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PRIME MINISTER

DEFENCE AND OVERSEA POLICY COMMITTEE: 22 JULY 1982

ITEM 2: A COMMUNAUTAIRE ENERGY INITIATIVE

(OD(82) 61)

BACKGROUND

1. The idea of an energy initiative has been considered before. It was canvassed in Community circles before the 30 May 1980 agreement on the Mandate, and following that agreement officials suggested it (OD(80) 57) as a proposal which could be put forward by the UK in the budget restructuring exercise as a possible means of reducing the net UK contribution to the Community budget. OD decided on 13 October 1980 (OD(80) 20th meeting) that "the British Government should not advocate an oil levy but internal studies of its feasibility should continue on a restricted and confidential basis." At the meeting, doubts were expressed about the possibility of negotiating a scheme which brought the UK significant budgetary advantage to set against its difficulties. Since then, officials have done further work on the fiscal and legal implications and on the impact on industry. Detailed studies on the fiscal and industrial aspects have recently been completed by the Treasury and the Department of Industry, and will have been submitted as background to some of those attending. (We have not troubled you with these papers but can let you have them if you wish.)

2. The idea has recently been looked at again within the Commission. Mr Tugendhat mentioned it at a recent informal meeting of the Commission - but the reaction of his colleagues was generally reserved. It is not very likely that it will emerge as a formal Commission proposal.

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3. You will wish to ask Mr Lawson to introduce his paper. The Foreign Secretary will want to speak in support. The Industry Secretary will wish to comment on how it will affect the costs and competitiveness of UK industry; the Chancellor will probably also wish to comment on this aspect as well as its implications for the taxable capacity of the existing excise duties and for the Community's interest in our North Sea oil policy and its legal basis. The points to establish in discussion are:

(a) Would an oil levy reduce the costs of UK membership? Almost certainly 'yes', while we remain a major oil producer, as our share of own resources contribution will be lower than under the present system. The precise form and coverage of the levy will however influence the extent to which the costs of UK membership will be reduced, as will how the Community disposes of the additional revenues, and these considerations would need to be kept in mind in any Community negotiation of an oil levy.

(b) Are there other advantages? The proposed levy would provide an opportunity for UK oil producers to match in Community markets the post-levy price of other oil delivered in the EC and thus to increase their revenues, and the UK government tax take under the UK oil regime. The domestic oil price increase would also probably lead to a fall in oil consumption.

(c) Would there be unacceptable effects on UK industry? There would be significant adverse effects on the costs of most sectors of industry because of higher oil prices and probably higher electricity and transport costs. Certain sectors (metal manufacture, textiles and vehicles) could be severely hit. Department of Industry officials estimate that the impact on the UK manufacturing industry's trade balance could range from £30-£90 million per annum

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depending on what reliefs were given and on whether all EC countries operated the same regime. The psychological effects of an apparent penalisation of industry could also be serious unless other taxes on costs were cut as Mr Lawson suggests. On the other hand, if industry believes that a settlement of the British budget problem involving an oil levy were necessary for continued UK membership of the Community, they might accept it as being in their wider interest.

(d) Are the other disadvantages of major significance? There will certainly be OPEC protests, and Mr Pym could be invited to confirm whether these would be manageable. An oil levy would be seen by consumers as an additional tax on oil; this could make it more difficult for the Chancellor to increase excise duties. The present UK "landing requirement" means that all oil and gas from the North Sea must first be landed in the UK unless the Energy Secretary gives permission for direct export. This preserves the security of UK supplies, ensures the economic benefits of refining oil in the UK and facilitates price control and tax collection. The imposition of a levy might increase the risk of challenge to this regime and of a Community claim to "competence" over North Sea oil. But there are still legal arguments we can use to rebut such a challenge, as Mr Lawson points out in OD(82) 61.

(e) Are the coverage and form proposed by the Energy Secretary those most likely to maximise the benefits to the UK minimise the disadvantages? Probably "broadly yes". The exclusion of gas would work to UK advantage given that the UK is still a significant importer. Whether the levy should be on an ad valorem or a specific basis might need further examination: both have advantages and disadvantages. The domestic production tax is necessary to avoid conflict with GATT rules which require that imports

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should not be subject to taxes not applied to domestic products. The UK would in practice be virtually the only Community country which would need to impose it, and it could be done on a national basis, with the proceeds accruing to the Exchequer.

(f) Would Mr Lawson's proposal be seen as communautaire by our partners?
It can be argued that an oil levy would so obviously work to the UK's advantage that our partners will see it as an entirely self-interested ploy. The Foreign Secretary could be asked to comment on whether, if it is taken with the other proposals in Mr Lawson's skeleton draft speech, the oil levy proposal will have the desired presentational effect as an indication of UK willingness to seek constructive solutions to the Community's long-term problems. Mr Pym could also be asked to comment on whether the other energy proposals in the draft speech would add up to enough of a communautaire initiative to be worth making by themselves. Although most are little more than a reiteration of previously announced policy, the specific hint in paragraph 4 about Community companies strengthening their holdings on UK Continental Shelf licences is new and could be extremely well received by our partners.

(g) Would the proposal be negotiable within the Community?
So far there are no real signs that either the Commission or our partners would be seriously interested in the proposal. But once it was on the table, and as the 1% VAT ceiling came closer, interest in it could grow. Even if it were rejected by our partners, the very fact we had made a constructive proposal of this nature could burnish our communautaire image. On the other hand, if the idea caught on, there is a distinct risk that the scheme would be severely altered in negotiation to our disadvantage.

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(h) How best could the proposal be presented within the Community?

It is probably likely to make more impact if, as suggested by Mr Lawson, it is presented in a speech in a Community country on a separate occasion rather than during a normal Community meeting on either the budget or energy matters.

CONCLUSION

The Committee may decide to endorse Mr Lawson's proposal. If not, the Committee might be guided to reach the following conclusions:

(a) While the United Kingdom should not put forward publicly at this stage the idea of an oil levy, they should keep it in mind and respond constructively to any such proposal which emerges from the Commission in the context of its studies of own resources.

(b) The Secretary of State for Energy should make a speech in a Community country in the autumn putting forward the other ideas outlined in his draft skeleton speech.

D.H.

D J S HANCOCK

21 July 1982