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Treasury Chambers, Parliament Street, SW1P 3AG
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20th December 1979

Dear Tim,

FUTURE OF BNOC AND THE PSBR

The Chancellor of the Exchequer was asked at the meeting of E Committee last week to arrange for officials from the Departments concerned and from the CPRS urgently to review the implications for the PSBR of the various options for introducing private capital into BNOC, including delaying such an introduction for a period (E(79)19th Meeting, Item 3). The Prime Minister would then arrange for this further work to be considered by the Ministers directly concerned, if possible before Christmas (a meeting has now been arranged for Friday morning).

.... I attach a note which the Chancellor has approved on the PSBR consequences of the various options for introducing private capital into BNOC. The note has been produced in consultation with officials from the Department of Energy, the CPRS and Inland Revenue. In accordance with the remit from E Committee it concentrates on the narrow, though important, PSBR points and is not intended to cover other issues relevant to BNOC privatisation.

.... I also attach an aide memoire summarising the options, produced by Treasury officials as part of the Chancellor's briefing.

I am sending a copy of this letter and its attachments to the Private Secretaries of the Secretaries of State for Energy, Industry, Foreign and Commonwealth Affairs and Trade and to the Attorney General. Copies also go to Sir Robert Armstrong and to Sir Kenneth Berrill.

Yours ever,

MH

(M.A. HALL)

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SUMMARY COMPARISON OF OPTIONS WITH STATUS QUO

	Unified Management	Control of UKCS oil	PSBR (see para 4 of draft paper)	Private Shareholders
Status quo	No change	No change	No change	No change
<u>Case 1</u> Mr Howell's proposal - split Trading and Operating and sell 75% of Operating to private shareholders	Split	Lose 49% of BNOC's equity oil	Large early reductions in PSBR, later increase; <u>provided</u> clear statement made about giving up control, & intention to sell at least 51%; & oil subject only to 51% participation options	Private shareholders control all Operating assets
<u>Case 2</u> Maintain unified management but sell 49% to private shareholders	No change	No change	Share sales, at depressed prices compared with Case 1, finance but don't reduce PSBR	Private shareholders get income stream but no control
<u>Case 3</u> <u>Partial</u> privatisation of upstream assets: selling porportion of BNOC's license interests to separate company, with 75% private shareholding	No change	Lose <u>some</u> oil but less than Case 1	Some early reduction in PSBR; later increase. As in Case 1 but no Statement on future privatisation needed	Partial private control of oil assets
<u>Case 4</u> Transferring the right to, say, 5% of the revenue from BNOC's oil fields to a company, with 100% to private shareholding	No change	No change	Proceeds finance PSBR but don't reduce it	As in Case 2 above but smaller scale

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THE FUTURE OF BNOC & THE PSBR

Note by the Chancellor of the Exchequer

1. I was asked to arrange for officials from the departments concerned and from the CPRS urgently to review the implications for the PSBR of the various options for introducing private capital into BNOC, including delaying such introduction for a period (E 79) 19th Meeting, Item 3). The position is as follows.

Assumptions

2. Any assessment of the PSBR effects of introducing private capital into BNOC must inevitably rely on many working assumptions. But the figures in paragraph 4 below illustrate the broad size and direction of the effects for the main options for introducing private capital into BNOC listed in paragraph 3 below. The critical assumptions in those figures are:

a) Tax. It is assumed that payments of PRT and Corporation Tax to the Exchequer will be the same for all 4 cases in paragraph 3.

b) Oil prices. These are assumed by BNOC to be at $28.50 per billion barrels in April 1980, an assumption which now looks conservative in view of Caracas. The higher oil prices, the greater BNOC's prospective revenues. It is uncertain whether the full benefits of these higher revenues would be reflected in sale proceeds from privatisation (for the reasons in paragraph 5 below). If BNOC, or a part of it, remains under public sector control, the PSBR would certainly benefit.

c) BNOC's capital expenditure programme. This is taken to be at the level assumed by BNOC in their recent review (see Annex). This is some £45 million to £90 million a year below levels agreed by Ministers in September. The higher the capital programme, the less the PSBR case for keeping BNOC, or any part of it, in the public sector.

d) Size of sale proceeds. These are calculated on the basis of Mr Philip Shelbourne's valuation of BNOC as at 1st January 1980 of £1.5 billion (about £1.25 billion at 1979 Survey prices). This valuation took no account of any effect on the sale price of any Opposition threats to re-nationalise the privatised company on onerous terms.

The Options

3. In broad terms the options for introducing private capital into BNOC are set out below. Their PSBR effects are summarised in paragraph 4 below.

a) Case 1. Splitting BNOC into two independent companies, BNOC (Trading) and BNOC (Operating), and selling 75% (or a somewhat lesser amount) of the

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shares in Operating to private shareholders, with a minimum of 25% being owned by Trading, which would remain 100% owned by the Government. This is the option favoured by the Secretary of State for Energy in E(79)67.

The shares could be sold in 3 equal tranches of 25%, but for the proceeds to count as a PSBR reduction, it would have to be made clear at the outset that the public sector was immediately relinquishing control over Operating and that it intended to sell at least 51% of the shares eventually.

The proceeds would finance the PSBR but would not reduce it if there were obligatory arrangements whereby 100% of its oil (as distinct from the normal 51%) was sold to Trading. Three years after the start of the sale the PSBR would be increased, because Operating's cash surpluses would no longer accrue to the public sector and there would be no more sales proceeds to offset this loss.

b) <u>Case 2</u>. Maintaining BNOC's present unified management by transferring the oilfield assets to a subsidiary company, and selling a minority (e.g. 49%) of this company to private shareholders. This is the option discussed in paragraphs 5-7 of E(79)67 and in the Annex to E(79)80.

The proceeds from this sale would finance, but would not reduce the PSBR, since the privatised subsidiary would be under BNOC's control and thus within the public sector. If the company's cash surpluses in later years are to continue to reduce the PSBR, they would have to be invested in public sector debt so that the cash remained available to the public sector and this has been assumed in estimating the figures for Case 2. Such a requirement would have to be made clear to prospective investors in the prospectus, and sale proceeds could be reduced if they believed the company too much under Government control. The size of the cash surpluses would partly depend on the amount of capital expenditure undertaken by the company. The Government would therefore want to control the capital programme. This too would need to be disclosed to investors with potential effects on sale proceeds.

c) Maintaining BNOC's present unified management by routes other than at (b) above. For example:

i) <u>Case 3</u>. Selling a proportion of BNOC's license interests in individual oilfields to a separate company in which private shareholders would own 75% of the shares. The company would be essentially an investment company owing e.g. X% of Dunlin field, Y% of Statfjord and Z% of Ninian. The effect would be to sell part of BNOC's assets to the private sector

through the medium of a company owned by private shareholders. The attraction to investors would be the prospect of increased revenues and capital gains. Investors would prefer the widest possible spread of interests in BNOC's fields. The inevitable negotiations necessary with field partners could prevent an early sale, though this might apply equally with Case 1.

The proceeds from the sale would reduce the PSBR (as distinct from financing it) if the new company was wholly independent (e.g. its management and its marketing and its pricing policies) from BNOC and it had the normal participation obligation of selling no more than 51% of its oil to BNOC. In later years the PSBR would be increased since the revenues from the field interests sold would no longer be available to the public sector.

This course, which Ministers have not so far considered, would produce a smaller reduction in the short term and a smaller increase in the longer term in the PSBR compared to Case 1; keep, except for the proportion of assets transferred to the separate company, a unified BNOC management; and reduce the amount of oil lost from public sector control. The figures for Case 3 in paragraph 4 illustrate the PSBR effects of privatising some £250 million (about one-fifth) of BNOC assets in this way. The more assets sold, the more the privatised company would resemble an oil company rather than an investment company.

ii) Case 4. Transferring the rights to, say, 5% of the revenue (but not to the oil) from BNOC's oilfields to a company, all of whose shares would be sold to the public.

The proceeds from the sale would finance, but not reduce the PSBR, since such a company would in effect only be a channel for advancing money to BNOC with no control over the oil assets. In later years the PSBR would be higher, since the revenues paid out to the privatised company would no longer be available to the public sector.

Summary of PSBR Effects

4. The estimated PSBR effects of the 4 cases above compared with the base line of the status quo (i.e. assuming BNOC remains as it is) are as follows:

Estimated Effect of the 4 Cases on the PSBR Compared with the Status Quo Baseline (+ means the PSBR is higher, - means it is lower)

£m 1979 Survey Prices

	1980-81	81-82	82-83	83-84	84-85	85-86	86-87	Total
Status Quo Baseline (ie BNOC's contribution to PSBR assuming it stays as now and capital expenditure as now assumed by BNOC)	-140	-340	-285	-215	-255	-180	-170	-1585
Changes in above baseline produced by	450	-325						
Case 1	-310	+ 15	- 45	+200	+240	+160	+150	+ 410
Case 2	0*	+ 5*	+ 15*	+ 30	+ 35	+ 40	+ 45	+ 170*
Case 3	-190	+ 65	+ 55	+ 45	+ 50	+ 35	+ 35	+ 95
Case 4	+ 20*	+ 20	+ 20	+ 20	+ 20	+ 30	+ 30	+ 160*
Tax assumed payable in every case	-	-	-125	-245	-250	-360	-375	-1355
Capital expenditure assumed in status quo baseline	+215	+210	+220	+200	+185	+170	+155	+1355

* In Case 2 and Case 4 the proceeds would not reduce the PSBR and therefore are not reflected in the asterisked figures. For case 2 (49 per cent privatisation) it is very hard to estimate the scale of the sale proceeds because the share price would be depressed by the prospect of continued public sector control (see paragraph 3(ii)). But it is clear that the figures would be a good deal less than the theoretical value of around £200m in each year in the period 1980-81 to 1982-83. For Case 4 (the revenue rights company) the proceeds would be some £200m in 1980-81, and like the proceeds under Case 2, would help finance the PSBR.

Timing

5. There are two factors affecting the timing of sales. PSBR reductions are achieved quicker the earlier the shares are sold. The longer the period over which a share sale of a given size is phased, the longer the period it takes to achieve the PSBR reductions and the later consequent PSBR increases. On the other hand, the CPRS argue that the stock market has not fully reflected the prospect of future oil price rises. If this is right, the later the sale of the shares the higher the proceeds are likely to be, since they will reflect the full effect of actual higher prices. This latter effect cannot be quantified.