ANAIS DEBUSSCHER FOR THE TELEGRAPH

How painful trade-offs and policy switches led Britain to squander its North Sea oil bonanza

As Liz Truss pushes towards energy independence by 2040, *Alex Kemp* looks at how various governments' attitude towards offshore oil and gas drilling has evolved

Britain's historic approach to oil and gas should be seen in the context of the energy trilemma: transition to net zero; security of supply; and fuel poverty. In practice, our oil policies have also taken in other issues, including licensing, taxation, and pricing to name a few. Governments have given varying weight to each of these considerations at different points over the years. Security is of supply is the biggest consideration today, but it is useful to understand how we got here.

Following the discovery of the giant Groningen gas field in the Netherlands in 1959, Harold Macmillan's government realised that gas deposits might be found in the North Sea.

By 1964 it had issued licences for exploration, which reflected the high risks perceived at the time. After an initial six-year period, the government allowed companies to retain half of the licensed areas for another four decades and required only modest rent payments. They were also not linked to inflation – leading to a realisation later on that the terms had been overly generous.

In the 1980s, this led to the problem of fallow acreage, where companies retained licensed areas but did not use them for production – which made it harder for new players to carry out exploration. It took years to rectify the problem.

Policies in the 1960s gave the Gas Council, later British Gas Corporation (BGC), a monopoly on buying all early gas produced from the UK continental shelf.

Much controversy – and acrimony – ensued regarding how the gas would be priced. The government was emphatic that it would be determined on a cost-plus basis, rather than market values, and – given BGC's monopolistic powers – this prevailed, with inflation only partially taken into account.

Strong take-or-pay provisions in long-term sales contracts provided some compensation to producers, however.

The government and BGC were both conscious of the need for security of supply given the policy of converting the nation's domestic appliances to North Sea gas and away from town gas and naphtha, so they imposed a landing obligation on UK producers. BGC also signed a long-term deal to buy gas from the licensees in the Norwegian part of the Frigg field, where prices were higher than in UK waters.

The dramatic rise in world oil prices in 1973 and 1974 led to major upheaval. Oil prices were determined by market forces, while gas prices were still determined on a cost-plus basis.

This prompted consumers to switch from oil to gas in their droves, to take advantage of the large price differential. Eventually, in the early 1980s this discrepancy was recognised and Margaret Thatcher's government authorised a substantial increase in gas prices along with the imposition of a gas levy, or windfall tax, on extra profits made by the BGC.

The 400pc increase in oil prices in 1973 and 1974 also led to major changes in how the North Sea was taxed.

Under Harold Wilson's administration, the Petroleum Revenue Tax (PRT) was introduced in 1975 along with a complex set of allowances designed to capture a high share of any profits, plus encouragement to develop less profitable fields.

From then on, the PRT rate and allowances were changed very frequently – usually in an upward direction when oil prices increased. The reverse was not always carried out as quickly when prices fell. Tax stability was extremely elusive for producers.

The most dramatic tax increase came in 1981 and 1982, when Margaret Thatcher's government levied a supplementary petroleum duty after the doubling of oil prices. This amounted to a fourth tier of government take – lifting the overall marginal rate of tax to 90pc on the biggest fields such as Forties.

This proved so controversial that the government sought legal advice on whether the very high rates constituted expropriation. Ministers subsequently decided this was discouraging development and eased the tax burden in 1983.

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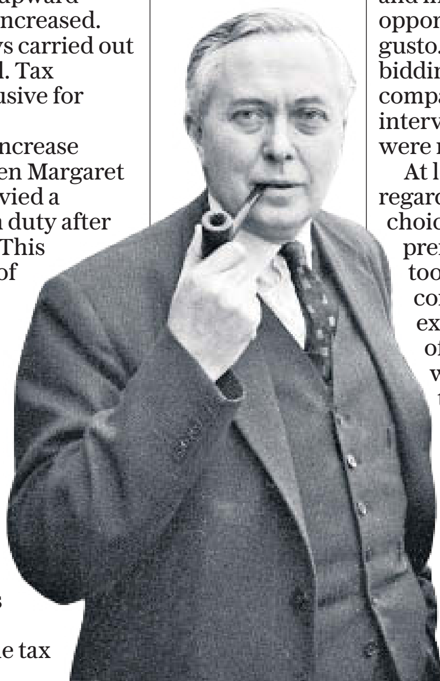
Harold Wilson, below, brought in a petroleum revenue tax in 1975



Britain also saw a major debate on state participation in North Sea oil and gas licences in the 1970s. As a result, BGC and even the National Coal Board were awarded shares in some licences.

The biggest debate followed from the formation of the British National Oil Corporation (BNOC). Rather than the concept of a national oil company, the controversy centred on the privileged position given to the company in some licences compared with private sector rivals.

BNOC was advising the government while acting as an equity partner in licences with private companies.

This led to complaints that it should not sit on both sides of the table when, say, development plans were being discussed. In the early 1980s, Nigel Lawson, the then energy secretary, affirmed that a public body should not be involved in oil and gas exploration or production. BNOC and BGC were both privatised. As this episode shows, care should be taken to ensure that conflicts of interest are minimised.

In the 1970s a major policy debate developed over the UK content of North Sea activities, such as construction of production platforms and the provision of pipelines and the multitude of equipment necessary for exploration, development and production. The government was aware of the huge magnitudes involved and became proactive in attempting to greatly increase the UK content. The Offshore Supplies Office (OSO) of the Department of Energy was the specific organisation established to execute this policy.

The OSO was highly interventionist and instigated the "full and fair opportunity" for UK companies with gusto. It had oversight of contract bidding lists and could suggest UK companies be added, and could intervene further if it felt operators were not giving them a fair hearing.

At least some companies objected, regarding bidding procedures and choice of suppliers as being their prerogative. For others, the OSO took a rather liberal view of what constituted UK content. For example, activities of subsidiaries of foreign companies in the UK were regarded as British because the value-added emanated in the UK. Others felt that only UK-owned companies should have this distinction.

Britain's entry into the EU brought the scheme to an end. The EU felt that the OSO's policies discriminated against companies with bases in the Continent.

The overall lesson is that local content policies need to be carefully designed to ensure private sector investment is not damaged.

By 1975 the government could see oil production from giant fields such as Forties, Brent, Piper, Ninian and Beryl was going to increase rapidly, such that by 1980 the UK would be self-sufficient in oil. After that, for some years production was likely to exceed UK consumption. This prompted discussion about policies that might constrain production to prolong self-sufficiency.

The importance of this was emphasised when, in the late 1970s, the Iranian revolution led to a further doubling of oil prices and Iranian exports fell sharply.

This made security of supply the dominant consideration in energy policy, as petrol ration coupons were issued to motorists in the UK.

Regulations were introduced in the mid-1970s giving the government powers to hold back the development of new fields and to require cuts in production from existing fields.

These interventions were unpopular with the industry, both as a matter of principle and because it was unclear how they would work. In the end, there was almost no intervention to cut production because of other pressing factors: namely, the government's deteriorating finances and the need for greater borrowing.

This made levying tax revenues a priority and in the early 1980s ministers decided that extracting them from the North Sea was more important than prolonging self-sufficiency.

The clash between one policy objective and another has often resulted in difficult decisions for UK governments.

In the 1970s, particularly after the huge oil price increase in 1973 and 1974, there was a growing balance of payments problem. The expected growth of North Sea oil production offered much-needed relief. Oil production from the huge Brent field had started, but gas production was being held back by the late completion of a large pipeline to St Fergus.

The result was gas flaring on a very large scale. In terms of environmental policy, it was not a comfortable situation. As the gas was associated with the oil, the only way to reduce the flaring was to cut back on oil production. In the end, a compromise was reached where production was cut back for a time.

There have been other situations where health-and-safety policies have sat uneasily next to the maximisation of returns.

Historically, the Department of Energy played a leading role in offshore safety, despite the existence of the Health and Safety Executive (HSE).

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The argument at the time was that the department was the repository of oil and gas expertise and thus was best placed to deal with safety issues. But the idea that there could be a conflict of interest between policy objectives was soon raised after offshore accidents such as the Piper Alpha disaster in 1988.

An official report on the tragedy recommended that the HSE be responsible for safety policy, a separation of responsibilities that has proved important in recent years when the HSE has pointed to the backlog of safety-critical maintenance work.

Currently, there is a potential for conflict between the government's aim of maximising economic recovery to improve security of supply and environmental protections, given the importance of climate change and the need to reduce carbon emissions.

The UK relies on imports for more than half of its gas requirements. Over four fifths of households rely on gas for heating. In addition, about two fifths of total electricity generation is powered by gas in a typical 12-month period.

The two policy objectives can potentially be reconciled by insisting that production on the UK continental shelf is conducted in such a way that carbon emissions are greatly curtailed.

For example, through electrification of their power requirements offshore, which could come from renewable sources rather than the use of diesel or fuel gas. This is very likely to result in lower carbon emissions compared with imports from foreign countries which may not have comparable targets to cut emissions. The recent case of a liquified natural gas tanker arriving at the Isle of Grain, all the way from Australia, inevitably invites questions about the carbon emissions generated by such a long journey.

But by far the most urgent policy issue today is fuel poverty. The huge increase in gas prices and the expectation that this situation will persist for a considerable (but uncertain) time demands immediate attention. Fuel poverty will affect people in many different circumstances, such as pensioners, the unemployed, low paid workers and businesses large and small. Given the heterogeneous nature of those in serious fuel poverty, measures that can be most broadly applied have obvious attractions. In general, the Government's various support schemes should aim for at least some consistency with security of supply and net-zero policies.

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