Energy: cef82

Prime Minister (4)

Mrs 24/11

CABINET OFFICE
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From: John Sparrow

Qa 06155

CONFIDENTIAL

24 November 1982

The Rt Hon Nigel Lawson MP
Department of Energy
Thames House South
S W 1

MS

Dear Nigel,

BNOC Trading after the separation of Britoil

I have only just seen your letter to Geoffrey Howe of 15 November, together with his reply of 22 November.

As you know, the CPRS has been closely involved with your officials in preparing the objectives and criteria for BNOC Trading. Although I agree with the Chancellor's view that the proposals are a considerable improvement on earlier suggestions, I would like to make a number of comments, which I hope will arrive before the proposals are communicated to the Corporation.

Our intention must be to leave BNOC management full discretion in commercial decisions within the scope of the strategic objectives and overall financial exposure limits set by Government. It is therefore important that these objectives and limits are clear and unambiguous at the outset.

With this in mind there does seem to me to be some confusion in the documents between financial exposure and risk. Financial exposure should be an objective concept which can be measured according to defined criteria whereas the risk of loss is inherently a subjective assessment. I suggest, therefore, that the terms "financial exposure" and "risk of loss" need to be clearly defined in order to avoid any later misunderstandings.

I am generally content with the proposals for the trading of participation and quasi-participation oil subject to clarification of whether the £5m. limit refers to a perceived risk of loss or to an agreed definition of financial exposure.

As far as non-participation trading is concerned, I must admit to being unclear whether and with what discretion BNOC Trading will be allowed to enter into open positions or whether all trading will be on a back-to-back basis. The latter approach is one which I would favour and which would remove the risks which make financial exposure limits so necessary in normal commodity trading.

If all deals were to be on a back-to-back basis, there is no need for a limitation on financial exposure, which does not then arise. This does not rule out the possibility of losses which, if they occurred, would require a reconsideration by Government of whether, and with what scope, non-participation trading should be continued.

Annex 1 of the guidelines which will be forwarded to the Corporation includes a financial exposure limit but does not set out any other restrictions on type of business, open positions, back-to-back deals, etc. for non-participation trading. Although I note that it is your intention to provide the Corporation at a later date with these limitations, I do feel that they should be included in the current proposals as their scope could influence the appropriateness of a financial exposure limit of £6m.

One alternative approach would be to give BNOC Trading full discretion on non-participation trading, subject only to a limitation on financial exposure. This discretion could be curtailed if annual losses exceeded the financial exposure limit and could be reviewed if the Corporation failed to meet the financial target. Such an approach could meet our requirements with minimum involvement by Government in BNOC Trading's activities.

On a more detailed point, would it not be preferable in 1.3 of Annex 1 for the Corporation to be required to "inform" rather than "consult" the Secretary of State if it finds itself exposed to a risk of loss of £5m. or more. The current draft gives the impression that the Corporation is constrained from reacting on its own initiative which I presume is not the intention. Conversely, in the same paragraph, would not "consult" be better than "inform" when market pressures require a change in BNOC's prices?

I am sending a copy of this letter to the Prime Minister, other members of E(NI), and to Sir Robert Armstrong.

Yours sincerely,

John.

John Sparrow

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BNOC

Energy

Prime Minister (2)

MHS 3/12

SECRETARY OF STATE FOR ENERGY
THAMES HOUSE SOUTH
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Gerry Spence Esq
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2 December 1982

Dear Gerry,

BNOC TRADING AFTER THE SEPARATION OF BRITOIL

The Secretary of State was grateful for Mr Sparrow's letter of 24 November. Officials here have sought to cover the main substance of his points in the notes of guidance which have been sent to the Corporation (I attach a copy).

We have the following specific comments on points Mr Sparrow has raised:-

(i) the guidance makes clear that the limits of £5m on participation trading and £6m on other activities refer to perceived risks of financial loss. Broadly these limits would be measured by reference to the difference between the cost of particular volumes of crude oil or other material to the Corporation and the amount realisable if that material had to be sold spot;

(ii) restriction of non-participation trading to back-to-back deals with no exposure to risk of loss would prevent the Corporation from doing much of its present business (for example, most "freighting" involves some small element of exposure), and would add substantially to its difficulty in earning a sufficient trading profit to cover its operating costs;

(iii) the choice of "inform" and "consult" in paragraph 1.3 of the Annex is deliberate: we need to be particularly careful to avoid giving any impression that the Government has the last word on UKCS term prices. BNOC's prices are set in negotiation with its suppliers and customers, in the light of market conditions.

More generally, it is important to remember that the reconstituted BNOC Board is only just settling in, and that the Corporation has had to give priority to the scheme and privatisation exercises, to the exclusion of effort directed towards the planning and detailed financial control of its business activities. Discussions are now under way on future trading strategy, and fresh impetus will be given to this work when the new Finance Director takes up his post on 1 January.

The issues which Mr Sparrow has raised will be fully taken into account during the reconstituted Corporation's running-in period, and there will be an opportunity to look again at the position in the context of the review of the trading guidelines and limits on exposure to the risk of loss which the Corporation will be undertaking next summer.

I am sending a copy of this letter to the Private Secretaries to the Prime Minister, other members of E(NI) and to Richard Hatfield (Cabinet Office).

JEREMY CLAYTON
Private Secretary

ENERGY : FUTURE OF BNOC : PT 5.

BNOC AFTER THE SEPARATION OF BRITOIL

1. General Objectives for BNOC

(i) Through participation, to secure and dispose of UK and UKCS petroleum in a way which contributes to our national security of supply.

(ii) Through effective trading and marketing, to ensure that the UK economy receives the maximum benefits from BNOC's access, through participation rights, to UK and UKCS petroleum.

(iii) To trade profitably in all non-participation petroleum and petroleum products, within limits which may be set by the Secretary of State (Annex 1). 'Trading' may include the arrangement of shipping and of processing, although the Corporation would be expected not to seek to invest in ships or in refining and processing.

2. Specific Duties not covered by the general objectives

(i) To act as the Government's agent in the sale of oil taken as royalty in kind (RIK). (Although some small fields are being excluded from RIK, oil will continue to be available in future from this source on roughly the present scale.)

(ii) To discharge the requirements of the agency agreement covering the Government pipeline system.

3. Financial structure and financial target

(i) After disposing of its upstream assets BNOC will be provided with £30 million of retained profits.

(ii) The Department of Energy with Treasury consent will arrange to guarantee short-term borrowing facilities of up to £50 million on terms similar to those enjoyed by other nationalised industries.

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(iii) The Corporation's surplus funds are to be invested in public sector securities in accordance with existing general guidelines.

(iv) BNOC and the Department are agreed that a financial target set in terms either of annual percentage return on assets or a percentage on turnover would not be appropriate. BNOC will instead be asked to earn a net surplus pre tax of £10 million over the first four year period, after meeting all its administrative and other costs.

(v) Section 6(i) of the Oil and Gas (Enterprise) Act provides powers for the Government to make grants to BNOC, in support of the participation agreements. While the Government would expect to be called on to provide grants of this kind only in exceptional circumstances, BNOC would not, in the event of it making a loss too large to be covered by its own resources, be expected to reply for more than a short period on additional short-term borrowing.

(vi) Section 5(i) of the Oil and Gas (Enterprise) Act provides powers for the Corporation's profits to be recouped by the Exchequer. It is expected that these powers would be used either if BNOC generated continuing surpluses or if circumstances allowed a single large profit to be made.

(vii) The Corporation will not expose itself to risks in excess of limits set by the Secretary of State. These are set out at Annex 1 but may be reviewed from time to time.

4. <u>Reporting and Control</u>

(i) BNOC will submit to the Department of Energy not later than April each year a business plan covering the following four calendar years. Following discussion at official level, this will be submitted, subject to any necessary modifications, for the approval of

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Ministers not later than June. The business plan will cover the general sales strategy, and the extent of the risks to which BNOC might be exposed, as well as figures on forecast physical availabilities and projected financial results.

(ii) An updated version of the business plan covering the immediately following calendar year only will be prepared each October. Unless it is invalidated by unforeseen changes in market circumstances, this will provide a yardstick for assessing the Corporation's trading performance.

(iii) Six-monthly consultations will be held with the Department as hitherto.

(iv) Each quarter in January, April, July and October, the Department of Energy will review formally the trading results for the most recently completed quarter together with the prospects for the next two quarters ahead.

(v) The Chief Executive will report every month to the Corporation on trading results, plans and opportunities.

(vi) Each month the Corporation will provide a funds flow statement to the Department of Energy.

26 November 1982

ANNEX

LIMITS TO EXPOSURE TO FINANCIAL RISK

1. Crude Oil Trading

1.1 It is recognised that the major element of crude oil passing through BNOC's books is the aggregate of participation oil and royalty in kind. In addition, the Corporation is committed to buy some 40,000 b/d of oil on long term contracts from small producers. These latter arrangements were put in place in lieu of participation arrangements even though they cover 100 per cent rather than 51 per cent of production (net of royalty). For the purposes of defining financial risk, these existing contracts will be considered as quasi participation oil and subject to the same trading limits.

1.2 However, new contracts of this kind will not automatically be regarded in this light. The Corporation may enter into unlimited contracts where the seller agrees to accept from BNOC the same price as that at which BNOC disposes of the oil providing a sales fee is charged which covers adequately the administrative costs of managing both the buying and selling operations. Where the Corporation wishes to enter into contracts where the buying price is specified in the same way as for participation purchases, a handling fee should be sought sufficient to cover costs and provide cover against trading losses. Moreover, new contracts of this kind should not in total commit the Corporation to purchases in excess of 25,000 barrels per day at any time.

1.3 As far as participation and quasi participation oil is concerned, the Secretary of State expects the Corporation to follow past practice and inform him in advance of the event when market pressures require a change in BNOC's prices. In addition, the Corporation should consult the Secretary of State immediately if it finds itself exposed to a risk of loss of £5 million or more within a quarter on crude oil trading.

1.4 Where the Corporation is forced to buy or sell individual cargoes in order to balance volumes under long term selling contracts coupled with the acquisition of participation and quasi

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participation crude, this is to be regarded as falling under the rules for participation trading.

2. Other Trading Activities

2.1 This heading includes, but is not limited to:

(i) all trading in LPGs;

(ii) trading in petroleum products;

(iii) freighting arrangements;

(iv) true spot market trading in crude oil, including that which might stem from a deliberate policy to sell short (i.e. to enter into term supply commitments in excess of those to purchase participation oil or quasi participation oil).

2.2 In entering into contracts under these headings, the Corporation should not at any time allow itself to be exposed to a risk of loss in excess of 20 per cent of its reserves. At the point of severance from the National Oil Account, this means a limit of £6 million. In calculating its exposure, the Corporation should take account both of the risks on fully open positions and those associated with buying contracts where prices are fixed quarterly without provision on associated selling contracts for price variations within the quarter to be passed through on a back-to-back basis.