCTION/DISCRETIONARY SYSTEM ?

Under the present system, I do not have to disclose how I have decided on the individual awards. This would not be the case with auctions. The bids would become known and if we had disregarded the highest to favour a British company, the decision would be open for all to see.

It would not be unlawful for me to exercise my discretion in favour of a lower bid, either under UK or EEC law, provided that the terms of the Round allowed me to reject any bid, and provided the decision was not determined solely to discriminate on grounds of nationality. Even where the decision was so based, it is doubtful if one such case would cause difficulty with our European partners, or with the US (if US companies were to suffer). If, however, there was a marked tendency to favour British companies at the expense of foreign companies, international criticism would be inevitable and could spill over into EEC-challenge not only of our policy on this matter, but also of our other UKCS policies (such as the landing requirement and procurement of offshore supplies). Such considerations would deter acceptance of lower bids. Foreign companies would recognise that cash was to be the paramount factor, and would see no advantage in teaming up with, or carrying the costs of British partners. The result would be that few British companies, most of whom are small and cannot afford large front-end payments, would be successful. Our predecessors achieved a 74% British share in Fifth Round licences, and 65-70% in the Sixth Round. I would be surprised to obtain a third of this amount with a cash bidding Round. However, with a Round under the present system, the British content should hold up well - I believe we could achieve about 50%, notwithstanding the removal of our predecessor's mandatory state share.

CONFIDENTIAL

CONFIDENTIAL

AUCTIONS WOULD CAUSE FURTHER DELAYS

8. We have taken views of the industry on the principle of auctions, and would have to consult on procedures. We would need to look at the tax implications and the competitive advantage they give companies already paying tax. Companies have spent months organising consortia, in most cases with a strong British content. In corporating and auction at this late stage would break up some groups and require others to be restructured; some companies would be deterred, others would have to re-assess the level of their involvement. More time would be needed to develop competitive bids than to prepare applications under the present system. It is very unlikely that we could complete the awards in 1980/81.

THE INDUSTRY'S VIEWS ON AUCTIONS

9. The bigger companies have expressed opposition to auctions, but I suspect that some of the foreign majors would be attracted by the advantage it would give them. The small British companies have been unanimous in their hostility. These views are no surprise. But the introduction of auctions, on top of the recent tax changes, could damage the industry's confidence in our declared intention to encourage offshore exploration and development.

SIZE OF THE ROUND

10. This is dealt with in a separate paper but the subjects are related and colleagues will wish to bear this in mind in reaching decisions.

AN ALTERNATIVE SOLUTION

11. I have sought a solution which is least harmful to our objectives but would bring in substantial cash in 1980/81 - about £80 million - £100 million. This is described in Annex 'B' and would require higher initial payments on some blocks.

RECOMMENDATION

12. I invite the Committee to agree that:

- a. we should proceed on the existing basis for the Seventh Round, except that
- b. we should require an initial licence payment (an 'additional cash bonus') of £4 million for blocks in the company 'own choice' area; and
- c. we should adopt a more flexible approach to the size of the Round.

D.A.R.H.

Department of Energy
31 March 1980

33

34

35

36

37

OFFSHORE PRODUCTION LICENSING

THE CASE FOR AND AGAINST AUCTIONS AND 'ADDITIONAL CASH BONUS' SYSTEMS

Auctions on All Blocks

The advantages of auctions are that they

(i) bring in money at an earlier date; (ii) provide some extra revenue; and (iii) encourage companies to support their own estimates of the prospectivity of UKCS territory with their own cash.

The disadvantages are:

- a. As there can be no certainty that parent companies would increase their UK subsidiaries' exploration budgets to compensate for cash premia paid, there may be a reduction in overall exploration effort.
- b. Auctions would severely limit the ability of Secretary of State to award licences to any but the highest bidder. Money-in-hand is bound to be paramount in assessing applications and any divergence from this position would need to be defended before the Public Accounts Committee, and elsewhere. It would be much more difficult to secure by administration means that British interests, and small developing British firms, get a fair share of licences. The introduction of auctions would reduce (and perhaps remove) the support Ministers can give through the award of licences to the policies of affording UK suppliers full and fair opportunity to compete for offshore orders, and of ensuring the disposal of any oil found in a way which assists our security of supply.
- c. Such a fundamental change in approach would require re-examination of the licensing arrangements, to ascertain whether (and if so, how) auctions could be linked with the present licensing system. Thus considerations would be needed of how proper weight could be given to the normal criteria, where the assessment is essentially of a subjective nature and which do not have an objective and indisputable money value as do cash bids. We might then find that the top ranked company under the criteria was say BP, but the highest bid was from Deminex or Elf or Mobil (indeed BP's bid might not come second). The choice would then be between ignoring the foreign companies' higher bids or ignoring BP's Britishness, its better record on exploration on full and fair opportunity and on disposal.

33

34

35

36

37

d. The distorting effect of the tax position of applicant companies would enable some companies to make higher cash bids with corresponding tax offsets, and make a fair process of comparison of the bids very difficult. The dis-allowance of cash bids from PRT and Corporation tax assessment would require legislation and would reduce the amount of money bid by tax-paying companies. Even so, it would not remove unfairness from the process of comparison, in so far as foreign companies might still be able to set off losses incurred in the UKCS against their domestic tax position, and therefore be able to afford higher bids.

e. Because of the need to formulate suitable arrangements, to study the tax implications, and to consult with the industry on these matters; the Seventh Round timetable would be further delayed with consequential deferment in the awards of licences, the receipt of revenue from the bids and the start of drilling.

f. Small companies would be put at a severe competitive disadvantage: the majority of British companies fall into this category. In addition, potential newcomers to UKCS exploration could be discouraged. Such companies would need to re-appraise their planned involvement; some would withdraw, and some would reduce their proposed investment.

AUCTIONS ON SOME BLOCKS ONLY

The advantage of limitation of auctions to some blocks, as compared with application of the system to all blocks, is that we could maintain some measure of support for UKCS policies while securing some early money. The support would either be substantial or minimal, depending on which blocks the auction was attached to. To the extent that the more attractive blocks were retained for award under the present licensing arrangements, the support could be sustained, but significant bids would be unlikely for the remaining (less attractive) territory. On the reverse side of the coin, if the attractive territory was offered for auction, prospects of significant bids would be enhanced, but at the cost of largely removing support for our offshore policies.

Because the problems of developing suitable auction arrangements remain, revenue would be unlikely to be received from a partial 'cash-bidding' Round until after the Financial Year 1980/81.

'ADDITIONAL CASH BONUSES'

An alternative means of securing early money from licensing would be to increase substantially the initial payment on grant of licence from the planned figure of £250 per square kilometre (about £62,500 for an average size block). As in previous Rounds the plan has been to look for the main financial input from companies in the form of an exploration programme. The benefits of such a scheme would be that it would retain the full support that the licensing system affords other UKCS policies; it would bring in a substantial amount of early revenue; and because it could be readily grafted on to the Seventh Round arrangements; the money should be available in the Financial Year 1980/81. The disadvantages are that it would make things more difficult for small British companies, who, by and large, do not have the resources to meet heavy front-end payments, and it would inevitably discourage applications for the less attractive blocks. As with auctions, it would be possible to attach these higher payments- additional cash bonuses- to some blocks only (and as we expect the blocks in the company 'own choice area' to be the more attractive, that would be the place to attach the additional cash bonuses). The remaining blocks would attract the smaller initial payment, as currently planned i.e. £250 per square kilometre. The advantage of this differential treatment would be to remove some part of the disadvantages of attaching additional cash bonuses to all blocks, i.e. it would afford more scope for smaller companies, and would encourage applications for a wider spread of blocks outside the company nomination area.

LIKELY REVENUE

The systems mentioned above would bring in early money, though a high proportion of it would be offset by lower tax receipts at a later date. There is no way of making a realistic assessment of what revenue might accrue from an auction. For additional cash bonus revenue would be the product of the payment required and the number of blocks awarded. There can be no certainty about how many blocks would be applied for and awarded, but if 20-25 blocks each with an initial payment of £4m. were awarded, revenue would be £80m.-£100m.

TIMING

The licensing process typically takes about 12 months, from the preliminary announcement of proposed arrangements to the grant of

licences. This provides the necessary time for consultations within and outside the oil industry (3 months); thereafter, for the companies to prepare and submit applications (3 months); for the examination of applications including interviews with prospective licensees to probe their performance and plans on offshore policies (3 months); and, finally, for work programmes to be agreed and licences awarded (2-3 months).

For the Seventh Round there are three outstanding policy issues to be settled before the formal invitation to apply can be published. These are, auctions, the size of the Round and the arrangements for exercising the option to take up to 51% of any petroleum produced. Any move to auctions would represent a fundamental change which would have to be thought through carefully, fully developed and then discussed with the industry. Companies would need more time than at present to prepare their applications. This must raise real doubts as to whether revenue from auctions could be obtained in Financial Year 1980/81.

Since additional cash bonuses could be grafted on to the ^{present} system timing would be less affected and the additional revenue should be received within 1980/81.

ANNEX 'B'

PROPOSED SCHEME FOR OBTAINING SUBSTANTIAL EARLY PAYMENTS FROM THE GRANT OF LICENCES (THE 'ADDITIONAL CASH BONUS' SCHEME)

This note sets out the outlines of a scheme for combining the present licensing method - and its support for UKCS policies - with a means for obtaining more substantial payments on the grant of licences.

OPTIONS FOR THE SCHEME

2. The Gazette notices inviting applications for licences include (inter alia) details of the initial payments licensees must make immediately on grant of licence. Hitherto these payments have been set at a low level to ensure they do not discourage applications; instead the main financial requirement from licensees in the early years of the licence is expressed in terms of an agreed exploration programme. The proposed initial payment for Seventh Round licences - as agreed with Treasury officials - is £250 per square kilometre in the licensed area (£62,500 for an average size block). This proposed payment is significantly higher than the initial payment for Sixth Round licences.
3. It would be a simple procedure to revise the initial payment so that a much more substantial payment was imposed on the grant of licence: it would be necessary only to stipulate the details of the payment in the Gazette notices.
4. There are several possibilities for deciding the application of a more substantial payment. It could be the same for all blocks licensed (this would increase the risks of potential applicants being discouraged from applying for any but the very best blocks); or it could be based on the acreage of the block (however the prospectivity or attractiveness of a particular block is not in general related to its size); or it could vary from geographic area to area; or it could be applied to one discrete category of blocks only.
5. The payment would have to be set at a level (or levels) which did not discourage applications, and in particular did not deter the smaller British exploration companies, and non-exploration companies new to the UKCS. The level would necessarily have to be assessed on an arbitrary basis, as there is no empirical evidence on which to

33

34

35

36

37

187

rely.

A POSSIBLE SCHEME

6. The arrangements might be as follows:
- a. Licences for some, but not all, blocks would be offered on the basis that a more substantial initial payment (an 'additional cash bonus') would be required on grant of licence.
 - b. The blocks to which the additional cash bonus would be applied would be those in the area of the companies 'own choice'. This is a discrete category, and given the industry's welcome of the 'own choice' concept, it seems less likely to discourage applications than would the imposition of an additional cash bonus elsewhere on the UKCS.
 - c. The Additional cash bonus should be the same whatever the size of the block. Some blocks in the discrete area are very small (they vary from under 10 square kilometres each), and it has to be recognised that the one rate of payment may deter applications for these small blocks: however, only experience can tell how significant this factor will be overall.
 - d. The additional cash bonus might be set at £4 million, which is the approximate cost of a well in the North Sea. The figure is assessed on the basis that applicants would expect to have to offer to drill at least one well to obtain the licence.
 - e. Companies would additionally be required to drill at least one well to earn the right to continue the licence after the initial term, which would probably be of six years' duration.

ESTIMATE OF INCOME

7. It is difficult to assess with real confidence what the level of response would be for blocks to which a price tag of £4 million is attached. Companies have, however, welcomed the concept of an 'own choice' area in the northern North Sea, and it seems unlikely that in that area the larger companies would be entirely discouraged by the price tag. We think it not unreasonable to assume that applications would be received for perhaps 20-25 blocks in the 'own choice' area, producing revenue of £80 million to £100 million. If more blocks were awarded, the amount would of course be higher.
8. Provided that decisions can be taken fairly soon on the definitive arrangements for the Round, the licences should be granted and the payments accordingly received, in the Financial Year 1980/81.

33

34

35

36

37