ECONOMIC PERSPECTIVE

GAS GATHERING OR PENNY-PINCHING?

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On 11 September 1981 the British Government finally announced the abandonment of its proposed North Sea gas-gathering pipeline scheme, thus ending one of the most complicated and controversial investment projects considered in the UK in recent years. The story of the pipeline is a fascinating one, offering insights into the present government's economic strategy generally and into its relationships with private enterprise specifically.

The idea of a scheme to harness untapped gas resources from the North Sea is not a new one: as early as 1975 William Merz, a consultancy firm, were commissioned by the Department of Energy to assess the feasibility of a gas-gathering pipeline system. It was not until July 1980, however, that a specific scheme proposed by British Gas-Mobil was adopted by the government. This scheme represented a massive investment programme: costing £2.7billion, the proposed pipeline was to be over 400 miles long and would carry gas from a dozen or more offshore fields to a landing point at St Fergus. Additional pipelines may also have been constructed onshore to distribute the gas and associated gas liquids. Economically the investment seemedanattractive proposition since the estimated additional 12×10^{12} cubic feet of gas reserves were conservatively valued at £25billion, and furthermore, fields which were marginal in terms of oil reserves alone, could become economically viable if gas were also extracted. Politically the project also appeared attractive since the new gas reserves would help ensure UK energy self-sufficiency into the 1990's and more immediately would answer criticisms of the wasteful flaring-off of gas from oil fields already in operation. When it is considered that the construction and operation of the pipeline would create thousands of jobs and the enlarged supply of gas liquids (especially ethane) could lead to the development of new petrochemical facilities, then the arguments in favour of the project seem overwhelming. Unfortunately where British governments are concerned the force of logical argument does not appear to be a major consideration in making decisions, and the present case proved to be no exception.

Having proposed and promoted the gas-gathering scheme the Conservative government, in keeping with its general philosophy, insisted that the project be financed primarily privately by oil companies, gas users and financial institutions, with British Gas' stake being limited to a maximum of 30%. In spite of efforts by various groups, such as that headed by the Bank of Scotland, insufficient (in the government's view) private funding was forthcoming, though it is understood that committed private monies amounted to over 50% of the total estimated project cost. Worse still, many potential private investors insisted on certain conditions being met prior to their involvement. The most important of these conditions referred to government underwriting of at least part of private risk capital, to increases in gas prices offered to suppliers and to downward adjustments in Petroleum Revenue Tax. Being dissatisfied with this response from private industry, the government briefly toyed with the idea of proceeding with the scheme initially funded 100% by British Gas before deciding to abandon the project completely.

At first sight the government's actions seem unexceptionable: if the gas-gathering scheme could not attract private funds it would suggest that the project was uneconomic and, with projects like Concorde still fresh in the memory, the government would not wish to instigate any further 'lame ducks'. Furthermore, in the short to medium term government funding of the project could, **ceteris paribus**, increase the Public Sector Borrowing Requirement (PSBR) at a time when control of this variable is regarded as being of paramount importance. The PSBR consideration was also significant in leading to the rejection of any form of government guarantees and/or reductions in Petroleum Revenue Tax.

Further analysis indicates that many of these reasons are overly simplistic, are frequently misguided, and in the worst instances appear to be little more than ex post rationalisation of political dogma. Firstly, the suggestion that gas supply can be determined privately in the market place ignores the fact that the demand for gas in the UK is, by law, entirely in the hands of a public monopoly, British Gas. British Gas have not hesitated to use this monopoly power to increase their own economic rent by restricting the price offered to its suppliers: currently British Gas are paying 5p - 16p per therm for offshore gas supplies while charging 29p per therm to **their** customers. Offshore operators argue that, to make the pipeline attractive from their viewpoint, a price of approximately 25p per them would be required. This price is comparable to that being paid for gas supplies in other EEC countries. To suggest that a situation where a public firm might control 30% of gas supply and 100% of gas demand remotely approximates a 'free market' situation is ridiculous. In such circumstances, and by their own principles, the government should have de-monopolised gas demand or instructed British Gas to pay a price which allowed private investors to realise an internationally competitive rate of return. Secondly, while the government could not be expected to reduce **oil** tax to generate **gas** funding (for this would be a potentially dangerous precedent), the underlying concern of the offshore operators is of the history of numerous and unexpected changes in oil taxation. As recently as the last budget the imposition of Supplementary Petroleum Revenue Tax shook the offshore industry severely and may have rendered certain oil projects economically non-viable. For private investors, the undoubted technical risks associated with the gas-gathering scheme were compounded by fiscal risks aising from uncertainties surrounding the prevailing tax regime. Again, it is ironic that a government explicitly dedicated to providing incentives to private investment through tax reductions should be responsible for a tax system which, in the oil industry at least, appears to have quite the opposite effect. In summary. it cannot be concluded that the 'failure' of private enterprise to provide funding implied that the gas-gathering scheme was non-economic for the private rate of return was, for reasons outlined above, likely to be considerably less than the project rate of return.

If British Gas funded the entire project then, from the public sector's point of view, all the costs and revenues of the project can be internalised ie the project investment appraisal is appropriate in this case. Though a full cost/revenue profile for the gas-gathering scheme is not available to the authors, it seems clear that the project would have been highly profitable, with a payback period of 3-5 years. Additionally. since many of the thousands of new jobs created by the scheme would be filled from the ranks of the unemployed, the government could also count a substantial social security payment saving/tax revenue increase as a benefit from the project. If other non-monetary social benefits, such as the security of energy supplies, (would, one might ask, enhanced domestic energy supply be of greater **real** security value to the UK than even larger specifically defence expenditures such as Trident?) are also considered, then it appears that the government would have been justified in funding the project on social cost/benefit grounds, particularly since alternative energy schemes such as nuclear power are less cost-effective (see Sir Martin Ryle, letter to the Times, 17/9/81).

The only remaining government argument is that the financing of the project would have had a short-term adverse affect on the PSBR, though as has already been discussed this would have been partially offset by social security/income tax effects. It seems astonishing that a long-term project should be seriously affected by such considerations, thereby defeating the logic of investment appraisal. In addition, of course, once the gas started flowing government revenues would have increased substantially thereby reducing the PSBR, as oil is doing currently.

It now appears that the oil companies will undertake the construction of a large scale gas-gathering scheme privately. The government will receive less revenue, net, since the cost of the scheme can now be offset against petroleum tax; British Gas will pay a higher price for the gas thereby reducing the economic rent accruing to the public sector and, with less incentive to buy construction materials domestically, UK employment creation may be reduced. Thankfully, however, the UK will now obtain the manifest benefits of increased gas supply. In these circumstances, one must ask why the government became involved in the first place. What have been the costs of delays, and how much has been spent on feasibility studies for the aborted scheme? More serious still is the apparent willingness of the present government to treat the short-term implications on the PSBR of long-term projects as being of major importance in appraising the investment. Monetary discipline in the public sector is undoubtedly important, but to adopt a rigidly myopic view of public investment is the height of folly.