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cc Mr Walters
Mr Wright (CO)
Mr Spence (CPRS)

SECRETARY OF STATE FOR ENERGY
THAMES HOUSE SOUTH
MILLBANK LONDON SW1P 4QJ

211-6402

Prime Minister

This is confirmation from Mr Howell that the only way he now sees the gas gathering pipeline getting under-way is with BGC bearing the risks initially. I will let you see the Treasury's response.

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Tim Lankester Esq
Private Secretary to the
Prime Minister
10 Downing Street
London SW1

29 June 1981

Dear Tim

GAS GATHERING PIPELINE

Your letter of 19 June recorded a meeting the Prime Minister held that day to discuss coal matters. As you know, one of the points discussed in the course of that meeting was that considerable problems were being encountered in putting together the finance for the gas gathering pipeline project. The Prime Minister, as a result, asked the Department of Energy to make renewed efforts, in consultation with the Treasury, to find a solution to the problems preventing the project from getting under way.

You may wish to see the attached copy of a letter which my Secretary of State has sent today to the Chancellor of the Exchequer and which summarises the latest position on the project.

Yours ever

David Lumley

DAVID LUMLEY
Private Secretary

01 211 6402

The Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
London SW1

29 June 1981

Dear Geoffrey

GAS GATHERING PIPELINE

When I wrote to you on 16 April I said that the Organising Group were exploring whether companies with a potential interest in making use of the gas gathering line would be prepared to join in sponsoring its financing. But I warned that it might prove impossible to arrange financing without some form of guarantee, probably given by BGC. We discussed these points further on 28 April.

The Organising Group have duly sought private sector sponsorship of the line, concentrating now on the total financing rather than the earlier idea of interim financing which the Bank of Scotland was unable to put together. The Group have had meetings with senior executives of the key companies and now await written responses from them. But, unfortunately, it is already clear that this line of approach is getting nowhere. The companies are not prepared to take part in financing at this stage under the guidelines we laid down. A new initiative will be needed if the project is to be kept alive.

There are a number of reasons why the private companies are unwilling to invest in the pipeline at this stage. The Government guidelines issued to the Organising Group were of course intended, inter alia, to avoid the pipeline being built on the strength of tax reliefs and to prevent its effective monopoly position, once built, being exploited to yield excessive profits. These are clearly sound objectives but from the companies' point of view the consequences are:

i) the cost of service approach in the guidelines means that if things go better than expected the benefits will go to those who pay the transmission tariffs, which would be lower, rather than to those who invested in the line;

ii) the separation of the pipeline company from field development, as opposed to the joint venture approach, means that there is no strong tax incentive for any individual gas producer to join. As a group, producers do need the project. But a perfectly rational strategy for them, particularly for those with fields not due to produce gas in the early years of the pipeline's operation, is to sit back and let someone else bear the construction risks.

Then there is the physical design of the project. Some producers would like to undermine the integrated gas gathering concept so as to eliminate the risk of competition to their own pipelines. Naturally enough they are not concerned with the effect of that on fields owned by other companies, or on national gas supplies. Shell/Esso have proposed an alternative scheme based on several separate offshore pipelines and greater use of the FLAGS system which they own. Not only do we have strong reservations about the physical aspects of their proposals, but the central multi-user gathering line proposed in their scheme would still involve the same financing problems we are struggling with now. Shell/Esso have said that they would not contribute to sponsoring it.

Lastly there is the issue of gas prices. Knowing that we are seeking their financing support the producers naturally see a chance to exact high price terms. Most talk about crude oil parity, or a fraction of that not much less than 100%. BP have told us that for much of their gas they will be looking for prices equivalent to the highest paid internationally. Mobil are refusing to conclude a deal with BGC (which BGC thought to have been agreed in principle more than once during the negotiations) for associated gas which costs almost nothing to produce and for which BGC has offered some 16p/therm. Major price concessions would cause us embarrassment internationally at a time when we and other IEA or EC countries have been seeking to resist moves by producers (Algeria, Norway) to charge oil-related prices. More important they would be a drain on our national economy and raise prices to UK industry and domestic consumers.

All these points have featured in the Organising Group's discussions with the producers. Their written responses, including those from BP and Mobil, will inevitably ask for concessions on taxation, gas prices and project incentives as conditions for their backing the integrated gas gathering scheme. Even if we could eventually negotiate our way through those demands, which is in my judgment unlikely, the delay in doing so would undermine the present timetable. The joint BP/Mobil/BGC venture which is currently paying the costs of keeping the project on track expires at the end of July and there is no chance of the companies extending it beyond that date. At the same time major expenditure on the St Fergus terminal needs to be committed this Summer. If the project is now delayed the momentum will be lost and the integrated scheme would almost certainly collapse. Its replacement would be a few piecemeal developments (elements of which are recommended by Shell, Esso and the French) which would be much less favourable in national economic terms, and which would be largely built at the taxpayers' expense. Gas supplies would be delayed or lost and our hopes for petrochemical development based on the pipeline would probably have to be abandoned.

Despite the financing difficulties, the project remains highly economic. There is an overwhelming case for a gas gathering system - the discounted value of the gas and liquids which would be landed by the £1½ billion line is some £25 billion at today's prices. Investment in the pipeline has to be considered in the context of investment in the North Sea which has a history of extremely high profitability, rather than in terms of the projects with more dismal outcomes normally associated with the public sector. Even the most favourable pattern of piecemeal developments would certainly be less economic than the integrated scheme and could be seriously worse to the extent that it failed to collect all the gas reserves for which the integrated scheme is designed. What is more, such developments would be financed to a major extent by tax reliefs. The validity of the comparison has been tested against a number of alternative assumptions.

We therefore need to decide well before the end of July where the finance is coming from if we are not to lose the chance of building the most economic and nationally favourable gas gathering scheme. The only feasible way now to keep the integrated scheme going is for BGC to bear the risks initially. Morgan Grenfell have produced a fallback financing package which would keep the project alive and on timetable by BGC starting it off. Their and our expectation is that some of the producers would eventually join in to maintain their influence, and that other private sector money would come forward when the risks had visibly diminished. This is allowed for in the structure of the proposal and would get us back to our agreed objectives and to the form of pipeline company we want. I am certainly not wedded to the details of the Morgan Grenfell scheme, but if we do not pursue this option or some other way of BGC taking the initial risk we face the strong probability that the project will disintegrate, despite its economic sense.

One other point I should mention on this is the change we are now proposing to make in BGC's gas purchasing monopoly. I have recently told Sir Denis Rooke formally of our intentions and he has pointed out that his Board agreed in principle to the idea of BGC underwriting the scheme initially only on the basis that their gas purchasing privileges would be retained. I do not believe that this is an insurmountable problem. BGC are relying on the gathering line gas to meet their market commitments and, whatever the change in their monopoly position, will inevitably buy quite a lot of it when the time comes. For these reasons I hope to be able to persuade them to set aside their reservations and will if necessary argue the point with the full Board.

Your officials already have the details of the BGC/Morgan Grenfell proposal and we have agreed figures with them which show a strong economic case for going ahead with the integrated scheme. We now need to decide quickly whether, as I believe is fully justified, BGC should be authorised to take the initial risks. We have openly committed ourselves to giving the integrated gas gathering scheme the full backing of Government. If we now decide against proceeding with the scheme because the initial risks have to be borne by BGC, I believe that we shall attract severe criticism not only from the Opposition but also from our own supporters. We can also expect to see piecemeal schemes emerge which would be less economic and could be less favourable for the PSBR. I should be most grateful for an early meeting with a view to reaching a decision as early as possible in July.

Yours ever,

David

D A R HOWELL